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COMPARATIVE TAX LAW FOR THE INTERNATIONAL PRACTITIONER

Host Country Taxation of Tax-Motivated Transactions: The Economic Substance Doctrine

FACTS

The question presented for consideration is how does the Host Country deal with a transaction that is motivated almost exclusively by tax considerations, but that, in economic terms (leaving aside anticipated tax benefits), leaves the taxpayer in substantially the same position as it was prior to the transaction? There are many fact patterns that would fit this description (limited only by the taxpayer's ingenuity), and such fact patterns would vary from country to country. However, they would have in common the manipulation of the letter (or form) of the law to the detriment of its substantive intent.

QUESTIONS

A. Will the Host Country tax authorities respect the form of the transaction, which, on its face, satisfies each element of existing Host Country law, despite its lack of economic substance?

B. What are the pre-requisites for a transaction to be considered immune from challenge under Host Country's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines? For example:

1. Is a subjective business purpose/motivation (as contrasted with a tax motivation) necessary?
2. Must there be a "substantive economic effect" as a result of implementing the plan?
3. Must there be a realistic expectation of pre-tax profit?
4. Are there other factors that Host Country would take into account in evaluating the substance of this transaction?

C. What is the tax result of a determination that a transaction lacks economic substance?

1. Are all losses (and gains) disregarded as if the transaction never occurred?
2. May some aspects of the transaction that produce real gains or losses be given effect?

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Host Country
ARGENTINA

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I. Will the Argentine tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Argentine law, despite its lack of economic substance?

Argentina has its own version of the "substance over form" or "economic substance" doctrine the "economic reality principle." This principle has generated an enormous number of authors' opinions, tax rulings and court cases at different levels, as well as several approaches and even specific legislation on the matter. The latter continues to give rise to conflicts, the outcome of which cannot be predicted with any certainty.

Argentina has three levels of government, with particular taxing rights granted to each of them:

- The federal level, at which taxing power is exercised through the laws of the National Congress, by which the main taxes (income tax, value added tax (VAT), minimum deemed income tax, personal assets tax, excise taxes) are governed;
- The provincial level, for each Argentinean province, at which the main taxes are the turnover tax, the stamp tax and the real estate tax; and
- The municipal level, at which the taxes, most of the applicable taxes fund the services rendered by the relevant municipalities.

This paper will address the subject only in the context of federal taxes.

It is necessary to note two rules under the Tax Procedure Law[1] (the "Tax Code") that must be taken into consideration for purposes of interpreting a federal tax law and applying it to a particular factual situation for tax purposes.

The first rule is the general principle for interpreting the (federal) tax laws, which is contained in Article 1 of the Tax Code and which provides that:

> In interpreting the rules of this law and of the tax laws subject thereto, the purpose thereof and their economic meaning will be determinative. Only when it is not possible to determine by a literal interpretation or according to their purpose the meaning or approach of the rules or of the concepts or terms of those rules, will it be possible to refer to the rules, concepts or terms under private law.[2]

The second rule under the Tax Code, which directly bears on the issue under discussion here, embodies the economic reality principle and provides as follows:

> To determine the true nature of the taxable event, the focus will be on the acts, situations and economic relations that the taxpayers effectively carry out, pursue or establish. When said taxpayers submit these acts, situations or relations to legal forms or structures that are not evidently the ones offered or authorised to properly realise the true and effective economic intention of the taxpayers, the legal forms and structures will be disregarded in consideration of the true taxable event, and the actual economic situation will be considered as framed in the forms or structures that the Private Law would apply, apart from the ones chosen by the taxpayers, or would permit to apply as the best option for their actual intention.[3]

Even though the economic reality principle is an important rule for purposes of interpreting the application of a tax rule to a particular fact or group of facts, it is essential to note that such an interpretation rule may not interfere with the rule of law or "legality principle," according to which tax may not be claimed from a taxpayer if it this not provided for in a law. This concept is related to the taxing powers that a particular authority has in accordance with the rights granted to it under the National Constitution and such an authority may not claim, by way of interpretation, tax that is not claimed under a particular law. Accordingly, the Supreme Court has stated that:

> . . . the precedents of this Court have categorically established that the constitutional principles and precepts forbid other Power than the Legislative to establish taxes, contributions and rates (Sentences: 155:290; 248:482; 303:245; 312:912, among others) and, together with that, have repeatedly stated that no tax burden may be required without the preexistence of a legal disposition framed within the constitutional precepts and precautions, that is, without being officially created by the only power of government entitled to such attributions (Case 'Eves Argentina S.A.', Sentences: 316:2329 -10th whereas and its quote, among others)[4]
>
> It is repeated case law from Your Excellency that any analogous extension, even by statutory means, of the limited situations foreseen under the law, is in conflict with the constitutional principle of tax legality, and that no tax shall be required without a pre-existing legal disposition under the precepts and constitutional requirements, i.e. officially created by the only

power of the State vested with such responsibilities, pursuant to sections 4, 17, 44 and 67 -text 1853-1860- of the National Constitution (Judgments 248:482; 303:245; 305:134; 312:912; 316:2329, among many others related to the principle of tax legality).

Meanwhile, it has been argued that the principle of tax legality which governs the subject not only prevents a tax from being claimed in situations not considered by the law, but also bars the possibility of excluding from the rule that gives rise to an exemption the situations that are included in such rule pursuant to its terms (Judgments 316:1115).[5]

The legality principle therefore represents an important limitation on the economic reality principle and there is often a conflict between the two principles when the tax authorities contend that the latter is applicable.

It emerges from the rule quoted above that a challenge based on the economic reality principle requires that the taxpayer is using a legal structure that is evidently not the structure applicable under the legal framework for a particular act or situation. Indeed, an analysis of the rule leads to the conclusion that there are certain criteria that must be observed for the economic reality principle to be applied:

- The economic relations, situations or acts effectively established, pursued or carried out by the taxpayer must be considered in order to determine the real nature of the applicable taxable event.
- If an inappropriate legal structure is in place, the inappropriate structure will be disregarded.
- The inappropriate legal structure must be one that "evidently" is not the structure that private law offers or authorises for properly framing the real and effective economic purpose of the taxpayer.
- In such a case, the inappropriate legal structure will be replaced by the structure that private law would use, regardless of the structure chosen, and the economic situation would be deemed to be framed under the new legal structure.

It is difficult to characterise the economic reality principle by reference to other civil law doctrines such as the simulation of acts, abuse of law or *"in fraudem legis"* doctrines. However, it seems to be closer to some of these civil law concepts than to a substance over form approach. Indeed, the fact that the principle requires there to be an "inappropriate" legal structure underlines that there must be an abuse of form that is akin to the simulation of an act.

Even though the rule seems clearly to indicate that the above criteria must be observed, this approach has not been accepted without opposition and for many years there has been a trend that is more inclined simply to give prevalence to an economic approach, rather than attempting to make the economic reality under consideration compatible with the legal apparatus appropriate to it. This trend can of course be attributed to the tax authorities taking a revenue-oriented approach in order to expand the economic reality principle in such a way as to attract as much tax as possible.

Alberto Tarsitano has written that "notwithstanding the good intentions of the economic reality principle its application provides more obscurity than clarity: it provokes more pain than the ill it desires to avoid, which it is possible to cure with other, more effective and less invasive, juridical medicine . . . This does not mean that it should not be reckoned necessary to apply a brake to the artificial formulations that attempt to avoid tax, only that one should avoid the consequences of a method that affects a person's ability to foresee the juridical consequences of his own acts and that jeopardises juridical security."[6]

Fabián Cainzos and Verónica Rico have commented that the economic reality principle "requires a prudent and reasonable application since a broad and indiscriminate use would entail the violation of the no taxation without representation principle. Although the method is customarily used by the Tax Authority in order to challenge the formal structure selected by a taxpayer that eliminates or reduces its tax liability, it can also be applied in favour of the taxpayer. Determination of its exact implication shall be determined on a case-by-case basis although no analogy shall be allowed and any interpretation should not breach the strict legality principle."[7]

The economic reality principle thus entails not only that there be a lack of economic substance but also the presence of a legal structure that is inappropriate for the underlying facts. Nor should the economic reality principle be applied abusively either because this would lead to another breach of legal rules.

II. What are the pre-requisites for a transaction to be considered immune from challenge under Argentina's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

There is no particular formula or test that can be regarded as a fail safe for avoiding a challenge in the case of a doubtful situation that could generate a claim under the economic reality approach. The economic reality principle is a general principle that can be applied to any particular situation when a federal tax is being analysed. Its application must be considered on a case-by-case basis, using an analysis that accords with the precepts laid down in certain court rulings.

The economic reality principle has given rise to a number of cases in which the principle is alternatively merely referred to, used to interpret a particular situation, or used to determine the characterisation to be given to a particular legal structure in a given factual situation.

In *Parfums Francais S.R.L.*,[8] the Supreme Court upheld the tax authorities' tax assessment resulting from their determination of the applicable taxable base for purposes of excise taxes in the case of sales of products. The point at issue was whether a discount from the sales price applied by the seller was consistent with its nature and thus should be deducted from the "net sales price" on which the taxable base was computed. The discount was actually related to the place where the products were shown to the public for sale and to some adaptations made to them and was not the typical discount on the sale of products made by reference to such factors as the quantity of products sold or the time of payment of the purchase price.

The Supreme Court reasoned that:

> . . . as stated in the appeal request and as appears in the brief, in order to encourage some buyers to promote more sales, the plaintiff grants a "bonus" that also carries the obligation of displaying the products in a preferential place, that is to say, they ask in return for the advertising of the goods.
>
> . . . that the reach of the tax laws be determined by calculating the total rules that are necessary in order for

> the objective of said laws to comply with the rules of a reasonable and discrete interpretation (Sentences: 295:755; 302:661 and 307:871 –La Ley, 1976-D, 548, 1981-A, 322; 1986-B, 278–). In that sense, the interpretation of the tax laws should abide by the objective of those laws and by their economic meaning, by the true nature of the taxable event and by the real situation of the base, disregarding the forms and structures chosen by the taxpayer, in order to achieve the necessary prevalence of the reason of law over the formal judiciary ritual, a substitution of the essence that defines justice, seizing the objective judiciary truth (Sentences: 287:408 – La Ley, 153-386).

In the 1970s, the very aggressive position taken by the tax authorities in supposedly basing their tax treatment of foreign investments on the economic reality principle generated a number of cases (*Parke Davis*[9] and *Mellor Goodwin Combustion S.A.*[10] among others) in which that position was rather surprisingly upheld by the Supreme Court. In the relevant rulings, the court applied the theory of disregarding structures under the economic reality approach so as not to recognise the existence of different entities when they were part of the same economic group with corresponding tax consequences for the international transactions between the related parties concerned. These court rulings produced an openly adverse reaction in the private sector and among tax authors.

In *Kellogg Co. Argentina S.A.*,[11] the Supreme Court adopted the same criteria as it had used in the cases referred to above, but in this case accepted the taxpayer's position and rejected a tax assessment using the economic group approach.

In the leading case of *Parke Davis*, the sole fact of the relationship between the parties was enough for the Supreme Court to disallow the deduction of royalty payments made to the non-resident parent company.

In *Mellor Goodwin*, the Supreme Court concluded that the transfer of goods between entities in the same economic group does not generate a taxable event for sales tax purposes.

The general approach taken by the Supreme Court was that, for the configuration of a contract, there must be a diversity of parties, the possibility of negotiation and a difference of interests. As the fact that there was an economic group was enough for the effectiveness of the contractual relationship to be considered to have disappeared, the alleged real substance of the legal entities had to be taken into account. This clearly implies the application of the theory of disregarding structures.

The economic group approach to disallowing transactions was later abandoned in accordance with the separate entity approach at that time specifically provided for in an amendment to the Income Tax Law and anticipated in pending cases that governs the relationship between related parties in international transactions, which from 1998 became subject to the transfer pricing rules.

Many other tax issues related to the economic reality principle have also been the subject of discussion. Historically, there has been a concept in the Tax Code known as "unjustified increase in net worth," which provides for a deemed income penalty in the case of the existence of funds as to the origin of which there is no concrete evidence. In such cases, the relevant amount plus 10 percent is deemed to be taxable income and the relevant base is deemed to give rise to VAT and excise taxes.

At one point, the tax authorities began to claim that this presumption and the consequent taxation should apply when funds entered an Argentine company from a low-tax jurisdiction, by way of either a capital contribution or a loan. The tax authorities considered that these were funds of the Argentine taxpayer that were unreported in the formal economy and then reentered that economy in the form of a capital contribution or a loan. This issue gave rise to a great deal of controversial case law.

In *Oddone*,[12] the point at issue was whether alleged loans from a Uruguayan company were actually loans from a third party or really funds of the company or its owners (from unreported income) that were contributed to the company. The fact that the funds were proved to have come from Uruguay but it was not established that the funds were in the nature of loans, led the Federal Tax Court to uphold the position of the tax authorities. The presumption of the tax authorities was based on a series of indices and facts (for example, the lack of guarantees and the insufficiency of the assets to support the loan, the fact that the interest was not paid on time and that the principal was not paid by the prescribed deadline, and the fact that the lender showed no interest in claiming the debt on the bankruptcy of the local borrower).

Although, the economic reality principle underlay the imposition of the unjustified increase in net worth penalty, the claims of the tax authorities were not subject to any limitations in this context and their revenue-oriented approach led to many excesses, until the Supreme Court established limitations in *Trebas*.[13] *Trebas* was a case in which the tax authorities challenged the capital contributions made to an Argentine company by its shareholder, which was located in Lichtenstein, because the taxpayer had not proved the origin of the funds but only the party that has contributed them. The ruling of the Chamber revoking the ruling of the Federal Tax Court that had confirmed the tax authorities' assessment was appealed to the Supreme Court. The ruling of the Chamber was based on the fact that Argentine law does not require it to be proven that the funds originated from activities carried on in or investment made in third countries. The fact that the lender was located in a tax haven was not an issue. The Supreme Court confirmed the Chamber's arguments and emphasised that the law requires no more than that the funds be proven to have been effectively contributed and that the contributors be identified.

After the Supreme Court ruling was handed down, the legislation was changed and the current rule in the Tax Code provides that:

> When dealing with funds from low-tax countries as referred to in section 15 of the Income Tax Law (text consolidated in 1997 and its amendments) whatever the nature, concept or operation type, said funds shall be considered unjustified net worth increments for the local borrower or recipient of the funds.
>
> The unjustified net worth increments referred to in the paragraph above in addition to ten percent (10 percent) as income consumed in non-deductible expenses represent income subject to tax in the fiscal year in which they take place for purposes of determining the income tax and the base if any, for estimating the omitted transactions of said fiscal year for the purposes of value added taxes and excise taxes.
>
> Regardless of the above, the Argentine Tax Authority shall consider as justified those funds received by the local taxpayer if it proves irrefutably that they

originated from activities performed by the taxpayer or by a third party in said countries or from a duly declared placement of funds.[14]

Thus, unlike previously, the rule now contains a direct presumption that places on the taxpayer the burden of proving the origin of funds coming from a low-tax jurisdiction.

As noted above, the legality principle is a limitation on the application of the economic reality principle. In a way, this is demonstrated by *Trebas*, which led to a change in the legislation establishing for tax purposes the situations that previously the tax authorities were in the practice of challenging, that practice being in conflict with rights provided for in the tax laws.

The tax authorities embarked on another series of claims in connection with foreign financing where loans were taken out by local entities with nonresident (related) parties, alleging that unless certain requirements were met, such loans should be recharacterised as capital contributions. These claims were initiated after the devaluation suffered by Argentina in December 2001, significant tax losses having been generated by the Argentine borrowers as a result of foreign currency exchange losses. Some clarity was brought to the matter by the Federal Tax Court in its telephone company ruling, *Compañia Ericsson S.A.C.I.*,[15] but it is still being challenged in the courts, the economic reality principle and the legality principle and the conflict between the two being among the issues that are generating controversy.

An important ruling relating to the conflict between the economic reality and legality principles was handed down by the Supreme Court in a case involving the taxable base for VAT purposes, where Ford automobiles were sold under a savings plan.[16] The points at issue were the time at which the sales price should have been considered to have been received for VAT purposes and what that price should have been. The taxpayer adopted the market value of the assets at the time when the savings contract was agreed. The tax authorities challenged the pricing, among other things, taking into consideration the roles played in the transactions by other group companies, which, according to the tax authorities, organised the transactions "*in fraudem legis*."

The reasoning of the Supreme Court is worth stating: "...the application of the interpretative principle of economic reality cannot lead to the distortion of what has been specifically set forth by the legal rules that specially regulate the tax relation, otherwise, the principle of reserve or legality would be affected, causing the consequent diminution of judicial security and the ignoring of the need for the Government to clearly prescribe the taxes and exemptions so that taxpayers can easily accord their conduct with tax matters. In fact, the fact that the taxable event must be interpreted by reference to a tax base said consideration being based on financial and technical reasons cannot lead to the modification of the amount of the fiscal obligations resulting from the applicable legal rules, since the principle of reserve or legality governs them."

A. The economic reality principle in a tax treaty context

Until it ceased to be effective on January 1, 2009 (Argentina gave notice of its intention to terminate the treaty on June 26, 2008), Argentina had in place a tax treaty with Austria that, unlike other Argentine treaties, provided taxpayers with many benefits in terms of the restrictions it imposed on Argentina's taxing rights.

An interesting application of the economic reality principle was analysed in a competent authority ruling of January 1, 2009,[17] which reviewed the application of the treaty provisions in the case of an Argentine company that held a major participation in an Austrian company that, in turn, wholly owned a British Virgin Islands (BVI) company.

The tax authorities made a tax assessment and, because tax treaty issues were involved, the proceedings were turned over to the Argentine competent authority (which is a different government agency from the tax authorities) for its opinion and the National Directorate of Taxes issued Memorandum 64/09. The underlying issue was whether the Austrian company was interposed in order to avoid the application of the Argentine controlled foreign company (CFC) rules, which otherwise would have had the effect that the passive income derived by the BVI company would have been subject to tax in the hands of the Argentine company, irrespective of whether that income was distributed.

As quoted in Memorandum 64/l09, the view of the legal department of the tax authorities was that:

> There is no other reason worth considering, apart from the obtaining of the tax advantages of the tax treaty, for the interposition of the Austrian company.
>
> . . .once the necessary elements are gathered to qualify the Austrian company, according to economic reality, as a conduit entity, it seems feasible to deny the tax treaty benefits. . .
>
> . . . regarding the possibility of framing the maneuver carried out by the taxpayer as treaty abuse, it should be noted that as, in theory, there is no anti-abuse regulation allowing the prevention of such tax artifice, it is extremely important that the concerned authority should evaluate the incorporation of suitable regulations for this case.
>
> . . . *a contrario sensu*, performing a cunning tax planning activity consisting of interposing entities with direct or indirect privileged regimes would certainly favor the intention of damaging the national tax regime. Therefore, it would be advisable to promote the introduction of amendments to the regulatory system to contemplate similar situations to the ones discussed herein.
>
> . . .The result would be prima facie that the taxpayer improperly used the Double Taxation Agreement tending to distort the economic reality of the facts, with the intention of causing a tax damage, using it as an effective means to organise business, administer the management of assets and carry out transactions in places where the sovereign taxing power of Argentina may not intervene.

After analysing the case, the National Directorate of Taxes concluded that it shared the opinion of the tax authorities and that the treaty benefits should not be granted because the Austrian company had the characteristics of a company that had been interposed in order to allow the tax treaty benefits to be enjoyed. The National Directorate of Taxes based its conclusion mainly on the following considerations:

- The sub-committee on inappropriate use of treaties of the committee of experts on international cooperation in tax-related matters of the United Nations has prepared a draft comment on Article 1 of the U.N. Model Convention, which, though it expresses some doubts regarding the application of domestic general anti-avoidance measures (as opposed to specific anti-avoidance measures) that might be in conflict with the provisions of tax treaties, nonetheless shows that there is a consensus in the Committee to the effect that, if the application of such general anti-avoidance measures are limited to cases of abuse, no such conflict should arise;

- General anti-avoidance rules providing that substance prevails over form and the rule of the economic reality are not considered by the OECD to be in conflict with the provisions of tax treaties when there is an abusive use of the treaty concerned, i.e., when one of the main purposes of a transaction is to secure a more favourable tax position; and
- In the case under analysis, it appeared from the available evidence that there was no other motivation for the structure apart from tax avoidance.

The ruling does not, however, provide clear and concrete arguments in support of the application of a legal rule that is sufficient to allow the existence of the Austrian company to be challenged, and thus the availability of treaty benefits, not to be recognised. The fact that this is an administrative ruling and there have been no court case in which all the proofs and arguments were discussed points up the limitations of the analysis. There is something of a contradiction between, on the one hand, the position of the tax authorities that it is advisable to provide a legal rule to prevent this type of arrangement because otherwise there is no rule to counteract it and, on the other hand, the conclusion that a general anti-avoidance rule should be sufficient for the existence of the Austrian company to be challenged, without even a review of how the legal rule would actually work. Nor does a draft Comment of the Committee of Experts on Article 1 of the UN Model Convention appear to be a valid legal tool for interpretation purposes. As discussed above, the risk of infringing the legality principle is something that needs to be borne in mind when the economic reality principle is used to deny the applicability of a particular legal structure. The analysis should be even more rigorous when a tax treaty is involved. It would seem that the arguments debated and the conclusions drawn in this administrative proceeding are just a prelude to the full exploration of a complicated matter such as treaty abuse and its interaction with the constitutional right to carry on business in a way that is not prohibited by the law.

III. What is the tax result of a determination that a transaction lacks economic substance?

In Argentina, this question would more properly be phrased as: What is the tax result if, in accordance with the economic reality principle, it is deemed that the legal structure that should be recognised is not the structure chosen by the taxpayer but the structure that private law would apply in such circumstances?

The actual consequences will depend on the type of transaction that is under review. For instance, in *ParfumsFrancais* (see II., above), the consequences were the imposition of an additional amount of tax (in this case excise taxes) plus interest and, ultimately, fines. This followed from the fact that the point at issue was whether the discount applied by the company was in fact a discount that should be deducted from the net sales price or remuneration for a service provided by the recipient of the product.

In the case of Memorandum 64/2009, the consequence would be the application of the CFC or fiscal transparency rules and thus the inclusion of the passive income derived by the BVI company as part of Argentine taxable income.

The imposition of an interest charge is always a direct consequence of a tax claim unless the taxpayer is able to prove, for various reasons, that there has been no "guilt" in its behaviour.

Penalties may also ultimately be imposed. Of the several types of penalties, the most common is a fine for failure to pay the tax due, the quantum of which ranges from 50 percent to 100 percent of the omitted tax. If the taxpayer's behavior is deemed to constitute fraud, the monetary fine may be assessed at between two to ten times the amount of the evaded tax. Special penalties apply in the case of transfer pricing adjustments and international transactions.

If the tax authorities consider that the taxpayeŕs behaviour was intentional and if certain conditions are satisfied (for example, a threshold is reached of, currently, ARD 100,000 (roughly USD 25,000) per tax for a particular tax period), they may refer the case to the criminal courts for an alleged violation of the criminal tax law and the possible application of penalties in the form of imprisonment.[18] One form of fraudulent behavior that leads to an increased tax charge consists in the use of interposed persons to hide the identity of the actual person liable to the tax where the tax evaded exceeds ARD 200,000 (roughly USD 50,000). A new criminal tax law bill is currently being discussed in the Argentine Congress that, among other things, would increase the thresholds for the applicability of the criminal tax law.

NOTES

[1] Law 11,683 as amended.

[2] Tax Code, Art. 1.

[3] Tax Code, Art. 2.

[4] *Berkley International A.R.T.S.A. v. Ministerio de Economía y Obras y Servicios Públicos*, Supreme Court, Nov. 21, 2000.

[5] Arguments from the Supreme Court Attorney in *Cámara Argentina del Libro y otros vs. Poder Ejecutivo Nacional*, Supreme Court, Jan. 9, 2003.

[6] Tarsitano Alberto, "*Presupuestos, límites y consecuencias de la recharacterization tributaria de los actos jurídicos. La experiencia argentina* ("Facts, limits and consequences of the tax recharacterisation of legal acts. The Argentine experience") in "*Interpretación económica de las normas tributarias*" ("Economic interpretation of the legal rules"), Editorial Abaco de Rodolfo Depalma, p. 86. (Free translation by the author.)

[7] Fabián O. Cainzos and Verónica Rico in "Approaches to tax avoidance internationally. Argentina," prepared for the IBA Conference 2003, Committee N – Taxation, San Francisco, California.

[8] *Parfums Francais S.R.L.*, Supreme Court, June 16, 1992,

[9] *Parke Davis y Cía S.A.*, Supreme Court July 31, 1973.

[10] *Mellor Goodwin Co.*, Supreme Court Oct. 18, 1973.

[11] *Kellogg Co. Argentina S.A.*, Supreme Court, Feb. 26, 1985.

[12] Luis Alberto Oddone y Cía. Asesores Financieros S.A. Tribunal Fiscal de la Nación, sala "A". Oct. 10, 1988.

[13] *Trebas S.A.*, s/recurso de apelación – impuesto a las ganancias. Sept. 14, 1993.

[14] Article included after Tax Code, Art. 18.

[15] *Compañia Ericsson S.A.C.I.*, Federal Tax Court, Aug. 15, 2007.

[16] *Autolatina Argentina S.A.*, c Dirección General Impositiva, Dec. 27, 1996.

[17] Memorando 64/2009 of the General Directorate of Taxes (Dirección Nacional de Impuestos).

[18] Law 24,769 as atended.

Host Country BELGIUM

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I. Will the Belgian tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Belgian law, despite its lack of economic substance?

Broadly speaking, under Belgian tax law, the *legal form* of a transaction prevails over what might be viewed as its *"economic substance,"* but *legal substance* prevails over *legal form* if the actual legal rights and obligations of the parties are in contrast to any false appearance they might create, whether purportedly or otherwise. In short, and probably more accurately, the *legal reality* of a transaction prevails over its economic substance and mere legal form.[1]

Legal reality prevails over what can be viewed as the "economic substance" of a transaction because of two fundamental principles.

One principle is that of the "legality of tax." The authors of the Belgian Constitution viewed tax as an infringement of individual freedom and the right of property; the principle is that persons and goods are generally exempt from any levy, and tax is an exception that can be established by the legislature only (Article 170 of the Constitution).[2] From this principle, it can be inferred that the tax laws are to be interpreted and applied strictly.[3] In the case of doubt as to the meaning of a tax provision, the interpretation favourable to the taxpayer must prevail[4] and tax provisions cannot be applied by analogy.[5]

The other fundamental principle is that tax law is, as a rule, governed by private law: concepts used in a tax statute are to be interpreted in accordance with their private law meaning, and transactions entered into by taxpayers are to be characterised in accordance with private law principles.[6]

Although the interpretation rule nevertheless leaves the courts a fair amount of discretion, as in the interpretation of any legal language,[7] and although there is nothing to prevent the legislature from using economic, rather than legal, concepts in a tax provision,[8] it remains the case that the above two principles leave no room for any general "(economic) substance over (legal) form" approach in Belgian tax law. As a rule, the legal form of a transaction will prevail over what might be viewed as its economic substance; the courts cannot give priority to some "economic reality" that might be different from the reality of the contracts entered into by the parties without sham and of which they accept all the consequences.[9]

The situation is similar in purely private law relations, no doctrine like "(economic) substance over (legal) form" being accepted in Belgian private law; according to most commentators, the same applies to the *"fraus legis"* doctrine.[10]

The "economic substance over legal form" approach may, however, make certain inroads into tax law in the context of determining the taxable income of corporations and, more generally, enterprises. Indeed, that determination is governed, as a rule, by accounting law, where such an approach is often advocated.[11]

There are, however, a number of exceptions to this rule.

A. Simulation ("sham transaction doctrine")

Although it is not an anti-avoidance measure *per se*, the simulation or sham transaction doctrine, which is well-established under Belgian tax law, is in reality directed at tax evasion or tax fraud.

The criterion here is the private law concept of "sham," the classic definition of which is as follows: "there is sham where the parties outwardly enter into an act whose effects they agree to modify or destroy by another contract, which remains secret. Sham thus pre-supposes two contracts, each contemporaneous with the other, but one of which is intended only to lay a false scent. There exists only one real contract, the secret contract."[12] In other words, the test is: did the parties accept all the legal consequences of the contract presented to the tax authorities, or is there a secret contract that modifies any or all of the legal consequences of the apparent one? This secret contract need not be in writing[13].

There can be different degrees of sham. Sometimes sham is limited to one element of the legal transaction: for instance, with a view to evading part of the registration duty calculated on the purchase price, the parties to a real estate purchase agreement might indicate a price of EUR 250,000, whereas the price really agreed upon is EUR 350,000. In other cases, sham affects the legal characterisation of the transaction: for instance, again in order to evade registration duty, the parties might disguise a gift of real estate as a sale, by indicating in the agreement a price that they agree will not be paid. Sham can affect the very existence of the legal transaction: the parties might sign a

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sale agreement but secretly agree that it should be deemed to be non-existent. A last form of sham concerns who it is that is the actual party to the transaction concerned: A, B and C might agree that a contract be presented as being between A and B, when the contract is actually between A and C.

Not only can sham affect isolated legal transactions, it can also consist in presenting as independent different legal transactions between which the different parties have secretly agreed to establish such a link that their legal content is modified in some respect. The scheme considered in a judgement of October 26, 1982 by the Court of Appeal of Brussels[14] is a good example of this, although the court based its decision on other legal reasons: the taxpayer forewent a severance payment to which he was entitled while the parent company of his employer agreed to purchase shares from the taxpayer's spouse at a price above their fair market value. The two transactions were presented as independent, whereas in reality the one was the consideration for the other.[15]

A peculiar situation is where the parties conceal the existence of an undisclosed agency contract behind the front of a contract that mirrors the contract that the agent enters into with a third party for the account of the principal. For instance, A and B enter into an agency contract that provides that B will enter into a loan agreement with an unrelated borrower in its own name but for the account of A. Remittance, first by A to B of the amount lent, and later by B to A of the interest and capital repayments by the borrower, merely constitute the performance of the agency contract between A and B, but with a view to hiding from the tax authorities the fact that A is the true lender and that it is A who receives the interest from the unrelated borrower, A and B disguising these aspects of the agency agreement as a sham loan contract.

In private law relations, third parties confronted with a simulation may freely choose to rely either on the apparent act or on the real one. Because tax law is a public policy matter and because of the principle that tax is based on legal reality, the tax authorities are denied that choice and, hence, are required to assess tax on the basis of the real act.[16]

According to well-established case law of the Supreme Court, there is no simulation and, hence, no tax fraud when taxpayers, with a view to benefiting from a more favourable tax regime, use freedom of contract, without, however, infringing a legal obligation, to establish legal acts all the consequences of which they accept, even if the legal form that they give to such acts is not the normal form.[17]

Sham needs to be distinguished from the incorrect characterisation of transactions. There is incorrect characterisation where the parties give their contract, or a legal transaction in the more general sense, a legal characterisation that is incompatible with its content. This situation is often a consequence of the true content of the contract being different from that presented by the parties, but not necessarily. In any event, the tax must be assessed on the basis of the correct legal characterisation.[18]

The principle of the "legality of tax," on the one hand, and the principle that tax law is governed by private law, on the other, are the basis of what is called the "free choice of the least taxed route," as the Court of Cassation expressed it in its *Brepols* judgement of 1961 and confirmed in the *Au Vieux Saint-Martin* case in 1990, rejecting in turn the *fraus legis* and economic reality doctrines: "There is no sham, or, therefore, tax fraud, where, in order to enjoy a more favourable tax treatment, and using the freedom to contract, without however violating any legal obligation, the parties enter into acts of which they accept all the consequences, even if the form they give thereto is not the most usual one" (*Brepols*) and "even if these acts are entered into with the sole purpose of reducing the tax burden" (*Au Vieux Saint-Martin*).[19]

Thus, as a matter of principle, tax avoidance is effective unless there is sham within the meaning of that concept in private law and the tax authorities can prove it.[20]

In practice, cases where sham has been held to exist are less exceptional than one might think – for two reasons. The first reason is that, in order to prove the existence and terms of the sham, the tax authorities can use all means of evidence, including "presumption of fact," by which the judge assumes one fact from another fact or group of facts, and which, according to Article 1353 of the Civil Code is "left to the insight and wisdom of the judge." Thus, the Court may decide that the facts and circumstances surrounding the transaction concerned demonstrate that the parties' real contract was different from the contract they present. It is true that the taxpayer should be given the benefit of the doubt in this respect, since the burden of proof lies with the tax authorities, but this principle is not always strictly adhered to in practice, and, since the matter is a determination of fact within the absolute discretion of the court, the Belgian highest court, the Court of Cassation, may not review what a lower court finds to be presumptive evidence, unless the judge's assumption is either based on a fact that is itself unproven[21] or is incapable of justification.[22]

The second reason is that, when confronted with aggressive tax schemes, the courts sometimes find that there is a sham in circumstances hardly compatible with the legal concept of sham and the Court of Cassation will reject an appeal on the grounds that the decision is based on a determination of fact, which is outside its power of review[23].

One fairly recent case[24] can serve to illustrate the application of the sham doctrine.[25] In this case, the Court of Appeal ruled that there was sham where the main shareholder and manager of a company had sold its business to the company. The Court ruled that part of the consideration received for the sale was in fact remuneration for the activities of the manager, and taxable accordingly (and not as a sale of the business). The Court of Appeal based its ruling on the fact that the consideration paid was totally disproportionate when compared with the value of the business and in view of other elements surrounding the case. The Belgian Supreme Court upheld this decision, ruling that the Court of Appeal had correctly applied the sham doctrine in ruling that the real consideration agreed between parties was lower than the consideration expressed in the sale and purchase agreement.

B. Specific anti-abuse provisions in Belgian law

The Belgian legislator has for many years introduced specific anti-abuse provisions, targeted at specific abuses, particularly in cases where non-Belgian tax resident companies have been found to benefit from an advantageous tax regime. These provisions have greatly increased in number since the beginning of the 1990s. In the context of direct taxation, these specific anti-abuse provisions include the following provisions of the Belgian Income Tax Code (BITC):

- Article 18, 4: classification of interest as dividends;
- Article 26: taxation in the hands of a Belgian company of an "abnormal or gratuitous advantage" granted to a company benefiting from a more advantageous tax regime than the Belgian tax regime;
- Article 32: classification as remuneration of certain rents paid by companies to their directors;
- Article 54: specific requirements for the deductibility of interest and other payments made to a non-Belgian tax resident company benefiting from a more advantageous tax regime than the Belgian tax regime;
- Articles 79 and 207, al. 2: denial of the deduction of losses (carryforward), and, for companies, the dividend received deduction, the notional interest deduction and the investment deduction from profits arising from "abnormal or gratuitous advantages" received from a company to which the recipient company is related;
- Article 207, al. 3: loss of carried forward losses on a change of control where there are no legitimate financial or economic reasons for the change of control;
- Article 344, § 2: the transfer of certain assets cannot be upheld against the Belgian tax authorities where the transfer is to a non-Belgian resident taxpayer benefiting from a significantly more advantageous tax regime than the Belgian tax regime;
- Article 289: limitation in the application of the Belgian foreign tax credit regime;
- Article 362bis and 280: *pro rata* application of the taxation of interest and credit for withholding tax on interest;
- Article 203: limitation of the dividend received deduction to dividends deriving from profits that were subject to regular tax;
- Article 206: limitation of losses in the case of tax neutral reorganisations;
- Article 198, 11: restrictions with respect to the deduction of interest paid to tax haven entities;
- Article 205ter: limitation with respect to the basis on which the notional interest deduction is calculated; and
- Article 307, § 1 and Article 198, first indent: requirement for companies that are subject to Belgian corporate income tax or nonresident income tax to report in their income tax returns all payments to persons established in tax havens. Transactions have to be reported only if the total payments made during the taxable period reach a minimum of EUR 100,000. Payments that are made directly or indirectly to tax havens and that are not reported are not tax deductible. Where the payments are reported, the taxpayer must prove that they are made in connection with *bona fide* business transactions.

C. Court based anti-avoidance rules

The words "without however violating any legal obligation" in the Court of Cassation's landmark cases of *Brepols* and *Au Vieux Saint-Martin* (see I.B., above) introduced a new limitation in Belgian law on the freedom to choose the least taxed route, the court having ruled that the tax authorities can disregard a transaction if it violates a non-tax statute of public policy, for the purpose of tax avoidance. The Court of Cassation ruled this way for the first time in its decision of March 5, 1999[26] and subsequently confirmed this in its decision of October 16, 2009[27].

The facts underlying the 1999 case can be summarised as follows. A pharmacist decided to sell his pharmacy shop to a company incorporated by the pharmacist. In this way he would realise a low-taxed capital gain and his company would be able to depreciate the purchased assets (including the goodwill attached to the pharmacy that was the subject of the sale). The consideration exceeded the maximum price regarded as allowed to be paid under specific Belgian legislation. The Court of Cassation stated that, although the agreement was not a sham, the lower court was correct in ruling that the depreciation could not be allowed from a fiscal point of view with respect to the consideration that exceeded the consideration that could be paid according to the specific legislation.

The facts underlying the 2009 case can be summarised as follows. The general meeting of a Belgian company decided to draw up a specific reserve for a pension plan of one of its directors. For that purpose, the company concluded an agreement with the director concerned. A group insurance policy was concluded in order to fund the plan. For the period prior to the conclusion of the group insurance policy, the company issued a special guarantee with respect to the director, and provided for a special provision in its accounts rather than paying an extra-ordinary premium to its insurer. The tax authorities, followed by the Court of Appeal, refused the exemption of the provision based on Article 48 of the BITC, as the creation of the provision was considered to be contrary to the Law of July 9, 1975 on the auditing of insurance companies, which is a matter of public policy.

Most writers[28] have criticised the 1999 ruling as lacking legal grounds and relying on a mistaken interpretation of the wording of the *Brepols* and *Au Vieux Saint Martin* judgements cited above.[29] This wording does not refer to the violation of a legal *provision* but to the violation of a legal *obligation*, and purports, in response to the proponents of the *fraus legis* doctrine, to stress that the taxpayer does not violate any legal obligation in choosing the least taxed route.

These rulings show that if the taxpayer acts in a way that is contrary to public policy in order to avoid taxes, the tax authorities can (but are not obliged to) disregard the taxpayer's act.[30]

D. General anti-abuse of law provision

1. General

The Law of July 22, 1993 introduced a general anti-abuse of law provision in the area of income taxation.[31] According to Article 344, § 1 of the BITC, which applies to transactions entered into after March 31, 1993, the legal classification given by the parties to an act or to separate acts that effect a single transaction cannot be upheld against the tax authorities if the tax authorities ascertain (*constater/vaststellen*), by way of presumptions or other allowable means of evidence, that the classification is designed to avoid tax, unless the taxpayer is able to demonstrate that the classification corresponds to legitimate financial or economic needs. The legal classification is the legal form or "label" given to a legal act (*negotium*) that constitutes a transaction.

Identical provisions can be found in the Belgian Registration Code and the Belgian Inheritance Code.[32]

The introduction of the general anti-abuse of law provision contained in Article 344, § 1 of the BITC, at least theoretically, puts an end to what was generally referred to in Belgian tax law as the dichotomy between, on the one hand, tax evasion in the form of simulation (sham transaction) and, on the other, tax avoidance through the choice of the least taxed route. There now seems to be a three-way distinction between:

- Tax evasion/simulation;
- "Acceptable" tax avoidance; and
- "Unacceptable" tax avoidance.

"Unacceptable" tax avoidance would thus imply the use of a legal classification for the sole or main purpose of avoiding tax.

The provision does not introduce into Belgian tax law the principle of taxation based on economic reality independent from legal reality.[33] The provision leaves intact the principle that a taxpayer can choose the least taxed route, but places limitations on that principle.[34]

The introduction of Article 344, § 1 of the BITC has had mixed results. On the one hand there have been relatively few cases in which this article has been successfully applied, in particular because of the stringent condition requiring the reclassification to respect the legal effects of the reclassified act (see I.D.2., below). On the other hand, the mere existence of the article has most likely resulted in taxpayers engaging less in aggressive tax planning schemes than before its introduction.[35]

2. Conditions for application

Four cumulative conditions must be fulfilled if Article 344, § 1 of the BITC is to apply.

First, there needs to be an act, or separate acts that together bring about the same operation.

The word "act" has no particular meaning in Belgian tax law. Accordingly, its civil law meaning applies in tax matters. In Belgian civil law, the word "act" can theoretically refer to both the *negotium* (i.e., the legal act that the parties intend to produce rights and obligations among themselves) and the *instrumentum* (i.e., the deed in which the parties have reflected their intentions and embedded their rights and obligations). The only meaningful interpretation is that the statute is referring to the *negotium*, i.e., the legal act.[36] This is confirmed by the legislative history, in which "act" is defined as an expression of will intended to produce legal effects.

The phrase "separate acts that together realise the same operation" is a novel term that is not further defined in the statute. The legislative history makes it clear that the statute is targeting the artificial disaggregation of one economic operation into a number of successive acts that are linked by a unity of intent, but artificially split. This requires that the successive acts represent a series of acts conceived from the outset as forming part of an inseparable chain or, differently expressed, as forming part of a single operation.[37]

The legislative history indicates in this respect that Article 344, § 1 of the BITC represents the application of the English "step transaction" doctrine, as developed by the House of Lords, which was introduced by the House of Lords in *Ramsay v IRC* (1981) and further developed in *Furniss v Dawson* (1984). In *Craven v White*, Lord Oliver summarised the four essential requirements of the doctrine:

- That the series of transactions was, at the time when the intermediate transaction was entered into, preordained in order to produce a given result;
- That the transaction has no other purpose than tax mitigation;
- That there was at that time no practical likelihood that the pre-planned events would take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life; and
- That the preordained events did in fact take place.

So far, the Belgian courts have had little difficulty in construing the phrase "separate acts that together form the same operation." It must be admitted that the group of cases in which the courts have ruled in this context have involved relatively simple schemes and left little room for argument. The ruling of the Court of Cassation dated November 22, 2007, concerned an existing lease agreement between an individual taxpayer as the lessor and a corporation as the lessee. In order to achieve a more advantageous tax result, the lease was terminated and replaced by a head lease/sub-lease via an intermediate person. The head and sub-leases related to the same property and were entered into at the same time and for the same term.

The second condition is that the acts, or separate acts that together realise the same operation, must be capable of receiving a different characterisation. Article 344, § 1 of the BITC does not allow an abstraction to be made of the acts concluded by the taxpayer, but only of the legal characterisation given by the taxpayer. The Court of Cassation ruled in its decision of November 4, 2005 that this can only be done if the new characterisation respects the legal consequences of the recharacterised act. It follows from this that Article 344, § 1 can only be applied if there is room for more than one correct legal characterisation of an act under private law. That condition will rarely be met if an operation is accomplished through a single legal act. The scope of the article is wider in the case of a premeditated series of legal acts that form a single, composite operation. "Separate acts that together realise the same operation" must be capable of reclassifying the act(s) of the taxpayer. Reclassification must be made on the basis of the economic content of the underlying transaction and the purpose pursued by the parties. According to the *travaux préparatoires* relating to Article 344, § 1, the reclassification process must result in the "normal" legal classification, i.e., the legal classification that restores the taxable base. However, the reclassification must neither alter nor affect the legal consequences of the act(s) entered into between the parties. In the case of successive separate acts, the reclassification issue only arises if the tax authorities first establish that such acts effect a single transaction. This implies that evidence must be given as to the fact that the acts were planned, from the outset, as an indivisible chain and carried through as a whole with a view to effecting a single transaction.[38] In turn, this means that, in the case of a single operation where the intermediate acts have be introduced in order to avoid taxation, Article 344, § 1 authorises the tax authorities only to look at the legal situation of the parties before the first legal act beginning the operation and the legal situation of the parties after the last act of the operation, and to give a characterisation to the operation making an abstraction of the characterisation of each separate act in isolation. Recharacterisation will only be possible if the legal effects that exist at the end of the operation are respected. In the case of different acts, as well as in the case of a single act, the "characterised content" must remain the same (otherwise the characterisation would no longer be a legal characterisation). The difference between a series of separate acts and a single act is that, in the case of separate acts, the "characterised content" has to be looked at the end of the entire operation, without stopping at each intermediate step.[39] Further, legal scholars are of the opinion that Article 344, § 1 does not allow the tax authorities to change the chronology of the different acts.[40]

One of the most difficult questions concerns the extent to which recharacterisation must respect the legal consequences of the recharacterised act. The Court of Cassation has ruled that the legal consequences after recharacterisation must be similar to those before recharacterisation. Legal scholars are of the opinion that there is only room for similar (rather than identical) legal consequences in the case of several acts realising the same operation, and not where there is a single act (where the legal consequences should be identical).[41] Further, only the legal effects that are without practical importance in the case concerned can be disregarded. In any event, the recharacterisation cannot result in a modification of the object of, the parties to or the date of the legal act, none of which are related to the legal characterisation. The Court of Cassation has so far provided no answer as to what is to be understood by "similar consequences" and seems to wish to leave a great deal of freedom to the lower courts to decide if consequences are similar, thus only exercising minimal control in this area.[42]

The third condition is that the tax authorities can only apply Article 344, § 1 of the BITC if they can show that the parties chose the legal characterisation of the transaction in order to avoid taxes. First, a characterisation driven by a tax motive does not, in the authors' view, qualify as "tax avoidance" if it produces a tax result that does not contradict the purpose of the tax law — neither Article 344, § 1 nor any other provision of the tax law obliges taxpayers to choose, of two routes available to reach a desired result, that which attracts the greater tax charge. The legislative history to Article 344, § 1 expressly states that the Article cannot be used to invalidate other provisions of the BITC.[43] This means, again in the authors' view, that Article 344, § 1 cannot be applied if the taxpayer chooses a characterisation in order to reduce its taxes where the taxpayer only makes use of the possibilities offered by the legislator itself. Second, the sole fact that taxes are more reduced as a result of the chosen characterisation than they would have been as a result of another characterisation cannot, of itself, be sufficient grounds for concluding that the taxpayer wishes to avoid taxes. There can only be avoidance if, even though the tax law is correctly applied, this correct application goes against the purpose of the tax law.

The fourth condition is that the taxpayer must be unable to prove that his chosen legal classification meets legitimate financial or economic needs. According to the *travaux préparatoires* relating to Article 344, § 1 of the BITC, the taxpayer must be able to show that there was a sufficient link or nexus between the legal classification chosen by the parties and the economic content of the underlying transaction. The text of the law, the legislative history, and the Administrative Circular, as well as certain case law, show that the taxpayer's intention to avoid taxes can coincide with a legitimate economic or financial need. The question then arises as to how these two (i.e., the intention to avoid taxes and the legitimate need) relate to each other. It is probably possible to say that if it would be reasonable to characterise the transaction as it would have been characterised in the absence of the fiscal advantage attached to the characterisation, proof of legitimate need would have been shown.

3. Examples

A decision of the Court of Cassation of November 22, 2007 relates to the question of the extent to which the legal consequences of the original transaction can be put aside by recharacterisation. In this case, a company acquired the usufruct of a building, while its shareholders simultaneously acquired the bare ownership of the building. The tax authorities recharacterised the usufruct as a lease by the company in favour of its shareholders, which was not accepted by the Court of Appeal of Ghent.[44] The Court of Cassation rejected the appeal of the tax authorities against the decision of the Court of Appeal, ruling that the lease characterisation in substitution for the usufruct characterisation chosen by the parties to the transaction did not have the same legal consequences, that the recharacterisation did not produce the same consequences in terms of ownership, and that it also ignored the relation between the third party seller and the company. The Court of Cassation decided that the transaction could not be recharacterised as a lease, which meant that Article 344, § 1 of the BITC could not be applied.[45] The differences between a usufruct and a lease were too important to allow the recharacterisation of the usufruct.[46]

In a decision of April 21, 2005, the Court of Cassation rejected the appeal of the taxpayer against a decision accepting recharacterisation. The facts of the case can be summarised as follows. A building was leased and immediately granted in sublease to a company (via an intermediary) to avoid the tax consequences of a direct lease to the company. The lessor was the manager of the company and the scheme was used to avoid the taxation of a part of the rent as professional income under Article 35 of the BITC. Before the entry into effect of Article 344, § 1 of the BITC, the tax authorities generally considered these schemes to be cases of simulation and the Court of Appeal of Mons had already accepted the applicability of simulation in similar cases.[47] In the case under discussion here, the Court of Appeal of Mons accepted recharacterisation,[48] focusing especially on a specific contractual clause, under which the principal lessor could demand payment directly from the sub-lessee. On appeal to the Court of Cassation, the taxpayer argued that the recharacterisation of the contracts as one lease contract did not respect the legal consequences of the acts, i.e., the rights and obligations that existed between the contracting parties to both contracts. However, the Court of Cassation rejected this argument, affirming that the Court of Appeal had legally justified its decision to the effect that the tax authorities had correctly applied Article 344, § 1. The Court did not examine how the recharacterisation of the transaction as a pure and simple lease was compatible with the contractual rights and obligations that were invoked on appeal.

There are a number of decisions relating to the acquisition of its own shares by a company, where the acquisition was recharacterised by the tax authorities as an ordinary dividend. The courts have generally condemned such recharacterisation.[49] There are also a number of decisions relating to the acquisition of a usufruct by a company, where the usufruct was recharacterised as a simple lease, to make the taxation of lease income by the bare owner possible. The courts have also generally condemned this recharacterisation.[50]

More recently, the courts have also ruled on a number of other operations. The Court of Leuven decided that a sale of shares to a Belgian company (X) that preserved the ownership of the shares after the sale could not be recharacterised as a sale of shares to a U.S. company (Y), which was the 100 percent parent of X. The sale was made to X, rather than Y, to avoid taxation as miscellaneous income of the capital gains on "important participations" under Article 90, 9° of the BITC. The recharacterisation would have consisted in taxing other facts than those that fell within the scope of the initial characterisation.[51]

The Court of Appeal of Antwerp, confirming a decision of the Court of Antwerp, decided that distributions to shareholders in the context of the liquidation of a company could not be recharacterised as ordinary dividends. The liquidation of a company has specific factual and legal characteristics that are unlike those attached to the distribution of ordinary dividends.[52]

The Court of Appeal of Antwerp, confirming a decision of the Court of Antwerp, accepted the recharacterisation of a "chain" of two contracts for management and consultancy services as a direct contract between the first company and the third company, finding that the two contracts were concluded on the same day, that it was materially impossible for the second company to provide the services that were the object of the contract and that the two contracts were split up mainly for tax purposes[53].

The Court of Appeal of Antwerp, reversing a decision of the court of Hasselt, accepted the recharacterisation as a single loan of a transaction that the parties concerned had split up into a loan with interest and an advance without interest with a view to avoiding the recharacterisation of interest and dividends under Article 18, 1st paragraph of the BITC.[54]

According to a decision of the Court of Bruges of March 4, 2008, the tax authorities were justified in recharacterising a transaction whereby the taxpayer contributed his commercial trust to a company for a value of Belgian Francs 5 million and a few days later sold the shares received as consideration for this contribution for Belgian Francs 17 million to a second company, which was the parent of the first one, in a direct sale of the commercial trust.[55]

E. Anti-abuse provision with respect to reorganisations

Under its implementation into Belgian law of the EC Merger Directive,[56] a new anti-abuse provision with respect to reorganisations, based on the general anti-abuse provision of the Merger Directive, was inserted in Article 183*bis* of the BITC.[57] The new provision applies to operations carried out on or after January 12, 2009 and replaces the former anti-abuse provision, which provided that such operations had to meet legitimate financial and economic needs.[58]

Under the new anti-abuse provision, a merger, a division, a transfer of assets or an exchange of shares cannot have as its principal objective, or as one of its principal objectives, tax evasion or tax avoidance. The fact that an operation is not carried out for valid commercial reasons, such as the restructuring or rationalisation of the activities of the companies participating in the operation, may give rise to a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives.[59] Under the new provision, the tax authorities have the burden of proving that tax evasion or tax avoidance is the principal objective of the operation concerned. A presumption of tax evasion or tax avoidance exists in the absence of valid commercial reasons.

The jurisprudence of the European Court of Justice (ECJ) with respect to Article 11, 1, a) of the EC Merger Directive is a guideline for the interpretation of this anti-abuse provision. In the *Kofoed*-case, the ECJ ruled that Article 11, 1, a) reflects the general Community law principle that the abuse of rights is prohibited.[60] Individuals must not improperly or fraudulently take advantage of provisions of Community law. The application of Community legislation cannot be extended to cover abusive practices. Abusive practices are transactions carried out not in the context of normal commercial operations, but solely for purposes of wrongfully obtaining advantages provided for by Community law.[61]

It is, as yet, unclear what is meant in this context by "tax avoidance." Can a taxpayer be refused the benefits of the EC Merger Directive only in the case of avoidance of corporation tax or does tax avoidance also include the avoidance of other taxes, such as a tax on transactions? This question arose in the *Zwijnenburg* case, in connection with the plan of the Zwijnenburg family to bring about a change of generations in the running of their fashion shop. To avoid the payment of a transaction tax, the "business merger" method was proposed for the transfer of the property. The Dutch tax authorities declined to grant the benefits of merger taxation to the transaction because its predominant objective was to avoid or defer liability to the transaction tax.

The ECJ has not yet ruled in this matter, but the opinion of Advocate General Kokott is worth mentioning.[62] The opinion of the Advocate General is similar to the "freedom to choose the least taxed route" doctrine introduced by the Court of Cassation in its landmark *Brepols* case. Advocate General Kokott concluded that conduct that is merely taking advantage of the options presented by Community law – in this case the EC Merger Directive – cannot by itself justify suspicion of abuse or tax avoidance. The mere fact that, in order to achieve a legitimate economic aim, a taxpayer chooses, out of several lawful options, the one that is most favourable to it for tax purposes is not, of itself, a sufficient ground for a charge of tax avoidance within the meaning of the anti-abuse provision. This provision applies only to the avoidance of taxes to which the benefits provided for in the Directive relate. This also means that the anti-abuse provision exhaustively determines the circumstances in which the tax benefits provided for in the Directive can be refused in the event of abuse. Advocate General

Kokott was of the opinion that no recourse to the general prohibition on the abuse of rights is possible, since the legal certainty with regard to the restructuring of companies that the Directive seeks to achieve would be jeopardised by this. However, even if the general prohibition on the abuse of rights were considered to be applicable, it could not serve as the basis for simply withholding all benefits under the Merger Directive from the taxpayer in the event of the avoidance of transaction tax according to the principle *fraus omnia corrumpit*. The principle of proportionality requires that tax advantages in the context of merger taxation be denied to the taxpayer only insofar as is necessary to prevent a threat of tax avoidance or to redress tax avoidance that has already occurred. This interpretation also accords with the principle that exceptions are to be interpreted narrowly.

It should be noted that, while they awaiting the decision of the ECJ, the Belgian tax authorities apply the prohibition on tax avoidance to both direct and indirect taxes. Should the ECJ follow the opinion of the Advocate General, it would only be possible to apply the anti-abuse provision to operations designed to avoid corporate tax.

It is important to stress that the former anti-abuse provision applies in the case of a change of control of a company. In this event, the carried forward investment deduction, the carried forward notional interest deduction, the former losses and the carried forward tax credit will be lost.[63]

F. Anti-abuse provision with respect to the deductibility of costs

Case law of Belgium's highest court, the Court of Cassation, indicates that costs are only tax deductible if they are linked to the effective commercial activities performed by the company, as set out in its bylaws.

It will also need to be determined whether costs are effectively deductible in light of the application of the "cash drain" analysis.[64] Under the "cash drain" approach, which was developed by the tax authorities, costs are not tax-deductible in circumstances in which the pre-tax cost of a transaction or series of transactions is necessarily higher than the maximum pre-tax income or return generated by the transaction(s) (pre-tax structural net loss).[65] The "cash drain" approach is generally targeted at transactions (or series of transactions) that generate tax-free profits while giving rise to tax-deductible costs, in such a manner that the net result before any tax consequences are taken into account is negative. The after-tax results of such transactions (or series of transactions) will be positive, because the profits realised are tax-exempt and the costs connected with the transactions (or series of transactions) are tax-deductible.

A number of court cases decided in the last few years have upheld this approach or a variation on it. These cases involved, in particular, taxpayers who had purchased put and call options with respect to shares. The taxpayers in these cases contended that the price they paid for the options was a tax-deductible cost, while the capital gains they realised on the disposal of the shares were tax exempt. As a consequence, the operations concerned produced a positive result when the tax advantages were taken into account (i.e., the tax deductibility of the costs and the exemption from tax of the gain realised on the shares), while producing a negative pre-tax result. The Belgian tax administration challenged these transactions and the Court of Cassation found for the tax administration, while stopping short of giving its explicit approval to the "cash-drain" approach. The theoretical basis for the "cash-drain" approach is Article 49 of the BITC. The decisions of the Court of Cassation indicate that it does not necessarily follow from the fact that a commercial company is a legal entity that is created with the aim of generating a commercial profit that all the costs incurred by it are tax-deductible. The decisions go on to state that the court was unable to see how the acquisition of options could be linked with the effective commercial activities carried on by the company, even if the by-laws of the company provided that the company could effectuate any financial operation directly or indirectly connected with its commercial purpose.

II. What are the pre-requisites for a transaction to be considered immune from challenge under Belgium's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

Please refer to the answers given in I., above.

III. What is the tax result of a determination that a transaction lacks economic substance?

Please refer to the answers given in I., above.

NOTES

[1] D. Garabedian, « « *Forme » et « substance » en droit fiscal belge - rapport belge au Congrès 2002 de l'International fiscal association », JDF, 2003, p. 193 et suiv. (traduction du texte original anglais publié dans lesCahiers de Droit fiscal international*, vol. LXXXVIIa, sujet A, « *Form and substance in tax law* », 2002, p. 153 et suiv.).

[2] See: W. Ganshof van der Meersch, "L'impôt et la loi", *En hommage à Victor Gothot*, 1962, pp. 257 *et seq.*; Th. Afschrift, *L'évitement licite de l'impôt et la réalité économique*, 1994, §§ 63-64; S. van Crombrugge, *De grondregels van het Belgisch fiscaal recht*, 5th ed., 1999, §§ 63-64.

[3] See, *e.g.*, Court of Cassation, Nov. 10, 1997, *Pas.*, 1997, I, no. 464.

[4] Court of Cassation, Oct. 24, 1938, *Pas.*, 1938, I, p. 331; Court of Cassation, May 28, 1942, *Pas.*, 1942, I, p. 134.

[5] Court of Cassation, Jan. 17, 1924, *Pas.*, 1924, I, p. 127; Court of Cassation, April 13, 1978, *A.C.*, 1978, p. 928. See generally: E. Krings, "Le problème des lacunes en droit fiscal" *in Le problème des lacunes en droit*, Travaux du Centre national de recherches de logique, 1968, pp. 463-469; Th. Afschrift, *op. cit.*, §§ 67-84; S. van Crombrugge, *op. cit.*, §§ 8-11.

[6] Belgian law is based on a civil law, as opposed to a common law, tradition. The principle that tax law is, as a rule, governed by private law is not embodied in a statute but is a settled court-based rule and is generally supported by scholars. See: Court of Cassation, July 9, 1931, *Pas.*, 1931, I, p. 886, and Court of Cassation, March 13, 1986, *Pas.*, 1986, I, p. 886; F. Dumon, "*Les impôts directs, l'Etat de droit et la Constitution*", *JDF*, 1984, p. 17; P. van Ommeslaghe, "*Droit commun et droit fiscal*", *JDF*, 1989, pp. 5 *et seq.*; Th. Afschrift, *op. cit.*, §§ 96-98; S. van Crombrugge, *op. cit.*, §§ 39-40 and 42.

[7] *Cf.*, *e.g.*, S. van Crombrugge, *op. cit.*, § 8.

[8] See, *e.g.*, the concept of "abnormal or gratuitous advantage" used in Belgian Income Tax Code 1992 (BITC), Art. 26.

[9] See Court of Cassation, Jan. 29, 1988, *A.C.*, 1987-88, no. 329. For the theory of "economic reality" and its condemnation by the Court of Cassation, see: J. Kirkpatrick, *Le régime fiscal des sociétés en Belgique*, 2nd ed., 1995, §§ 1.23-1.26; Th. Afschrift, *op. cit.*, §§ 127-157.

[10] See, *e.g.*, X. Dieux, "Tendances générales du droit contemporain des obligations – 'Réforme et contre-réforme' " *in Les obligations contractuelles*, Jeune Barreau Bruxelles, 2000, pp. 38-40, § 28.

[11] See D. Garabedian, "Bénéfice imposable et droit comptable", *RCJB*, 2000, pp. 539 *et seq.*, and esp. the literature cited in footnote 74, below.

[12] H. De Page, *Traité élémentaire de droit civil*, t. II, 3ème éd., 1964, p. 618, no. 618.

[13] P. van Ommeslaghe, "La simulation en droit des obligations" *in Les obligations contractuelles*, Jeune Barreau Bruxelles, 2000, pp. 153-154, § 9.

[14] *FJF*, no. 82/153.

[15] For comments on this case, see: J. Kirkpatrick, "Examen de jurisprudence - Les impôts sur les revenus et les sociétés", *RCJB*, 1984, pp. 703-704, § 21, and the literature cited; and Afschrift, *op. cit.*, §§ 195-198, who considers, however, that there is no sham but simply incorrect characterisation.

[16] See Court of Cassation, Jan. 4, 1991, *A.C.*, 1990-91, p. 466; Court of Cassation, May 19, 1995, *A.C.*, 1995, no. 247 and J. Kirkpatrick, "Le droit fiscal se fonde sur les réalités", *JPDF*, 1969, pp. 161 *et* seq.; Th. Afschrift, *op. cit.*, §§ 131-140.

[17] Cass. June 6, 1961, Pas., 1961, I, 1082.

[18] This situation should be distinguished from that in which the legal characterisation given by the parties is not incorrect but the contract is susceptible to being given another correct legal characterisation. In such a case, the legal characterisation given by the parties may not be disregarded unless the general anti-abuse provision applies.

[19] Court of Cassation, June 6, 1961, *Pas.*, 1961, I, p. 1082, and Court of Cassation, March 22, 1990, *Pas.*, 1990, I, p. 853 (free translation of French original).

[20] Of course, unless the general or a specific anti-avoidance provision applies. The general anti-avoidance provision is dealt with later in this paper.

[21] See, *e.g.*, Court of Cassation, March 5, 1999, *Pas.*, 1999, I, no. 133.

[22] See, *e.g.*, Court of Cassation, April 17, 1998, *Pas.*, 1998, I, no. 198; Court of Cassation, Jan. 28, 1999, *Pas.*, 1999, I, no. 52.

[23] See, *e.g.*, Court of Cassation, Jan. 4, 1991, *A.C.*, 1990-91, p. 466; Court of Cassation, Feb. 20, 1986, *Pas.*, 1986, I, p. 783.

[24] This and other examples are explained in more detail in J. Kirkpatrick and D. Garabedian, « Examen de jurisprudence (1991-2007) - Les impôts sur les revenus et les sociétés », *RCJB*, 2008, p. 283 to 285, n° 17, and page 291 to 293, n° 20.

[25] Other examples can be found in the Administrative Circular N° AFER 14/2008 dated June 2, 2008.

[26] *Pas*., I, no. 134; *JT*, 2000, p. 200, preceded by a study of J. Kirkpatrick, «*L'opposabilité au fisc des conventions illicites non simulées*», *JT*, 2000, p. 193 et suiv.; *TFR*, 1999, p. 616, note M. Ghyselen.

[27] *FJF* No. 2010/34. The Belgian courts have in the meantime applied this theory in a number of cases: Bruxelles, June 2, 2000, two rulings, discussed in *Fiscologue*, no. 768, p. 9; Bruxelles, June 8, 2000, *JDF*, 2001, p. 109; Gand, April 6, 2005, *TFR*, 2006, p. 39.

[28] See, in particular: J. Kirkpatrick, «L'opposabilité au fisc des conventions illicites non simulées», *JT*, 2000, p. 193.

[29] This interpretation of the *Brepols* and *Au Vieux Saint-Martin* rulings is defended by: S. van Crombrugge, « De fiscale aspecten van het gebruik van vennootschappen met rechtspersonlijkheid », in *De ik-vennootschap*, Biblo, 1987, p. 89, no. 88; idem, « Vennootschap met rechtspersoonlijkheid in het fiscaal recht », in *Rechtspersonenrecht*, Mys & Breesch, 1999, p. 309 et suiv., p. 318, spéc. No. 9 et note 29; idem, *De grondregels van het Belgisch fiscaal recht*, Biblo, 5ème éd., 2007, p. 47, no. 35. Voir également : S. Huysman, *Fiscale winst*, Biblo, 1994, no. s 433 et suiv.; M. Ghyselen, *Fiscale gevolgen van nietige rechtshandelingen*, Biblo, 1996, no. s 250 et suiv.; idem, « Schending van de wet in het kader van de keuze van de minst belaste weg », note sous Cassation, March 5, 1999, *TFR*, 1999, p. 618.

[30] B. Peeters, "De dunne lijn tussen belastingontwijking en belastingontduiking", *AFT* 2010, March 2010, 14.

[31] P. FAES ., *Het rechtsmisbruik in ficale zaken*, Ghent, Mys & Breesch, 1994 and P. FAES , *Het rechtsmisbruik in ficale zaken. Article 344 § 1 WIB – 15 jaar later*, Ghent, Larcier, 2008.

[32] Belgian Registration Code, Art. 18, § 2 and Belgian Inheritance Code, Art. 106, al. 2.

[33] Parliamentary Works of the Law of July 22, 1993 and report of the Senate Commission, *Doc. Parl.*, Belgian Senate, 1992-1993, no. 762-2, p. 37, and report of the Belgian Chamber of Representatives, *Doc. Parl.*, Chamber, 1992-1993, no. 1072-8.

[34] Report of the Senate Commission, p. 3 and report of the commission of the Chamber of Representatives, pp. 93 and 99.

[35] D. Garabedian, "*Le principe du choix licite de la voie la moins impose – un état des lieux*", in *L'évolution des principes généraux du droit fiscal. 20 anniversaire de la maîtrise en gestion fiscale.* Brussels, Larcier, 2009.

[36] L. de Broe, *International tax planning & prevention of abuse under domestic tax law, tax treaties & EC-law*, 2007, p. 187.

[37] See in this respect the ruling of the Court of Cassation dated Nov. 22, 2007, and the Circular Letter of the Belgian Registration Tax Authorities dated Dec. 18, 1995, RGEN, 1996, no. 24.563.

[38] This can be compared with the "step transaction" or "step-by-step" doctrine developed by the House of Lords in *Craven v. White* (three cases) [1988] S.T.C. 476 (H.L.): "a series of transactions [that] was preordained to produce a given result."

[39] D. Garabedian, "Forme et substance en droit fiscal belge", *Rapport belge au congrès 2002 de l'IFA,* JDF, 2003, p. 7.

[40] D. Garabedian, "Le principe du choix licite de la voie la moins imposée – Un état des lieux", in *L'évolution des principes généraux du droit fiscal,* Larcier, p. 16 ; T. Wustenberghs, « Registratierechten : antimisbruikbepaling in (inter)nationale context », *TFR*, 2005, p. 214 ; C. Cheruy et C . Laurent, *Le régime fiscal des sociétés holdings en Belgique*, Larcier, 2008, p. 75-76 ; L. De Broe, *International Tax Planning and Prevention of Abuse,* IBFD, Doctoral Series, 2008, p. 172 to 176, nrs. 91 to 93.

[41] B. Peeters, " De dunne lijn tussen belastingontwijking en belastingontduiking?", *A.F.T.* 2010, 3, p. 25.

[42] B. Peeters, "De dunne lijn tussen belastingontwijking en belastingontduiking?" , *A.F.T.* 2010, 3, p. 25.

[43] Doc. Parl., Chambre, 1992-93, no. 1072/8, p. 42.

[44] Ghent, 13 September 2005, *F.J.F.*, no. 2006/79 and *T.F.R.* 2006, p. 157.

[45] Cass. 22 November 2007, *T.B.O.* 2008, 67-72, note.

[46] J. Kirkpatrick and D. Garabedian, "Examen de jurisprudence (1991-2007) – Les impôts sur les revenues et les sociétés", *R.C.J.B.* 2008, p. 320, no. 31, and note 75 for different opinions.

[47] Mons, June 21, 2002 and Mons, March 31, 2004, www. fisconet. fgov.be

[48] Mons, Sept. 5, 2003, *JLMB,* 2005, p. 129.

[49] J. Kirkpatrick and D. Garabedian, "Examen de jurisprudence (1991-2007) – Les impôts sur les revenues et les sociétés", *R.C.J.B.* 2008, p. 321 to 323, no. 32.

[50] J. Kirkpatrick and D. Garabedian, "Examen de jurisprudence (1991-2007) – Les impôts sur les revenues et les sociétés", *R.C.J.B.* 2008, p. 320 to 321, no. 31.

[51] Court of Leuven, Dec. 23, 2005, reviewed in *Cour. Fisc.* 2006, p. 531

[52] Antwerp, April 17, 2007, *FJF,* no. 2007/226, confirming Court of Antwerp, March 6, 2006, reviewed in *Cour. Fisc*. -, 2006, p. 749.

[53] Antwerp, Feb. 19, 2008, reviewed in *Cour. Fisc.* 2008, 429.

[54] Antwerp, March 18, 2008, reviewed in *Cour. Fisc.*, 2008, p. 451.

[55] Court of Bruges, March 4, 2008, reviewed in *Cour Fisc.*, 2008, p. 451.

[56] Council Directive of July 23, 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (90/434/EEC) (hereinafter: the Merger Directive), amended by the Council Directive 2005/19/EC of Feb. 17, 2005 (2005/19/EC). A statute of Dec. 11, 2008 implemented the EC Merger Directive into Belgian law, so that cross-border reorganisations can also be effected in a tax neutral manner.

[57] EC Merger Directive, Article 11, 1, a).

[58] The Court of Cassation ruled on Dec. 13, 2007 (Cass. Dec. 13, 2007, *F.J.F.*, no. 2008/285, *T.F.R.* 2008, 340, 404-17, note J. Verstraelen) that this former provision had to be interpreted in line with the EC Merger Directive and the jurisprudence of the ECJ (case C-28/95, *Leur Bloem)*. According to certain commentators, this implied that the replacement of this provision by a provision based literally on the Merger Directive was not indispensable (D. Garabedian, "Nieuwe 'antimisbruikbepaling': nauwelijks wijzigingen ten gronde", *Fiscologue,* ed. 1132, Oct. 8, 2008, 1-4).

[59] A draft-advice is published on the site of the Governmental Service for Preliminary Decisions with respect to how the ruling commission interprets the anti-abuse provision.

[60] ECJ, July 5, 2007, Case C-321/05, *Kofoed*.

[61] See, to that effect, also Case C212/97 *Centros* [1999] ECR I-1459, paragraph 24; Case C255/02 *Halifax and Others* [2006] ECR I-1609, paras. 68 and 69; Case C456/04 *Agip Petroli* [2006] ECR I-3395, paras. 19 and 20; and Case C196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* [2006] ECR I-7995, para. 35.

[62] Opinion Advocate General J. Kokott, July 16, 2009, case C-352/08, *Modehuis A. Zwijnenburg BV*, nrs. 45, 47, 60-69.

[63] BITC, Arts. 207, para. 3 and 292*bis*, par. 2.

[64] H. Verstraete, "Aftrek beroepskosten door vennootschappen", *Fiscoloog Tribune*, Biblo, Oct. 21, 2004, 26 p.; H. Verstraete, "Cash drain: fiscaal aftrekbare beroepskosten?", *RABG* 2003, 1028-1032.

[65] See, *inter alia*, Tax Regulation no. Ci.RH.840/592.613 (AFER 14/2008), dated April 3, 2008, point 21, with reference to case law Luik, Sept. 22, 1999, *FJF*, nr. 2000/50. Bergen, May 25, 2001, *FJF*, nr. 2001/286.

Host Country BRAZIL

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I. Will the Brazilian tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Brazilian law, despite its lack of economic substance?

Historically, like a number of other civil law countries, Brazil has generally adopted a fairly formal approach when dealing with tax planning. To some extent, this policy derives from the principle of legality, according to which no person is to be required to or prevented from doing something unless provided by law (Article 5, Item II of the Brazilian Constitution,).

Nonetheless, because of the increasing sophistication of business transactions on the one hand, and the Government's need to grow tax revenues to finance burgeoning public expenses on the other, it is possible to detect a significant move towards the "substance over form" approach over the last few decades.

This trend is attested to more clearly in decisions issued in recent years by the Administrative Tax Courts (as opposed to the Judicial Courts). As these courts (which are charged with reviewing tax assessments issued by the Federal, State and Municipal tax authorities) are composed of individuals equally appointed by the Government and taxpayers' associations, their decisions have traditionally been reliable guidelines as to whether or not a particular transaction should be deemed valid.

Based on these more recent administrative precedents, transactions carried out without a reasonable economic substance or business purpose, even if in compliance with the applicable law, bear a significant risk of being challenged by the tax authorities. Furthermore, such transactions are sometimes even regarded as constituting tax fraud or sham transactions and are consequently subject to qualified penalties (at the Federal level, tax assessments are issued with a penalty equal to 75 percent penalty of the tax owed, which may be increased to 150 percent in cases involving tax fraud, tax evasion or tax collusion).[1] The line of reasoning underlying these decisions is well described in these words of scholar Marco Aurélio Greco, an author commonly quoted in the relevant administrative precedents:

> In summary, there is no doubt that the taxpayer has the right, set forth in the Federal Constitution, of organising his life in the way he sees fit. However, the exercise of this right requires the existence of true causes for his actions. Organisation of one's life with the sole intent of paying less tax is an abuse of rights. As such, the tax authorities may, if proof is provided that such transaction was performed with the sole intent of not paying taxes, disregard a transaction for tax purposes, analysing the concrete situation as if such transaction had never occurred. The burden of proof that the transaction was performed with this sole intent is not on the taxpayer, but on the tax authorities (. . .)[2]

One of the first decisions in this context involved the spin-off of a legal entity into eight affiliates in order to allow each of them to elect for the presumed profit regime (a simpler and usually privileged regime in comparison to the real profit regime, which is restricted to companies with gross revenues below a given limit). The deeds effecting the corporate spin-off even acknowledged that one of the purposes of the transaction was to allow election for the presumed profit regime. The Federal Administrative Tax Court (formerly *Conselho de Contribuintes*, recently renamed *Conselho Administrativo de Recursos Fiscais* (CARF)) considered the transaction to constitute tax evasion and disregarded its fiscal effects on the grounds that the eight legal entities derived from the spin-off were actually just one (the spun-off company), despite the fact that the spin-off procedure itself complied with all legal requirements, as indicated by the Opinion of the Reporting Administrative Judge:[3]

> Hence, it seems to me that there is no legal or logical possibility of a legal entity being constituted with the declared sole objective of obtaining tax gains, despite the right of the partners to freely decide on the best structure to be adopted from a tax perspective, which is a completely different matter.
>
> Indeed, one thing is creating an entity with the ultimate goal of avoiding taxation and another very different thing is to create a partnership which, as an ancillary matter, does not require the payment of higher taxes.
>
> Entities or partnerships must be created to pursue their declared subject matters/objectives.
>
> In the present case of eight identical twins having been given birth to by the partners of the appellant, it is absolutely clear (in fact, confessed) that, notwithstanding the fact that its subject matter includes the resale of the appellant's products, the entire reason for their existence was a disguise. Perhaps disguise is not even the correct word, since there was no effort to conceal the truth.

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In reality, the creation of the eight entities is a clear simulated transaction, with the confessed intent of deceiving the tax authorities.

An interesting aspect of this case is that the taxpayer challenged the administrative level decision before the Judicial Courts, which upheld the administrative level decision (the final judicial decision was handed down by the now defunct Federal Court of Appeal *Tribunal Federal de Recursos*).[4] The following is an extract from the reporting Judge's position on the matter:

President, there is no doubt that "tax avoidance", as some call it, is not prohibited by Law. The taxpayer may adopt the structure that reduces or even completely avoids taxation. This is permitted by law. In this case, however, there was much more; a gigantic fraud was structured. Eight fake entities, which, in reality, only existed in documents, with the sole purpose of reducing taxation.

The mother entity sold to another of the entities at a reduced price and therefore reduced its taxable revenue, while the other eight entities remained subject to a privileged tax regime.

Another, somewhat controversial tax planning device is known as a "cash spin-off" (*"cisão de caixa"*). In Brazil, because gains from an increase in the net equity of a corporation may be accrued according to the "pick-up method" by its shareholders without triggering taxation, the following transaction became very common in the context of corporate acquisitions:

1. The investor (A) would enter into an association agreement with the shareholder (B) of the target company (C), whereby A would increase the capital of C by paying a goodwill premium on the share price. B would thus accrue a non-taxable pick-up gain on its investment in C.

2. Subsequently (sometimes within a few hours of the capital increase), A and B would cause the spin-off of C, whereby B would receive the cash and A would receive the shares of C.

CARF used to consider this structure valid on the grounds that taxpayers have the right to organise their transactions in the most tax-efficient way, provided all the legal requirements are met.[5] However, more recent decisions have reviewed this position and have begun to support tax assessments that deem a cash spin-off to be a sale disguised by an association to circumvent the taxation of the gains derived by the seller.[6] There have even been cases in which such transactions were regarded as sham transactions, causing the relevant tax assessments to be issued with a penalty of 150 percent of the principal tax amount.

This sudden change in the criteria for evaluating tax planning, from a very formal approach to one of substance over form, left taxpayers in a peculiar position. As the statute of limitation for tax matters in Brazil is five years[7] from the triggering event, some transactions that were executed when CARF regarded them as valid later came to be challenged and subject to the imposition of the qualified penalties referred to above. In other words, taxpayers that had relied on administrative precedents to use certain tax planning structures now found themselves in the position of having to defend themselves against charges of tax evasion.

With regard to the legislation, the first statutory provision representing a step towards a substance over form approach was Article 51 of Law no. 7,450 of December 23, 1985. This provision authorised the tax authorities to disregard the legal form of a transaction and to take into account its ultimate result and the intent of the taxpayer in determining its tax consequences.

Article 51 of Law no. 7,450 was strongly opposed by the large majority of tax experts who felt that it violated the constitutional principle of legality referred to above and, in any event, that in accordance with its terms it should only apply to financial transactions, and not as a general principle of tax law.

Several years later, as part of a new attempt to combat tax planning, Congress approved Supplementary Law (LC) no. 104, of January 10, 2001. This added a new paragraph to Article 116 of the National Tax Code (CTN)[8] authorising the tax administration to disregard formal acts engaged in or contracts entered into by taxpayers with the intent of disguising the occurrence of a taxable event or the nature of any elements of their tax obligation, with due regard for the procedural rules to be set forth by law. The new provision was welcome by the Revenue Service as Brazil's most important anti-avoidance provision. The requisite procedural rules were enacted by Articles 13 through 19 of Provisional Decree (MP) n. 66, of August 29, 2002.

Pursuant to Article 13 of MP no. 66/02, its provisions did not apply to acts engaged in or contracts entered into in willful misconduct, fraud or simulation. For purposes of disregarding acts or contracts, the tax administration could take into account, among other features, a lack of business purpose or an abuse of form. The adoption by the parties of a more complex form for a transaction would be indicative of a lack of business purpose; abuse of form would occur whenever the taxpayer obtained in an indirect way, the same economic result at it would have under the disguised act or contract.

The new Civil Code,[9] which became effective as of January 10, 2003, adopted the doctrine of the disregarding of acts or contracts (which until then had been restricted in its application to product liability law and had very few judicial precedents in civil and commercial cases), and the concepts of *abus de droit* and *fraus legis*, which now are being argued by the tax authorities in addition to simulation.[10]

However, Articles 13 through 19 of MP n. 66/02 were formally rejected by Congress and the anti-avoidance provision of LC no. 104/01 is still ineffective due to the lack of a regulation. Nevertheless, several recent tax assessments have relied on the provision.

Despite the rejection of these articles, in practice, as has already been shown, the tax authorities are now applying the common law concepts (standards, tests) of "business purpose," "the disregarding of acts or contracts," "step transactions" and "sham transactions," as well as the civil law concepts of *fraus legis*, simulation and abuse of form (and *abus de droit*).

Indeed, many scholars expressly defend the position that Article 116, sole paragraph of the CTN is fully applicable and does not require any further regulation. The position adopted by Douglas Yamashita is illustrative: "Therefore, (. . .) Article 116, sole paragraph, CTN, is currently applicable (. . .) and any subsequent legislation will only create a more specific procedure."[11]

Though he does not clearly address the statutory rules referred to above, Justice Castro Meira of the Superior Court of Justice (the highest Brazilian court for non-constitutional matters), in analysing Writ of Mandamus n. 15.166 - BA (2002 0094265-7) clearly states that the tax authorities have always (and, therefore, regardless of the legal authorisation described above) been allowed to disregard mere tax avoidance measures adopted by the taxpayer:

> For some time now, the dominant doctrine has admitted that the Tax Administration proceeds with what is referred to as the economic interpretation of the tax assessment, in order to disconstitute/disregard the legal form of business transactions or acts performed with the objective of tax evasion. (. . .)
>
> There is no doubt that the tax administration (. . .) has always been able to disregard acts or transactions performed by the taxpayer in order to dissimulate the occurrence of the tax triggering event.

II. What are the pre-requisites for a transaction to be considered immune from challenge under Brazil's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

Under the new approach adopted by tax authorities, described in I., above, one can safely say that only a very few transactions would be considered "immune from challenge" in Brazil. In fact, only very straightforward transactions with no tax-driven elements can be regarded as falling into this category. Nonetheless, in the case of transactions that are in compliance with the law and have a clear business purpose and economic substance there would only be a remote risk of their being successfully challenged, even if they were carried out in a tax-efficient manner. Conversely, a purely tax-motivated transaction would have a high risk of being declared abusive.

A substantive economic effect or an expectation of pre-tax profit is not essential to validate a transaction, although the presence of such features would be powerful evidence of the business purpose of the transaction. There are several other objectives that do not necessarily have a direct economic effect but are usually raised by taxpayers and taken into consideration by judicial and administrative tax courts to demonstrate the substance of a transaction, such as synergy, market share, logistics improvement, systems optimisation, etc.

There is no rule of thumb for determining whether a transaction has enough business and/or economic purpose to succeed in a substance over form test. In fact, recent and very comprehensive research coordinated by Luís Eduardo Schoueri and organised by Rodrigo de Freitas[12] reviewed the decisions issued by the CARF from 2002 to 2008 in an attempt to identify the criteria used by that tax court to rule on matters involving tax planning.

An interesting finding of the study is that the members of CARF do not apply concepts such as abuse of law, fraud of law, indirect transaction, and simulation, and other concepts uniformly. In some cases they use the same concept to identify different situations and in others they use different concepts to characterise similar situations. The study was also able to outline some of the factors that repeatedly led the members of CARF to decide against taxpayers:

- Transactions that apart from the tax benefits obtained would have no justification for their implementation (lack of business purpose);
- Facts described by the taxpayer that apparently did not correspond to reality (simulation); and
- Transactions that were against the law (fraud of law).

The study concluded that, at the beginning of the analysed period, simulation was the most commonly used criterion but, from a certain undeterminable moment onward, a lack of business purpose began to be the predominant criterion.

III. What is the tax result of a determination that a transaction lacks economic substance?

In Brazil, whenever the tax authorities succeed in demonstrating that a particular transaction lacks economic substance, the consequence is the reclassification of the transaction's tax effects. In other words, unless there is a fraud of law, in which case the transaction itself is disregarded, the transaction remains valid for all other purposes but its tax consequences are disregarded.

For example, in the tax planning scheme involving the presumed profit regime described in I., above, the eight companies were treated as one for tax purposes, but the spin-off remained valid and the companies remained segregated for all other purposes. Likewise, even when a "cash spin-off" is treated as a pure sale of shares for tax purposes, for corporate purposes the association and the subsequent spin-off remain valid. Indeed, precedents on the matter usually indicate quite clearly that the effects of a decision only apply for tax purposes, as is demonstrated by the wording of Decision 103-20754, of October 17, 2001, of CARF:

> Since it has been verified that the contracts were entered into by the taxpayer in order to hide the true nature of another transaction, the *tax consequences* of said contracts must be disregarded (. . .)." (Emphasis added.) (Speaking for the Court Victor Luís de Salles Freire, Published on 12.12.2001).

In complex structures, involving a series of transactions, the tax consequences (whether gains or losses) of those transactions that are not regarded as lacking economic substance are usually preserved.

NOTES

[1] These concepts are defined by Brazilian Law as follows:

- Tax evasion: willful misconduct intending to avoid or postpone, totally or partially, the identification by the tax authority of a tax obligation triggering event.
- Tax fraud: willful misconduct, action or omission intending to avoid or postpone, totally or partially, an event triggering a future tax obligation.
- Collusion: unlawful agreement between two or more individuals or legal entities in order to cause any of the effects of tax evasion or tax fraud.

[2] "Tax Planning and Abuse of Law " in "Income Tax Studies," Ed. Tax Digest, São Paulo, 2004, p. 105.

[3] Decision no. 103-05.942, of Dec. 12, 1983.

[4] Appeal n. 115.478-RS.

[5] For instance, Decision no. 106-09.343 of Sept. 1, 1997.

[6] For instance, Decisions no. 103-21226 and 103-21227 both of May 13, 2003 and Decision 104-21.498, of March 23, 2006.

[7] Except in some specific circumstances.

[8] Law no. 5,172, of Oct. 25, 1966.

[9] Law no. 10,406, of Jan. 10, 2002.

[10] Pursuant to the new Civil Code, there will be simulation when a legal act: 1. seems to assign or transfer rights to persons other than those to whom the rights are actually assigned or transferred; 2. contains a false statement, confession, condition or clause; or 3. is predated or postdated.

[11] "Tax Avoidance and Evasion," Sao Paulo, Lex Editora, 2005, p. 153.

[12] "Tax Planning and the "Business Purpose" – São Paulo: Quartier Latin, 2010.

Host Country
CANADA

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I. Will the Canadian tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Canadian law, despite its lack of economic substance?

Subject to specific anti-avoidance provisions in the Income Tax Act (the "Act") and subject to the applicability of the general anti-avoidance rule (GAAR), the jurisprudence[1] supports the notion that a transaction is legally effective if the proper and necessary legal steps are taken to create the rights and obligations that the taxpayer purports to create, unless the transaction is a sham. Once the transaction is determined to be legally effective, its results (including the tax consequences) generally should not be disturbed. In particular, the Supreme Court of Canada has distanced itself from any *economic* substance over legal form doctrine.[2]

The tenet that a taxpayer can minimise his or her taxes by way of entering into particular types of transactions – that is, form over substance – is most famously associated in Anglo-Canadian tax lore with what is known as "the *Duke of Westminster* principle." This principle is expressed concisely in Lord Tomlin's statement from the famous case: "[e]very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be."[3] It is worth noting that, while the *Duke of Westminster* principle permits legal form to prevail over substance, the principle was never meant to be entirely unqualified. While the *Duke of Westminster* principle stands for the rejection of substance over form, the case nonetheless can also be read as an affirmation of other earlier judicial pronouncements that the courts may disregard the legal terminology used by the parties to a contract in situations where the results created thereby differ from the legal rights and obligations the parties intended to create. In other words, at least in the income tax context, the Canadian courts have accepted that the *legal* substance of a transaction prevails over the nomenclature used by the parties, but they have rejected the more expansive doctrine of *economic* or commercial substance over form.[4]

In addition, Canadian jurisprudence has generally interpreted the sham doctrine narrowly. The Supreme Court of Canada has defined "sham" as "acts done or documents executed by parties to the 'sham' which are intended by them to give third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations which parties intend to create."[5]

Somewhat similarly, the ineffective transactions doctrine is based on the doctrine of legal substance over form or nomenclature. If a taxpayer attempts to set up a particular structure to avoid taxation but fails to follow all of the necessary formalities through which specific relationships are established in law, the transaction sought by the taxpayer will be ineffective and tax will be assessed based on what the taxpayer actually did instead of what was attempted.[6] As one recent Tax Court decision held here, "[r]egardless of the parties' intention, the tax consequences must apply to the facts as they actually were. This principle arises out of numerous decisions by our courts."[7]

Beyond these subsets of the *legal* substance over form doctrine, however, the Supreme Court of Canada has refused to give effect to a judicial doctrine of *economic* substance over legal form. In 1984, the Supreme Court of Canada in *Stubart Investments Ltd. v. The Queen*[8] rejected the validity of a "business purpose test" as a judicial anti-avoidance doctrine. In *Stubart*, the taxpayer had transferred its profitable business to a sister corporation with accumulated losses. The sole reason for the transfer was to combine the profits and losses in order to enable the taxpayer to minimise its taxes through the utilisation of the sister company's tax losses. The Supreme Court was asked whether the taxpayer's arrangement was invalid on the basis that it lacked a business purpose. Estey J., writing for the Supreme Court held that no business purpose was necessary:

> I . . .reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or *bona fide* business purpose. A strict business test in certain circumstances would run counter to the apparent legislative intent which, in modern taxing

statutes, may have a dual aspect. Income tax legislation, such as the Federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus, the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the taxpayer for whom the induced action would otherwise have no *bona fide* business purpose. Thus, by imposing a positive requirement that there be such a *bona fide* business purpose, a taxpayer might be barred from undertaking the very activity Parliament wishes to encourage. At minimum, a business purpose requirement might inhibit the taxpayer from undertaking the specified activity which Parliament has invited in order to attain economic and perhaps social policy goals.[9]

In addition to its rejection of a business purpose test, the Supreme Court in *Stubart* also broke with a literalist approach to the interpretation of the Act. The Act was to be interpreted in accordance with the "modern" approach to statutory interpretation which involves examining a statutory provision's text, context, and purpose, as with other types of legislation. Nevertheless, three years after *Stubart*, the federal government released a White Paper outlining a number of tax reforms and proposing, *inter alia*, the enactment of a new general anti-avoidance rule in order to combat tax avoidance schemes. The 1987 White Paper provoked a great deal of critical attention and commentary, which prompted a number of amendments to the proposal. The new provision, section 245 of the Act, came into effect on September 13, 1988.[10]

The Supreme Court of Canada reaffirmed that legal substance prevails over economic form in *Shell*. Justice McLachlin (as she was then) stated:

[T]his Court has never held that the economic realities of a situation can be used to recharacterise a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. . . [I]t is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. . . Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.[11]

In other words, the Supreme Court appeared to be stating that it would be inappropriate to inquire into the "economic realities" of a situation, instead of applying the Act's clear and unambiguous provisions to the taxpayer's transactions, and that courts must consider what taxpayers did – not what they could have done – regardless of the advantageous tax consequences of one course of action versus another. According to McLachlin J. in *Shell*, "in the absence of a specific statutory bar to the contrary, taxpayers are entitled to structure their affairs in a manner that reduces the tax payable . . . An unrestricted application of an 'economic effects' approach does indirectly what this Court has consistently held. Parliament did not intend the Act to do directly."[12] Following *Shell*, the Canadian courts have consistently rejected a party's reliance upon economic substance over form in interpreting the Act.[13]

As the Supreme Court explained in *Canada Trustco Mortgage Co. v. Canada*,[14] its first (and much anticipated) GAAR decision released in 2005, as a result of the *Duke of Westminster* principle, Canadian tax legislation received a strict interpretation by the courts in an era of a more literal statutory interpretation than is now the case. Moreover, the particularity of many of the tax provisions in the Act has often led to an emphasis on textual interpretation of the statute. "Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe."[15] The Court continued, noting that the Act remains a statute dominated by explicit provisions which provide for specific consequences for specific transactions, thereby inviting what is largely a textual interpretation. However, it also noted that Parliament has chosen to add a very different sort of provision to the Act. The GAAR is a provision with broad application, and it has been drafted in such a way as to allow for the recharacterisation of transactions that would otherwise be permissible under a literal interpretation of other provisions of the Act on the grounds that they amount to abusive tax avoidance.[16] Accordingly, "[t]o the extent that the GAAR constitutes a 'provision to the contrary' as discussed in *Shell*, *the Duke of Westminster principle and the emphasis on textual interpretation may be attenuated*." As the Supreme Court affirmed in *Shell*, "[t]he courts' role is to interpret and apply the Act as it was adopted by Parliament. The court must to the extent possible, contemporaneously give effect to both the GAAR and the other provisions of the *Income Tax Act* relevant to a particular transaction."[17]

Notwithstanding the tradition of a literalist approach to the interpretation of the Act in Canada based on the *Duke of Westminster* principle, by the time the Supreme Court came to interpret the GAAR in *Canada Trustco*, the principles of statutory interpretation had evolved, albeit in an uneven and nonlinear fashion.[18] The modern approach to the interpretation of the Act was restated in *Canada Trustco* by McLachlin C.J. and Major J., writing for an unanimous Supreme Court:

It has been long established as a matter of statutory interpretation that "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament": see *65302 British Columbia Ltd. v. Canada*, [1999] 3 S.C.R. 804, at para. 50. The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole.[19]

The Supreme Court added that, "[w]hen the words of a provision are precise and unequivocal, the ordinary meaning of the words play[s] a dominant role in the interpretive process."

However, where the words of the statute can be read as supporting more than one reasonable understanding, the ordinary meaning of the words plays a reduced role. In all cases, a court seeking to interpret the provisions of the Act must read the tax statute as a harmonious whole and interpret it in a textual, contextual and purposive way.[20]

Despite what has been a fairly clear rejection of an economic substance doctrine, the Canadian tax authorities have challenged and continue to challenge transactions where the legal result offends their view of the policy underlying the provisions of the Act.

II. What are the pre-requisites for a transaction to be considered immune from challenge under Canada's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

A. Must there be a realistic expectation of pre-tax profit?

Before contemplating the pre-requisites for a transaction to be immune from challenge under various economic substance or anti-abuse rules or doctrines, it is worth mentioning an unenacted legislative proposal to add section 3.1 to the Act, requiring a taxpayer to have a reasonable expectation of a "cumulative profit" before being allowed to deduct a loss for a taxation year on account of a business or property.[21] Proposed section 3.1 was introduced in October 2003 as a response to the Supreme Court of Canada's decisions in three particular cases, with the stated aim of restoring prior *status quo*.[22]

However, the provision as proposed goes well beyond restoring the prior law and related administrative practices to their prior state, as understood by the Canada Revenue Agency (CRA) and Department of Finance. Not surprisingly, concerns were raised immediately about the scope of the new provision and the Department of Finance received many submissions about the proposal. Although the Department of Finance had announced (in 2005) that, in response to these submissions, it would reintroduce a more modest version of the provision, further refinements do not appear to have been a priority of the Department and no amended provision has been made public.[23]

Finally here, although there is no specific rule in the Act requiring a realistic expectation of pre-tax profit with regards to a taxpayer's business income,[24] in evaluating a taxpayer's claimed deduction, a court will still need to determine if the expenses asserted are precluded from deduction under sub-section 18(1) of the Act.[25] If not, the deduction for the expenses will be allowed, but only to the extent that they are "reasonable in the circumstances" as is required under section 67 of the Act.[26]

B. Is a subjective business purpose/motivation (as contrasted with a tax motivation) necessary? Must there be a "substantive economic effect" as a result of implementing the plan? Are there other factors that host country would take into account in evaluating the substance of the transaction?

No transaction can ever be said to be completely "immune from challenge;" however, in order to avoid the scrutiny of the Canadian revenue authorities, the principal statutory provision that taxpayers should consider is the GAAR, found in section 245 of the Act. As one author has stated here, "[i]n effect, GAAR is a statutory business type purpose test that looks through all of the steps of a transaction or series of transactions."[27] (The Act is also replete with specific anti-avoidance rules designed to target particular types of situations and forms of transactions in order to further assorted policy objectives that lie behind the tax statute's provisions, with many of these specific rules containing economic or commercial substance requirements of their own.[28]) As explained in greater detail below, the courts have held that a taxpayer's purpose or motivation for entering into the transactions at issue must be assessed objectively under the GAAR, not subjectively. And while a "substantive economic effect" is not mandated in the Act or the jurisprudence, the achievement of a desirable tax result may be a significant factor in a court's determination of whether the taxpayer's transaction frustrates the object, spirit and purpose of the relevant statutory provisions, although other factors may also be taken into account.

If applicable, the GAAR can result in the recharacterisation by the CRA of a transaction or series of transactions with consequences different from those otherwise applicable under the Act. In particular, the GAAR may allow the CRA to recharacterise a transaction or series of transactions to deny a "tax benefit" if the transaction or any transaction in the series is an "avoidance transaction" that is considered abusive. "Tax benefit" is defined as "a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty."[29] "Avoidance transaction" is defined to include any transaction, including a transaction that is part of a series of transactions, that results, directly or indirectly, in a tax benefit unless the transaction or series of transactions may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes, other than to obtain the tax benefit.[30] Thus, in order to be considered an avoidance transaction, a transaction or series must result in a tax benefit, as defined above, and which is generally considered to mean the realisation of Canadian tax savings relative to a particular benchmark.[31]

The meaning of "series of transactions" is extended by sub-section 248(10) of the Act to include "related transactions or events completed in contemplation of the series." In an earlier case, the Federal Court of Appeal had held that this occurs where the parties to the transaction "knew of the . . . series, such that it could be said that they took it into account when deciding to complete the transaction."[32] In *Canada Trustco*, the Supreme Court elaborated upon this interpretation, stating that "in contemplation" is to be "read not in the sense of actual knowledge but in the broader sense of 'because of' or 'in relation to' the series. Thus, a 'series of transactions' may take place, in part or in whole, before or after the basic avoidance transaction described in subsection 245(3)."[33]

Notwithstanding the existence of a tax benefit and an avoidance transaction, however, the GAAR only applies if it may reasonably be considered that the transaction or series of transactions would result directly or indirectly in a misuse of any one of the provisions of the Act, the Income Tax Regulations, the Income Tax Application Rules, a tax treaty, or any other enactment that is relevant in computing tax or any other amount payable or refundable under the Act, or would result directly or indirectly in an abuse having regard to those provisions, read as a whole.[34] This third step in the GAAR analysis is discussed in greater detail below.

Since the release of the Supreme Court's judgments in *Canada Trustco* and *Mathew*,[35] the Tax Court of Canada and the Federal Court of Appeal have considered the Supreme Court's approach to the GAAR in a number of cases.[36] For example, the case law has established that sub-section 245(3) requires that the primary purpose of each transaction in a series of transactions be considered separately. The fact that a series of transactions, as a whole, may be considered to have been undertaken primarily for *bona fide* non-tax purposes does not necessarily mean that each step in the series has such a purpose. As indicated by Sharlow J.A. in *MacKay v. The Queen*:[37] "If the primary purpose of the entire series is to obtain a tax benefit, then the entire series is an avoidance transaction. However, the converse is not necessarily true. The existence of a *bona fide* non-tax purpose for a series of transactions does not exclude the possibility that the primary purpose of one or more transactions *within the series* is to obtain a tax benefit."[38] It is therefore necessary to consider the primary purpose of each transaction or step in a series of transactions separately.

The Supreme Court in *Canada Trustco* also made a number of key observations relating to the primary non-tax purpose test in sub-section 245(3), which are summarised below:

- This requirement involves a "factual inquiry" in which "[t]he Tax Court judge must weigh the evidence to determine whether it is reasonable to conclude that the transaction was not undertaken or arranged primarily for a non-tax purpose".[39] In this respect, "[i]f there are both tax and non-tax purposes to a transaction, it must be determined whether it was reasonable to conclude that the non-tax purpose was primary. If so, the GAAR cannot apply to deny the tax benefit."[40]
- The words "reasonably" and "primarily" in sub-section 245(3) dictate "an objective assessment of the relative importance of the driving forces of the transaction."[41]
- It "will not suffice" that some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes.

The Court summed up its views by asserting that "Parliament did not intend section 245(3) to operate simply as a business purpose test, which would have considered transactions that lacked an independent *bona fide* business purpose to be invalid." Significantly, the Court added that the expression "non-tax purpose" in sub-section 245(3) connotes a broader scope than the expression "business purpose:" transactions, for example, that may reasonably be regarded to have been undertaken primarily for family or investment purposes should, therefore, be immune from the application of the GAAR.[42]

The case law following *Canada Trustco* has not definitively resolved whether the reason *why* the taxpayer engaged in the transaction at issue is more significant than *how* it did so (*i.e.*, the manner in which the transaction was implemented) for the purposes of subsection 245(3). In particular, it is not yet clear how the Federal Court of Appeal's statements with respect to avoidance transactions in *MacKay*[43] will be reconciled with the *dicta* of other cases that emphasise that the "how" of a transaction is subordinate to the "why."[44]

In one early post-*Canada Trustco* case, the Tax Court held that the taxpayer had a non-tax *purpose*, but that the *method* he had chosen to accomplish this purpose resulted in a lower tax cost than an alternative method.[45] The Court added that the Crown was effectively arguing for a recharacterisation of the taxpayer's transactions. Quoting from the Department of Finance's Explanatory Notes on subsection 245(3), the Court stated that the provision "does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes."[46] In a more recent decision, the Tax Court similarly concluded that the transaction at issue in the case ensured the taxpayer's financial security, a *bona fide* non-tax purpose: "This is the 'why' for each transaction in the series. The 'how' of the series was the implementation of a complex plan formulated by Appellant's Canadian tax counsel."[47] Later in its judgment, the Tax Court made the point explicitly: "one of the 'driving forces' of the transactions was the Appellant's desire to ensure the sale of its shares in a tax effective manner. I conclude, however, that the 'how' is subordinate to the 'why' of the sale."[48]

Despite a taxpayer's ability to avoid the application of the GAAR by demonstrating a primary non-tax purpose under sub-section 245(3), most of the legal battles over the GAAR's application have arisen over the "saving" provision in sub-section 245(4) – the third step in the GAAR analysis. Indeed, in many recent cases, the taxpayer has conceded the existence of a tax benefit and that the transactions at issue amounted to avoidance transactions, so the only issue is whether the avoidance transactions constituted abusive tax avoidance.[49]

In *Canada Trustco*, the Supreme Court analysed abusive tax avoidance in the context of sub-section 245(4) as follows:

> The heart of the analysis under subsection 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the application of the properly interpreted provisions to the facts of a given case. The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit, and purpose. The next task is to determine whether the transaction falls within or frustrates that purpose. The overall inquiry thus involves a mixed question of fact and law. The textual, contextual and purposive interpretation of specific provisions of the *Income Tax Act* is essentially a question of law but the application of these provisions to the facts of a case is necessarily fact-intensive.
>
> This analysis will lead to a finding of abusive tax avoidance when a taxpayer relies on specific provisions of the *Income Tax Act* in order to achieve an outcome that those provisions seek to prevent. As well, abusive tax avoidance will occur when a transaction defeats the underlying rationale of the provisions that are relied upon. An abuse may also result from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions. By contrast, abuse is not established where it is reasonable to conclude that an avoidance transaction under subsection 245(3) was within the object, spirit or purpose of the provisions that confer the benefit.
>
> Once the provisions of the *Income Tax Act* are properly interpreted, it is a question of fact for the Tax Court judge whether the Minister, in denying the tax benefit, has established abusive tax avoidance under subsection 245(4).[50]

LeBel J., writing for the majority of the Supreme Court in *Lipson v. Canada*, the only GAAR case considered by the Supreme Court subsequent to *Canada Trustco* and *Mathew*, affirmed this framework for applying sub-section 245(4).[51]

Although Parliament clearly intended to combat abusive tax avoidance through the GAAR, it also intended to preserve predictability, certainty and fairness in tax law and a taxpayer's right to engage in legitimate tax minimisation. The Supreme Court echoed these dual intentions in *Canada Trustco*, noting that "Parliament intends taxpayers to take full advantage of the provisions of the *Income Tax Act* that confer tax benefits. Indeed, achieving the various policies that the *Income Tax Act* seeks to promote is dependent on taxpayers doing so."[52] According to the Supreme Court, these policies would be frustrated if the Minister or the courts were able to override the specific provisions of the Act without any basis in a textual, contextual and purposive interpretation of those provisions.[53] Achieving these dual purposes obviously involves a balancing of competing interests. This was expressed by LeBel J., writing for the majority of the Supreme Court in *Lipson*, when he acknowledged that "the *Duke of Westminster* principle has never been absolute, and Parliament enacted section 245 of the *ITA*, known as the GAAR, to limit the scope of allowable avoidance transactions while maintaining certainty for taxpayers."[54]

The Supreme Court in *Canada Trustco* also presented the following interpretive guidelines to assist courts in determining if abusive tax avoidance is present:

> Whether the transactions were motivated by any economic, commercial, family or other non-tax purposes may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under subsection 245(4). However, any finding in this respect would form only part of the underlying facts of a case, and would be insufficient by itself to refute abusive tax avoidance. The central issue is the proper interpretation of the relevant provisions in light of their context and purpose;
>
> [and]
>
> Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack proper basis relative to the object, spirit, or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.[55]

Sub-section 245(4) is intended to deny a tax benefit that takes advantage of the Act's technical rules but nevertheless is inconsistent with the overall purpose of these rules or is abusive of the scheme of the Act as a whole, even though it does not amount to a misuse of any specific provision.[56] The Department of Finance confirms this result in its Explanatory Notes, which state that section 245 should apply *even though the strict words of the relevant provisions support the tax result sought by the taxpayer*. "Thus, where applicable, section 245 will override other provisions of the Act since, otherwise, its object and purpose would be defeated."

McLachlin C.J. and Major J., however, stated in *Canada Trustco* that "[c]ourts have to be careful not to conclude too hastily that simply because a non-tax purpose is not evident, the avoidance transaction is the result of abusive tax avoidance. Although the Explanatory Notes make reference to the expression 'economic substance', *sub-section 245(4) does not consider a transaction to result in abusive tax avoidance merely because an economic or commercial purpose is not evident*." Additionally, "courts have on occasion discussed transactions in terms of their 'lack of substance' or requiring 'recharacterisation'. However, such terms have no meaning in isolation from the proper interpretation of specific provisions of the *Income Tax Act*." The Court stressed that the central inquiry under sub-section 245(4) is focused on whether the taxpayer's transaction was consistent with the purpose of the provisions of the Act that the taxpayer has relied upon when those provisions are properly interpreted in light of their text, context, and purpose. Abusive tax avoidance on the part of the taxpayer will only be established if the taxpayer's transactions frustrate or defeat those purposes.[57]

In *Lipson*, the Supreme Court's decision was fragmented into three opinions (LeBel J. for three others in the majority; Binnie J. for Deschamps J. in dissent; and Rothstein J. on his own also in dissent). In his majority judgment, LeBel J. explained that after the relevant statutory purpose is identified, the second step under sub-section 245(4) is to determine whether the taxpayer's avoidance transaction frustrates the object, spirit or purpose of the relevant provisions.[58] LeBel J. added, however, that care should be taken here not to shift the focus of the inquiry to the "overall purpose" of the taxpayer's transactions. "Such an approach might incorrectly imply that the taxpayer's motivation or the purpose of the transaction is determinative. In such a context, it may be preferable to refer to the 'overall result', which more accurately reflects the wording of section 245(4) and this Court's judgment in *Canada Trustco*."[59]

Binnie J. began his dissent in *Lipson* (Deschamps J. concurring) with the rhetorical question "[h]ow healthy is the *Duke of Westminster*? There is cause for concern." Although the Supreme Court affirmed the continuing viability of the principle that taxpayers are permitted to structure their affairs in order to minimise their taxes in *Canada Trustco*, this principle has been tempered by the application of the GAAR. "The question in these appeals, as it was in *Canada Trustco*, is where the appropriate balance is to be struck." As Justice Binnie explained in his minority judgment in *Lipson*, "*Canada Trustco* recognised that the line between legitimate tax minimisation and abusive tax avoidance is 'far from bright'. This has proven to be an understatement."[60]

III. What is the tax result of a determination that a transaction lacks economic substance?

Sub-section 245(5) provides that, where the GAAR applies, the Minister may determine the tax consequences to a person in a manner reasonable in the circumstances in order to deny the tax benefit that would otherwise result from an avoidance transaction.[61] In *Lipson*, LeBel J. for the majority of the Supreme Court explained that "[w]hen considering the application of section 245(5), a court must be satisfied that there is an avoidance transaction that satisfies the requirements of section 245(4), that section 245(5) provides for the tax consequences and that the tax benefits that would flow from the abusive transactions should accordingly be denied. The court must then determine whether these tax consequences are reasonable in the circumstances."[62]

In *XCO Investments Ltd. et al. v. The Queen*,[63] Bowman C.J. (as he then was) of the Tax Court made some interesting observations with respect to the application of sub-section 245(5). He recognised that the wording of the subsection gives a variety of options to the Minister, such as the recharacterisation of the nature of any payment or other amount and the disallowance (in whole or in part) of any deduction, exemption or exclusion; however, he also noted the following:

- Sub-section 245(5) does not give the minister discretionary powers to impose sanctions.
- What is "reasonable" is relative and depends on the facts and circumstances of the particular case.
- Anti-avoidance rules such as section 245 are not intended to be a means of punishing the taxpayer.
- Section 245 is not intended to "top up" any remedies that exist under specific anti-avoidance rules.[64]

Arguably, sub-section 245(5) requires an analysis of the "economic substance" of the taxpayer's avoidance transaction in order to determine the appropriate tax consequences as a result of the GAAR's successful application. The provision provides in this way that "the nature of any payment or other amount may be recharacterised" and "the tax effects that would otherwise result from the application of other provisions of this Act may be ignored" for the purposes of applying the GAAR.[65]

IV. Conclusion

As one commentator has aptly summarised the current state of the Canadian jurisprudence, post-*Lipson*, "*Westminster* prevails over GAAR, except in those circumstances where GAAR prevails over *Westminster*."[66] Following *Lipson*, it certainly appears that the tension between certainty and fairness with regard to tax avoidance is unsettled in Canadian tax law.[67] The *Lipson* case is far from the last word on the GAAR's application to future cases in which such hot topics as "surplus stripping" and paid-up capital, offshore spousal trust arrangements, and the Part XIII (withholding) tax will be decided. In fact, the Supreme Court has recently agreed to hear another GAAR case only a short time after *Lipson*.[68] Perhaps the Court wishes to resolve some of the uncertainty that the decision created and to present a more unified and reflective view as to how section 245's general anti-avoidance rules should operate.

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NOTES

[1] * See *e.g.*, *Dominion Taxicab Association* v. *MNR*, 54 D.T.C. 1020 (S.C.C.), *Front & Simcoe Limited* v. *MNR*, 60 D.T.C. 1081 (Ex. Ct.), *MNR* v. *Ouellette and Brett*, 71 D.T.C. 5094 (Ex. Ct), *Purdy* v. *MNR*, 85 D.T.C. 254 (TCC), *Stubart Investments Ltd v The Queen*, 84 D.T.C. 6305 (S.C.C.), *Alberta Gas Ethylene Co. Ltd.* v. *The Queen*, 89 D.T.C. 5058 (F.C.T.D.), aff'd 90 D.T.C. 6419 (F.C.A.), *The Queen* v. *McClurg*, 91 D.T.C. 5001 (S.C.C.), *The Queen* v. *Friedberg*, 92 D.T.C. 6031 (F.C.A.), aff'd 93 D.T.C. 5507 (S.C.C.) and *Mark Resources Inc. v. The Queen*, 93 D.T.C. 1004 (T.C.C.).

[2] See *Shell Canada Limited v. Canada*, [1999] 3 S.C.R. 622, [1999] 4 C.T.C. 313 [*Shell*] and *Continental Bank Leasing Corporation v. The Queen*, 98 D.T.C. 6505 (S.C.C.).

[3] *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] AC 1 (H.L.) at 19.

[4] This approach was aptly restated by Viscount Simon a little over a decade following the *Duke of Westminster* case: "It may be well to repeat two propositions which are well established in the application of the law relating to income tax. First, the name given to a transaction by the parties concerned does not necessarily decide the nature of the transaction. To call a payment a loan if it is really an annuity does not assist the taxpayer, any more than to call an item a capital payment would prevent it from being regarded as an income payment if that is its true nature. The question always is what is the real character of the payment, not what the parties call it. Secondly, a transaction which, on its true construction, is of a kind that would escape tax is not taxable on the ground that the same result could be brought about by a transaction in another form which would attract tax." See *C.I.R. v. Wesleyan and General Assurance Society*, [1948] 1 All ER 555 at 557, 30 T.C. 11 at

24, 25 (H.L.). As Rip J. (as he was then) rather colourfully stated in a more recent case, "calling a horse a dog does not make the horse a dog." See *Gillette Canada Inc. v. The Queen*, [2001] 4 C.T.C. 2884, 2001 D.T.C. 895 (T.C.C.) aff'd [2003] 3 C.T.C. 27, 2003 D.T.C. 5078 (F.C.A.).

[5] *M.N.R. v. Cameron*, [1972] C.T.C. 380, 72 D.T.C. 6325 (S.C.C.), quoting from *Snook v. London & West Riding Investments Ltd.*, [1967] 1 All ER 518 (C.A.). A recent case reaffirming this "classic" definition of sham in Canadian tax law is *2529-1915 Quebec Inc. et al. v. The Queen*, 2008 FCA 398, aff'g 2007 TCC 286 [*Faraggi*]. Significantly, *Faraggi* also established that the sham doctrine will bypass the need for other rules (specific anti-avoidance rules or the GAAR) if the documents are deceptive as to the true nature of the transaction: "Only the advent of the GAAR and its invocation in a particular case allow the Minister to repudiate a transaction on the sole ground that it gives rise to an abuse of the Act or some of its provisions. . . The concepts of 'sham' and 'abuse' are not the same." See paras. 54-5.

[6] *Atinco Paper Products Ltd. v. M.N.R.*, [1978] C.T.C. 566, 78 D.T.C. 6387 (F.C.A.). See also *Central Supply Company (1972) Ltd. et al. v. The Queen*, [1997] 3 C.T.C. 102, 97 D.T.C. 5295 (F.C.A.) per Linden J.A.

[7] See *Genex Communications Inc. v. The Queen*, 2009 TCC 583, citing Linden J.A.'s judgment for the Federal Court of Appeal in *Friedberg v. The Queen*, [1992] 1 C.T.C. 1, 92 D.T.C. 6031 (F.C.A.) where the Court held that a taxpayer is entitled to arrange his or her affairs so as to take advantage of tax benefits, but he or she must do so in the correct manner. *Genex Communications Inc. v. The Queen* is currently under appeal to the Federal Court of Appeal, although not on this point.

[8] [1984] 1 S.C.R. 536, [1984] C.T.C. 294, 84 D.T.C. 6305 [*Stubart*, cited to D.T.C.].

[9] *Ibid.* at 6322.

[10] For the history of the process leading up to the enactment of the GAAR, see *e.g.*, David G. Duff *et al.*, *Canadian Income Tax Law*, 2nd ed. (Markham: LexisNexis Canada, 2006) at 190-1 and Vern Krishna, *The Fundamentals of Canadian Income Tax*, 9th ed. (Toronto: Thomson Carswell, 2006) at 1013-7. See also Vern Krishna, *Tax Avoidance: The General Anti-Avoidance Rule* (Toronto: Carswell, 1990), William I. Innes *et al.*, *The Essential GAAR Manual: Policies, Principles and Procedures* (Toronto: CCH Canadian, 2006) at 27-36, Brian J. Arnold & James R. Wilson, "The General Anti-Avoidance Rule – Part 1" (1988) 36 Can. Tax J. 829, Arnold & Wilson, "The General Anti-Avoidance Rule – Part 2" (1988) 36 Can. Tax J. 1123, Arnold & Wilson, "The General Anti-Avoidance Rule – Part 3" (1988) 36 Can. Tax J. 1369, Harry Erlichman, ed., *Tax Avoidance in Canada* (Toronto: Irwin Law, 2002) and "Tax Reform Exercise Finally Ends" (1988) 10 Can. Taxpayer 145.

[11] *Supra* note 2 at paras. 39 and 45.

[12] *Ibid.* at para. 46.

[13] See Daniel Sandler, "GAAR and the Supreme Court of Canada: The Road to Nowhere" in David W. Chodikoff & James L. Horvath, eds., *Advocacy & Taxation in Canada* (Toronto: Irwin Law, 2004) 430 at 433. See also Brian J. Arnold, "Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance" (2001) 49 Can. Tax J. 1 at 22.

[14] 2005 SCC 54, [2005] 2 S.C.R. 601 at para.11 [*Canada Trustco*].

[15] *Ibid.* at para. 11.

[16] *Ibid.* at para. 13.

[17] *Ibid.* at para. 13 [emphasis added; internal citation removed], citing *Shell*, *supra* note 2 at para. 45.

[18] On the evolution of statutory interpretation principles with respect to the *Income Tax Act*, see Peter W. Hogg *et al.*, *Principles of Canadian Income Tax Law*, 6th ed. (Toronto: Thomson Carswell, 2007) at 575-99.

[19] *Canada Trustco*, *supra* note 14 at para. 10.

[20] *Ibid.* at paras. 10-11. In *Mathew v. Canada*, 2005 SCC 55, [2005] 2 S.C.R. 643 at para. 43 [*Mathew*], the companion GAAR case decided by the Supreme Court at the same time as *Canada Trustco*, the Court adds that while "it is useful to consider the three elements of statutory interpretation separately to ensure each has received its due, they inevitably intertwine. For example, statutory context involves consideration of the purposes and policy of the provisions examined. And while factors indicating legislative purpose are usefully examined individually, legislative purpose is at the same time the ultimate issue — what the legislator intended."

[21] Although "cumulative profit" is not defined in proposed section 3.1, the Department of Finance considers it to mean the aggregated profit or loss over the entire period in which the taxpayer holds the property or carries on the business, requiring a fact-specific and objective determination. The proposal does make it clear, however, that, for the purposes of proposed section 3.1, profit does not include capital gains or losses.

[22] See *Ludco Enterprises Ltd. v. The Queen*, [2001] 2 S.C.R. 1082 [*Ludco*], *Stewart v. The Queen*, [2002] 2 S.C.R. 645 [*Stewart*], and *Walls v. The Queen*, [2002] 2 S.C.R. 684 [*Walls*]. In *Ludco*, the Supreme Court held that interest on borrowed money used to buy shares was a deductible expense because the taxpayer had a reasonable expectation of *gross* dividend income, even though there was no expectation of *net* income in excess of the interest expense. In *Stewart*, the Supreme Court held that a taxpayer could deduct losses from a real estate investment (the losses arose primarily due to the fact that the taxpayer's interest expense exceeded its rental income), even though the taxpayer's motive for making the investment was to realize a capital gain on the resale of the real estate, but it had no expectation of net operating or rental income. Finally in *Walls*, the taxpayers, limited partners of a limited partnership that acquired a mini-warehouse, were entitled to deduct their share of the losses of the partnership for income tax purposes even though they were clearly motivated by tax considerations when they purchased their interest in the limited partnership.

[23] See *e.g.* Wilfrid Lefebvre, "REOP and Interest, Once More" in *Report of Proceedings of Fifty-Sixth Tax Conference: 2004 Conference Report* (Toronto: Canadian Tax Foundation, 2005) 3:1. David Duff reads the Supreme Court's narrow approach to a reasonable expectation of profit test in the *Stewart* and *Walls* decisions as "the culmination of a return to the literalism and formalism" of earlier Canadian tax jurisprudence. Of course, subsequent to the debate over proposed section 3.1, the Supreme Court has weighed in on the GAAR and the CRA has become increasingly aggressive in its attempts to apply the general anti-avoidance rule. See David G. Duff, "Interest Deductibility, the Reasonable Expectation of Profit Test, and the Supreme Court of Canada: From *Bronfman Trust* and *Moldowan* to *Singleton*, *Ludmer*, *Stewart*, and *Walls*" in David W. Chodikoff & James L. Horvath, eds., *Advocacy & Taxation in Canada* (Toronto: Irwin Law, 2004) 399 at 428.

[24] A reasonable expectation of profit will still be a factor in a court's determination of whether an individual taxpayer is engaged in a business or a personal/hobby activity.

[25] Paragraph 18(1)(a) of the Act provides a general limitation on deductions, stating that "no deduction shall be made in respect of an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property." Following *Ludco*, the "income" required here is gross (and not net) income. The remaining provisions in sub-section 18(1) provide restrictions on deductions for specific types of expenses. In the context of permitted deductions, subsection 18(1) is read together with subsection 9(1) of the Act, which provides that "a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property." Sub-section 9(1), then, refers to the basic inclusion of profit in a taxpayer's income, with "profit" being inherently a net concept normally calculated in accordance with well accepted principles of business practice.

[26] Section 67 provides a general limitation regarding expenses, stating that "[i]n computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances." What is reasonable is determined objectively: See *e.g. Petro-Canada v. The Queen*, 2004 FCA 158 at para. 62, leave to appeal to S.C.C. ref'd.

[27] See Krishna, *The Fundamentals of Canadian Income Tax*, *supra* note 10, at 1017.

[28] For example, subsection 16(1) of the Act aims to prevent taxpayers from engaging in tax avoidance by way of receiving payments under a contract or other arrangement that "can reasonably be regarded as being in part interest or other amount of an income nature and in part an amount of a capital nature" by deeming the appropriate portion of the payments to be interest or another amount of an income nature. Section 68 of the Act, similarly, aims to prevent taxpayers from engaging in tax avoidance by way of receiving payments under a contract or other arrangement that "can reasonably be regarded as being in part the consideration for the disposition of a particular property of a taxpayer or as being in part consideration for the provision of particular services by a taxpayer" by deeming the appropriate portion of the consideration to be the proceeds of disposition of the property and the cost of the property for the acquirer or, if the amount is in part consideration for services, the consideration to be an amount received or receivable by the taxpayer in respect of those services and the amount paid by the person to whom the services were rendered. See *e.g.* Duff *et al.*, *supra* note 10, at 189.

[29] Sub-section 245(1) of the Act – definition of "tax benefit."

[30] Sub-section 245(3) of the Act – definition of "avoidance transaction." "Transaction" is defined in sub-section 245(1) to include an arrangement or event.

[31] In *Canada Trustco*, the Supreme Court noted that: "Whether a tax benefit exists is a factual determination . . . If a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax. In some other instances, it may be that the existence of a tax benefit can only be established by comparison with an alternative arrangement." See *supra* note 14 at paras. 19-20.

[32] *OSFC Holdings Ltd. v. Canada*, 2001 FCA 260, [2001] 4 C.T.C. 82, 2001 D.T.C. 5471 at para. 36 (leave to appeal to S.C.C. ref'd).

[33] *Supra* note 14 at para. 26.

[34] Sub-section 245(4) of the Act. Subsection 245(4) was amended in 2005 with retroactive application to transactions entered into after Sept. 12, 1988 (the time when the GAAR originally came into force). The amendments extended the GAAR's application to the Regulations,

the Income Tax Application Rules, tax treaties and other relevant legislation. The amended subsection 245(4) overruled previous court decisions which held that the GAAR did not apply to the Regulations. See *e.g. Fredette v. The Queen*, [2001] 3 C.T.C. 2468, 2001 D.T.C. 621 (T.C.C.).

35 *Supra* note 20.

36 *Lehigh Cement Limited v. The Queen*, 2009 TCC 237; *Collins & Aikman Products Co. et al. v. The Queen*, 2009 TCC 299; *Garron Family Trust et al. v. The Queen*, 2009 TCC 450, *Remai Estate v. The Queen*, 2009 FCA 340, aff'g 2008 TCC 344; *Landrus v. The Queen*, 2009 FCA 113, aff'g 2008 TCC 274; *MacKay v. The Queen*, 2008 FCA 105, rev'g 2007 TCC 94, leave to appeal to S.C.C. ref'd; *Lipson et. al. v. The Queen*, 2009 SCC 1, aff'g 2007 FCA 113, aff'g 2006 TCC 148; *The Queen v. MIL (Investments) SA*, 2007 FCA 236, aff'g 2006 TCC 460; *Copthorne Holdings Ltd. v. The Queen*, 2009 FCA 163 aff'g 2007 TCC 481; *McMullen v. The Queen*, 2007 TCC 16; *Ceco Operations Ltd. v. The Queen*, 2006 TCC 256; *Desmarais v. The Queen*, 2006 TCC 44; *Overs v. The Queen*, 2006 TCC 26; *Evans v. The Queen*, 2005 TCC 684; *Univar Canada Ltd. v. Canada*, 2005 TCC 723.

37 2008 FCA 105, rev'g 2007 TCC 94, leave to appeal to S.C.C. ref'd [*MacKay*].

38 *Ibid*. at para. 25 [emphasis in original].

39 *Supra* note 14 at para. 29. See also para. 30 which explains that "[t]he courts must examine the relationships between the parties and the actual transactions that were executed between them. The facts of the transactions are central to determining whether there was an avoidance transaction."

40 *Ibid.* at para. 27.

41 *Ibid.* at para. 28. See also para. 29, explaining that "[t]he determination invokes reasonableness, suggesting that the possibility of different interpretations of events must be objectively considered." Although the Court also declares (at para. 28) that "[i]t is not helpful to speak of the threshold imposed by sub-section 245(3) as high or low," the language of the provision – which requires the taxpayer to make a reasonable case that the transaction was undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit – suggests that the threshold is more likely to be low than high.

42 *Ibid.* at paras. 32 and 33.

43 In *MacKay*, *supra* note 37, the Federal Court of Appeal further stated at para. 22 [emphasis added] that, on the facts of the case, "[n]othing in the record suggests that the non-tax business objectives of the respondents required those steps to be taken." Later, the Court of Appeal added at para. 24 that "within a particular series of transactions, there may be one or more transactions undertaken primarily to obtain a tax benefit, even if the series as a whole is undertaken for a *bona fide* purpose other than to obtain the tax benefit." As noted above, for the Court of Appeal in *MacKay*, a non-tax purpose for the series as a whole does not exclude the possibility that the primary purpose of a given step along the way is to obtain a tax benefit; in other words, the manner in which the transaction is implemented matters along with the overall purpose of the transaction.

44 The Supreme Court of Canada denied leave to appeal the decision of the Federal Court of Appeal in *MacKay*. In *Fraser Milner*, a pre-*Canada Trustco* case, the Federal Court explained that in (objectively) assessing a taxpayer's purpose under subsection 245(3), a court may consider "evidence as to what motivated certain actions", including tax planning information. See *Fraser Milner Casgrain LLP et al. v. MNR*, [2002] 4 C.T.C. 210, 2002 D.T.C. 7310 (F.C.T.D.) [*Fraser Milner*] at paras. 30-3. The Federal Court of Appeal has approved of this statement as to the relevance of tax planning information in *Kitsch et al. v. The Queen*, 2003 FCA 307 at para. 31.

45 See *Evans v. The Queen*, 2005 TCC 684 at para. 22 per Bowman C.J [*Evans*].

46 *Ibid.*

47 See *MIL (Investments) S.A. v. The Queen*, [2006] 5 C.T.C. 2552, 2006 D.T.C. 3307 (T.C.C.) per Bell J. aff'd on other grounds 2007 FCA 236 at para. 50 [*MIL*].

48 *Ibid.* at para. 53. Bell J. added that this position is consistent with the "established jurisprudence on the legitimacy of seeking out tax planning," including the post-*Canada Trustco* decision of Chief Justice Bowman (as he then was) in *Evans*. The Tax Court's decision in *MIL* was affirmed by the Federal Court of Appeal on other grounds.

49 The taxpayer in *Lipson*, for example, conceded these items, meaning that *Canada Trustco* (and *Mathew*) are the only cases in which the Supreme Court has considered the meaning of an avoidance transaction. See *Lipson*, *infra* note 51.

50 *Supra* note 14 at paras. 44 to 46.

51 2009 SCC 1 at para. 40 [*Lipson*].

52 *Supra* note 14 at para. 31.

53 *Ibid.* at para. 42.

54 *Supra* note 51 at para. 21.

55 *Supra* note 14 at para. 66.

56 See Canada, Department of Finance, *Technical Notes to Bill C-139*, June 30, 1988 [emphasis added].

57 *Supra* note 14 at paras. 57 and 59 [emphasis added].

58 *Supra* note 51 at para. 33.

59 *Ibid.* at para. 34.

60 *Ibid.* at para. 63, citing *Canada Trustco*, *supra* note 14 at para. 66, point 3.

61 Sub-section 245(5) was amended in 2005 in order "to clarify that tax consequences shall be determined notwithstanding any other enactment, that such determination includes the allowance or disallowance in whole or in part of any exemption or exclusion in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof, and that any such exemption or exclusion or part thereof may be allocated to any person." See Canada, Department of Finance, *Technical Notes to Bill C-33* (S.C. 2005, c. 19, May 2005).

62 *Lipson*, *supra* note 51 at para. 51.

63 2005 TCC 655.

64 See *ibid.* at paras. 39-40. These comments were *obiter dicta*, however; it remains to be seen how a future court will treat the issue.

65 See *e.g.* Jinyan Li, ""Economic Substance": Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006) 54 Can. Tax J. 23 at 35-6.

66 See Vern Krishna, "GAAR Trumps Westminster in *Lipson*" (2009) 19 Can. Current Tax 85 at 89.

67 See *e.g.* Gilles Larin *et al.*, *Effective Responses to Aggressive Tax Planning: What Canada Can Learn from Other Jurisdictions*, Canadian Tax Paper No. 112 (Toronto: Canadian Tax Foundation, 2009) at 2.

68 *Copthorne Holdings Ltd. v The Queen*, 2009 FCA 163 aff'g 2007 TCC 481. Leave to appeal granted with costs by S.C.C. (file 33283), Jan. 28, 2010. The hearing has been tentatively scheduled for Nov. 2, 2010. The Supreme Court is expected to address both the extended meaning of "series of transactions" and the abusive tax avoidance analysis in its decision in the case.

Host Country PEOPLE'S REPUBLIC OF CHINA

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I. Will the PRC tax authorities respect the form of a transaction that, on its face, satisfies each element of existing PRC law, despite its lack of economic substance?

China has not codified the principle of economic substance. However, according to the explanation of the State Administration of Taxation (SAT) concerning the general anti-tax avoidance rule (GAAR), a transaction that lacks economic substance may not be able to pass the business purposes test under the GAAR and therefore may not be respected.

China's new Enterprise Income Tax Law ("EIT Law") includes a chapter entitled "special tax adjustment." The chapter covers the rules on transfer pricing, cost sharing, advance pricing agreements (APAs), thin capitalisation, and controlled foreign companies (CFCs), as well as the GAAR.

According to the GAAR, the Chinese tax authorities are empowered to make reasonable adjustments where an enterprise implements an arrangement "without reasonable business purposes" to reduce its taxable income or profit. The Implementing Regulations of the EIT Law provide that the term "without reasonable business purposes" refers to an arrangement whose primary purpose is to reduce, avoid or defer the payment of tax.

The SAT has issued the Implementing Measures on Special Tax Adjustments (Guo Shui Fa [2009] No. 2 or Notice No. 2) to provide guidance on the implementation of the Special Tax Adjustment rules. In particular, with regard to the GAAR, Notice No. 2 provides that the PRC tax authorities may investigate:

- Abuse of tax treaties;
- Abuse of the forms in which an enterprise may be organised;
- Tax avoidance using tax havens; and
- Other business arrangements without reasonable business purposes.

The tax authorities are required to apply the principle of "substance over form" in examining whether an enterprise has engaged in a tax avoidance arrangement. The tax authorities are empowered to re-characterise an enterprise's tax avoidance arrangement based on economic substance and to cancel the tax benefit enjoyed by the enterprise as a result of the tax avoidance arrangement. An enterprise with no economic substance, especially an enterprise established in a tax haven, which makes it possible for both related and unrelated parties to avoid tax, can be disregarded for tax purposes.

Thus, it appears that the PRC tax authorities are expanding the GAAR to encompass the principle of substance over form. If a transaction has no economic substance, it would be difficult to justify the reasonable business purposes test under the GAAR and, therefore, the transaction may not be respected.

II. What are the pre-requisites for a transaction to be considered immune from challenge under PRC's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

Because the GAAR has only recently been adopted in China, there are no safe harbor or other established checklists that enable a determination to be made as to whether a transaction is within or without the scope of the GAAR. Instead, the PRC tax authorities are likely to take into account all the relevant facts and circumstances of the transaction in a GAAR investigation. It would, therefore, be premature to give a definitive answer to the above question.

Nonetheless, Notice No. 2 requires that when applying the substance over form principle in examining whether an enterprise has engaged in a tax avoidance arrangement, the tax authorities take into account the following:

- The form and substance of the arrangement;
- The time of conclusion of the arrangement and the period of its implementation;
- The way in which the arrangement was realised;
- The connection between the various steps or components of the arrangement;
- The change in the financial status of the parties involved in the arrangement; and
- The tax consequences of the arrangement.

According to the tax notice on indirect equity transfers, Guo Shui Han [2009] No. 698 (Notice 698), the controlling non-resident enterprise is required to provide the following information to the PRC tax authority to facilitate a "business purposes" review:

- The equity transfer contract;
- Information reflecting the actual controlling non-resident enterprise's relationship with the transferred non-resident holding company in respect of funding, operation, sales and purchases, etc.;
- Information on the manufacturing and operations, personnel, accounting, assets, etc., of the non-resident holding company;
- Information reflecting the non-resident holding company's relationship with the PRC resident enterprise in respect of funding, operation, sales and purchases, etc.;
- A statement that the transferred non-resident holding company was established by the actual controlling nonresident enterprise for reasonable business purposes; and
- Any other relevant information that may be required by the PRC tax authority.

In addition, it should be noted that "reasonable business purposes," which is the core element of the GAAR, is also required in order to obtain the benefits of tax deferral treatment for certain enterprise restructurings, as provided under Guo Shui Fa [2009] No. 59 (Notice 59). In this regard, the SAT has circulated a draft explanation of how Notice 59 will be implemented. In particular, the draft rules require that taxpayer justify the "reasonable business purposes" by reference to the following:

- The restructuring transaction method, i.e., the specific form taken, the transactional background, the time of the transaction, other purposes that could be objectively attributable to the transacting parties, whether the transaction was prompted by professional counsel, the operational methods before and after the transaction, and the common business norms;
- The form and substance of the transaction, i.e., the legal rights and responsibilities arising from the transaction based on its form, that is, the legal consequences of the transaction, and the final substantive business result of the transaction;
- Changes to the tax status of the parties arising from the transaction;
- Changes to the financial status of the parties arising from the transaction;
- The extent to which the restructuring has brought to the parties unusual economic benefits or potential obligations that would not otherwise arise under the market principle; and
- Information on non-resident enterprises that participated in the restructuring.

The above criteria suggest that the PRC tax authorities may look at both the legal and economic consequences of the transaction, and the relative tax and financial positions of the parties before and after the transaction, as well as other related information, in order to determine whether the transaction has reasonable business purposes.

Thus, it is more likely than not that, for a transaction to be outside the scope of the GAAR:

- A subjective business purpose/motivation (as contrasted with a tax motivation) is necessary (although not sufficient);
- There should be a "substantive economic effect" as a result of implementing the plan;
- There should be a realistic expectation of pre-tax profit; and
- There are other factors that China would take into account in evaluating the substance of the transaction, such as the timing and the relationship of the related steps and components of the transaction.

III. What is the tax result of a determination that a transaction lacks economic substance?

As provided under Notice No. 2, the tax authorities may re-characterise an enterprise's tax avoidance arrangement based on the economic substance of the arrangement and cancel the tax benefit enjoyed by the enterprise as a result of the tax avoidance arrangement. An enterprise with no economic substance, especially an enterprise established in a tax haven, which makes it possible for both related and unrelated parties to avoid tax, can be disregarded for tax purposes. Thus, depending on the particular transaction, either the tax benefits arising from a tax avoidance transaction may be cancelled or the entity involved in the transaction may be disregarded.

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Currently, there are only a few reported cases and published rules relating to the disregarding of the intermediary nonresident holding company in an indirect equity transfer scenario. For example, according to Notice 698, if the PRC tax authority finds that a foreign investor indirectly transfers an equity interest in a PRC enterprise through an abuse of organisational form or other tax arrangement that has no reasonable business purposes and results in the avoidance of the obligation to pay enterprise income tax, with the SAT's approval, the nonresident holding company may be disregarded for tax purposes and the equity transfer may be re-characterised according to its economic substance.

There was also a reported case in which a Singapore company A transferred its equity interest in a Singapore holding company B that, in turn, owned a PRC subsidiary to a third party. The indirect equity transfer was re-characterised as a direct equity transfer by Singapore company A of its equity interest in the PRC company after the Singapore holding company B was disregarded. Therefore, company A's gain from the transfer of company B's equity interest was subject to the PRC withholding income tax.

While there are so far no other reported cases, according to the principle of the GAAR, if the generation of losses or gains is the benefit intended to result from participation in a tax avoidance arrangement, the PRC tax authorities may cancel or disregard such losses or gains. It is not yet clear whether those aspects of such a transaction that produce real gains or losses would be given effect. It would be reasonable, however, to anticipate that, when a tax avoidance arrangement is disregarded, all components of the transaction would be disregarded and re-characterised based on their economic substance.

The disregarding of a transaction should only be for tax purposes the legal consequences arising from the disregarded transaction arguably should continue to be respected. For example, in the above example of the Singapore company, while Company B was disregarded for tax purposes, Company B should be treated as remaining the legal shareholder of the PRC company, with the consequence that the indirect transfer of equity in Company B should be legally respected without the PRC approval requirement for regulatory purposes (which would be required in the case of a direct transfer of the equity interest in the PRC company) being triggered.

Host Country
DENMARK

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I. Introduction

The "substance over form" concept plays an important role in the decisions of the Danish courts on whether a transaction is to be set aside or upheld for income tax purposes.

As early as 1982,[1] the Eastern Court of Appeals (*Østre Landsret*) applied the *substance over form* doctrine in a case concerning an investment by a partnership in an aircraft. The managing director and the owner of a tour operator created a partnership, which leased an aircraft to the tour operator. In its decision, the court emphasised that the leasing agreement was entered into between non-independent parties. The intention was to create a situation of formal ownership that was not accompanied by any right to dispose of the aircraft and did not entail any financial risk for the partners. The decisive factors for the court in setting aside the partnership for tax purposes were the absence of the right to dispose of the aircraft, the lack of any economic contributions by the partners and the absence of economic risk.

In one of the leading cases in this area, which concerned the leasing of a Boeing 747 aircraft by a Danish partnership[2] to a foreign lessee, the Danish Supreme Court found that the leasing arrangement could not be recognised for Danish income tax purposes. In reaching its conclusion, the court took into consideration the fact that the partnership could not in any way dispose of the aircraft. The financing was arranged in such a manner that no additional profits could be realised and the partners were at no risk, because of the obligations of the lessor and the insurance coverage provided. The Court further stated that it was the intention of the parties that, at the end of the lease, the lessee should become the owner of the aircraft. Against this background, the Court found that the taxpayers had only bought a provisional ownership in the aircraft that did not afford them the right to a depreciation deduction for tax purposes. The Court further added that a substance over form evaluation of a specific arrangement by the courts can result in the entire transaction being set aside, as generally intended by the legislator.

In a 2006 case that ultimately came before the Supreme Court,[3] the taxpayer, a corporation sold lubricating grease to another corporate taxpayer that had no substantial assets or activities. No security was given for payment by the purchaser, which only paid the value added tax (VAT) charged on the sale of the grease at the time when it recovered the input VAT from the tax authorities. The seller, which had substantial tax losses that expired in the year in which the sale took place, included the sales proceeds in its taxable income, thus utilising the tax loss. In the following year, the purchaser agreed to sign a note for the purchase price outstanding. The seller claimed a tax loss on the note and the purchaser claimed a loss for the grease that could not be sold. In its decision, the Eastern Court of Appeal found that the parties had a community of interests and set aside the transaction for tax purposes. The Court reasoned that both parties had an interest in carrying out the transactions: the seller would be able to utilise a tax loss that would otherwise expire and to create a new loss that it would be able to carry forward; the purchaser would also be able to obtain a tax loss. Given these circumstances, the transaction lacked substance and should be set aside for tax purposes. This line of reasoning was upheld on appeal by the Supreme Court.

In a decision of February 25, 2009, an interest deduction of DKK 33 million was disallowed by the Supreme Court.[4] In the case concerned, a taxpayer borrowed DKK 1.4 billion from a bank in Ireland, which was then contributed as share capital to a company formed in Jersey. The company was only allowed to invest the proceeds in government bonds having an AAA rating. The bank had a security interest in the shares issued by the Jersey company, the bank account of the company and the bonds purchased. The loan was further personally guaranteed by the taxpayer. In the following tax year, the taxpayer sold all shares in the Jersey company and was relieved of all obligations under the arrangement. The Eastern Court held that the sole object of the transaction was to create an interest deduction of DKK 33 million against a payment of DKK 5 million. The Court also found that the transactions were irrevocable and self-liquidating. The taxpayer could not in any

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way dispose of the assets during the term of the transaction and all currency risks were covered by put options and swap agreements. Even though, according to the wording of the loan agreements, the loans could be terminated at any time, the loans were *de facto* non-terminable. Taking these factors into consideration, the Court stated that the taxpayer was not at risk at any time, even though the loans were personally guaranteed by the taxpayer. The interest deduction on the loan was consequently disallowed due to lack of substance. The decision of the Eastern Court was upheld on appeal by the Supreme Court.

In its most recent decision, the Supreme Court set aside another loan transaction.[5] In the case concerned, a company issued convertible bonds to a bank for an amount of DKK 213 million carrying interest at a rate of 25 percent per annum. The proceeds were invested in bonds. The capital gain realised on the redemption of the bonds was tax-free in accordance with the rules in force at the time of the transaction. The taxpayer claimed an interest deduction of DKK 15 million. The Court of Appeals found that the issuance of the convertible bonds and the investment by the taxpayer were made between parties that had no conflicting interests and that all terms and conditions were agreed in advance. The bank did not undertake any risk as it was granted a security interest in the proceeds of the loan. The interest paid on the convertible bonds did not reflect a commercial risk undertaken or any market risk. The sole purpose of the transaction was to create an interest deduction and a tax-free capital gain. The only cash flow was the fee paid to the bank. This decision was also upheld by the Supreme Court.

A decision rendered by the European Court of Justice (ECJ) in 2007 should also be mentioned in this context.[6] The facts of the *Kofoed* case were as follows. Two Danish residents each held 50 percent of the total share capital of a limited liability company incorporated under Danish law. On October 26, 1993, each of them acquired one share in an Irish limited company for the price of IEP 1. On October 29, 1993, all the shares in the Danish company were exchanged for new shares in the Irish company. On November 1, 1993, the Irish company collected a dividend of IEP 2,742,616 (approximately USD 5,500,000), paid by its newly acquired Danish subsidiary. On November 3, 1993, it was decided at a general meeting of the Irish company to distribute a dividend of IEP 2,742,616 to the company's two Danish shareholders.

For purposes of their income tax relating to the year 1993, the taxpayers stated in their income declarations that the exchange of shares in the Danish company in return for new shares in the Irish company should be exempt from tax. The Danish tax authorities did not accept that statement, taking the view that the dividend distribution had to be regarded as forming part of the consideration for the exchange of shares, with the result that the maximum cash payment threshold of 10 percent of the nominal value of the securities issued in exchange, allowed under the EC Taxation of Mergers Directive,[7] had been exceeded. In the authorities' view, the exchange of shares could, therefore, not be exempt under the Directive.

The taxpayers brought an action before the Eastern Regional Court (*Østre Landsret*), which decided to stay the proceedings and to refer the following question to the ECJ for a preliminary ruling:

> Is Article 2(d) of Directive 90/434/EEC . . . to be interpreted as meaning that there is no "exchange of shares" within the meaning of that directive where the persons involved in the exchange of shares, at the same time as agreeing to exchange the shares in a non-legally binding manner, declare it to be their common intention to vote, at the first general meeting of the acquiring company after the exchange, in favour of distributing a profit in excess of 10 percent of the nominal value of the security transferred by way of the exchange of shares and such a profit is in fact distributed?

The ECJ stated in paragraph 38 of its decision that the exchange of shares in question is covered by Article 8(1) of the Taxation of Mergers Directive, which implies that it cannot, in principle, be subject to tax. The Court went on to state that since the National Court and the Danish Government had stated on a number of occasions that the exchange of shares at issue in the main proceedings was not carried out for any commercial reason whatsoever, but solely for the purpose of achieving tax savings, it was appropriate to consider the application of Article 8(1) in the event of a possible abuse of rights.

The ECJ concluded in paragraph 46 of its decision that it is for the National Court to ascertain whether there is, in Danish law, a provision or general principle prohibiting the abuse of rights or other provisions on tax evasion or tax avoidance that might be interpreted in accordance with Article 11(1)(a) of the Taxation of Mergers Directive and that might, therefore, justify taxation of the exchange of shares in question. The tax authorities accepted the judgment of the ECJ and the taxpayers were allowed to benefit under the terms of the Directive (presumably on the grounds that they accepted that there was no such provision or principle in Danish law).

The judgment indicates that national authorities and courts are required to apply EC law in deciding a national tax matter, that domestic provisions are be interpreted in accordance with EC law and, finally, that any decision that imposes a tax burden must be based on a provision that enables the persons concerned to know the full extent of their rights and obligations.

The Danish courts have in a number of instances set aside attempts by the tax authorities to recharacterise a transaction for tax purposes.

One example of this is afforded by the 2007 decision of the Supreme Court, in which a redemption of shares by the issuing company was upheld as such.[8] The tax authorities had characterised the transaction as a sale of shares triggering capital gains taxation, whereas a redemption of shares by the issuing company would have been a tax-free distribution of dividends. The share capital of the issuing company was increased by an amount equivalent to the amount distributed immediately before the redemption. The capital increase was subscribed by an independent party. The tax authorities claimed that the transaction should be regarded as a sale of shares to the independent party and not redemption of capital. In reaching its decision, the Supreme Court reviewed the legal history of the applicable tax provisions and found that the redemption of shares is tax-free irrespective of the manner in which the equity of the company was provided (i.e., whether by way of accumulated earnings or as a result of a capital contribution). The fact that, prior to the capital increase, the company redeeming the shares did not have sufficient funds to carry out the share redemption could not change the way the transaction was treated for tax purposes.

II. Will the Danish tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Danish law, despite its lack of economic substance?

As illustrated by the decisions discussed in the introduction, the Danish courts will set aside a transaction if it lacks economic substance despite the fact that the transaction, on its face, satisfies each element of existing Danish law. On the other hand, the Supreme Court has set aside a year-long practice of the tax authorities preventing artists from incorporating for tax purposes. In a 1998 decision,[9] the Supreme Court allowed an opera singer to incorporate for tax purposes, as the court found that there was no statutory or other legal authority for not recognising a company the services of which could only be provided by one performer.

III. What are the pre-requisites for a transaction to be considered immune from challenge under Denmark's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

The Danish courts pay great attention to the underlying economic aspects of the transaction in question. For example, in a 2007 decision, the Supreme Court disallowed a deduction for interest on the grounds that the debentures issued with respect to which the interest was paid did not cover any real obligation.[10] It had not been demonstrated that payments would be made in full and, according to the prospectus, the investment did not show a profit, except for the tax benefits claimed.

On the other hand, in a decision that was subsequently appealed to the Supreme Court,[11] the Western Court of Appeal held that the existence of a non-recourse provision in itself was not sufficient argument for setting aside for tax purposes an investment made by a partnership in a UK hotel. The partnership had registered title to the property and other loans obtained in connection with the financing of the investment did not contain non-recourse provisions. The partnership thus had the opportunity to make a profit or loss on the investment. (On appeal, the Supreme Court upheld the decision of the Western Court of Appeal.)

A professor in law at the University of Århus summarised the position in an article published in 2008 as follows: "the courts will not recognise the otherwise legal and valid transactions of a taxpayer if these are merely substitutes for another economic reality. Instead the tax consequences will be tied to the underlying economic reality."[12]

IV. What is the tax result of a determination that a transaction lacks economic substance?

In the decisions discussed above, where the relevant investment was not recognised for tax purposes, the transactions were set aside in their entirety. In certain cases, however, the courts have upheld the transaction itself but denied a deduction for certain expenses. For example, in the case concerning the UK hotel investment,[13] the investment as such was recognised, but a deduction fee paid to the seller was not allowed to be included in the depreciable basis of the hotel and was also not allowed to be deducted as a start-up expense, such expenses not being deductible for tax purposes.[14]

NOTES

1 UfR (a weekly case reporter) 1982.738Ø.
2 UfR 2000.1011H.
3 UfR 2006.818H.
4 UfR 2009.1241H.
5 SKM 2010.123H (SKM is the official tax reporter of SKAT –the Danish Tax and Customs Administration).
6 C-321/05 *Kofoed*.
7 90/434/EEC.
8 UfR 2007.736H.
9 UfR 1998.1314H.
10 UfR 2008.2838H.
11 UfR 2009.449H.
12 Professor dr. jur. Jan Pedersen UfR 2008B.197.
13 UfR 2009.449H.
14 State Tax Act of 1922 –Act no. 149 of April 10, 1922 (*Statskatteloven*), Sec. 6.

Host Country FRANCE

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I. Introduction

The French tax treatment of a transaction depends primarily on its legal analysis. Unlike in some countries, the economic analysis of a transaction is not the prime factor in determining how the transaction should be treated for tax purposes, when it is clear how the transaction is to be classified from a legal point of view.

However, Article L 64 of the French Tax Procedure Code (LPF), which is generally referred to as the "abuse of law" (AOL) rule, allows the French tax administration (FTA) to challenge the tax treatment of a transaction when the real nature of that transaction has been disguised or the transaction has been entered into for the sole purpose of avoiding tax.

This paper first describes how and when the AOL rule can be implemented (see II., below). The paper then goes on to describe the situations in which taxpayers can avoid the application of the AOL rule (see III., below). Finally, it indicates what are the consequences of the AOL procedure when it is implemented (see IV., below).

II. Will the French tax authorities respect the form of a transaction that, on its face, satisfies each element of existing French law, despite its lack of economic substance?

The AOL rules have evolved over time (see A, below). Recourse to the AOL rule by the French tax authorities is subject to a specific procedure, which is governed by the law and aims to protect taxpayers against extensive use of the rule (see B, below).

A. Evolution and current status of the AOL rules in France

1. Evolution until 2006: from simulation to fraud by intent

The notion of "fraud by intent" is a general concept of French law that was first enunciated in a civil law context in the *Princesse de Beaufremont* case of 1878, which concerned the attempt of the princess to obtain a divorce by changing French nationality and getting divorced in another country, when divorce was not yet allowed in France.

In the tax area, an 1867 civil court decision,[1] which concerned registration duties, and several administrative court decisions between 1930 and 1935 already allowed for the possibility of reclassifying transactions in the case of simulation, but the AOL procedure was not officially enacted as a specific rule until 1925 in relation to registration duties and 1941 in relation to income tax, the rule being unified and codified in Article L 64 of the LPF.[2] Until 2008, this Article provided that:

"acts are non-enforceable against the French tax administration (below referred to as the FTA) when they conceal the true nature of a contract or agreement through clauses that:

- Result in lower registration duties or less duty on property transfers; or
- Disguise the realisation or transfer of income or profit; or
- Provide partial or full shelter from turnover taxes on operations carried out under a contract or agreement.

The FTA then has the right to rely on the true nature of the transaction."

Initially, the application of the AOL procedure was mainly limited to pure simulation, which was considered by some commentators[3] to be a concept distinct from that of "*fraus legis*." Pursuant to that approach, the administrative courts admitted the AOL procedure in cases dealing with the three traditional forms of civil "simulation:"

1. A purely fictitious act: here, the simulation is intended to lend credence to a legal operation that does not actually exist (for example, a false invoice or a false lease[4]);
2. A disguised act: in this situation, the nature or the content of the ostensible act is contradicted by a secret agreement (for example, a donation of shares disguised as a sale to avoid registration duties or a sale of assets disguised as a sale of shares); and
3. The interposition of persons: this last form of simulation features an apparent party to the act (the "figurehead") and a hidden beneficial owner (or debtor).[5]

Under this initial approach, the question that had to be determined was whether the legal position was masking a different economic reality.[6]

In 1981, the scope of the AOL procedure, as defined by Article L64 of the LPF, was extended by case law in a landmark decision[7] that introduced the "purpose test." In this decision, the Administrative Supreme Court ruled that, as well as in cases involving fictitious acts, the FTA may implement the AOL procedure if it can prove that the transactions concerned have no other purpose than avoiding or reducing the tax burden to which the taxpayer would normally have been subject in view of its situation and activities. Subsequent decisions have confirmed that, under this purpose test, the AOL procedure can be implemented to counter non-fictitious acts that are exclusively tax-driven.

With this decision, the Supreme Administrative Court introduced a new interpretation of the AOL close to the concept of "*fraus legis*" or "fraud by intent," thus potentially considerably extending the scope of the procedure. However, since 1981 the Administrative Supreme Court has taken a restrictive approach to the purpose test and confirmed, in many cases, that the AOL procedure is not intended to prevent taxpayers from choosing the most favourable legal framework, but only to punish tax evasion.[8] Besides, addressing the validity of the purpose test in connection with favourable tax provisions, the High Court has refined its approach by ruling that, in these situations, there is an abuse of law only if the taxpayer applies the favourable tax provisions in such circumstances that the objective that the legislator had assigned to them is not fulfilled.[9]

2. 2006: finalised definition of AOL

In the 2006 *Janfin* case,[10] the French High court had to decide whether the wording of Article L64 of the LPF (see II.A.1., above) allowed it to be applied to a transaction involving the use of a tax credit (*avoir fiscal*). This gave rise to a question of interpretation in relation to Article L64, the wording of which (again, see II.A.1., above) did not expressly authorise its application in the context of matters relating to the computation of corporate tax, but only in the context of matters relating to the computation of the taxable basis for corporate tax purposes (so excluding situations involving the use of tax credits). The High Court decided that Article L 64 could not be read broadly and, therefore, could not be applied to a situation that was not within the scope of the provision. However, the Court indicated that the general "*fraus legis*" principle could also apply in the tax area, in circumstances that were outside the scope of the narrower definition of Article L64.

In addition, this decision was important because it saw the Court introducing a new "subjective" criterion in the definition of fraud to the law, when it referred to the intention of the legislator in creating the tax rule that the taxpayer is seeking to apply, in order to align the French approach in this context with the criteria adopted in European case law (see below). The new criterion did not dramatically change the overall approach (in fact, the purpose of a "derogatory tax regime" (i.e., a tax regime that differs from the normal tax regime) had already been taken into consideration by the High Court in the 1981 case referred to above), but, as will be seen in the next section, it has been interpreted in a way favourable to taxpayers (see the comments on *Axa* in II.A.3., below).

Even though they were subject to different procedures at that time, as the High Court later confirmed,[11]the definition of AOL and the wider concept of fraud to the law were identical *Janfin*, however, gave rise to a procedural problem because there were situations in which the concept of fraud to the law could be applied, but not the narrower AOL tax procedure, that were not subject to the specific AOL procedure, which involves specific penalties and guarantees (as, described in II.B., below). The tax law was therefore modified so that the new refined and EU-compatible AOL definition would apply to all situations in which a tax issue was involved.

Article L64 of the LPF now provides that: *"In order to restore their true character, the Administration has the right to ignore, as not binding, acts that constitute an abuse of law, either because these acts are fictitious, or because, by seeking the benefit of a literal application of the law or decisions contrary to the objectives pursued by their author, they cannot have been inspired by any other motivation than avoiding or reducing the tax burden that the person would have normally borne in view of his/her situation or his/her real activities."*[12]

3. Important cases on AOL

Since 2004, there have been a number of court decisions that have focused on the application of AOL rules, particularly in the financial area. Although there was some fear in 2006 and 2007 that the AOL could become a weapon to which the FTA might frequently and easily resort, it appears that the judiciary wishes to restrict the scope of its application to situations in which there is evident fraud. Some of the important AOL cases of the last 15 years can be summarised as follows:

- *Gras Savoye* and *SAMO*[13] concerned "Turbo funds," i.e., mutual funds in which investments were made shortly before coupon date so as to benefit from favorable official FTA guidelines that allowed tax credits available at year end on income received by such fund to be attributed in the same amount to all investors existing on the coupon payment date as if they owned shares in the funds at year end. Such funds were used to multiply artificially the tax credits available to new entrants in the funds. The High Court decided that the AOL could not be applied on the grounds that applying a favorable guideline can never be abusive if the taxpayer respects the wording of the guideline. This was regarded by some (or, rather, many) commentators as a very tolerant viewpoint, implying that the AOL had an extremely narrow scope of application, but later case law has shown that the High Court is not so tolerant in all situations.

- *Pléiade*,[14] decided in 2004, and *Sagal*,[15] decided in 2005, concerned situations in which various companies jointly invested in an exempt Luxembourg holding company, the purpose of which was to convert taxable interest into non-taxable dividends. The Court agreed with the FTA that the structure, the purpose of which was to benefit from the participation exemption while at the same time avoiding the application of the French controlled foreign company (CFC) rules, was abusive.
- *Janfin*, which was decided in 2006 and is referred to above, concerned dividend stripping transactions involving dividend payments on shares of dormant companies effected within a group of affiliated companies. Each dividend payment had been tailored in order to match exactly the amount of the subsequent capital loss on the sale of shares. Furthermore, the transfers of the portfolio allowed the initial buyer to offset its corporate income tax liability generated by previous capital gains. The High Court decided that the AOL rule as worded at that time did not apply to tax credits and that, although the general "*fraus legis*" concept could have been applied, it was not applicable in practice, because the FTA had failed to invoke it.
- *Bank of Scotland*, decided in 2006,[16] concerned the sale of a usufruct with respect to French shares by a US corporation to a UK bank, which gave rise to the refund of a French tax credit and a lower rate of withholding tax on dividends under the France-U.K. tax treaty than under the France-U.S. tax treaty. The High Court decided that the FTA could characterise the sale agreement in accordance with its true nature and refuse the benefit of the France-United Kingdom tax treaty without having to follow the AOL procedure, by relying on the more general fraud to the law principle applicable to treaty shopping, which was not at that stage included in the scope of Article L 64 of the LPF as regards matters relating to tax credits.
- In *Axa*, which again concerned transactions in stocks dividends on which attracted a tax credit, the Court gave an example of how it will apply the new subjective test that looks to the "intention" of the legislator and denied the application of the AOL. *Axa* is discussed further in III.C., below.
- Cases concerning registration duties are heard by the Civil High Court (*Cour de Cassation*) rather than the Administrative High Court (*Conseil d'Etat*). Historically, the civil courts have taken a restrictive approach when addressing AOL issues, although some 2006 and 2007 decisions seemed to signal a significant move in the direction of a broader approach in favor of the FTA.[17] Hopefully, the changes in the law will help to align the positions of the two High Courts.

B. The compulsory AOL procedure

If the FTA is able to establish that there is AOL, the taxpayer concerned suffers very significant financial consequences (see IV., below). This is why the law provides strict procedural guarantees to taxpayers, although the procedure can work against the taxpayer. The main features of the procedure are as follows:

- Implementation of the procedure by a tax inspector requires control and formal approval of the reassessment notice by the local head of the FTA (*inspecteur divisionnaire*).
- The burden of the proof lies with the FTA, which must prove that the prerequisites for the AOL procedure have been satisfied. In practice, however, the burden of proof is shared with the taxpayer in so far as the taxpayer must establish that there were reasons other than tax reasons for entering into the transaction concerned.
- In the case of a disagreement as regards the proposed reassessment, either the taxpayer or the FTA can submit the case to a dedicated national committee. This committee comprises representatives of the administration, a law professor, a lawyer, a notary and an accountant. Although its opinions are not binding on the parties, an opinion of the committee ruling against the taxpayer transfers the burden of proof to the taxpayer for the rest of the procedure before the courts. The opinions issued by the committee are published annually.

If the FTA does not observe the above procedure, because either it fails to obtain the appropriate certificate from the local head of the FTA, or it fails to prompt the taxpayer to submit the case to the committee, the AOL procedure is regarded as null and void. This can occur when the FTA attempts to recharacterise the legal nature of a transaction, but fails to invoke Article L 64 of the LPF (in what are known as "hidden AOL" situations) and therefore does not follow the procedure. However, the administration does not have to apply the AOL procedure when the point at issue is the existence of a transaction for which the taxpayer has provided no justification, or where a situation is incorrectly characterised by the taxpayer.

It is clear, however, that there is a grey area between those situations in which the AOL evidently applies and those in which it does not. (When a tax inspector recharacterises a transaction, is it because its original characterisation was erroneous or because that characterisation was concealing a different transaction to avoid tax?) It can, thus, be tempting for taxpayers to argue that the FTA is implicitly invoking the AOL in circumstances in which it fails to follow the procedure.

III. What are the pre-requisites for a transaction to be considered immune from challenge under France's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

The following sections look at the factors that may have to be considered when challenging the AOL rule:

A. The existence of tax fraud under "local" rules

Attempting to reduce one's tax liability is not, of itself, fraud. Taxpayers with a choice of various ways in which to achieve their legal or operational objectives are not obliged to select the most tax-expensive way.[18] The European Court of Justice (ECJ) has also confirmed that minimising one's tax burden does not, of itself, constitute fraud (see *Cadbury Schweppes*, of which more below).

The notion of fraud presupposes that there has been effective evasion with respect to the tax that the taxpayer would normally have been subject to in view of its situation and activities. This must necessarily be the case with respect to the tax paid in the "local state," i.e., here, France. Again this has been confirmed by the ECJ in a number of cases, most recently in *Cadbury Schweppes*.[19]

According to *Cadbury Schweppes*, the AOL and other anti-avoidance rules (for example, CFC rules) should not apply in an EU context if the taxpayer has created a structure that gives rise to a lower tax liability but the tax concerned was not avoided in the country applying the anti-avoidance rule (which, for example, raises the question of the application of CFC rules where shares are owned indirectly, through a foreign holding company that is not itself a CFC. The question can also be raised in a non-EU context, depending on whether anti-avoidance rules should be read restrictively or whether they can also be regarded as applying in situations in which no effective evasion in the country applying them has occurred).

The 2007 French *Pharmacie de Chalonges*[20] decision also confirmed that the AOL cannot apply when the transaction concerned, though entered into only for tax purposes, had no effective tax consequences, in view of the fact that it "corrected" the effect of another transaction, thus leaving the taxpayer with the same tax liability as it would have had originally.

B. The existence of reasons other than tax reasons

The AOL will not apply when the taxpayer can show that there are reasons for entering into a transaction other than tax reasons. Do the tax reasons have to be "exclusive" or "essential" if the AOL is to apply? In other words, is it sufficient to prevent the AOL from applying that there are other reasons than tax reasons, or is the court required to consider and compare the relative importance of the tax and non-tax reasons? This remains an open debate — a number of ECJ cases initially suggested that the criterion would be that the purpose of a transaction must be "exclusively" to avoid tax.[21] Later ECJ case law states that the purpose of a transaction must "essentially" concern tax.[22]

While it is difficult at this stage to predict what will be the interpretation of the French courts, this is largely a question of semantics, because it will be each judge's subjective opinion on a case-by-case basis that will determine whether a transaction is considered to be fraud (and each judge will therefore disregard those elements that he views as not material).[23]

C. The subjective condition: purpose of the law test

In accordance with the 2006 *Janfin* decision and the new wording of Article L 64 of the LPF, when a taxpayer relies on a literal interpretation of a law to obtain a tax benefit, the AOL will apply if that interpretation is contrary to the intention of the legislator.

However, this new criterion, which is regarded as the "subjective" part of the definition, could prove more difficult to apply than might initially appear. Benefiting from a favourable tax regime cannot, of course, be abusive when it is the intention of the law to provide such a benefit in a defined economic situation. In more ambiguous situations, where the FTA would challenge the provision of a benefit under the law on the grounds of the AOL, the courts will have to look to the intention of the legislator to determine whether he intended to cover the taxpayer's particular situation.

The French High Court recently had occasion to rule on this issue. In *Axa*,[24] the Court confirmed that transactions over the coupon date involving French stock, dividends on which attracted the *avoir fiscal* (i.e., the tax credit attached to French dividends), that allowed the taxpayer to transfer the tax credit to the purchaser of the stock, or lending transactions having the same effect, were not abusive, because the intention of the law was to avoid double taxation by granting a tax credit, which is a means of payment of tax. Nothing in the law or the *travaux préparatoires* require any more than that the taxpayer should be the legal owner of the stock at the time of the payment of the coupon. The High Court, therefore, considered that the second "subjective" element required by the new AOL definition was not present and the AOL could not apply.

In *Axa*, the Court had to analyse what was the intention of the law of July 12, 1965 creating the *avoir fiscal*. Unfortunately, it is far from certain that such a teleological explanation will be available with respect to all laws. In many situations, where there is little literature on the process by which the law concerned was implemented, the judge will have to determine himself, based on what little material he is able to obtain, what he believes the intentions of the legislator were, which would be even more subjective. *Axa* seems to suggest that, if the *travaux préparatoires* are vague or silent as to the objective of the law with respect to the situation at issue and do not confirm that what the taxpayer is trying to achieve is contrary to the legislator's intention, then the second element of the AOL definition is absent.

This state of affairs obviously favours taxpayers, who must hope that, when having registered discussions at the parliament during the *travaux préparatoires*, members of parliament will refrain from ambiguous discussions or from raising issues without answers, which could subsequently gain the force of law.

D. The EU principles: freedom of establishment

The ECJ has ruled in a number of cases that national rules cannot restrict freedom of movement or freedom of establishment within the EU, freedoms which are protected by Article 43 of the EC treaty, and that restrictions on these freedoms cannot be justified by the need to remove the potential threat of tax avoidance.[25] In *Cadbury Schweppes*,[26] the ECJ also condemned over-extensive anti-avoidance rules (specifically, the UK CFC rules) applying to situations other than qualifying fraud in the country concerned. In an EU context, anti-avoidance rules, such as CFC rules, are contrary to the principle of freedom of

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establishment and can be applied only if the State applying them can show that the scope of the rules is limited in its application to situations in which a taxpayer enters into a transaction for the sole purpose of avoiding tax due in that State.

The French High Court indicated in its 2005 *Sagal* decision[27] (see also above) that, in accordance with this ECJ case law, the French AOL can be implemented in an EU context to the extent it applies to transactions whose only purpose is to avoid French tax.

E. Prior rulings

France does not have the kinds of compulsory disclosure rules that exist in the United States and the United Kingdom, although discussions are on-going on this subject. The French legislation does, however, contain a safe-harbour provision (Article L 64 B of the LPF), which provides that the AOL procedure does not apply when the taxpayer has requested and obtained a preliminary ruling from the central tax authorities before entering into a transaction. In the absence of a reply to a ruling request after the expiry of a six month period, the FTA cannot invoke the AOL. In practice, however, the ruling procedure has not much been used by taxpayers, who tend to make their own analyses. This is consistent with the fact that case law only allows the AOL to be applied in relatively obvious situations, where the taxpayer can easily guess what is likely to be the FTA's response.

IV. What is the tax result of a determination that a transaction lacks economic substance?

In situations in which a taxpayer has created an apparent situation and has disguised the real situation or has entered into a secret transaction, the FTA can decide to accept the apparent situation and does not have to invoke AOL.

If the FTA successfully applies the AOL procedure, the challenged transaction, if it is fictitious, is totally ignored, or, in other situations, is treated according to its effective substance.

AOL is sanctioned by a specific tax penalty equal to 80 percent of the amount of tax reassessed, plus late payment penalties.[28] The 2008 law, however, reduced the penalty to 40 percent when there is no proof that the taxpayer was primarily responsible for initiating the abusive transaction or was its main beneficiary. It is the FTA's responsibility to prove that the 80 percent penalty is applicable and that the taxpayer should not benefit from the lower 40 percent penalty. All parties to the contract, agreement or action concerned are jointly and severally liable with the taxpayer for the payment of the tax and penalties.

Apart from these tax penalties, the FTA can also prosecute the taxpayer on a personal basis for a criminal offence, which can generate additional penalties, up to a maximum amount of EUR 37,500 and up to five years' imprisonment.[29] The penalty can be increased to EUR 75,000 in certain specified cases of fraud (the conducting of transactions without invoices or the obtaining of undue refunds) or even EUR 100,000 in the case of recidivism, and up to 10 years' imprisonment. Accomplices can also be pursued. The offending persons can also lose their civil rights and rights of citizenship.

V. Conclusion

The FTA has always stated that AOL procedure can only be used to challenge the genuineness of legal actions in exceptional circumstances.[30] However, the possibility that the AOL affords of challenging the overall tax treatment of a transaction can be very tempting to tax inspectors, especially because of the high level of penalties involved when use of the AOL procedure is sanctioned by a judge. The AOL creates a "double or nothing" dilemma for taxpayers, who must either face the high pressure of negotiating a reassessment so as to reduce penalties, or take the risk that the tax cost maybe doubled if AOL is confirmed by the courts.

Except where an agreement is reached between the FTA and the taxpayer, this procedure largely relies on the level of control effected by the courts, which have the difficult task of adjudicating the objective of fighting or discouraging tax avoidance, without creating systemic doubt for taxpayers as to how transactions will be treated for tax purposes. This puts both great power and great responsibility in the hands of judges and the procedure has been the subject of severe criticism on the grounds that it can create a climate of systemic uncertainty and insecurity, which is both harmful for business and contrary to the general principles of freedom. In practice, however, the experience has been that the Courts have exercised a high level of restraint as regards this procedure and it continues to be applied only in relatively rare cases.

There has probably been tax avoidance since the first tax was introduced — it is certainly not a purely modern problem, but it is, and will doubtless remain a very sensitive one, hinging as it does on the equilibrium between the desires of the administration and those of the citizens. The criticism of the rather subjective nature of the French AOL procedure invites a comparison with more specific anti-avoidance provisions, which also aim to prevent tax avoidance either by defining objectively the situations that are within and outside the law, or by "deeming" fraud to exist in certain circumstances (for example, CFC rules and deemed distributions rules). The specific provision approach forces the tax administration to rule in advance on all possible situations of economic life in laws and regulations, by creating rules with exceptions, exceptions to exceptions, etc, to prevent all possibilities of fraud or avoidance. The problem is that it is very difficult — indeed, probably technically impossible — to prevent all fraud and avoidance in this way. The approach is also open to criticism because the complicated deeming rules required apply to all taxpayers and not only to the minority they concern, which can often create significant difficulties for genuine transactions where no avoidance is involved.

The AOL procedure is less than perfect and its relatively imprecise definition creates uncertainty in some situations but the subjective nature resulting from the power allowed to the judge, gives it, like avoidance itself, a "human" character that allows it to adapt to the effective circumstances.

It could be asked whether the implementation of a general AOL procedure precludes the need for more specific anti-avoidance rules or at least reduces the number of such rules that are required, by acknowledging the fact that the law cannot organise everything and that abuses of the law should be subject to the discretion of the courts. Systematically combining both the general AOL rule and specific ant-avoidance rules would certainly create a "belt and braces" situation for the administration to the detriment of the principles of freedom.

NOTES

[1] Cass. civ. 20 août 1867 : D.P. 1867, 1, 337, cité par Stéphane Verclytte,Abus de droit et garanties des contribuables ayant appliqué la doctrine administrative : le triomphe de la sécurité juridique, RJF May 1998, p. 367, Sous Avis CE April 8, 1998, no 192539, Ass., *Sté de distribution de chaleur de Meudon et Orléans* (SAMO).

[2] These provisions first appeared in a Law of July 13, 1925, which provided a 200 percent penalty in the case of an abuse of law concerning registration duties and in a Law of Jan. 13, 1941 (which also introduced the first French thin-capitalisation rules), concerning income tax. The Law of Dec. 27, 1963 unified the provisions of these two laws in a single Article.

[3] See Maurice Cozian, «La gestion fiscale de l'entreprise», *Revue de Jurisprudence Fiscale* 5 (1980), p.202; Stéphane Verclytte «Abus de droit et garantie des contribuables ayant appliqué la doctrine administrative: le triomphe de la sécurité juridique» *Revue de Jurisprudence Fiscale* 5 1998), p.359 and RJF 02 1993 p 106.

[4] See CE Nov. 10, 1993, No. 62445, *Gianoli*.

[5] CE Feb. 20, 1974, No. 83270.

[6] CE Feb. 23, 1979 No. 6688, *Gamon*.

[7] CE, Plenary session, June 10, 1981 No. 19079.

[8] CE March 2, 1987, No. 51846.

[9] CE, Plenary session, Feb. 3, 1984, No. 38230. However, according to some commentators, the Supreme Administrative Court was applying the "simulation" concept in this case (see G. Goulard, Opinion "Fonds Turbo: abus de droit et garantie contre les changements de doctrine", *Revue de Jurisprudence Fiscale* 5 (1998), p.378).

[10] CE Sept. 27, 2006 no. 260050 sect., *Sté Janfin*: RJF 12/06 no. 1583.

[11] CE March 5, 2007 no. 284457, 8e et 3e s.-s., *Selarl Pharmacie de Chalonges* : RJF 5/07

[12] New Art. L64 provides that «*Afin d'en restituer le véritable caractère, l'administration est en droit d'écarter, comme ne lui étant pas opposables, les actes constitutifs d'un abus de droit, soit que ces actes ont un caractère fictif, soit que, recherchant le bénéfice d'une application littérale des textes ou de décisions à l'encontre des objectifs poursuivis par leurs auteurs, ils n'ont pu être inspirés par aucun autre motif que celui d'éluder ou d'atténuer les charges fiscales que l'intéressé, si ces actes n'avaient pas été passés ou réalisés, aurait normalement supportées eu égard à sa situation ou à ses activités réelles*»

[13] CE April 8, 1998, no. 189179, Ass., *Sté Gras Savoye*.

[14] CE Feb. 18, 2004 no. 247729, 8e et 3e s.-s., min. c/ *Sté Pléiade*: RJF 5/04 no. 510.

[15] CE May 18, 2005 no. 267087, 8e et 3e s.-s., min. c/*Sté Sagal*: RJF 8-9/05 no. 910.

[16] CE Dec. 29, 2006 no. 283314, 3e et 8e s.-s., min. c/ *Sté Bank of Scotland*.

[17] Cass. Com Oct. 31, 2006 n 1174 *StéAudit sud est* RJF é/07 n 40 and *StéDistribution Casino France* Dec. 5, 2007.

[18] CE June 16, 1976 no. 95513, 7e et 9e s.-s. : RJF 9/76 no. 399).

[19] CJCE Sept. 12, 2006 aff 196/04 RJF 2006 no. 1644.

[20] CE March 5, 2007 *Pharmacie des Chalonges*, Droit Fiscal, May 18, 2007 no. 522.

[21] CJCE 21-2-2006 aff. 255/02, *Halifax plc*, CJCE 22-5-2008 no. 162/07, *Ampliscientica Srl*.

[22] CJCE 21-2-2008 aff. 425n06, *Part Service Srl*.

[23] Maurice Cozian, a renowned French professor of tax law, has stated that "AOL is one of a number of « soft » legal concepts, such as good faith, morality, or the family's interest. It is all a question of situation and circumstances, we are in casuistry" (« l'abus de droit relève [. . .] de ce que l'on appelle les « concepts mous », au même titre que la bonne foi, les bonnes moeurs ou encore l'intérêt de la famille. Tout est question de contexte et de circonstances ; on est en pleine casuistique »).

[24] CE Sept. 7, 2009 no. 305586, 8e et 3e s.-s., min. c/ *SA Axa*, see also *Société Henri Goldfab*, which concerned transactions over the coupon date between related parties, with the same conclusion.

[25] CJCE Jan. 28, 1986 aff. 270/83, Commission c/ France: RJF 11/86 n° 1020; CJCE July 16, 1998 aff. 264/96 plén., ICI : RJF 11/98 no.1382 point 26.

[26] CJCE Sept. 12, 2006 aff 196/04,*Cadbury Schweppes*: RJF 2006 n 1644.

[27] CE May 18, 2005 no. 267087, 8e et 3e s.-s., min. c/ *Sté Sagal*.

[28] In practice, the penalties thus applied usually amount to 100 percent of the tax reassessed. Initially, they amounted to 200 percent of the tax reassessed.

[29] Article 1741 of FTC

[30] Administrative written directive 31st October 1941; Statement of practice No. 13 L-153 § 4

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Host Country GERMANY

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I. Introduction

While the German tax authorities clearly do not countenance tax *evasion* transactions, they are obliged to tolerate tax *avoidance* arrangements, because taxpayers may, of course, so arrange their affairs that their taxes be as low as possible. This principle has often been enunciated by the tribunals.[1] The problem is how to draw the line between tax avoidance, which is legal, and tax evasion, which is illegal. This is an extremely difficult problem, because there is no clear borderline between tax avoidance and tax evasion.

While Germany, like many other countries, has a general anti-abuse rule,[2] it also has a substance-over-form rule, which takes priority over the general anti-abuse rule, because it is an interpretative approach: the law must be construed pursuant to its purpose (the "teleological interpretation approach"). Moreover, in certain tax evasion cases, the authorities may also consider that there is a sham that must be disregarded,[3] or they may levy tax by applying the "analogy method."

To sum up, there are four general rules or approaches for combating tax evasion:

- Interpretation of the law according to its purpose, i.e., substance-over-form;
- Analogy;
- Sham;[4] and
- Abuse of law.[5]

In addition to these general rules or approaches for combating tax evasion, the tax administration and the legislator have introduced numerous specific anti-abuse rules. When the tribunals have found that there was legal tax avoidance where the tax administration assumed the existence of illegal tax evasion, the reaction of the legislator has often been to enact these specific rules. Some of these specific rules or methods are briefly discussed in II., below, before the general approaches to tax evasion are explained in more detail.

II. Specific anti-evasion rules

Germany's specific anti-evasion rules include the following:

- *Adjustment of income (transfer pricing).* If a taxpayer abusively tries to reduce its tax liability by shifting income to a foreign country by fixing, or agreeing upon, inappropriate transfer prices in transactions involving a closely-related foreign taxpayer, the income will be adjusted according to the arm's length standard. This is provided for in a number of special rules.[6]
- *Extended limited tax liability.* If a taxpayer moves to a foreign tax haven, this is deemed to constitute tax evasion. During the ten years subsequent to the move, the taxpayer will be treated more severely than a normal nonresident taxpayer.[7]
- *Capital gain on emigration.* A German shareholder who moves to a foreign country, whether with or without the intention of avoiding capital gains tax is subject to an exit tax.[8]
- *Controlled foreign corporation (CFC) legislation*. If a German domestic taxpayer establishes a corporation in a tax haven country in order to avoid taxation by creating a corporate veil, passive income of that corporation will be taxed as if it were distributed to the taxpayer.[9]
- *Anti-treaty-shopping-rule.* A non-resident shareholder of a German corporation who transfers his shares to a passive corporation in a tax treaty country in order to enjoy a reduction of withholding tax on dividends under the treaty will be treated as if he received the dividends directly.[10]
- *Thin capitalisation rule.* If a non-resident shareholder of a German corporation grants excessive loans to the corporation in order to strip taxable income from the corporation, the interest is only partially allowed as a deductible expense of the corporation.[11]
- *Exclusion of negative income from taxation.* A resident taxpayer may not deduct certain foreign losses incurred to reduce his taxable income.[12]

III. General anti-evasion approaches

This paper considers only the substance-over-form rule and the general anti-abuse rule.

A. Interpretation according to the substance-over-form rule

As noted above, the substance-over-form rule is conceived of as an interpretative approach, specifically the teleological interpretation approach.

There are two situations in which the administration may try to deal with international tax evasion by applying the substance-over-form rule:

1. The taxpayer has arranged the facts so that, by virtue of their form, they avoid the application of the clear wording of an unfavourable tax provision; or

2. The taxpayer has arranged his affairs with the intention of having the clear wording of a favourable tax provision apply to them.

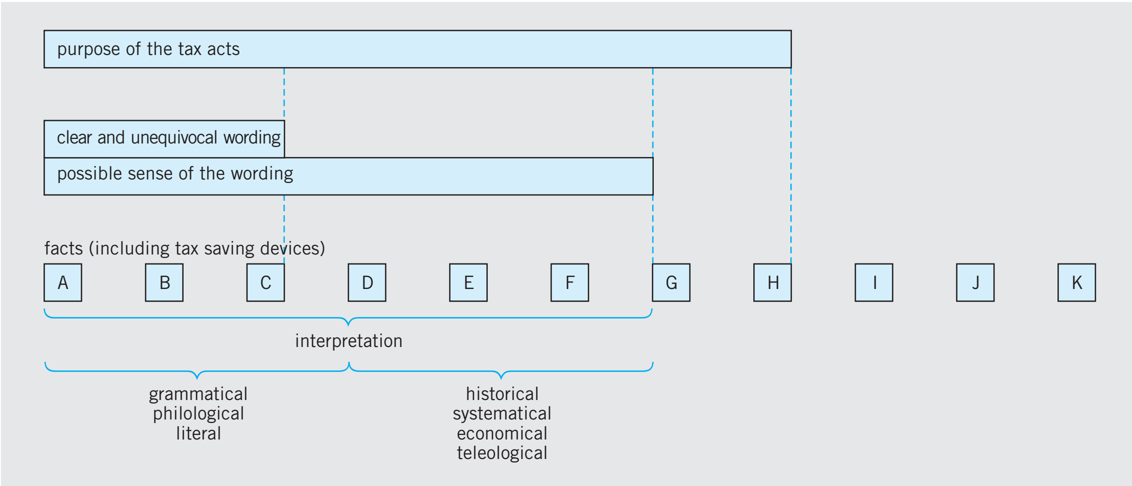
In other words, the taxpayer wishes form to prevail over substance. The administration may find, however, that the literal interpretation of the tax provision concerned is not consistent with the intention of the provision and may interpret the provision in accordance with its economic substance. The procedure for interpreting and applying legal provisions is illustrated in Chart 1.

B. General anti-abuse rule

There are cases, however, where the interpretation of the law is not sufficient to combat tax evasion because the facts are outside the possible meaning of the provision concerned. In such cases, the general anti-abuse rule of § 42 of the *Abgabenordnung* (AO Fiscal Code) may apply. Unlike the Anglo-Saxon countries, Germany has traditionally had a specific anti-abuse rule. The current rule reads as follows:

> "The tax act may not be circumvented by an abuse of possible legal arrangements. If the requirements of a special anti-evasion rule are met, that rule shall have priority. Otherwise, if there is an abuse, the tax claim

Chart 1: Interpretation of the tax acts



Thus, a taxpayer who applies a literal and grammatical interpretation may believe (and indeed hope) that the facts D, E and F are not covered by the provision concerned in accordance with its clear and unequivocal wording. The administration, however, may apply the teleological interpretation approach in looking to the economic substance of the provision and, in so doing, may find that the facts created by the taxpayer are covered by the provision. This approach to dealing with tax evasion is restricted to cases in which the facts are not beyond the possible meaning of the words of the provision concerned. The following example illustrates this approach: a businessman who has to support his daughter who is studying at a university gives her EUR 200,000 as a gift and receives from her a loan of EUR 200,000. He treats the loan as a business loan and pays his daughter interest at a rate of 6 percent, i.e., EUR 12,000 per year, paid in monthly installments of EUR 1,000. He treats the interest as a business expense.

Under § 4(4) of the *Einkommensteuergesetz* (EStG Income Tax Act), a business expense is defined as an expense occasioned by the business. The payment of the monthly sum of EUR 1,000 is not occasioned by the business, but by the family relationship between the businessman and his daughter. It is, therefore, not a business expense, but a maintenance payment. The legal form of a gift and a loan is disregarded in favour of the substance of the relationship. The approach taken is a teleological interpretation of § 4(4).[13]

In the famous U.K. *Duke of Westminster* case,[14] the German administration and the tribunals would have treated the payments to the Duke's private personnel as non-deductible salary payments.

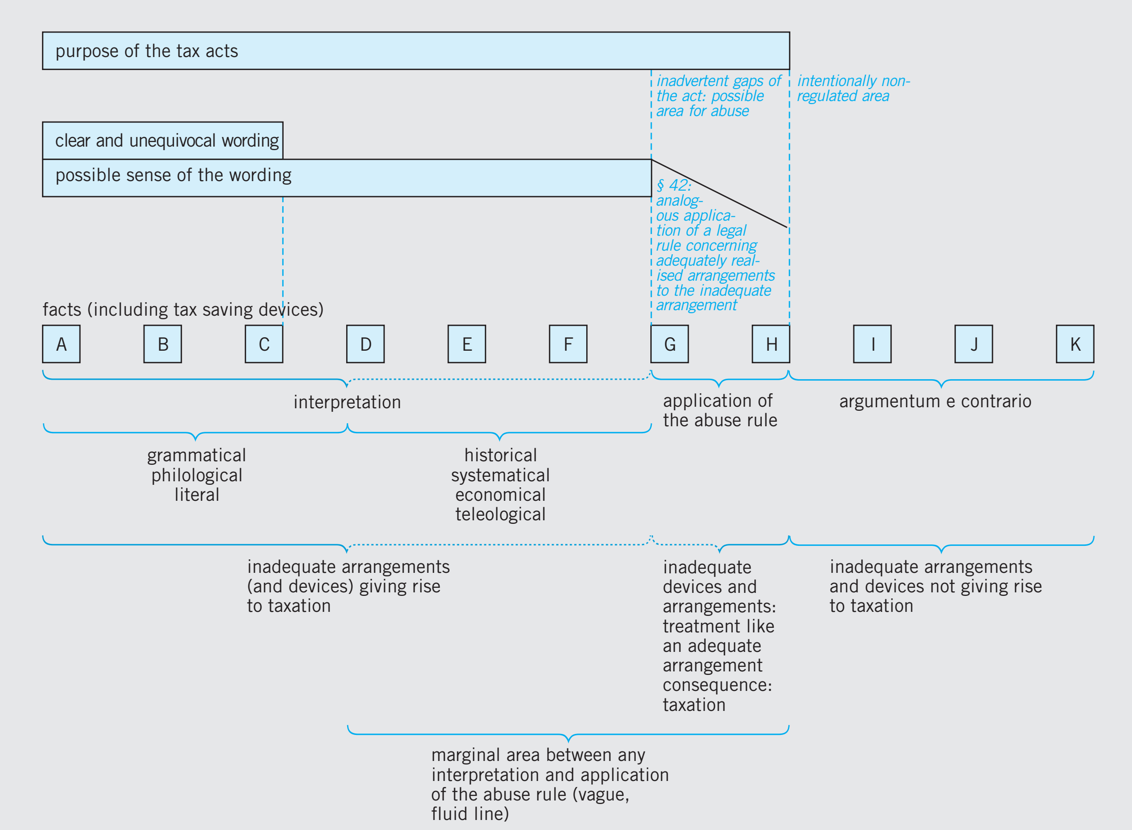
> shall be such as it would be if the legal arrangement were appropriate to the economic substance."

The provision can be summarised as encompassing the following legal elements and having the following consequences:

- An attempt to circumvent the tax act by arranging the facts so that:
  - They are not covered by the wording of the tax act, but
  - They are covered by the purpose of the tax act.
- Abuse of possible legal arrangements, i.e.:
  - A discrepancy between means and purpose;
  - An inadequate arrangement;
  - A "dodge;" or
  - The presumption of a right.
- A purpose of avoiding or reducing tax.
- A subjective element (which is controversial), i.e., the intention of circumventing the tax act.
- Legal consequences:
  - Fiction (analogous assumption) of an adequate arrangement, consequent tax claim.

The anti-abuse rule has some similarity with the analogy approach in that both the analogy approach and the anti-abuse-rule make the facts and the statute coincide. The difference between the two is that, where the analogy approach is used, the statute is extended beyond the possible meaning of its words to facts that do not come within the possible meaning of the wording of the statute; under the anti-abuse rule, the facts are restricted so that they are made to coincide with the wording of the statute. In short, the analogy approach entails an extension of the legal provision; the anti-abuse rule entails a fictitious restriction of the facts. This difference is illustrated in Chart 2.

Chart 2: Interpretation of the tax acts and analogy



IV. Pre-requisites for immunity from challenge under Germany's substance-over-form doctrine and anti-abuse rule

It is very difficult to say what are the pre-requisites for a transaction to be considered immune from challenge under Germany's substance-over-form doctrine and anti-abuse rule. One could say that a transaction would be immune from challenge if it were not abusive and its purpose were not to evade tax, but the question of whether there is abuse may be a matter of opinion where the case is not an extreme one and, as indicated above, the borderline between illegal tax evasion and legal tax avoidance is vague and nebulous. Also as indicated above, the tribunals are often more generous than the administration and, where the administration considers a transaction abusive, the tribunals will often hold that the transaction is a legal tax avoidance device.

In the case of thin capitalisation, the administration initially assumed that thin capitalisation was an abuse of possible legal arrangements: to the extent that a German company's indebtedness to its foreign shareholder exceeded 10 times the amount of its equity capital, the so-called "interest payments" were to be qualified as a constructive dividend, that is, the administration replaced the payment of interest with a fictitious dividend payment.[15] The *Bundesfinanzhof (*BFH Federal Finance Court), however, held that the conclusion of loan agreements was never an abuse of possible legal arrangements, because every shareholder was absolutely free to choose between equity and debt.[16] The ultimate consequence of this decision was the enactment of a special rule attacking thin capitalisation § 8a of the *Körperschaftsteuergesetz* (KStG Corporation Tax Act). This provision met an unhappy fate when, after several amendments, it was held to be inconsistent with European Community law and, after further amendments, it was replaced by the new earnings-stripping rule of § 4h of the EStG (the "interest barrier rule").

Another case in which the BFH held a transaction not to be abusive was the famous *Monaco* case.[17] The taxpayer, a resident of Monaco, held shares in German corporations. The dividends paid to him by these corporations were subject to a 25 percent withholding tax. The taxpayer established a wholly-owned corporation in Switzerland to which he transferred his shares in the German corporations. The sole purpose of the Swiss corporation was to hold the shares in the German corporations. The Swiss corporation claimed a reduction of the German withholding tax under the Switzerland-German tax treaty[18] and filed a request for a refund of the excess tax withheld. The Federal Finance Office, however, refused to refund the excess withholding tax, arguing that the establishment of the Swiss corporation was an abusive transaction that came within the scope of the general anti-abuse clause of § 42 of the AO.

The BFH held that § 42 of the AO was not applicable because it refers only to the arranging of facts in accordance with the rules of domestic law. The Court was of the opinion that the establishment of a corporation under Swiss law was outside the reach of § 42 and, therefore, did not constitute abuse. The reaction of the legislator to this decision was to introduce § 50d (1a) of the EStG, which later became § 50d (3) of the EStG. According to this provision, a foreign corporation cannot claim an exemption from or a reduction of German withholding tax, if it is held by persons that would not be entitled to such exemption or reduction if they held the shares in the German corporation directly, and if there is no economic or other respectable reason for the interposition of the foreign corporation.

In a case, often referred to as the *Hilversum* case, a Netherlands Antilles corporation held shares in various Dutch and German operating corporations. The dividends received from the German corporations were subject to German withholding tax. In order to have the dividends tax-exempt under the EC Parent-Subsidiary Directive, the Antilles corporation established holding corporations in the Netherlands that had their seat and management at the premises of the Dutch sister operating corporations. The shares in the German corporations were transferred to these Dutch holding corporations.

The German tax administration considered this transaction to constitute abusive "Directive shopping" and refused to refund the withholding tax on the dividends paid by the German corporations. However, the BFH[19] held that the transaction was based on sound business reasons, because it served to concentrate the European business of the Antilles corporation in the Netherlands. The reaction of the legislator to this decision was to insert additional conditions into § 50d (3) of the EStG that must be fulfilled in order for a foreign corporation claiming an exemption from or a reduction of withholding tax to be immune from a finding of abuse. Specifically, the foreign corporation must derive at least 10 percent of its earnings from an active business activity and must have a business establishment (in the jurisdiction that is used for the Directive shopping) that is sufficiently equipped to participate in general economic transactions.

The *Monaco* decision has been overturned by the BFH itself in a number of cases, and in particular in the case of the Dutch foundation. A foundation, which had its seat and management in the Netherlands, had two subsidiaries, X-BV and Y-BV. These two corporations had no offices of their own, but were domiciled with the foundation. X-BV and Y-BV had a partnership agreement and together contributed to the partnership DM 100,000. In addition, the partnership received a loan of DM 10 million from the foundation. The interest rate on the loan was 12 percent. The partnership acquired real estate in Germany for DM 10 million and derived rental income of DM 1 million from letting the real estate to third parties. The interest that the partnership had to pay to the foundation amounted to DM 1.2 million. The intention of this arrangement of the facts was to avoid taxation in Germany and the Netherlands: as nonresident taxpayers, in Germany X-BV and Y-BV had only domestic losses and, therefore, there was no base for German corporation tax purposes. The foundation (probably a pension fund), which had interest income from its loan to X-BV and Y-BV, was tax-exempt in the Netherlands.

The administration refused to recognise the payment of interest to the parent foundation as a deductible expense and, consequently, did not recognise the loss from letting and leasing on the grounds that the interest payment was abusive. The administration, therefore, taxed X-BV and Y-BV on their gross rental income. The case went before the tribunals, and the BFH finally rendered a decision, as follows.[20] The interposition of X-BV and Y-BV was an abuse of the law, because its only purpose was to divert taxable income from Germany. The two corporations had absolutely no function other than to avoid corporation tax. No third person would have granted them a loan of DM 10 million for the acquisition of the real estate. The adequate arrangement of the facts would have been for the foundation to invest its money directly in the German real estate and to realise domestic German taxable income from letting and leasing. The BFH, consequently, held that all the elements required by § 42 of the AO were present:

- There was an attempt to circumvent German corporation tax by the arrangement of facts that were not covered by the wording of the tax act, because the foundation had no income from letting and leasing.
- The interposition of the two corporations and the loan were arrangements that were inadequate and artificial. The purpose was to invest money in German real estate and to earn money from that investment. If that had been done directly and without a "dodge," the foundation itself would have realised the income.
- The purpose of the arrangement was to save tax.
- Consequently, the foundation had to be taxed according to the fictitious adequate facts. Rather than the two corporations, the foundation was the taxpayer and owed tax on the fictitious rental income.

The *Monaco* case has thus been overturned by this decision (and other decisions) in which the BFH applied § 42 of the AO to facts that were arranged exclusively abroad.

Another case in which the BFH applied § 42 of the AO to facts arranged abroad is that of the Dutch sister and brothers. In this case, A and B were brothers and H was their sister. All three were residents of the Netherlands. A and B were partners in a German commercial partnership, *offene Handelsgesellschaft* (OHG). H had a silent share in the partnership. A and B established a corporation (AG) in Switzerland to which H transferred her silent share in the partnership.

The profit of the OHG was distributed as follows: A and B each received 25 percent of the profit; the remainder was equally divided between A, B and the AG. The AG returned its profit share as a loan to the OHG. It thus received not only its profit share but also interest on the loan. The point at issue was whether the payment of the profit share and the interest to the AG were deductible expenses for the OHG. The purpose of the arrangement was to divert income of A and B from Germany and to have it realised as income of the AG in Switzerland. The AG, as a nonresident taxpayer, would not be taxable in Germany on its profit share and its interest, because neither would qualify as domestic income. If A and B had realised such income themselves, they would have been taxed. As partners of the OHG, they would be deemed to derive from Germany domestic business income, which would include the interest and the profit share from the silent participation. All the income of A and B would be attributed to their German permanent establishment, which they would be deemed to have in Germany as partners of the OHG.

The German tax administration refused to recognise the payments to the AG as deductible expenses of the OHG. However, the administration did not apply § 42 of the AO instead it did not follow the taxpayers' interpretation of the law. Specifically, it did not consider the AG to be a silent partner in and a creditor of the OHG but as a sort of agent or trustee of A and B, and attributed the AG's income directly to A and B. As a trustee or agent, the AG served exclusively the purposes of its shareholders.

The Finance Tribunal of Düsseldorf,[21] which had to deal with the case, held that the AG was neither a trustee nor an agent, because every corporation serves the purposes of its shareholders. The tribunal also did not apply § 42 of the AO and held that A and B were entitled to arrange their affairs with the legitimate intention of saving taxes.

The BFH,[22] however, held that the arrangement was an abuse of the law. An abuse must be assumed if the arrangement of the facts is unusual and inadequate and does not serve a good business purpose. The establishment of a base company in a foreign country is an abuse, if there are no business reasons or other good reasons for its establishment and if the base company does not carry on its own business activity. Such was the case of the AG in Switzerland, which did not even have its own telephone. Its only purpose was to attract income from Germany and to circumvent taxation in Germany. The BFH, therefore, substituted the facts as arranged by A and B with fictitious facts, i.e., the payment of the profit share and the interest directly to A and B. As income of A and B, the profit share and the interest qualified as domestic business income of A and B as partners in the OHG.

These two decisions are among those rare instances in which the BFH has applied the general anti-abuse rule of § 42 of the AO. Normally, the BFH is likely to hold that there is legal tax avoidance where the administration assumes that there is illegal tax evasion. However, one cannot be certain that a tax-saving device will be immune from challenge under the substance-over-form rule or the general anti-abuse rule. Absolute immunity from that challenge is guaranteed only where a tax-saving transaction relies on numerical amounts used in a tax provision unlike words, numbers are never equivocal and are, therefore, not amenable to a teleological interpretation. This has not always been clear, however. In its famous "*Pfennig-Urteil*" ("penny-decision"), the *Reichsfinanzhof* (RFH Imperial Finance Court) [23] decided against the taxpayer, who had taken advantage of a provision that used a numeric definition. The facts of the case were as follows:

An employee earned a monthly salary of DM 500. Under an Act in force since June 1, 1933, taxpayers who earned at least DM 500 had to pay a special tax that was used to support young families. The employee and his employer agreed to reduce the employee's salary to DM 499.99. The employee thus intended to avoid the special tax. The RFH applied the substance-over-form rule and held that the reduction of the salary by one Pfennig had no economic substance; the purpose and the economic meaning of the tax provision had to be respected.[24] This decision was later overturned by the RFH itself.[25] Taxpayers may calculate and choose their salary in such a way as to reduce their tax burden. They may reduce their salary by one Pfennig to avoid a higher tax scale bracket. DM 499.99 are not, even in substance, DM 500.

All explicit provisions combating tax evasion are precluded from application if the evasive transaction concerned cannot have the intended tax result because the tax provisions, as construed teleologically, do not justify the intended tax saving device. In other words, in these circumstances, the unwritten substance-over-form rule precludes the application of any written special or general anti-abuse rule. If the mere interpretation of the law is a sufficient tool against tax evasion, no written anti-abuse rule may be applied. For example, in the example (see above) of the businessman who gives money to, and borrows money from, his student daughter, the administration and the tribunals would not apply the literal interpretation desired by the businessman, under which the interest paid to the daughter would be qualified as a business expense; instead, they would consider the payments to be what they really are, i.e., private maintenance payments, which are not deductible from business income.

Until 1976, the substance-over-form rule was a statutory provision. § 1 of the *Steueranpassungsgesetz* (StAnpG Tax Adjustment Act) expressly provided that the tax acts had to be construed according to their economic substance. The draft of the AO of 1977 contained a similar provision, which was ultimately eliminated. The reason for the provision's elimination was that it was considered to be superfluous, because the interpretation of the tax acts according to their economic purpose follows from the general rules of interpretation with respect to tax provisions. In construing a tax provision according to its purpose, it is not the appearance of the facts, that counts, but their economic substance.[26]

V. Tax result of a determination that a transaction lacks economic substance

The tax result of a determination that a transaction lacks economic substance differs depending on which provision is being applied to combat the tax evasion. If a specific anti-abuse rule applies, the tax result must be derived from that rule. For example, if income is abusively shifted to a foreign country by an inadequate transfer pricing agreement between closely-related parties, the income is adjusted as if adequate prices had been agreed on as between unrelated third parties. To take another example, if a domestic taxpayer establishes a foreign corporation in a tax haven country, the passive income of the foreign corporation is attributed to the domestic taxpayer as if it were distributed to him.

Under general legal theory, a specific provision prevails over the general anti-abuse provision of § 42 of the AO. In other words, § 42 applies only if a specific anti-abuse rule cannot be applied. The legal consequence following from the application of the general anti-abuse rule is the replacement of the abusive transaction with the appropriate fictitious transaction that conforms to the economic substance of the abusive transaction. The tax result is then derived from the appropriate fictitious transaction.

NOTES

[1] E.g., BFH – *Bundesfinanzhof (*BFH Federal Finance Court), decision of Feb. 19, 1975, I R 26/73, BStBl.II 1975, 584; May 20, 1997 VIII B 108/96, BFH/NV 1997, 462.
[2] *Abgabenordnung* (AO Fiscal Code), § 42.
[3] AO, § 41(2).
[4] AO, § 41(2).
[5] AO, § 42.
[6] *Auszensteuergesetz* (AStG Foreign Relations Tax Act), § 1; *Körperschaftsteuergesetz* (KStG Corporation Tax Act), § 8(3) [hidden dividends]; (*Einkommensteuergesetz* (EStG Income Tax Act), §§ 4(1), 6(6) [hidden capital contribution].
[7] AStG, § 2.
[8] AStG, § 6.
[9] AStG, §§ 7 ff.
[10] EStG, § 50d(3).
[11] EStG, § 4h.
[12] EStG, § 2a.
[13] BFH decisions of: June 1, 1978, IV R 109/74, BStBl.II 1978, 618; and April 10, 1984, VIII R 134/81, BStBl.II 1984, 705.
[14] *IRC v. Duke of Westminster*, decision of the House of Lords of May 7, 1935, 1936 A.C. 1 (H.L.).
[15] *Bundesministerium der Finanzen* (BMF Federal Finance Ministry), letter of March 16, 1987, BStB.I 1987, 373.
[16] BFH, decision of Feb.5, 1992, I R 127/90, BStBl.II 1992, 532.
[17] BFH, decision of Oct. 29, 1981, I R 89/80, BStBl.II 1982, 150.
[18] Art.10 provides for a reduction of the withholding tax on dividends from 25 to 15%.
[19] BFH, decision of May 31, 2005, I R 74,88/04, BStBl.II 2006, 118.
[20] BFH, decision of Aug.27, 1997, I R 8/97, BStBl.II 1998, 163.
[21] FG Dusseldorf, decision of Nov. 20, 1981, II 38/76 F, EFG, 1982, 413.
[22] BFH, decision of Nov. 10, 1983, IV R 62/82, BStBl.II 1984, 605.
[23] *Reichsfinanzhof* (RFH the predecessor of the BFH).
[24] RFH, decision of May 22, 1935, VI A 467/34, RStBl.1935, 899.
[25] RFH, decision of Oct. 17, 1940, VI 142/40, RStBl.1941, 306.
[26] It is interesting to note that, unlike the German Fiscal Code, the Austrian fiscal code still contains an interpretation provision (BAO, § 21).

Host Country INDIA

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I. Introduction

Of course, all taxpayers will wish to minimise their tax liabilities and taxpayers will, therefore, often resort to tax planning and arrange their affairs to minimise the incidence of tax. Such behaviour may be within or outside the ambit of the tax laws. When a taxpayer's arrangement of his affairs is outside the ambit of the tax laws, this constitutes tax evasion and is an offence. Even when the arrangement is within the four corners of the law, doubts regarding liability to tax may arise in cases where the arrangement is motivated almost exclusively by tax considerations and not by commercial considerations. In such circumstances, the tax authorities may attempt to disregard the form of a transaction and decide the tax liability by looking at the substance of the transaction. The application of the doctrine of "economic substance" or of "substance over form" is the subject of constant litigation between taxpayers and tax authorities all over the world and India is no exception in this respect. This paper examines the effect of the economic substance doctrine on the taxation of tax-motivated transactions.

II. Will the Indian tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Indian law, despite its lack of economic substance?

A. Provisions under domestic law

The Income-tax Act, 1961 (the "Act") contains certain provisions that deal with this issue and determine tax liability on the basis of the substance of the transactions concerned. The following are examples of circumstances in which a transaction will be taxed on the basis of its substance, the form of the transaction being disregarded:

- **Taxation of dividend stripping transactions**: under Section 94 of the Act, if a taxpayer buys or acquires any securities or units within a period of three months prior to the record date for the dividend/income declaration and sells or transfers such securities within three months (the timeframe for units is nine months) of acquisition/purchase, any loss arising on account of such purchase and sale is ignored to the extent it does not exceed the amount of the dividend/income.
- **Taxation of deemed dividend**: if a loan or advance is granted to a shareholder by a company in which the public is not substantially interested, the shareholder can use this amount without payment of tax. Under section 2(22)(e) of the Act, such a loan or advance is treated as dividend income.
- **Taxation of capital gains on the transfer of land and/or buildings**: Section 50C of the Act provides for the substitution of the value for purposes of the payment of stamp duty for the actual sale consideration for the land and/or buildings.
- **Determination of the actual cost of an asset**: Explanation 3 to section 43(1) of the Act permits the tax authorities to determine the cost of an asset acquired by a taxpayer if it is satisfied that the asset was used by another person prior to such acquisition and the main purpose of the transfer of the asset was to reduce tax liability by claiming excess depreciation.
- **Sale and leaseback transactions**: Explanation 4A to section 43(1) of the Act disregards sale and leaseback transactions to a limited extent. It provides that the actual cost of the asset in a sale and leaseback transaction will be the same as the written down value of the asset in the hands of the lessee at the time of the sale of the asset.
- **Clubbing provisions**: Section 64 of the Act provides for "clubbing" the income of the taxpayer with that of his/her spouse or that of his/her son's wife in cases where an asset is transferred by the taxpayer to his/her spouse or his/her son's wife, as the case may be, without adequate consideration.

There are many situations not expressly covered by the Act in which the tax treatment is not specifically defined – for example, in the case of sale and leaseback transactions, it was not previously clear whether the lessor could get depreciation for the asset transferred and leased back. As a result, some of the tax authorities took a view that a lessor was not an owner and was not entitled to depreciation. In substance, this was a financing transaction and the lessor would be entitled to a deduction for the principal component in calculating its lease rental income. Similarly, the circumstances in which tax treaty benefits may be denied in the case of inbound transactions is not specifically defined in the Act. The tax authorities may sometimes take the view that investment into India made by an international institution via the Mauritius route does not qualify for benefits under the India-Mauritius tax treaty.

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B. Legal position – before the McDowell decision

The Indian courts have examined the issue of "substance over form" in a number of cases. As India was a British colony prior to independence, Indian courts generally followed precedents established by the English courts and were initially guided in this area by the landmark decision of the House of Lords in *Duke of Westminster v. IR*.[1]

In *Duke of Westminster v. IR,* the Duke had executed deeds of covenant in favour of his employees covenanting to pay a fixed weekly amount for a predetermined time period in consideration for services rendered. The Duke claimed a deduction of the annuity amount from his total income for purposes of surtax. The Crown argued that the payments made were towards the remuneration of services and were not deductible.

The House of Lords held that the subject has the legal right so to dispose of his capital and income as to attract upon himself the least amount of tax. The subject cannot be taxed by ignoring the legal position and looking at "the substance of the transaction." The principle laid down in *Duke of Westminster* was approved in various cases before and after India became independent. Some of the decisions confirming this principle are listed below:

- *Bank of Chettinad Ltd. v. CIT*;[2]
- *CIT v. Parthasarathy Naidu and sons*;[3]
- *CIT and Ors. v. G Parthasarathy Naidu and Ors.*;[4]
- *S. Raghbir Singh Sandhawalia v. CIT*;[5]
- *CIT v. Elder*;[6]
- *CIT v. The Madras and Southern Maharatta*;[7]
- *Re Central Talkies*;[8]and
- *Aruna Group of Estates v. State of Madras*.[9]

1. Legal position in the pre-independence era

The principle laid down in *Duke of Westminster v. IR* (see above) was approved by the Privy Council in *Bank of Chettinad Ltd. v. CIT* (see above). This Privy Council judgment was the law until the Indian Constitution came into being.

2. Legal position in the post-independence era

By virtue of Article 372 of the Constitution,[10] the principle laid down in *Bank of Chettinad Ltd. v. CIT (*see II.B.1., above) continued to apply even after India became independent.

In *Jiyajeerao Cotton Mills Ltd. v. CIT*,[11] the Supreme Court held that there is nothing wrong with business being done in such a way as to escape taxation. No exception can be taken to that statement. Every person is entitled so to arrange his affairs as to avoid taxation. But the arrangements made must be real and genuine and not a sham or make-believe.

In *CIT v. A. Raman & Co.,*[12] the tax officer wished to reopen the assessment of the taxpayer on the grounds that the income that normally would have been earned by the taxpayer was divided between the taxpayer and another person. The Supreme Court once again held that avoidance of tax liability by arranging commercial affairs so that the charge of tax is distributed is not prohibited. A taxpayer may resort to a device to divert income before it accrues or arises to him. The effectiveness of the device depends not on considerations of morality but on the operation of the Act. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may lawfully be circumvented.

The approach of probing into the "substance of the transaction" was accepted by the Supreme Court in *CIT v. B. M. Kharwar*.[13] Even in this case, the Supreme Court observed that avoiding tax liability by so arranging commercial affairs that the charge of tax is distributed is not prohibited. The taxing authority is entitled, and indeed is bound, however, to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal the true legal relation by a device, it is open to the taxing authorities to unravel the device and to determine the true character of the relationship. But the legal effect of a transaction cannot be displaced by probing into the "substance of the transaction." This principle applies both to cases in which the legal relation is recorded in a formal document, and to cases where it has to be gathered from evidence – oral and documentary – and the conduct of the parties to the transaction.

In *UOI v. Gosalia Shipping (P.) Ltd.*,[14] the Supreme Court observed that one must have regard to the substance of the matter and, if necessary, look beneath the surface in order to see whether the true character of a payment is something other than what, by a clever device of drafting, it is made to appear. In this case, a ship owned by a nonresident was taken on a time-charter. The ship owner was entitled to receive payment for the use and hire of the ship irrespective of the nature of the use of the ship. It was held that the amount paid by the time charterer to the owner of the ship could not be treated as payment for carriage of goods as contemplated by section 172 of the Act.[15]

In *Smt. C. Kamala v. CIT*,[16] the Karnataka High Court respected the form of a transaction, holding that "it is well settled that it is the duty of a Court while administering any tax law to give importance both to the form and substance of a transaction. It is quite possible that when a transaction is entered into in one form known to law, the amount received under that transaction may attract liability under the Act and if it is entered into in another form which is equally lawful, it may not attract such liability. But when the assessee has adopted the latter one, it would not be open to the Court to hold him liable for tax on the ground that in substance the transaction is one which resulted in gain subject to tax. In matters of this kind, the Court cannot ignore the form altogether as also the legal effect of the proceedings in the Court."

The following sections deal in detail with the major cases in which the tax authorities attempted to apply the doctrine of economic substance by ignoring the form of the transactions concerned. The permissibility of tax planning, tax avoidance and tax evasion under the Act was examined in detail in these cases. The Courts have deliberated as to when a transaction is to be regarded as an attempt at tax evasion or tax avoidance using colourable devices or dubious methods. When the transaction concerned was used for tax evasion or unacceptable tax avoidance purposes, the doctrine of "substance over form" was applied by the tax authorities to tax the substance of the transaction.

C. McDowell

The form of a transaction was respected by the courts until the Supreme Court rendered its decision in *McDowell & Co. Ltd. v. CTO*.[17] This ruling actually blurred the distinction between tax avoidance and tax evasion for many years and served as a reference point allowing the tax administration to assert that colourable devices or dubious methods used to avoid the payment of tax cannot be part of tax planning, and provided it with an impetus to apply the "doctrine of economic substance" and disregard the legal form of the transaction. Although the decision concerned a sales tax matter, the principles were extended to income tax cases as well. The rigorous application of the "doctrine of economic substance" under the

McDowell ruling continued until the decision was substantially rationalised by the Supreme Court in *UOI v. Azadi Bachao Andolan*.[18]

McDowell & Co. Ltd., the taxpayer, was a liquor manufacturer. When liquour was sold, a certain amount of excise duty had to be paid in order for the liquour to be taken out of the godown used to store it. The excise duty was recovered from the customer. However, this recovery was made via separate documentation and it was contended that the excise duty was not part of the total turnover and hence, sales tax was not payable on the excise duty amount paid by the customers. The Supreme Court decided against the taxpayer.

Justice Chinnappa Reddy observed that the principle of avoidance of tax liability, known as the "Westminster principle," had been departed from by the British Courts and it was high time for the judiciary in India also to part ways with the Westminster principle and the alluring logic of tax avoidance. It should be examined whether a transaction is a device to avoid tax and whether the transaction is such that the judicial process may accord its approval to it.

Justice Ranganath Mishra, speaking for the majority, did not share the views of Justice Chinnappa Reddy and observed that tax planning may be legitimate if it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. The law regarding tax evasion was restated in much stronger expressions such as "dubious device," "subterfuge," "colourable transaction," etc. The Supreme Court further observed that

> "we must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less a moral plane than honest payment of taxation. In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it."

The observations made in the *McDowell* case were basically founded on three decisions of the House of Lords in *W.T. Ramsay Ltd. v.* IRC,[19] *IRC v. Burmah Oil Co. Ltd.*[20] and *Furniss v. Dawson*.[21]

D. Legal Position – post-McDowell but before Azadi Bachao Andolan

The *McDowell* decision was followed in various subsequent decisions, the most prominent of which are:

- *Workmen of Associated Rubber Industries Ltd. v. Associated Rubber Industries Ltd.*;[22]
- *Heroth Oil Mills Co. Ltd. v. CIT*;[23] and
- *CIT v. Minal Ramesh Chandra*.[24]

With the decision in *McDowell*, there was a major shift in the attitude of the Indian courts. The courts started examining whether there a colourable device had been adopted in arranging the affairs of the taxpayer. Before the Supreme Court decision in *UOIv. Azadi Bachao Andolan* (see II.C., above), the *McDowell* decision was considered in a number of cases. Some of the relevant observations in the various decisions are given below.

In *Kantilal Manilal & Co v. DCIT*,[25] it was held that "McDowell is confined to a case where *prima facie* the transaction is not what it purports to be."

In *M. V. Valliappan & Ors. v. ITO*,[26] the amendment made to the Act to enable an Assessing Officer to refuse to recognise the partial partition of a Hindu Undivided Family (HUF) was challenged. The tax authorities relied on *McDowell*, which was refused to be applied because the orders were all passed by the Assessing Officer in 1983 and 1984, before *McDowell* was decided (in 1985). It was recognised that the rule would not apply to a genuine transaction or arrangement in which the assessee (i.e., the taxpayer) really and in fact parted with a part of his property just because there was a reduction of liability, and it was held that honest and *bona fide* transactions cannot be subjected to the *McDowell* approach merely because there is a reduction in tax liability. The decision in *McDowell* cannot be read as laying down that every attempt at tax planning is illegitimate and must be ignored, or that every transaction or arrangement that is perfectly permissible under the law but that has the effect of reducing the tax burden of the assessee must be looked upon with disfavour.

In *CWT v. Arvind Narottam*,[27] it was held that, provided the true effect of the construction of a deed was clear, the question of tax avoidance was not a relevant consideration. The case concerned the Wealth Tax Act, 1957. Three trust deeds had been created for the benefit of the assessee, his wife and children in identical terms specifically to avoid wealth tax and the tax authorities placed reliance on the decision in *McDowell*. The Supreme Court observed that:

> "reliance was also placed by learned counsel for the revenue on McDowell & Co Ltd *v.* CTO [1985] 154 ITR 148 (SC). That decision cannot advance the case of the revenue because the language of the deeds of settlement is plain and admits of no ambiguity."

It was further held that:

> "where the true effect of the construction of the deeds is clear, as in this case, the appeal to discourage tax avoidance is not a relevant consideration. But since it was made, it has to be noted and rejected."

McDowell was not applied to this case in which the deeds concerned were clearly worded and admitted of no ambiguity. The tax authorities could not bring any evidence to show that the documents were a subterfuge or an artifice or embodied a colourable transaction.

In *UOI & Ors v. Playworld Electronics Pvt. Ltd. & Anr.*,[28] it was held that:

> "tax planning may be legitimate provided it is within the framework of the law. The colourable devices cannot be part of tax planning. One must find out the true nature of the transaction."

In *Banyan & Berry v. CIT*,[29] the Gujarat High Court observed that:

> "the Court (in *McDowell*) nowhere said that every action or inaction on the part of the taxpayer which results in reduction of tax liability to which he may be subjected in future, is to be viewed with suspicion and be treated as a device for avoidance of tax irrespective of the legitimacy or genuineness of the act . . . .. The principle enunciated in the above case has not affected the freedom of the citizen to act in a manner according to his requirements, his wishes in the manner of doing any trade, activity or planning his affairs with circumspection, within the framework of law, unless the same falls in the category of colourable device."

The right of freedom of business and the right to enter into commercial transactions was confirmed in this case, the application of *McDowell* being confined to cases in which a colourable device or a subterfuge is adopted in order to evade tax liability.

In *Bhagat Construction Co Pvt Ltd v. CIT*,[30] it was held that:

> "a colourable transaction is one which is seemingly valid but a feigned or counterfeit transaction entered into with some ulterior purpose."

In *DCIT v. Kashyap Sweetners Pvt Ltd.*,[31] it was held that:

> "the concept of 'colourable devices' being used for tax avoidance can be applied only when a series of transactions are carried through without any commercial purposes, but which have been artificially inserted for tax purposes into a composite transaction."

In *CIT v. Sri Abhayananda Rath Family Benefit Trust*,[32] it was held that

> "evading payment of tax is quite different from tax planning. A person may plan his finances in such a manner, strictly within the four corners of the taxing statute that his tax liability is minimized or made nil. If this is done and strictly in accordance with and taking advantages of the provisions contained in the Act, by no stretch of imagination can it be said that payment of tax has been evaded. In the context of payment of tax, 'evasion' necessarily means; to try illegally to avoid paying tax.
>
> Avoidance of tax is not tax evasion and it carries no ignominy with it, for it is sound law and certainly, not bad morality, for anybody to so arrange his affairs as to reduce the brunt of taxation to its minimum."

In *Twinstar Holdings Ltd v. Anand Kedia*,[33] shares held in 100 percent investment companies were converted from stock-in-trade to investment account, and subsequently the investment companies were liquidated. The transfer was held to have been made for purposes of evading the tax arising on such shares in the event of liquidation. It was held that, although a genuine transaction, there was a motive to evade tax and the transaction was to be struck down. The transfer was held to be void for purposes of recovering the tax.

E. Azadi Bachao Andolan and later decisions

In *UOI v. Azadi Bachao Andolan & Anr.* (see II.C., above), the Supreme Court examined its earlier decision in *McDowell* (also see II.C., above). Under the India-Mauritius tax treaty, capital gains accruing in India to a Mauritius resident are not liable to tax. Central Board of Direct Taxes (CBDT)[34] Circular No. 682 dated March 30, 1994, stated that capital gains of a Mauritius resident from the alienation of shares would be taxable only in Mauritius. Later, CBDT Circular No. 789 stated that a certificate of residence issued by the Mauritian authority would constitute sufficient evidence for accepting residence status as well as beneficial ownership in Mauritius for purposes of applying the India-Mauritius treaty. The Circular was challenged before the Delhi High Court by way of public interest litigation. It was argued that the incorporation of an entity in Mauritius was a sham or device actuated by improper motives. The matter was taken before the Supreme Court.

The Supreme Court observed (on page 754) that, far from being exorcised in its country of origin, *Duke of Westminster* continued to be alive and kicking in England. The Supreme Court did not approve of the views of Justice Chinnappa Reddy and observed that the judgment in *M.V. Valliappan v. ITO* (see II.D., above) rightly concluded that the decision in *McDowell* could not be read as laying down that every attempt at tax planning was illegitimate and had to be ignored, or that every transaction or arrangement that was perfectly permissible under law but that had the effect of reducing the tax burden of the assessee had to be looked upon with disfavour. The Supreme Court quoted with approval the judgment in *Banyan & Berry v. CIT* (see II.D., above) that the principle enunciated in *McDowell* had not affected the freedom of the citizen to act in a manner according to his requirements and his wishes in the manner of doing any trade or activity or planning his affairs with circumspection, within the framework of the law, unless they fell within the category of a colourable device that might properly be called a device or a dubious method or a subterfuge clothed with apparent dignity. After considering the decisions of the House of Lords in *Craven (Inspector of Taxes) v. White (Stephen)*[35] and other cases, the Supreme Court (page 758) further observed: "with respect, therefore, we are unable to agree with the view that Duke of Westminster's case (1936) 19 TC 490 (HL) is dead, or that its ghost has been exorcised in England. The House of Lords does not seem to think so, and we agree, with respect. In our view, the principle in Duke of Westminster's case (1936) 19 TC 490 is very much alive and kicking in the country of its birth. And as far as this country is concerned, the observations of Shah J. in CIT *v.* A. Raman & Co [1967] 67 ITR 11 (SC) are very much relevant even today." After examining the decision in *McDowell* in *CWT v. Arvind Narottam* (see II.D., above) and *Mathuram Agarwal v. State of Madhya Pradesh*,[36] the Supreme Court, came to the conclusion (page 760) that "it thus appears to us that not only is the principle in Duke of Westminster's case [1936] 19 TC 490 (HL) alive and kicking in England, but it also seems to have acquired judicial benediction of the Constitutional Bench in India, notwithstanding the temporary turbulence created in the wake of McDowell's case." The Supreme Court (pages 762 and 763) further observed: "the judgment of the Privy Council in Bank of Chettinad's case [1940] 8 ITR 522 (HL), wholeheartedly approving the *dicta* in the passage from the opinion of the Lord Russell in Westminster's case was the law in this country when the Constitution came into force. This was the law in force then, which continued by reason of Article 372. Unless abrogated by an Act of Parliament, or by a clear pronouncement of this Court, we think that this legal principle would continue to hold good. Having anxiously scanned McDowell's case, we find no reference therein to having dissented from or overruled the decision of the Privy Council in Bank of Chettinad's case [1940] 8 ITR 522 (PC). If any, the principle appears to have been reiterated with approval by the Constitutional Bench of this Court in Mathuram's case [1999] 8 SCC 667 (SC). We are, therefore, unable to accept the contention of the respondents that there has been a very drastic change in the fiscal jurisprudence, in India, as would entail a departure. In our judgment from Westminster's case [1936] AC 1 (HL); 19 TC 490 to Bank of Chettinad's case [1940] 8 ITR 522 (PC) to Mathuram's case [1999] 8 SCC 667 (SC), despite the hiccups of McDowell's case [1985] 154 ITR 148 (SC), the law has remained the same."

Thus, the Supreme Court made it very clear that an act that is otherwise valid in law cannot be treated as *non est* merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interest. In other words, if a transaction is otherwise valid in law and results in the reduction of the tax liability of an assessee, it cannot be brushed aside on the grounds that the assessee's underlying motive in entering into the transaction was to reduce its tax liability to the State.

The Supreme Court (page 762) further observed that "if the Court finds that notwithstanding a series of legal steps taken by an assessee, the intended legal result has not been achieved, the Court might be justified in overlooking the intermediate steps, but it would not be permissible for the Court to treat the intervening legal steps as *non est* based upon some hypothetical assessment of the 'real motive' of the assessee. In our view, the Court must deal with what is tangible in an objective manner and cannot afford to chase a will-o'-the-wisp."

Commenting on the words "sham" and "device," the Court observed that these words are not intended to be used as magic mantras or catch-all phrases to defeat or nullify the effect of a legal situation and the following paragraph from the judgment of Lord Atkin from *Duke of Westminster* case was reproduced: "I do not use the word device in any sinister sense for it has to be recognised that the subject, whether poor and humble or wealthy and noble, has the legal right so to dispose of his capital and income as to attract upon himself the least amount of tax. The only function of a Court of law is to determine the legal result of his disposition so far as they affect tax." The Court further observed that "we are unable to agree with the submission that an act which is otherwise valid in law can be treated as *non est*, merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interest." The legal principle laid down in *Duke of Westminster*, despite the "hiccup" of *McDowell*, continues to hold good. From the above, it is clear that tax avoidance is still permissible as long as it remains within the four corners of the law. It is also clear that the concept of "colourable devices" being used for tax avoidance can be applied only when a series of transactions is carried through without any commercial purpose, when the transactions were artificially inserted for tax purposes into a composite transaction.

In *CIT v. George Williamson (Assam) Ltd.*,[37] it was held that "there is nothing sinister in so arranging one's affairs as to keep losses as low as possible and tax avoidance is and will be permissible." It was held that the transactions of sale of plant and machinery and taking them back on lease were genuine and *bona fide* transactions.

In *Industrial Development Corpn of Orissa Ltd. v. CIT & Ors.*,[38] it was observed that the Supreme Court had made it very clear in *UOI v. Azadi Bachao Andolan* (see above) that an act that is otherwise valid in law cannot be treated as *non est* merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interest. If a transaction is otherwise valid in law and results in the reduction of the tax liability of an assessee, it cannot be brushed aside on the ground that the assessee's underlying motive in entering into the transaction was to reduce its tax liability to the State.

Finally, the legal position on *McDowell* is summarised in the following observation of the Bombay High Court in *CIT v. Mrs. Sarita P. Shirke*.[39]

The extreme view of Chinnappa Reddy J., in the judgment of McDowell & Co. Ltd. *v.* CTO [1985] 154 ITR 148 (SC) should be understood in the light of the majority view, which was that of Ranganath Mishra J., who had faulted only 'colourable devices' and a resort to 'dubious methods' because they cannot be part of legitimate tax planning. It is also pointed out that this was the view taken in UOI *v.* Azadi Bachao Andolan [2003] 263 ITR 706 (SC). Even otherwise, the later decision of the Supreme Court in Azadi Bachao Andolan's case (above) waters down the ratio of the decision in McDowell & Co's case with reference to the majority judgment.

This position was confirmed by the recent decision of the Punjab and Haryana High Court in *Porrits and Spencer (Asia) Ltd. v. CIT*,[40] in which the Court held that once a transaction is genuine, it will not become a colourable device and, consequently, be subject to any disqualification merely because it has been entered into with the motive of avoiding tax. The Court acknowledged the various judicial precedents establishing that not every attempt at tax planning can be stretched so as to be regarded as illegitimate nor every transaction or arrangement that is perfectly permissible under the law and that has the effect of reducing the tax burden of the assessee be looked upon with disfavour.

F. Position under India's tax treaties

The "substance over form" rule is recognised in tax treaties based on the OECD Model Convention in relation to Article 11. Paragraph 21.1 of the 2008 OECD Commentary states that the definition of interest in the first sentence of Article 11(3) does not normally apply to payments where there is no underlying debt. However, the definition will apply to the extent the loan is considered to exist under a "substance over form" approach.

It should, however, be noted that the applicability of the OECD Commentary and its views in the context of India's tax treaties is the subject of some doubt.

III. Pre-requisites for a transaction to be considered immune from challenge under the doctrine of "economic substance"

A question may arise as to what are the pre-requisites for a transaction to be considered immune from challenge under the "economic substance" doctrine. Specifically, what is often asked is whether a subjective business purpose is essential to provide immunity from challenge under the doctrine of economic substance. In other words, will a transaction be challenged because it is not entered with a specific business purpose but mainly out of tax considerations. Another question that can arise is whether the tax authorities are entitled to expect that a taxpayer should earn a realistic amount of pre-tax profit and make adjustments if it does not do so.

From an analysis of the various decisions discussed in II., above, one may take the view that the presence of a subjective business purpose/motivation is not essential for immunity from challenge under the doctrine of economic substance. However, the presence of a subjective business purpose/motivation will definitely ensure that a transaction is beyond the reach of a challenge under the doctrine of economic substance.

On the other hand, even if the affairs of the taxpayer are arranged keeping tax considerations in mind, provided no colourable devices are used or dubious methods resorted to, legitimate tax planning need not be regarded as unacceptable in view of the doctrine of economic substance.

In the cases of *CIT v. Sree Meenakshi Mills Ltd.*[41] and *Juggilal Kamlapat vs CIT*,[42] it was observed that a company is a legal personality entirely distinct from its members from the juristic point of view, but in exceptional cases, the court is entitled to lift the veil of corporate entity if it is used for tax evasion or to circumvent tax obligations or to perpetrate fraud.

Worth noting in this context is the decision in *Bhagat Construction Co. Pvt. Ltd. v. CIT* (see II.D., above), where it was held that a "colourable transaction is one which is seemingly valid but a

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feigned or counterfeit transaction entered into for some ulterior purpose."

In *DCIT v. Kashyap Sweetners Pvt. Ltd.*,[43] it was held that the concept of colourable devices being used for tax avoidance can be applied only when a series of transactions are carried through without any commercial purpose and have been artificially inserted for tax purposes into a composite transaction.

IV. Commercial expediency

The substantive economic result of implementing a transaction motivated by tax considerations is not a criterion for deciding for or against the taxpayer. If the transaction is not a colourable device, there need be no expectation of any reasonable profit. Only if the transaction concerns the payment of expenses to persons referred to in section 40A(2)(b) of the Act[44] or is covered by sections 92 to 92F of the Act (transactions affected by the transfer pricing provisions), is it permissible for an adjustment to be made to the transaction value affecting the taxable profit of the taxpayer. The legal position is settled by the Supreme Court decision in *S.A. Builders Ltd. v. CIT*,[45] in which the taxpayer claimed a deduction for interest on moneys borrowed to grant an interest-free loan to a sister concern. It was held that in order to decide whether interest on funds borrowed by the taxpayer to give an interest-free loan to a sister concern (i.e., a subsidiary of the taxpayer) should be allowed as a deduction under section 36(1)(iii) of the Act, one had to enquire whether the loan was given by the assessee as a measure of commercial expediency. The expression "commercial expediency" was held to be of wide import and to encompass such expenditure as a prudent businessman incurs for the purpose of business. The expenditure may not have been incurred under any legal obligation, yet it is allowable as business expenditure if it was incurred on the grounds of commercial expediency. The term "for the purpose of business" encompasses expenditure voluntarily incurred "for commercial expediency," and it is immaterial if a third party also benefits thereby. The expression "for the purpose of business" is wider in scope than the expression "for the purpose of earning profits, income or gains." Its range is wide; it may take in not only the day-to-day running of a business but also the rationalisation of its administration and the modernisation of its machinery; it may include measures for the preservation of the business and for the protection of its assets and property from expropriation, coercive process or assertion of hostile title; it may also comprehend the payment of statutory dues and taxes imposed as a pre-condition to commencing or for carrying on a business; and it may comprehend many other acts incidental to carrying on a business. However wide the meaning of the expression may be, its limits are implicit in it. The purpose must be the purpose of the business. That is to say, if the expenditure is for the carrying on of the business and the taxpayer incurs it in his capacity as the person carrying on the business, the expenditure will be allowed as a deduction in the hands of the taxpayer. The result of the expenditure may be a loss or a profit. The same principles may be extended to income foregone. One may take the position that earning a specified amount of profit is not a pre-requisite when the transaction is carried out by the taxpayer for the purpose of his business and statute does not expressly authorise adjustment.

If "colourable devices" are used or dubious methods resorted to by the taxpayer, the tax authorities may apply the statutory provisions to the substance of the transaction disregarding the artificial form of the transaction concerned. When a series of transactions are inserted for purposes of obtaining a tax advantage, the artificial steps in the composite transaction are identified and disregarded and the statutory provisions are applied to what is left.

The principle set out in *Salomon v. Salomon & Co.*,[46] that the corporate veil cannot be lifted is well-accepted in India. However, the corporate veil has been lifted in cases such as *CIT v. Sree Meenakshi Mills Ltd.* (see III., above) and *Juggilal Kamlapat v. CIT* (also see III., above), where the doctrine of economic substance was accepted by the courts.

V. Proposals in Direct Taxes Code

The new Direct Taxes Code (the "Code") is proposed to enter into effect on April 1, 2011. The bill for the Code is proposed to be presented before the Parliament in the monsoon session (i.e., in August/ September 2010). As reported in the press, the proposed draft issued earlier is under review by the government, which has been considering industry/taxpayer representations.

The draft Code proposes the introduction, for the first time in India, of provisions regarding a General Anti-Avoidance Rule (GAAR). The Indian GAAR is a replica of the South African GAAR, which contains the same or similar provisions. Under the GAAR provisions, any arrangement entered into by a person may be declared an impermissible avoidance arrangement.

- An "impermissible avoidance arrangement" is defined to mean a step in, or a part or whole of, an arrangement, whose main purpose is to obtain a tax benefit, where the arrangement:
  - Creates rights or obligations not normally created between persons dealing at arm's length;
- Results (directly or indirectly) in the misuse or abuse of provisions of the Code;
- Lacks commercial substance (in whole or in part); or
- Is entered into (or carried out) in a manner (or by means) not normally employed for *bona fide* purposes.

The tax authorities may determine the consequences of the arrangement and may make appropriate adjustments to the total income or tax liability of the taxpayer. The consequences of an impermissible avoidance arrangement may be determined by:

- Disregarding, combining or re-characterising any step in, or a part or whole, of the arrangement;
- Treating the arrangement:
  - As if it had not been entered into (or carried out); or
  - In such other manner as (in the circumstances of the case) the Commissioner deems appropriate for the prevention or reduction of the tax benefit concerned;
- Treating parties (or deeming persons) who are connected persons as one and the same person; or
- Disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;
- Re-allocating or re-characterising among the parties to the arrangement:
  - Any accrual (or receipt) of a capital or revenue nature; or
  - Any expenditure, deduction, relief or rebate; or
- Recharacterising equity as debt and vice-versa.

VI. Conclusion

Normally, under Indian tax law, form prevails over substance. However, when colourable devices are used for purposes of tax evasion, the doctrine of "substance over form" prevails. The proposed Direct Taxes Code may allow the tax authorities to disregard the form of a transaction in certain circumstances. In view of the prevalence of complicated tax avoidance and reduction arrangements, the tax authorities are inclined to apply the doctrine of "substance over form." After the decision in *Azadi Bachao Andolan* (see II.C., above), the legal position was reasonably settled in India. It remains to be seen how the doctrine will evolve if it is recognised by statute under the Direct Taxes Code.

NOTES

[1] [1936] 19 TC 490, 511, 520 (HL).
[2] [1940] 8 ITR 522, 526 (PC).
[3] [1980] 121 ITR 97, 108 (AP).
[4] [1999] 236 ITR 350 (SC).
[5] [1958] 34 ITR 719 (Punjab).
[6] [1954] 25 ITR 150 (Calcutta).
[7] [1943] 11 ITR 380 (Chennai).
[8] [1941] 9 ITR 44 (Bom).
[9] [1965] 55 ITR 642, 648 (*Ch*ennai)
[10] Article 372 of the Constitution provided that all the law in force in the territory of India immediately before the commencement of the Constitution was to continue in force until altered or repealed or amended by a competent Legislature or other competent authority.
[11] [1958] 34 ITR 888, 897 (SC).
[12] [1968] 67 ITR 11 (SC).
[13] [1969] 72 ITR 603 (SC).
[14] [1978] 113 ITR 307 (SC).
[15] Act, Sec. 172 relates to the taxation of the shipping business of a non-resident.
[16] [1978] 114 ITR 159 (Kar).
[17] [1985] 154 ITR 148 (SC).
[18] [2003] 263 ITR 706 (SC).
[19] (1982) AC 300, HL (E).
[20] (1982) STC 30.
[21] (1984) AC 474 HL (E) at pg. 160.
[22] [1986] 157 ITR 77 (SC).
[23] [1987] 166 ITR 418 (Ker).
[24] [1987] 167 ITR 507 (Guj).
[25] [2002] 82 ITD 354 (Mum).
[26] [1988] 170 ITR 238 (Mad).
[27] [1988] 173 ITR 479 (SC).
[28] [1989] 184 ITR 308 (SC).
[29] [1996] 222 ITR 831 (Guj).
[30] [2001] 250 ITR 291 (Del).
[31] [2004] 91 ITD 603 (Ind).
[32] [2002] 255 ITR 436 (Ori).
[33] DCIT [2002] 260 ITR 6 (Bom).
[34] CBDT is the apex Income Tax Authority under the Act
[35] [1990] 183 ITR 216.
[36] [1999] 8 SSC 667 (SC).
[37] [2004] 265 ITR 626 (Gau).
[38] [2004] 268 ITR 130 (Ori).
[39] [2005] 281 ITR 373 (Bom).
[40] [2010-TIOL-230-HC-P&H-IT].
[41] [1966] 62 ITR 38 (SC) and [1967] 65 ITR 609 (SC).
[42] [1969] 73 ITR 702 (SC).
[43] [2004] 91 ITD 603 (Ind).
[44] Act, Sec. 40A(2)(b) covers relatives of or parties related to the taxpayer.
[45] [2007] 289 ITR 26 (SC).
[46] [1987] AC 22.

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Host Country IRELAND

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I. Will the Irish tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Irish law, despite its lack of economic substance?

In summary an Irish court will respect the legal form of a transaction, even if the transaction lacks economic substance. A *substance over form* doctrine was rejected by the Irish Supreme Court in 1988. In response to that court decision, the Irish legislature introduced a general anti-avoidance provision into Irish tax legislation, and it is that provision, or alternatively specific statutory anti-avoidance provisions, that must be relied upon by the Irish Revenue if it wishes to disregard the form of a transaction that lacks economic substance. In the context of value added tax (VAT), the Irish High Court has applied the European law concept of "abusive process" and a transaction that lacks commercial reality and constitutes an abusive practice may be redefined for the purpose of VAT in order to reflect the true reality of the actions of the taxpayer concerned.

The approach of the Irish Supreme Court in favouring a form-based approach follows from certain basic Irish legal principles. Irish taxation law, in contrast to other branches of law such as tort, is not based on a body of common law, but instead is principally based on statute, with case law interpreting that legislation. The Irish courts take a literal approach when interpreting a tax statute. The Interpretation Act 2005 provides for a purposive approach to be taken only in certain circumstances, for example where a literal interpretation would be absurd. The Irish courts will not look outside the wording of the relevant tax legislation so as to apply that legislation to circumstances that the court considers should be covered by the spirit or intention of the legislation or in circumstances where the court considers that it would be equitable for the legislation to apply. This literal approach is summarised by the statement of Kennedy CJ, made in 1933, in *Revenue Commissioners v Doorley* V ITR 539 that "[a] taxing Act . . . . of its own proper character and purpose, stands alone, and is to be read and construed as it stands upon its own actual language."

Another relevant legal principle providing a foundation for the Irish courts' approach is the doctrine of the separation of the powers of the legislature and judiciary as provided for by Article 6 of the Irish Constitution. "The manifest object of [Article 6] was to recognise and ordain that, in this State, all powers of government should be exercised in accordance with the well recognised principle of the distribution of powers between the legislative, executive and judicial organs of the State and to require that those powers should not be exercised otherwise" per O'Byrne J, *Buckley v AG* [1950] IR 67. The Irish courts have unequivocally rejected the concept of judicial legislation.

The issue of the application of a *substance over form* approach was addressed by the Irish Supreme Court in the late 1980s in the case of *JE McDermott v PW McGrath*, unreported SC 7 July 1988. The Irish Revenue sought to rely on the developments that had taken place in the English courts on the question of form versus substance, when Revenue took the case concerning an artificial tax transaction. By way of background, decisions of the English courts are not binding on an Irish court but may be of persuasive authority where Irish and English law are similar on the relevant matter. In England a form over substance approach was approved in *The Duke of Westminster v IRC* 19 TC 490. That case was approved and followed in Ireland in *O'Sullivan v P Ltd* (1962) 3 ITC 355.

The Duke of Westminster's case involved an arrangement whereby the Duke's employees agreed to work for no wages. Instead the Duke executed a deed of covenant in favour of each, entitling an employee to an annuity equal to what would otherwise be his wages. The Duke argued that the annuity was deductible for tax purposes, and the court agreed, even though in substance the arrangements were made wholly for the purpose of tax mitigation. Lord Russell in his judgment said that "I confess that I view with disfavour the doctrine that in taxation cases the subject is to be taxed if, in accordance with a Court's view of what it considers the substance of the transaction, the Court thinks that the case falls within the contemplation or spirit of the statute. The subject is not taxable by inference or analogy, but only by the plain words of a statute applicable to the facts and circumstances of his case".

The English House of Lords however adopted a new approach in the early 1980s in the case of *Ramsay v IRC* [1981] STC 174 and *Furniss v Dawson* [1983] STC 549. These cases involved the approval of the doctrine of fiscal nullity. Under that doctrine, a liability to tax is computed by reference to the end result of a series of transactions and intermediate steps involving preordained transactions aimed purely at avoiding a liability to tax are ignored, i.e., a substance over form approach. It was this doctrine of fiscal nullity that the Irish Revenue sought approval of in *McDermott v McGrath*. However the Supreme Court rejected the approach taken by the English courts.

The Supreme Court held in favour of the taxpayer on the basis of the two general legal principles mentioned above; the literal interpretation of tax legislation and the constitutional doctrine of the separation of powers. The court held that the function of the courts was confined to interpreting the plain meaning of relevant statutory provisions and that a court may not add to or delete from express statutory provisions in order to achieve an objective that the court considers desirable. The Supreme Court considered that the Irish Revenue, and not the courts, was best placed to deal with tax avoidance schemes and it noted the existence in other common law jurisdictions of a general anti-avoidance rule.

"Not only am I quite satisfied that it is outside the functions of the courts to condemn tax avoidance schemes which have not been prohibited by statute law but I would consider it probable that such a role would be undesirable even if it were permissible. . . In some jurisdictions such as Canada and Australia, generally statutory provisions against tax avoidance have been enacted, which in the cases to which they apply would, of course, affect the interpretation of specific provisions of taxation laws. In the absence of any such general provisions in our law, there are no grounds for departing from the plain meaning of these sections," per Finlay CJ.

In response to the *McGrath* case, which rejected the substance over form approach, the Irish Minister for Finance in his Budget speech of 1989 announced measures to introduce general anti-avoidance legislation along the lines noted by the Supreme Court in that case. These measures are now provided for by section 811 of the Taxes Consolidation Act 1997. The Explanatory Memorandum to the Finance Bill 1989 summarised the intention of section 811 as follows: "The purpose of the section is to counteract certain transactions which have little or no commercial reality but are carried out primarily to create an artificial tax deduction or to avoid or reduce a tax charge."

Section 811 allows the Irish Revenue to form an opinion as to whether a transaction is a tax avoidance transaction on the basis of both the form and substance of the transaction, and thus to apply a substance over form approach in considering the tax treatment of the transaction. Where the Irish Revenue is of the opinion a transaction has been carried out giving rise to a "tax advantage" and the transaction was entered into primarily for the purposes of securing that tax advantage, section 811 can be invoked to counteract the avoidance. It empowers the Irish Revenue to calculate the "tax advantage" of the tax avoidance transaction and to decide on the adjustments to be made or acts to be done in order to withdraw the tax advantage.

Outside of the application of the general anti-avoidance rule in section 811, underlying the principle of form over substance is the principle that the courts will look to the true nature of the transaction under consideration. In the High Court decision in the *McGrath* case the judge stated that "It seems to me therefore that the principle in *The Duke of Westminster's case*. . . as approved [in *O'Sullivan v P Ltd*] can be stated thus – in determining whether liability to tax arises, the court does not look at the substance or financial results of a transaction. It looks at the actual legal effect and legal rights of the parties according to legal ideas and concepts. The rights are not necessarily determined by the words used by the parties". A leading Irish tax commentary describes the form over substance approach in Ireland as being a "legal substance over economic substance" approach.

The descriptions or labels used by the parties are therefore not determinative of the matter. In *O'Sullivan v P* II ITR 464, Kenny J stated that "Although liability to tax is to be determined by reference to the legal rights of the parties to the transaction, the court has to decide in each case what the rights are having regard to legal ideas and concepts and so that the words used by the parties do not necessarily determine what the rights are." In *Waterford Glass (Group Services) Ltd v The Revenue Commissioners* [1990] 1 IR 334 Carroll J said "The court is entitled to look at the reality of what has been done. Just because the parties put a particular label on a transaction the court is not obliged to accept the label blindly. The court will look at the legal effect and the legal rights of the parties resulting from the transaction".

This approach of the courts is well illustrated in two Irish tax cases. In the recent case before the Irish High Court of *Patrick W Keane & Co v The Revenue Commissioners* [2008] TITR 57, the court had to consider the application of a relief from Irish stamp duty in relation to a company reconstruction, which, among other things, requires the shareholders of the new company to whom a business is transferred to be substantially the same as the shareholders of the transferor company. The relief is not available in respect of a transfer of a business to a new company that amounts to a partition of the business of a company. In order to have the transaction come within the technical requirements of the stamp duty relief, a class of shares was issued that did not have voting rights, described as an "E" class of shares. The judge looked at the transaction and determined that while the technical requirements of the relief were met what in reality was being effected was a partition and not a reconstruction of the transferor company's business. Edwards J said "I consider that to avail of the [stamp duty] exemption the quality of the ownership enjoyed by the party claiming the exemption must be real and meaningful and not merely technical. I am driven to the conclusion in this case that the "E" class of shares are a contrivance whose sole purpose was to "technically" qualify the transaction as a reconstruction so that [the taxpayers] might seek to avail of the exemption [in the stamp duty legislation]. In reality, therefore, what we have here is a partition that is being dressed up to look like a reconstruction".

The High Court in *Keane* found against the taxpayer and considered the "legal substance" of the transactions to differ from their form. In *Airspace Investments Ltd v M Moore* (Inspector of Taxes) V ITR 3 (1994), the High Court found in favour of the taxpayer and rejected the Irish Revenue's contention that the form of the transaction did not reflect its reality. That case concerned the acquisition by the taxpayer company of film tapes, the funds for which were in part borrowed from the seller on a non-recourse basis pursuant to a loan agreement. The taxpayer claimed capital allowances (tax depreciation) in relation to expenditure incurred on the acquisition of the film tapes and the issue was whether or not expenditure had been incurred by the taxpayer. The Irish Revenue contended that the loan was not genuinely repayable by the company and therefore the sum purportedly borrowed was not expended by the company on the acquisition of the tapes. The High Court held that the lower tier Circuit Court judge had erred in law in finding that the loan was not repayable by the company and considered that the Circuit Court judge had been influenced by the subsequent commercial failure of the exploitation by the company of the film tapes.

A recent departure from the form over substance approach is the decision of the Irish High Court in a VAT case, *Cussens v Brosnan* [2008] IEHC 169, where the court applied the European concept of "abusive process" in relation to a transaction that had been entered into by taxpayers in order to achieve a favourable VAT outcome. Charleton J distinguished the application of the form over substance approach as set out in *McGrath v McDermott* by referring to that decision being in relation to Irish domestic legislation. The judge considered that in applying a measure in European law, the approach of the Irish courts in considering transactions entered into by taxpayers should reflect the obligations that Ireland has undertaken by virtue of its membership of the European Union. He held that there is a general principle of European law whereby a transaction may be redefined if it was subjectively entered into for the purpose of avoiding the application of a European legal measure and, objectively, the transaction "is not such as might be seen as constituting a legitimate choice or the exercise of any form of ordinary commerce." The judge considered this a matter of interpretation and, given the supremacy of European law, implementing Irish domestic legislation was not required in respect of this principle of European law.

Section 811 is largely used as a deterrent rather than relied upon by the Irish Revenue in order to challenge tax avoidance transactions. Specific anti-avoidance provisions are generally introduced in order to attack or prevent perceived abuse or avoidance. Irish tax legislation contains a number of such specific provisions. An example is the exit tax that applies on corporate migration.

An Irish tax resident company is subject to Irish tax on its worldwide gains. A non-Irish tax resident company is subject to Irish tax on gains arising on the disposal of certain assets only, for example, Irish land. Generally, a company could potentially avoid Irish tax on the disposal of assets with latent gains by migrating its tax residence from Ireland. That is generally achievable by having the central management and control of the company exercised outside of Ireland.

An exit tax is imposed (subject to certain exceptions) on the migration of an Irish company in respect of assets owned by the company at the time of cessation of its Irish tax residence. A company is deemed to have disposed of its assets, other than Irish situate assets that are used for the purposes of an Irish trade, or held for the purposes of an Irish trade, or held for the purposes of an Irish branch or agency. As a disposal is deemed to take place immediately prior to the company changing its residence the company cannot avail of a treaty with Ireland to avoid the charge as it would not yet be a resident of the other treaty country.

II. What are the pre-requisites for a transaction to be considered immune from challenge under Ireland's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

The position in Ireland is that a form over substance approach prevails, except where the general anti-avoidance rule, Section 811, or specific anti-avoidance provisions apply. In determining whether a transaction is immune from challenge under section 811 it is therefore necessary to consider the circumstances in which the provision applies and also the exclusions contained in the provision. In addition, in light of the *Cussens* case, in relation to VAT, one must consider the circumstances in which a transaction would be considered to be an abusive process.

In summary, section 811 allows the Irish Revenue to attack a transaction giving rise to a tax advantage for the taxpayer in cases where the Revenue is of the opinion that the transaction was undertaken primarily for the purposes of securing a tax advantage, with exclusions for *bona fide* commercial transactions and transactions properly using a tax incentive or benefit.

Section 811 allows the Irish Revenue to counteract "tax avoidance transactions." A transaction is a tax avoidance transaction if the Irish Revenue forms the opinion that the transaction gives rise to (or but for the provision would give rise to) a "tax advantage" and the transaction was not undertaken or arranged primarily for purposes other than to give rise to a "tax advantage." In arriving at its opinion, Irish Revenue is limited to the relevant considerations set out in the provision, being the results of the transaction, the use of the transaction in achieving those results, and any other means by which these results could have been achieved.

The term "tax advantage" is defined in a neutral manner in the provision.

It is defined as:

> (1) a reduction, avoidance or deferral of any charge or assessment to tax, including any potential or prospective charge or assessment; or (2) a refund or a payment of an amount of tax, refundable or otherwise payable to a person, including any potential or prospective amount so refundable or payable; in the case of both (1) and (2), arising out of, or by reason of, a transaction, including a transaction where another transaction would not have been undertaken or arranged to achieve the results, or any part of the results, achieved or intended to be achieved by the transaction.

The results approach of the provision means that an objective test is to be applied in determining whether or not a transaction is a tax avoidance transaction. The subjective motives of the taxpayer should not be relevant. This has been confirmed in the recent High Court decision of *Revenue Commissioners v O'Flynn Construction Ltd* [2006] ITR 81, described below. The purpose of the transaction therefore must only be inferred from the nature of the transaction itself. One must look at the transaction itself and see what is its effect, what it does, irrespective of the motives of the persons who made it.

The main purpose test implies that a transaction may have more than one purpose. The matter is not determined by the fact that a tax saving or benefit arises because of the relevant transaction. The provision only applies to a transaction the primary purpose of which is tax avoidance. Where there are two ways of carrying out a genuine commercial transaction, one by paying more tax and one by paying less tax, as was stated in the House of Lords decision of *CIR v Brebner* 3 TC 705, "it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved."

Section 811 provides for two exclusions. In *Revenue Commissioners v O'Flynn Construction Ltd*, it was held that the onus lies on the taxpayer to establish the conditions necessary for the exclusions to apply.

The first exclusion is a "business profits" exclusion. Two conditions must be met. The Revenue must be satisfied that:

1. The transaction was undertaken or arranged by the taxpayer with a view, directly or indirectly, to the realisation of profits in the course of the business activities carried on by the taxpayer; and
2. The transaction was not undertaken or arranged primarily to give rise to a "tax advantage." For this exclusion to apply there must be a business purpose, and an intention to realise profits.

The second exclusion is a "relief without misuse or abuse" exclusion. If a transaction is undertaken or arranged to obtain the benefit of a relief or allowance and does not result directly or indirectly in the misuse or abuse of a provision, having regard for the purpose for which it was provided, then section 811 will not apply to it. The Irish courts may not go beyond their role as interpreters of statute and in practice there may be difficulty in determining whether there has been misuse or abuse given the purpose for which the provision was provided. The courts must rely on the wording of the relevant legislation in order to ascertain its purpose and may not even refer to parliamentary proceedings.

In forming the opinion as to whether or not a transaction is a tax avoidance transaction, the Revenue is to have regard to the transaction in the whole and to connected transactions. The provision states that the Revenue must have regard to both the form and the substance of the transaction, of connected transactions, and the final outcome and result of the transaction and connected transactions. The Revenue in arriving at its opinion therefore is not required to follow the form over substance approach.

The Irish Revenue has used the general anti-avoidance provision, section 811, sparingly, preferring instead to rely upon specific anti-avoidance provisions. There is as a consequence little guidance as to how the provision operates in practice. The provision was considered recently by the High Court in *Revenue Commissioners v O'Flynn Construction Ltd.*, but unfortunately the decision has not resolved many of the questions raised by practitioners and commentators.

In that case, a group company had accumulated export sales relief (ESR) reserves in a number of subsidiaries which meant that dividends could be paid out to shareholders on a tax-free basis. ESR was a complete relief from corporation tax in respect of profits derived from the export of goods manufactured in Ireland. The reserves were sold to an unconnected construction company through a series of steps with the ultimate aim of paying tax-free dividends to the shareholders of that company. The Irish Revenue contended that the company, and its shareholders, had secured a "tax advantage" and that the specified transactions were each a tax avoidance transaction.

The Irish High Court held that the transaction was a tax avoidance transaction on the grounds that having regard to the purposes for which they were enacted the transaction did result, directly or indirectly, in a misuse of the ESR provisions. Smyth J held that he was satisfied that the Irish Appeal Commissioners (the first tier authorities to whom a taxpayer may appeal a decision of the Irish Revenue) were correct in holding that the transaction gave rise to a tax advantage and, furthermore, that the transaction was not undertaken, or arranged primarily, for purposes other than to give rise to a tax advantage.

Smyth J noted that the subjective motives of any of the parties to the transaction were not an issue in the case and that the matter had to be viewed objectively.

The judge also stated that the onus was on the taxpayer to satisfy the Irish Revenue Commissioners that they had availed of a relief "without misuse or abuse." The Justice opined, that, "the transaction the subject of these proceedings – whereby export sales relieved reserves in the . . . Group were transferred to a company that was not engaged in the manufacture of goods for export to enable fully tax relieved dividends to be paid to the shareholders of the construction company, is completely at odds with the purpose for which the export sales relief was provided." It is not clear from the judgment how "the purpose for which the export sales relief was provided" was ascertained by the judge.

In relation to VAT and the application of the abusive process principle as set out in the *Cussens* case, a different approach is required to be taken. In order to apply the EC VAT Directive, the court is required to properly construe the transaction, or series of transactions, as to its subjective intention and objective reality. An abusive process requires a subjective intention on the part of the taxpayer to enter into a transaction only for the purpose of misapplying the proper application of advantages derived from the European legislation at hand. In addition, there must also be an objective failure to comply with the spirit of the legislation.

From the *Cussens* decision it appears that in order for a transaction be to considered to be an abusive process, it must:

- Be entered into for no economic purpose and solely for the purpose of obtaining a tax advantage;
- Not have any independent objective justification; and
- Be effected solely for the purpose of undermining the application of the Irish VAT legislation, implementing the EC VAT Directive.

As the decision is that the principle of abusive process as provided for under EC law is to be applied by an Irish court in considering transactions in relation to VAT, it would appear that the test to be applied is not a fixed one but one which will depend on how that European law principle has developed at the time at which it is to be applied.

III. What is the tax result of a determination that a transaction lacks economic substance?

Where the Irish Revenue has demonstrated the existence of a "tax avoidance transaction" under section 811, the Revenue then must:

- Calculate the amount of the tax advantage accruing from the tax avoidance transaction;
- Decide on the adjustments to be made and the acts to be done in order to withdraw or deny the tax advantage; and
- Calculate the relief, if any, to be given in order to protect the taxpayer from being double taxed (on a domestic basis) as a result of such adjustments made or acts done.

Central to the concept of a tax advantage is a comparison of the transaction carried out by the taxpayer with a situation where more tax would have been paid by the taxpayer. The tax advantage is the difference between the tax, if any, on the transaction that the taxpayer actually carried out and the tax that would have arisen if the transaction had been carried out in a different manner achieving the same economic result. "There must be a contrast, as regards the "receipts" between the actual case where these accrue, in a non-taxable way with a possible accruer in a taxable way, and, unless this contrasts exists, the existence of the advantage is not established" per Lord Wilberforce in *CIR v Parker* 43 TC 396.

In general, the amount of the tax advantage arrived at should be such that the taxpayer will be left in the same after-tax position as would have been the case had the transaction been carried out in a different manner to achieve the same economic result. In light of this benchmark requirement, in a situation where an economic result could be achieved in a number of different ways, each giving rise to a different tax cost, an argument may perhaps be raised as to Revenue's ability to choose as the benchmark the method that results in the highest tax cost.

The disregarding of the losses or gains arising from the tax avoidance transaction is achieved through the

Revenue making such adjustments and doing such acts as to withdraw or deny the tax advantage from or to the taxpayer. The result should generally be that the tax advantage that has arisen will be lost in its entirety due to the disallowance of deduction, allocation of income, recharacterisation of proceeds or other such adjustment made or act done by the Revenue pursuant to section 811.

The application of the general anti-avoidance rule may go beyond simply disregarding the tax benefit and may result in the taxpayer being penalised, as interest and a 20 percent surcharge may be imposed on tax that becomes payable as a result of adjustments made or acts carried out by the Irish Revenue under section 811. Interest and the surcharge will not apply generally if the taxpayer has made a protective notification of the transaction to the Irish Revenue before a specified date, generally within 90 days of the date on which the transaction commenced.

In relation to the application of the principle of abusive process as provided for by the *Cussens* case, that decision required that the transaction carried out by the taxpayer be redefined for the purpose of VAT in order to reflect the true reality of the actions of the taxpayer. "The principle of abusive process operates so as to properly define the economic activity which is subject to VAT and to the circumstances in which it applies and the rate at which it applies," per Charleton J. As with the application of section 811, the application of the principle of abusive process should result in the losses or gains of the taxpayer arising from the abusive process being disregarded in their entirety.

While a finding of abusive practice may not lead to a penalty, as a clear and unambiguous legal basis would be necessary for such, the redefinition of the transaction is likely to result in the taxpayer being late in making a payment of the relevant tax, and liable to interest thereon. The taxpayer is effectively being penalised in such circumstances as the rate of interest for the late payment of VAT is close to 10 percent.

Host Country ITALY

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I. Introduction

A. General anti-avoidance rules and judicial doctrine

The Italian tax authorities can challenge transactions entered into by taxpayers on the grounds of either:

- A codified anti-avoidance rule (the "anti-avoidance rule") enshrined in Article 37 – *bis* of Presidential Decree No. 600/1973 (the statute governing income tax assessment procedures); or
- A recent judicial doctrine, rooted in the concept of the "abuse of rights."

The question of economic substance is one of the key elements of the anti-avoidance "test" embedded in the anti-avoidance rule and also occupies a central role in the abuse of rights test as developed in recent years by the Italian Supreme Court. However, while it is possible to arrive at a satisfactory analysis based on the anti-avoidance rule, it is quite difficult to draw any hard and fast conclusions from a consideration of the abuse of rights test.

B. Introduction to the Italian anti-avoidance rule

1. Historical developments

Although there were some legislative proposals during the 1980s, it was only in the 1990s that anti-tax avoidance legislation was actually introduced in Italy. In particular, the precursor of Article 37 – *bis* of Presidential Decree No. 600/1973 is to be found in Article 10, Paragraph 1 of Law No. 408/90.[1]

The 1990 provision differed from the current anti-avoidance rule in that it was more limited and objective in its scope of application (it provided for a fairly restricted *numerus clausus* of affected transactions) and that it incorporated a test under which a transaction was considered to constitute tax avoidance where the following conditions were met:

- There was "fraudulent behaviour;"
- A "valid business purpose" was lacking; and
- There was found to be an intent aimed exclusively at the achievement of a tax saving on the part of the taxpayer.

This provision was subsequently partially amended by Article 28 of Law No. 724/1994, which broadened its scope of application.

Despite this amendment, the provision still proved to be rather ill-focused and largely ineffective as an instrument for tackling tax-avoidance behaviour. Nor did it provide any guidance as to how illegal tax saving that was challenged under the provision was to be quantified.[2]

A significant step forward was taken a few years later with the adoption of Article 7 of Legislative Decree No. 358/97, which introduced Article 37 – *bis* of Presidential Decree No. 600/1973.

2. Structure of the current anti-avoidance rule

Article 37 – *bis* of Presidential Decree No. 600/1973 is currently the principal anti-avoidance provision in the Italian income tax system.[3] The main aim of this provision is to provide criteria for determining the tax-avoidance nature of a transaction (or a set of transactions).

Paragraph 1 of Article 37 – *bis* of Presidential Decree No. 600/1973 sets out the actual tax avoidance "test."

Paragraph 2 of Article 37 – *bis* of Presidential Decree No. 600/1973 grants the Tax Administration the power to disregard tax advantages obtained through transactions meeting the above test and to impose tax in accordance with the tax rules that have been avoided.

Paragraph 3 of Article 37-*bis* of Presidential Decree No. 600/1973 significantly limits the scope of application of Paragraphs 1 and 2, by stating that those provisions apply only where one or more of the transactions expressly listed in Paragraph 3 are involved. The list is extremely analytical and generally focuses on corporate re-organisations and transactions where the taxpayer is implicitly free to choose among a number of options (for example, financial statement valuations).

The last four Paragraphs of Article 37 – *bis* of Presidential Decree No. 600/1973 generally deal with the procedural aspects of tax assessments targeting tax-avoidance behavior, as well as giving the taxpayer the option of filing a request for an advance tax ruling.[4] This option is the main instrument available to a taxpayer wishing to have something of a "safe harbor" in implementing a transaction or series of transactions. The rulings issued by the (now-disbanded) Anti-avoidance Committee and by the Revenue Agency also constitute useful documentation of the way in which the anti-avoidance rule has so far been applied.

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C. Introduction to the "abuse of rights" test

A stream of tax cases from the Italian Supreme Court[5] based on the broader notion of the abuse of rights has recently attracted attention. More specifically, this is based on the principles elaborated by the European Court of Justice (ECJ) in the *Halifax* case,[6] in which the court proposed the existence of an implicit anti-abuse general clause in the Sixth VAT Directive.

According to the ECJ, there is an abuse of rights when, notwithstanding the formal application of the conditions laid down in the Sixth VAT Directive (as well as in the relevant national legislation implementing the Directive), a transaction results in "(. . .) the accrual of a tax advantage the grant of which would be contrary to the purpose of those (i.e., the Sixth VAT Directive and national legislation) provisions."[7]

In Decision No. 8772 of April 4, 2008,[8] the Italian Supreme Court concluded that all transactions aimed at achieving an undue tax saving can be disregarded by the tax authorities unless the taxpayer provides proof of the existence of concurrent underlying economic reasons that appropriately justify the transaction concerned.

This decision and its legacy seem to have inspired the Italian Supreme Court to conceive (even outside the field of VAT) of a general anti-avoidance doctrine that would reach well beyond the scope of application of Article 37–*bis* of Presidential Decree No. 600/1973 in an unprecedented way.[9] It should be noted that, unlike the anti-avoidance rule, the abuse of rights test would apply to all kinds of transactions.

An examination of the relevant case law suggests that the most well-structured definition of the "abuse of rights" is perhaps to be found in Decision No. 1465 of January 21, 2009. In this decision, "abuse of rights" is defined as abusive behavior as a result of which the transactions under scrutiny lead to the achieving of a tax saving that – despite the formal adherence to the provisions that are circumvented – qualifies as an illegitimate tax saving, regardless of whether that tax saving is the exclusive aim of the transactions entered into or only the principal aim.

II. Will the Italian tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Italian law, despite its lack of economic substance?

A. Anti-avoidance approach

Respect for the form of transactions entered into by a taxpayer can be set aside on the grounds that there is a concern that tax-avoidance may be taking place.

Under the anti-avoidance rule based approach, the tax administration is entitled to disregard "acts, facts and legal arrangements, also when they are linked together, lacking a valid business purpose, aimed at bypassing rights and duties provided for by the tax rules, and at obtaining tax reductions or tax reimbursements that would not be legally available"[10].

Such "disregard," however, is only directed at the tax implications of the transaction concerned and does not *per se* mean that the underlying contractual arrangements will be declared null and/or void. For the sake of completeness, it should be noted that the Italian Supreme Court has occasionally stated that, in some circumstances, a set of legal arrangements can be declared null and void for civil law purposes where they are carried out in pursuit of tax avoidance or the abuse of tax law.[11]

Whether the tax authorities will respect transactions that lack economic substance depends largely on how the anti-avoidance rule is interpreted. The most widely-shared view in recent years, which has also been endorsed by the Italian tax administration, is that all the conditions set forth in the law need to be met. More specifically, the mere fact that a set of transactions has no valid business purpose is not sufficient for that set of transactions to be deemed to constitute tax avoidance; on the contrary, the achievement of a tax saving and the circumvention of the tax rules would also have to be proved.[12] At the same time, it should be noted that early administrative rulings and judicial decisions delivered in the aftermath of the introduction of Article 37 – *bis* of Presidential Decree No. 600/1973 were almost exclusively focused on the lack of a valid business purpose.[13]

B. "Abuse of rights" approach

The "abuse of rights" doctrine gives the tax authorities similar powers to disregard tax-driven transactions.

In particular, such powers are available in the case of transactions that lack economic substance. Moreover, the "abuse of rights" test also makes the achievement of a tax saving a pre-condition for the disregarding of a set of transactions as being abusive of rights.

It is worth noting that while initially it was held that it lay with the taxpayer to prove that its behaviour was not abusive,[14] the most recent cases suggest that the burden of proof lies with the tax authorities with respect to the uncovering of a purposive scheme and on the taxpayer with respect to setting forth justification of a valid business purpose.[15]

III. What are the pre-requisites for a transaction to be considered immune from challenge under Italian "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

A. Transactions immune from challenge

As both anti-avoidance rule and abuse of rights assessments are applied on a case-by-case basis with respect to single transactions, no transaction can be presumed in advance to be immune from scrutiny or included in a "safe harbour." However, an analysis of the rulings issued by the tax authorities, as well as the existing case law, may afford some broad guidelines.

1. Anti-avoidance approach

Within the framework of the anti-avoidance rule approach, a transaction would be immune from challenge if the taxpayer were to file a request for an advance ruling and obtain a favourable response from the tax authorities.[16] In such a case, the anti-avoidance rule cannot be applied by default. However, it should be borne in mind that requesting an advance ruling but may prove to be a double-edged sword for the taxpayer, as the response of the tax authorities may be negative.

In other cases, based on the most recent rulings issued by the tax administration, all three requisites set forth in Article 37-*bis* of Presidential Decree No. 600/1973 need to be met for the anti-avoidance rule to apply, so that its application will be precluded if a transaction is backed either by a valid business purpose, does not represent a circumvention of the tax rules or does not achieve a tax saving.

2. Abuse of rights approach

There are currently no guidelines indicating how the abuse of rights test should be applied. In this respect, a provisional conclusion, based on the relevant existing case law, might be that a set of transactions that results in a tax saving cannot be considered immune from scrutiny under the judicial anti-abuse doctrine.

B. Business purpose vs. tax motivation

1. Anti-avoidance approach

With reference to the application of the anti-avoidance rule, Ruling No. 106/E of July 7, 2000 made it clear that where no tax saving is achieved, there cannot, by definition, be any tax avoidance.

Whether a tax saving has been achieved is determined by comparing the tax treatment of the taxpayer's ostensible transactions and the, presumably more burdensome, tax treatment that would have resulted from alternative transactions more in accordance with the spirit of the tax rules that were sought to be avoided.

Based on case law and the Tax Administration rulings issued with reference to the anti-avoidance rule, a given set of transactions may also be challenged when the related tax saving is merely prospective or even just potential.[17]

Under the anti-avoidance rule, a tax saving may not be challenged if it is the result of a set of transactions backed by a valid business purpose.

2. Abuse of rights approach

The main difference between the anti-avoidance rule and the abuse of rights doctrine is that, because the former has now been in force for over ten years, there is a certain amount of case law in addition to guidelines provided by the Tax Administration, which renders its application much more predictable in outcome.

As with the anti-avoidance rule, the achievement of a tax saving appears to be the pre-condition for a transaction to be disregarded.[18] However, the approach adopted by the Italian Supreme Court with respect to the abuse of rights test places the main emphasis on the achievement of a tax saving and the existence of a tax motivation.[19]

C. "Substantive economic effect" and the realistic expectation of pre-tax profits

1. Anti-avoidance approach

The notion of "valid business purpose"[20] encompasses all economic reasons that are not of a tax nature (i.e., that do not concern the reduction or minimisation of taxes). As already noted, the presence of a "valid business purpose" cannot be determined *ex ante,* but must be assessed on a case-by-case basis by considering various elements relating to the economic behaviour of the taxpayer.

In this respect, the Italian approach focuses on the intent of the taxpayer, that is, whether the taxpayer originally conceived the transaction as a tax-driven transaction,[21] rather than on the actual economic effects of the transaction. On this basis, the actual *ex post* economic results of the transaction should not be relevant.

2. Abuse of rights approach

To the best of the author's knowledge, in the limited number of decisions that have outlined the abuse of rights doctrine, there is no specific reference to the issue of whether the economic driver of a transaction should be evaluated *ex post* or *ex ante*. As noted above, the *ex ante* approach is predominant in the context of the anti-avoidance rule and it could be argued that this approach can also be adopted in an abuse of rights context.

D. Other factors considered in evaluating the structure of the transaction

1. Anti-avoidance approach

(i.) Scope of application

The anti-avoidance rule applies in the context of income taxes and certain indirect taxes, such as registration tax, mortgage tax and property tax.[22] It also applies to transactions carried out by any person, so that it is irrelevant whether the targeted transactions taken place in Italy or abroad.

It should also be remembered that, as noted in I.B.2., above, the rule applies only where one or more of the transactions expressly listed in Article 37 – *bis*, Paragraph 3, of Presidential Decree No. 600/1973 is/are involved.

(ii.) Circumvention of the tax rules

When one gets down to the practical application of the tests enshrined in the anti-avoidance rule or in the judicial abuse of rights doctrine, the issue of the "circumvention of the tax rules" should be examined carefully, as it often constitutes the actual dividing line between a legitimate tax-saving device and an illegitimate, tax-avoidance device. This distinction was initially addressed by the explanation accompanying the provision that introduced Article 37 – *bis* of Presidential Decree No. 600/1973[23] and was expressly recognised by the tax authorities in Ruling No. 117/E of July 15, 1999.

A legitimate tax saving could be characterised as a tax saving that is obtained without putting into place any circumvention of the tax rules, i.e., any application of the tax rules that is at variance with the spirit of those rules, which is to be found in adherence to the "ability to pay" principle enshrined in Article 53 of the Italian Constitution.[24]

2. Abuse of rights approach

(i.) Scope of application

The scope of the abuse of rights test appears to be much broader than that of the anti-avoidance rule, as its application is not limited to income tax but extends to all taxes, including VAT.

As with the anti-avoidance rule, there is also no reason to assume that the abuse of rights test can be implemented only with respect to transactions carried out in Italy.

(ii.) Circumvention of the tax rules

In three cases decided at the end of 2008,[25] the Italian Supreme Court held that the anti-abuse principle is designed to prevent such behaviour as may be at variance with the principle of the "ability to pay" enshrined in Article 53 of the Italian Constitution.

IV. What is the tax result of a determination that a transaction lacks economic substance?

B. Anti-avoidance approach

According to the anti-avoidance rule, a taxpayer that is found to have entered into a tax avoidance transaction is required to pay the difference between the taxes actually paid (if any) as a result of the tax avoidance transaction and the tax that would have been payable had the tax rules not been circumvented and the undue tax saving not been achieved.

As a matter of fact, however, if a number of transactions or persons are involved in the scheme concerned, there are no specific criteria for defining the borders of the scheme, so that not necessarily all of the gains or losses achieved will be disregarded.

C. Abuse of rights approach

Unlike the anti-avoidance rule, the abuse of rights approach does not provide for procedural rules for determining the tax obligations arising as a consequence of an abusive scheme having been found to exist. This represents a serious flaw in this judicial doctrine. Some statutory proposals are being discussed that would essentially merge the abuse of rights test with the anti-avoidance rule, while retaining the latter's procedural framework.

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NOTES

[1] For an accurate history of anti-tax avoidance approaches up to the introduction of Presidential Decree No. 600/1973, Art. 37 – *bis*, see A. Contrino, *Elusione fiscale, evasione e strumenti di contrasto. Profili teorici e problematiche operative*, Bologna, 1996.

[2] For a critique of this provision, see F. Paparella, "*Riflessioni in margine all'art. 10 della Legge 1990, n. 408, relativo alla ristrutturazione delle imprese,*" (1995) 6 *Dir. prat. trib*., 1835.

[3] For a recent and wide-ranging study on Presidential Decree No. 600/ 1973, Art. 37 – *bis*, see P.M. Tabellini, *L'elusione della norma tributaria*, Milano, 2007.

[4] For a critical assessment in the literature, see G. Zoppini, "*Lo strano caso delle procedure di interpello in materia di elusione fiscale*," (2002) 1 *Riv. dir. trib.*, 1991.

[5] For an overview of this case law in the English language, see R. Cordeiro Guerra, P. Mastellone, "The Judicial Creation of a General Anti-avoidance Rule Rooted in the Constitution," (2009) 11 *European Taxation*, 511. A comparative overview, not specifically devoted to Italy and preceding the most relevant Italian Supreme Court case law on the subject, can be found in J. Prebble, Z. Prebble, "Comparing the General Anti-avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law," (2008) 4 *European Taxation*, 151 and B. David, "*L'abus de droit enAllemagne, en France, en Italie, aux Pays-Bas et au Royaume - Un essai de comparation*," (1991) 1 *Riv. dir. fin.*, 220. In Italian, see P. Pistone, *Abuso del diritto ed elusione fiscale*, Padova, 1995 and G. Maisto (Ed.), *Elusione ed abuso nel diritto tributario*, Milano, 2009, 263.

[6] ECJ, Case C - 255/02, Decision of Feb. 21, 2006, *Halifax v. Commissioners of Customs & Excise.* Other precursors of the abuse of rights doctrine may be found, among the most recent ECJ case law although in areas other than tax law, in Case C-367/96, Decision of May 12, 1998, *Alexandros Kefalas and Others c. Greek State* and in Case C-167/01, Decision of Sept. 30, 2003, *Inspire Art c. Kamer van Koophandel en Fabrieken voor Amsterdam*, both of which dealt with the abuse of rights in a corporate law setting. The issue of the abuse of rights granted by Community Law was also addressed in Case C-110/99, Decision of Dec. 14, 2000, *Elmland Stärke GmbH c. Hauptzollamt Hamburg – Jonas*, which dealt with the issue of export refunds. Following the *Halifax* case, a further ECJ Decision, relevant for clarifying the notion of the abuse of rights in the context of European VAT and with respect to multi-step transactions was delivered by the ECJ in Case C-425/06, Decision of Feb. 21, 2008, *Part Service Srl c. Ministero dell'Economia e delle Finanze*.

[7] ECJ, Case C- 255/02, Para. 74. On this point, see further P. Pistone, "L'elusione fiscale come abuso del diritto: certezza giuridica oltre le imprecisioni terminologiche della Corte di Giustizia Europea in materia di IVA," (2007) 4, *Rivista di diritto tributario*, 17.

[8] For commentary on the decision in English, see C. Innamorato, "An Unwritten Anti-abuse Principle in the Italian Tax System," (2008) 8 *European Taxation*, 449.

[9] The theory constructed by the Italian Supreme Court has been the object of almost unanimous criticism from the most authoritative Italian legal doctrine. Among the most recent and most authoritative contributions are: R. Lupi – D. Stevanato, *Tecniche interpretative e pretesa immanenza di una norma generale antielusiva*, in *Corriere Tributario*, 2009, p. 403; A. Lovisolo, *Abuso del diritto e clausola generale antielusiva alla ricerca di un principio*, in *Rivista di Diritto Tributario*, 2009, p. 60; A. Manzitti, I. Vacca, R. Lupi, D. Stevanato, "Contrasto all'elusione e incertezza del diritto," (2009) 1 *Dialoghi Tributari*, 32; G. Marongiu, "Abuso del diritto o abuso del potere?," (2009) 13 *Corr. trib.*, 1077

[10] Presidential Decree No. 600/1973, Art. 37 – *bis*, Para. 1.

[11] Reference should be made, in particular, to Decision No. 20816/2005 and Decision No. 20398/2005 of the Italian Supreme Court. In the literature, see F. Moschetti et Al., *Elusione fiscale. La nullità civilistica come strumento generale antielusivo. Riflessioni a margine di recenti orientamenti della Cassazione civile. Atti del Convegno tenuto presso la Facoltà di Giurisprudenza dell'Università di Padova – 15 settembre 2006*, (2006) 43, *Il Fisco*, separate leaflet

[12] Ruling No. 62/E of Feb. 28, 2002.

[13] Transactions that led to a tax saving and that were not backed by a valid business purpose were generally considered to constitute tax avoidance. The uncovering of a purposive scheme aimed at circumventing the tax rules was not perceived as a necessary condition in this respect. The rulings issued by the Tax Administration evidenced a change of opinion in the early 2000s (see, in particular, Ruling No. 62/E of Feb. 28, 2002) and the new interpretative position subsequently became the dominant one.

[14] Italian Supreme Court, Decision No. 10257/2008.

[15] Italian Supreme Court, Decision No. 25374/2008.

[16] As provided for in Presidential Decree No. 600/1973, Art. 37 – *bis*, Para. 8.

[17] See in particular Ruling 200/E of Dec. 20, 2000, with respect to "prospective" tax savings. In relation to "potential" tax savings, it would be much more difficult to point to specific rulings. Nonetheless, the concept emerges quite clearly in pre-emptive rulings issued, in the past by the Anti-tax Avoidance Committee and, currently, by the Revenue Agency. All the possible scenarios in terms of tax saving arising from a set of transactions are taken into account when determining whether particular behavior is tax avoidance.

[18] See in particular Italian Supreme Court, Decision No. 4737/2010.

[19] See in particular Italian Supreme Court, Decisions Nos. 30055/08, 30056/08 and 30057/08.

[20] For an analysis of the concept of "valid business purpose" from a business economic perspective, see L. Potito, "*Le 'valide ragioni economiche' di cui all'art.* 37 – *bis* del D.p.r. n. 600/1973: *considerazioni di un economista d'azienda*," (1999) 1 *Rassegna tributaria*, 63.

[21] See Decision No. 239/1996 issued by the Provincial Tax Court of Milan.

[22] Law Decree No. 223/2006, Art. 35, Para. 2 extended the anti-avoidance rule to these taxes, but no guidance from the Tax Administration or case law has emerged in this respect.

[23] Explanation accompanying Legislative Decree No. 358/97, Art. 7.

[24] According to which "All persons must contribute to public expenditure in proportion to their ability to pay. The tax system must conform to the principle of progression."

[25] Italian Supreme Court, Decisions Nos. 30055/2008, 30056/2008 and 30057/2008.

Host Country JAPAN

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I. General

Whether, when a taxpayer effects a transaction and the transaction is legally valid in accordance with its legal form and its terms under the relevant private law, the Japanese tax authorities are allowed to disregard the legal form of the transaction solely for tax purposes where the transaction gives rise to tax avoidance has long been a subject of debate and academic discussion in Japan. That question has also been addressed in the courts. The current prevailing interpretation in Japan is that, in the absence of any statutory provisions specifically authorising the tax authorities not to do so, the tax authorities should respect the legal form of a transaction, as a prerequisite for determining the taxpayer's tax liability arising from the transaction.[1] Although no Supreme Court decision has directly addressed this issue, the most recent trend in the position taken by the lower courts suggests that the courts generally support the prevailing viewpoint.

The Japanese Corporation Tax Act (CTA)[2] does not contain any specific provision authorising the Japanese tax authorities to deny or disregard the legal form of a transaction on the grounds that it lacks economic substance or its legal form is abused.[3] On this basis, it is generally understood that the legal principle underlying Japanese tax law requires the Japanese tax authorities to respect the legal form of a transaction if the transaction is legally valid under private law, and that lack of economic substance, solely in and by itself, should not be grounds for allowing the tax authorities not to respect such legal form solely for tax purposes.

In other words, under Japanese tax law and according to the prevailing view mentioned above, in order for the tax authorities not to respect the legal form of a transaction solely for tax purposes, the tax authorities would have to find a specific statutory rule in the tax law authorising them to disregard and reconstruct the legal form of the transaction solely for tax purposes.

In this regard, although it is beyond the scope of this article to address how, in the absence of any statutory provisions, the Japanese tax authorities have dealt with situations in which they have found an "abuse of law" (without going into the question of what this phrase means), the following two aspects may be relevant to the subject matter of the Forum question.

First, the Japanese tax authorities have for some time (particularly in the last ten years or so) been attempting to argue the theory or theories that they should be allowed to reconstruct the "true legal form" of a transaction when the transaction gives rise to tax avoidance and that this "true legal form" (which is, in their view, different from the legal form) should be found in and reconstructed from the true intent of the parties involved in the transaction. This theory may still be compatible with the private law analysis because, under Japanese private law, if the parties to a transaction do not truly intend to enter into a transaction in the guise of legal form "A," but their true intent is not to enter into a transaction in the guise of legal form "A," such transaction in legal form "A" would be considered invalid, even if the documentation for the transaction (in legal form "A") is properly executed.[4] Thus, if and to the extent that the tax authorities' theory concludes that the transaction in the above example as entered into between the parties in legal form "A" should be treated as void and, thus, nonexistent, the tax authorities would still be respecting the legal analysis and consequences under private law).

However, the tax authorities sometimes appear to be going further by arguing that they should be allowed, as a matter of fact-finding, to reconstruct the "true legal form" from the true economic substance underlying the true intent of the parties involved in the transaction (the "true legal form reconstruction theory"). It appears that the objective of the true legal form reconstruction theory is to allow the tax authorities to disregard the legal form of a transaction even if it is legally valid under private law, and to reconstruct it solely for tax purposes. However, it is the prevailing understanding among tax law professionals and practitioners that this approach of the Japanese tax authorities or the true legal form reconstruction theory has already been indirectly rejected by the Supreme Court in its decision of January 24, 2006[5] (the "2006 Supreme Court Decision;" see II., below, for further discussion of this decision). Nevertheless, the Japanese tax authorities do not seem to have lost their appetite for challenging taxpayers when they allegedly find that the primary or main objective of a transaction entered into by a taxpayer is to avoid taxes or abusively to take advantage of particular tax treatment.

In another highly publicised case in which the tax authorities denied a foreign tax credit claimed by a certain Japanese bank, the tax authorities denied the claim by making an argument based on the true legal form reconstruction theory in addition to certain other arguments. The case involved a situation where:

1. A Japanese bank took a bank deposit from a nonresident customer, N1, and loaned the proceeds from such deposit to another nonresident customer, N2, with a view to enabling customer N2 to effectively use customer N1's funds;
2. The Japanese bank was subject to a foreign withholding tax when interest on the loan was paid by customer N2 to the Japanese bank; and
3. The Japanese bank's margin from such back-to-back deposit and loan transaction would not allow it to earn profits therefrom unless it was able to claim a foreign tax credit with respect to the foreign withholding tax mentioned in (2).

If the legal form of the transaction had to be respected for tax purposes, the Japanese bank would be entitled to claim a foreign tax credit with respect to the foreign withholding tax mentioned in (2) in full, which the Japanese bank did indeed claim.

The taxpayer Japanese bank was successful before the lower courts, i.e. the true legal form reconstruction theory argued by the tax authorities was rejected by the lower courts. Thereafter, on appeal to the Supreme Court by the Government, the lower courts' decisions were eventually reversed by, and the taxpayer lost before, the Supreme Court, which rendered its judgment on December 19, 2005.[6] Interestingly, the Supreme Court reached its conclusion not because it upheld the true legal form reconstruction theory. Rather, the Supreme Court held that, based on the finding that the entire scheme of the back-to-back deposit and loan transactions mentioned above had been arranged to enable N1 to avoid incurring the withholding tax that would have been imposed if N1 had loaned the funds directly to N2, the Japanese bank's claim should be disallowed on the grounds that its foreign tax credit claim in this case was found abusive in light of the underlying objective of the foreign tax credit system (that is, to achieve tax neutrality between a Japanese corporation's business activities in a foreign country and its business activities in Japan by enabling it to avoid double taxation). In a sense, this Supreme Court decision addresses an abuse of the foreign tax credit system and disallows such abusive claim based on the underlying objective of the system itself. However, because of the scarcity of judicial precedents, whether, how and to what extent a similar approach can and will be taken by the Japanese courts in dealing with potentially numerous other "abuse of law" situations is still unknown.

Secondly, it should be noted that the CTA includes certain specific provisions (Articles 132, 132-2 and 132-3) authorising the tax authorities to disregard any act done by, or any calculation made by, a taxpayer if it satisfies certain specified conditions and requirements under the relevant article (see III., below for further explanation of these three articles). Similar provisions are also included in certain other tax laws. These provisions, however, do not focus so much on whether the transaction in question lacks economic substance as on whether the act or calculation results in an "unjust" decrease in the relevant taxpayer's tax liability. It is possible that, depending on the facts and circumstances involved in a particular case, lack of economic substance may trigger or give support to the tax authorities' exercise of the authority granted under any of the three articles, provided the requirements of the articles are met.

II. 2006 Supreme Court decision

As noted in I, above, the Japanese tax authorities have been attempting to justify their true legal form reconstruction theory that the form of a transaction can be reconstructed or recharacterised by examining what was truly intended to be agreed by the parties to the transaction, as a matter of economic substance, and that, depending on what is found to be the agreement that was truly intended, the transaction should be recharacterised and taxed accordingly. In taking this approach, the Japanese tax authorities have sometimes argued that their approach is nothing other than the establishment of the facts in accordance with the correct application of private law. However, also as noted in I.A., above, the tax authorities' theory sometimes appears to go beyond the mere establishment of the facts when it is sought to be applied to a transaction as a result of which the parties appear to be left with almost nothing other than an advantageous tax position, even though the parties have a genuine intention of entering into and honour the legal form of the legally valid transaction from the perspective of private law.

The Japanese tax authorities seem to have attempted to apply their theory in particular to structured transactions that appear to be primarily or largely motivated by the desire to secure a tax advantage. The true legal form reconstruction theory was eventually tested in the courts in a certain limited number of cases, one of which was a case where some individual taxpayers entered into a structured film leasing transaction. In that case, the investors formed a partnership through which they acquired the legal ownership of a motion picture from a film production company. Substantially all the elements of the ownership of the film that could be exploited to generate profits (including various aspects of the copyright to the film) were stripped from the owner of the film under the contractual terms of the film lease, the distribution agreement and various other agreements. The owner of the film was, thus, left in substantially the same position as a mere leveraged lender extending financing to the major film company involved in the production and distribution of the film, but for the fact that the owner had the legal ownership of the film as a matter of legal form.

The investors claimed in their tax returns that, because they co-owned the film in question (through the partnership), they should be entitled to highly-accelerated depreciation with respect to the film as a tax deductible expense in calculating their income tax liabilities. The tax authorities denied this claim, taking the position that, although the investors had entered into a series of agreements, the effect of these agreements should be determined, as a matter of fact-finding, by investigating the investors' true intention: the investors had no intention of acquiring the ownership of the film and exploiting it; their true intention was solely to benefit from the depreciation deduction by holding the legal ownership of the film so that they could shelter their other income, thereby avoiding the respective income tax liabilities that they would otherwise have incurred. Actually, a number of film leasing cases were litigated and the detailed facts varied slightly from case to case, but the basic issues were the same in all cases.

Interestingly, in one of these film leasing cases, the lower courts (both the court of first instance[7] and the appeal court[8] upheld the Government's position, basically concurring with the true legal form reconstruction theory of the tax authorities discussed above. On further appeal, although the taxpayer lost before the Supreme Court, the 2006 Supreme Court decision did not adopt the reason given in the lower court judgment (which concurred with the tax authorities' theory that, even in the absence of any specific statutory provisions authorising the tax authorities to deny and disregard the form of the taxpayer's transaction, the form of the transaction could be disregarded and reconstructed solely for tax purposes based on the parties' true intention if the transaction in question was entered into for tax avoidance purposes), but put forward a reason that bore no relation to the tax authorities' true legal form reconstruction theory.

The 2006 Supreme Court Decision held that in order for a taxpayer to be able to claim depreciation with respect to the film in question, the film had to be actually used and exploited for the business of the partnership in which the taxpayer was one of the partners. However, the right in the film left to the partnership was not something that the partnership was able to use or exploit for its business, and accordingly the taxpayer's claim for depreciation of the film should be denied. This opinion has generally been interpreted to mean that the Supreme Court was of the view that the legal form of the transaction entered into by the taxpayer should be respected in the determination of the taxpayer's tax liability and, in that sense, effectively dismissed the tax authorities' true legal form reconstruction theory mentioned above.

III. Specific authority granted by law to reject acts and calculations of a taxpayer

As noted in I., above, the CTA contains three articles that authorise the Japanese tax authorities to disregard and reconstruct acts and calculations of a taxpayer solely for tax purposes, subject to certain requirements.

The first of these three articles is Article 132 of the CTA, which authorises the Japanese tax authorities:

- To disregard a taxpayer's act or calculation if the taxpayer falls within the category of a "family corporation"[9] and if the act or calculation unjustly reduces the family corporation's corporation tax liability; and
- To calculate the family corporation's corporation tax liability as if the family corporation had acted differently, as deemed by the tax authorities.

The second of the three articles is Article 132-2 of the CTA, which is applied by the tax authorities in determining the corporation tax liability of taxpayers who fall into any of the categories of parties to certain specific types of corporate reorganisations (including a merger, company split, contribution in kind, subsequent incorporation, stock exchange or stock transfer), any corporations issuing shares delivered in such corporate reorganisations (if different from the direct parties to such corporate reorganisations) and their respective shareholders (if different from any of the foregoing). If the Japanese tax authorities consider that any act or calculation of the relevant taxpayer unjustly results in a reduction of its corporation tax liability due to: a decrease in profits or an increase in losses arising from the transfer of assets and liabilities under the relevant corporation reorganisation; an increase in the amount of deductions allowed in arriving at the corporation tax liability; a decrease in profits or an increase in losses arising from the transfer of shares under the relevant corporate reorganisation; a decrease in deemed dividends arising from the relevant corporate reorganisation; or any other reason, they are authorised by Article 132-2 to calculate the relevant taxpayer's taxable income, net operating losses and/or corporation tax amount based on their recharacterisation, without regard to the disregarded act or calculation performed by the relevant taxpayer.

The third article is Article 132-3 of the CTA, which is applied by the tax authorities in determining the corporation tax liability of a taxpayer filing a consolidated tax return, either as the consolidated group's parent or as a subsidiary in the consolidated group. If the Japanese tax authorities consider that any act or calculation of the relevant taxpayer unjustly results in the reduction of its corporation tax liability due to: an increase in deductions from its income or the relevant consolidated income; or a decrease in the profits arising from the transfer of assets between the relevant consolidated group corporations; or any other reason, they are authorised by Article 132-3 to calculate the relevant consolidated taxable income, net operating losses, consolidated net operating losses and/or corporation tax amount based on their recharacterisation without regard to the effect of the disregarded act or calculation performed by the relevant taxpayer.

The second and the third articles (Articles 132-2 and 132-3) are relatively new[10] and so far there do not seem to be any published court cases in which the application of either of them was at issue and it appears that the Japanese tax authorities have not yet invoked the authority given to them under either article. On the face of it these provisions appear to give the tax authorities wide discretionary authority. However, as regards the corporate reorganisation situation mentioned in Article 132-2, provided the reorganisation is consummated by the undertaking of proper legal steps in the normal course of business, the prevailing view in practice appears to be that it would be difficult for the tax authorities to consider that the relevant taxpayer is "unjustly" reducing its corporation tax liability. If a particular corporate reorganisation transaction has no economic substance and leaves the taxpayer in exactly or substantially the same position as it was in prior to the transaction, it will not be at all surprising if the tax authorities seriously consider invoking the application of Article 132-2. However, because of the total lack of published precedent, the discussion on the question of what is required for the Japanese tax authorities to be able to invoke Article 132-2 has not matured, indeed has not even been well-aired. Article 132-3 addresses a situation different from that addressed by Article 132-2 in the sense that filing a consolidated tax return, in and of itself, involves not a transaction, but an act that has meaning solely for purposes of determining corporation tax liability. Thus, Article 132-3 does not really seem to be relevant for purposes of the Forum question.

Article 132 has a relatively long history and has been applied to family corporations in a number of cases. Basically, the article was enacted because family corporations, unlike non-family corporations, are considered to be capable of acting not at arm's-length and, accordingly, engaging in transactions to achieve a tax advantage in a form or on terms that would be unnatural or unreasonable for arm's-length parties or that would not normally have been entered into between arm's-length parties.

If the tax authorities find any act or calculation of a family corporation unnatural or unreasonable for an arm's-length party and the result is a decrease in the family corporation's tax liability, generally, the family corporation could be found to have unjustly decreased its tax liability. In such a case, the tax authorities would disregard the form of the act or calculation performed by the family corporation solely for tax purposes, and would recalculate the family corporation's tax liability as if the act or calculation performed by it were performed in the same form or on the same terms as would have subsisted between arm's-length parties.

NOTES

[1] See Hiroshi Kaneko "Sozeihou Dai-15-han" (Tax Law 15th Edition) (Koubundou, 2010) at pp. 117-118.

[2] Law No. 34 of 1965, as amended.

[3] The income attribution rule provided in CTA, Art. 11 may sometimes be referred to, in English, as a substance-over-form rule. Similar statutory rules can also be found in certain other tax laws. However, despite such nomenclature, this rule is not necessarily the same as the "economic substance" or "abuse of law" rules or doctrines focused on by the Forum question. Art. 11 provides, in relevant part, that income arising from the holding of an asset or the conduct of business shall be attributable to the person who enjoys the benefit of such income, rather than the mere nominee who does not enjoy the benefit of such income, for purposes of the CTA. The prevailing interpretation of the rule provided in Art. 11 is that the income arising from the asset or business in question should be treated as income of the person to whom the income is "legally attributable" and Art. 11 requires the determination of such person to be made based on the substance of the relevant matters, as opposed to a mere appearance or the person in whose name income is received. The other possible interpretation of the rule provided in Art. 11 is that the income arising from the asset or business in question should be treated as income of the person to whom the income is "economically attributable," as opposed to the person to whom the income is "legally attributable." The established position of the Japanese courts is the same as that in the former, prevailing interpretation. (Typical cases where this rule is applied include, for example, cases in which income arising from securities transactions effected in the name of a wife is treated as attributable to her husband based on the finding that the husband has given his wife a blanket authority to act on his behalf.) Accordingly, under the prevailing interpretation as well as the established position of the Japanese courts, this rule still makes it necessary to examine to whom income is "legally" attributable, although there may possibly be situations in practice where the tax authorities attempt to use this rule as an excuse not to respect the legal form or mere appearance.

[4] See, e.g., Civil Code of Japan (Law No. 89 of 1896, as amended), Art. 94, para. 1, which provides that "any fictitious manifestation of intention made in collusion with another party(ies) shall be void."

[5] Vol. 60-1 of Saikou-Saibansho Minji Hanrei-shu (Supreme Court Compilation of Civil Case Judgments) at p.252.

[6] Vol. 59-10 of *Saikou-Saibansho Minji Hanrei-shu* (Supreme Court Compilation of Civil Case Judgments) at p.2964.

[7] Osaka District Court judgment rendered on Oct. 16, 1998.

[8] Osaka High Court judgment rendered on Jan. 18, 2000.

[9] See CTA, Art. 2, item 10 and Corporation Tax Act Enforcement Order (Cabinet Order No.97 of 1965, as amended), Art. 4, for the definition of a family corporation (*douzoku kaisha*). Generally, a closely-held corporation, more than 50 percent of whose shares are held by three or fewer shareholders or shareholder groups (as more fully provided in the above provisions) is included in the definition of a family corporation.

[10] CTA, Art. 132-2 was first enacted in 2001 (and slightly amended subsequently), and CTA, Art. 132-3 was enacted in 2002.

Host Country NETHERLANDS

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I. Will the Dutch tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Dutch law, despite its lack of economic substance?

In the Netherlands, the tax authorities can challenge a transaction that is motivated almost exclusively by tax considerations and that leaves the taxpayer in substantially the same position as it was prior to the transaction. The Dutch tax authorities will base their challenge on a doctrine called *fraus legis,*[1] which has been adopted and developed by the Dutch Supreme Court in cases of evasion or avoidance of the law. Using this doctrine is considered a last resort for the tax authorities. In Dutch tax law, the predominant principle is that taxes can only be levied by rule of law. This principle is part of a broader principle of legal certainty, meaning that a taxpayer should be able to determine the scope of his or her tax obligations from the text of the law. The *fraus legis* doctrine thus goes beyond the rule of law and is, therefore, considered a last resort for the tax authorities.[2]

Furthermore, the tax courts will only apply this doctrine if they decide that the regular methods of interpretation will not be sufficient in a specific case. The most commonly used regular methods of interpretation in Dutch tax law are: literal interpretation, i.e., interpretation based purely on the text of the law; and the historical method, an interpretation method based on the intention of the legislature and on what was argued in the parliamentary legislative process. Other methods used include the teleological, systematic, and extensive methods of interpretation. In addition to these regular methods of interpretation, certain facts may be interpreted purely from a tax law point of view, so that their meaning or consequences under civil law are ignored. This is called "reformulating the facts for tax purposes" and occurs, for instance, when a contribution of capital is recognized for tax purposes, but not acknowledged for civil law purposes. Reformulating the facts for tax purposes can, in some cases, result in an outcome similar to that of using the *fraus legis* doctrine. Finally, the tax authorities can argue that a simulation has occurred. Simulation occurs when the facts of the case as presented do not represent what really happened. Depending on the facts of the case, the transaction in question will either be ignored or replaced by the transaction that has the effect that the taxpayer was trying to avoid.

This paper, however, will discuss only *fraus legis,* as this doctrine is more on point in the context of the questions raised here. Advocate General IJzerman[3] provides a very good illustration of the *fraus legis* doctrine in application: a taxpayer has paid interest on a loan. The loan is used to purchase securities that will produce a tax-exempt capital gain on disposal. The capital gain, however, is slightly lower than the interest paid on the loan. The transaction, thus, only makes sense if the interest is tax-deductible. It is, therefore, obvious that the transaction was effected primarily for tax reasons. Although the Personal Income Tax Act allows a tax deduction for interest, in this case, the deduction would cross the line and violate the intention and purport of the law. The tax deduction for interest is not intended to allow taxpayers to manipulate their taxable income or profit at will.

In this case, for the tax authorities to challenge transactions successfully on the basis of *fraus legis*, the following two conditions must both be met:

- The transaction or set of transactions must violate the intention and purport of the law; and
- Tax considerations or tax avoidance must be the decisive motivation for the transaction.

These two conditions are discussed in further detail in A. and B., below, respectively. It should be borne in mind that for them both to be met, the tax authorities will have to claim that the transaction concerned was effected *in fraudem legis*. Furthermore, the burden of proof lies with the tax authorities and is not applied *ex officio*. Thus, for the tax courts to apply the doctrine, the tax authorities must not only argue that the first condition has been met, but also prove that the second condition has been met.

A. Violation of the intention and purport of the law

The first condition is a pure question of law and is often referred to as the "objective condition." The tax court must take into account what was the intention of the legislature regarding the specific rule of law concerned and must weigh this intention against the outcome of the transaction concerned. The intention and purport of the law can be gleaned from the discussions and deliberations in Parliament leading to the introduction of the specific section in the Tax Act in question. In this respect, the tax court will research

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what the legislature intended and whether the legislature took a particular transaction or tax planning opportunity into account. The outcome, of course, depends on the specific section in the Tax Act in question, in combination with the specific transaction or tax planning opportunity. It is therefore very difficult to give a general outline of what the tax courts consider to be a violation of the intention and purport of the law. Generally speaking, the Dutch Supreme Court will regard transactions that allow a taxpayer to manipulate his or her taxable income at will as violating the intention and purport of the law.

There have been a number of cases in which no violation of the intention and purport of the law was found to exist. Some of these are summarised below:

> The Dutch Supreme Court ruled in its "ex-warrant" ruling of January 24, 1996, no. 29 954, BNB 1996/138 that no violation of the intention and purport of the law occurs if the legislature has explicitly considered a particular situation and has chosen not to take action. In the case of the ex-warrant ruling, a new section was introduced into the Personal Income Tax Act. The provisions concerned were implemented in order to combat tax benefits arising from investments in the bare ownership of bonds or of bond principals. These types of investments offered the investor the opportunity to obtain tax-free capital gains, because the bare ownership of bond principals was purchased for an amount below nominal value, but the investor received the nominal value on repayment of the bond. On the other hand, the amount of interest the investor received on the bond was taxed. Thus, there was no financial difference for the investor himself or herself. When the reparation bill containing this new section was introduced, a number of questions arose as to whether it should be explicitly stated that ex-warrant loans would be covered by the provisions. The legislature found that this was not necessary because these types of loans would implicitly fall within the wording of the new legislation. It was therefore clear that the legislature intended to include these loans. The Supreme Court, however, ruled in this case that since the question had been raised and had been explicitly discussed in Parliament and the legislature subsequently chose not to include ex-warrant loans in the provisions of the law explicitly, a violation of the intention and purport of the law did not occur.

No violation of the intention and purport of the law occurs when a tax planning opportunity is a direct consequence of the system of the law chosen by the legislature. This was the finding of the Supreme Court with regard to "turbo-companies" (under the Personal Income Tax Act of 1964, these were companies with a high level of contributed capital that were first injected with profit-generating activities and subsequently repaid their capital to the contributors):

> The system thus created by the legislature is based on such a fundamental choice on the part of the legislature that it cannot be put aside in a case such as this by an appeal to the doctrine of *fraus legis*. It could be admitted to the Deputy Minister of Finance that indeed in such a case as this, the objective system could lead to results that are not compatible with society's idea of income, but that to replace this system with the more subjectively determined concept of shares, as has already occurred with shares that form part of a substantial interest, can only be carried out by the legislature.[4]

No violation of intention and purport occurs when a tax avoidance opportunity is so apparent that the legislature should have taken it into account. This is illustrated by a Supreme Court ruling of July 8, 1992, no. 28 211, BNB 1992/308. Section 4 of the Taxation of Legal Transactions Act ensures that the obtaining of rights to real estate is subject to transfer tax in the same way as the obtaining of real estate. In the case concerned, the Supreme Court ruled that saving transfer tax by obtaining only the beneficial rights to shares in a company that only owned real estate by letting one's other company obtain legal ownership of the shares in the real estate-owning company was such an obvious tax planning opportunity that the legislature would have taken action had it deemed the transaction to be a violation of the intention and purport of the law.

However, it is very difficult to determine when tax planning or avoidance is so obvious that the legislature would have taken action had it wished to put an end to it. For example, the Supreme Court refused, in its ruling of July 11, 2008, no. 43 376, BNB 2008/266, to consider that the conversion of a loan into an annuity obligation constituted such an apparent tax avoidance opportunity. Interest on the loan in this case would have been subject to the interest deduction limitations, whereas payments on the annuity obligation would have fallen outside the scope of the interest deduction limitations. In deciding whether a particular tax planning opportunity is so apparent that the legislature should have taken it into account, the tax courts will take into account whether the provision in question is a detailed anti-abuse provision. However, even where an anti-abuse provision has been circumvented, the tax courts may still find that there has been a violation of the intention and purport of the law.

The Dutch Supreme Court did not consider the creation of an interest profit in a company with carryforward losses for the sole purpose of setting-off the losses to be a transaction in violation of the intention and purport of the law. The Supreme Court held, in its ruling of March 10, 1993, no. 28 139, BNB 1993/196, that provided the debtor's interest deduction was compensated for by a reasonable corporate income tax charge on the creditor, there was no violation of the intention and purport of the Corporate Income Tax Law. The use of carryforward losses was considered reasonable compensation, as was the imposition of a reasonable foreign corporate income tax charge. It should be noted that, in this case, the company's own losses were involved. In other rulings, however, the manipulation of taxable income with infusions of capital or payments of dividends followed by intragroup loans was not accepted by the Supreme Court, because the ability to manipulate taxable income at will is a violation of the intention and purport of the law. These rulings are often referred to as the "profit siphoning" rulings.[5]

To summarise, the Dutch Supreme Court will rule that a particular transaction or set of transactions is effected in violation of the intention and purport of the law if the transaction(s) would allow taxpayers to manipulate their taxable income or profit at will. In one of the "profit siphoning" rulings, the Supreme Court took into consideration the fact that allowing such transactions would erode the taxable base for corporate income tax purposes, since the taxpayer would be able to repeat the transactions without a change in the interests or position of the company. Another important circumstance in these cases was that the transactions (loans) played no role in financing the company. As described below, this last circumstance is also a consideration in determining whether a transaction is primarily motivated by tax avoidance.

B. Tax considerations or tax avoidance as the decisive motivation for the transaction

The second condition for the application of the *fraus legis* doctrine is not purely a question of law, but depends very much on the circumstances of each case. The motivation for certain transactions lies with the taxpayer, and depends on his or her intentions. Generally speaking, a Dutch taxpayer has freedom of choice, within the scope of the tax law, as to how he or she achieves his or her business purpose. The taxpayer is not required to choose an option that will be more expensive in tax terms. This freedom of choice, however, is limited by the doctrine of *fraus legis*. Once a taxpayer introduces artificial transactions or steps that lack economic substance, he or she may enter into the realm of *fraus legis*.

The following examples from the case law illustrate when a transaction is deemed to be motivated decisively by tax considerations:

- If a transaction will not be profitable unless one takes into account the tax benefits, the transaction will be deemed to be motivated by tax considerations, as was the case in Advocate General IJzerman's example described in I., above. The Supreme Court has ruled that, unless a taxpayer in this situation proves that another motivation was decisive for entering into the transaction, the tax motivation may be assumed to be decisive.[6]
- If a set of transactions results in a tax advantage but no other fundamental change results from it, the set of transactions is also deemed to be motivated decisively by tax considerations. The Supreme Court ruled that this was the situation in a corporate income tax law case in which the transactions in question, which were intercompany loans, brought about no fundamental change in the interests and position of the companies involved and the loans did not serve any financing needs of the company concerned.[7]

Other factors that may indicate to the tax courts that tax considerations or tax avoidance are the decisive motivation for a transaction are: artificiality, a lack of material economic form, and the unorthodox use of a specific transaction. This will not be the case, however, when the transaction is primarily motivated by considerations other than tax motives. When a taxpayer has a legitimate business purpose, the *fraus legis* doctrine cannot be applied. This is further discussed in II., below.

II. What are the pre-requisites for a transaction to be considered immune from challenge under Netherlands' "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

A. Is a subjective business purpose/motivation (as contrasted with a tax motivation) necessary?

As discussed above in I.B., above, under Dutch tax law, a transaction effected primarily because of a business motivation cannot be challenged successfully under the *fraus legis* doctrine. Business motivations can vary and include, but are not restricted to, business succession,[8] restructuring companies in order to avoid major liability,[9] or the concentration of the business in order to strengthen the economic base of the company.[10] Entering into a particular transaction in order to avoid certain provisions under civil law is also regarded as a business purpose.[11] The existence of such a circumstance by itself means that the transaction in question was not purely motivated by tax considerations.

B. Must there be a "substantive economic effect" as a result of implementing the plan?

If a transaction does not have a substantive economic effect or does not bring about a fundamental change in the taxpayer's position, the transaction is deemed to be motivated primarily by tax considerations. It lies with the taxpayer to prove that there is a motivation other than a tax motivation to avoid the transaction concerned being challenged as conducted *in fraudem legis*.

C. Must there be a realistic expectation of pre-tax profit?

In the context of Dutch tax law, this question is usually phrased somewhat differently. As indicated in I.B., above, transactions that cannot result in a profit if one does not take account the tax advantage they generate are deemed to be motivated by tax considerations. It lies with the taxpayer to prove that this is not the case.

D. Are there other factors that the Netherlands would take into account in evaluating the substance of this transaction?

In evaluating such cases, the tax courts will take all relevant facts into account. Also, transactions will be looked at in context, which means that sometimes a number of transactions entered into over a period of time can be evaluated together instead of separately. This paper has discussed the most important factors that are taken into account in making such an evaluation, but it will depend on the specific facts of each case whether other factors will also be taken into account.

III. What is the tax result of a determination that a transaction lacks economic substance?

The Dutch Supreme Court uses either "elimination" or "substitution" as the method for deciding the consequences of the application of the doctrine of *fraus legis* to a particular transaction. Which method the Supreme Court will choose will depend on the specific facts of the case. In its ruling of June 11, 1986, BNB 1986/283, the Supreme Court made it clear that it has a choice between the two methods.

A. Elimination

The method of eliminating the transaction is usually used in cases where an interest deduction is being challenged. In such cases, the interest paid is ignored, and the deduction is denied. As discussed in I., above, one of the reasons transactions have been ruled to be *fraus legis* in corporate income tax cases is that, in the transactions concerned, interest was not taxable in the hands of the recipient. The use of the elimination method, however, is more often found in older cases. In more recent cases, the Supreme Court has generally instead tried to arrive at a substitute for the challenged transaction.

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B. Substitution

The Supreme Court will generally try to substitute for the challenged transaction a similar transaction that has the taxable consequences that the taxpayer was trying to avoid. For example, a case of June 11, 1986 concerned the sale of a life insurance policy, when the sale of a life insurance policy to a person living outside the Netherlands gave rise to taxable income, but the sale of such a policy to a person living in the Netherlands was tax-free. According to the letter of the law, the sale of a policy to a person who was about to emigrate from the Netherlands was also tax-free. The Supreme Court, however, ruled that a transaction involving the sale of an insurance policy to a person who was about to emigrate could be substituted by a transaction comprising a sale to a person living outside the Netherlands, because this substitution would best serve the intention and purport of the law.

It is, however, possible that a transaction could be challenged successfully in some years but could generate income in other years. The question then arises as to whether the transaction should still be ignored. It is also possible that, for example, where a deduction for interest is refused, the loan on which the interest is paid is used to purchase investments that generate taxable income. In a case where the deduction for tax purposes of interest paid was denied on the grounds of *fraus legis*, the Dutch Supreme Court ruled that this meant that the income derived from that interest was also to be ignored.[12]

This paper has outlined the way in which the Dutch Supreme Court has applied the doctrine of *fraus legis* in its rulings. Although the rulings discussed illustrate the way in which the doctrine is applied, they do not always reflect current Dutch tax law. Very often, the rulings have been followed by either reparation legislation or codification of the outcome. As a result of the case law, therefore, resorting to the doctrine of *fraus legis* can be a very effective way for the Dutch tax authorities to deal with adverse tax consequences. On the other hand, the introduction of very detailed reparation legislation sometimes makes it more difficult for the tax authorities to argue that the legislature could not have foreseen certain tax planning opportunities (see I., above). In practice, the tax authorities also tend to argue that the facts of certain transactions should be reformulated for tax purposes. However, as discussed in I., above, this has not generated a significant body of case law.

NOTES

[1] Literally: abuse of law.

[2] See R.L.M. IJzerman, *Over fraus legis, herkwalificatie en het motiefvereiste*, from the Liber Amicorum for F. Van Brunschot, page 75. Mr IJzerman is Advocate General with the Dutch Supreme Court.

[3] R.L.M. IJzerman as quoted above, p. 77. The example is not based on current Dutch tax law.

[4] D.G. Barmentlo, NDFR Formeel belastingrecht 3.3. (Dutch Documentation Tax Law, Procedural Tax Law 3.3.)

[5] Supreme Court ruling of April 26, 1989, no. 24 446, BNB 1989/217, followed by rulings of March 10, nos. 27 295, 27 992, 28 139 and 28 484, BNB 1993/194, BNB 1993/195, BNB 1993/196 and BNB 1993/197.

[6] Supreme Court ruling of Sept. 21, 1983 no. 22 060, BNB 1983/316.

[7] Supreme Court ruling of April 26, 1989 no. 24 446, BNB 1989/217.

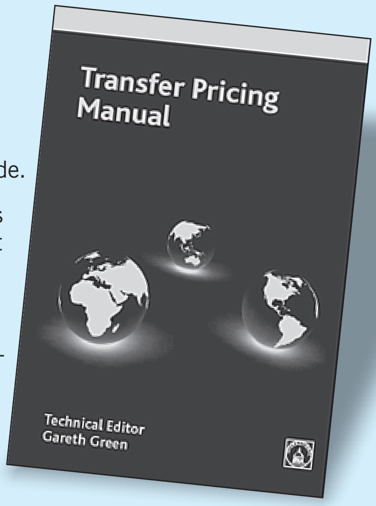
[8] Supreme Court ruling of July 11, 1990, no. 26 306, BNB 1990/293

[9] Supreme Court ruling of Dec. 1, 1999, no. 34 217, BNB 2000/11.

[10] Supreme Court ruling of Sept. 24, 1980, no. 19 552BNB 1980/332.

[11] Supreme Court ruling of Nov. 11, 1987, no. 24 167, BNB 1988/89.

[12] Supreme Court ruling of Jan. 27, 1993, no. 28 602, BNB 1993/111



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I. Will the Spanish tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Spanish law, despite its lack of economic substance?

Spanish legislation has never recognised the "substance over form" doctrine as such and it has therefore never been formally included in the Spanish General Tax Law.[1] In addition, the Spanish Courts have seldom referred to it as grounds for their decisions, precisely because the Spanish tax system — like other European tax systems — has looked to other, specific anti-abuse measures that perform the same function and have the same scope.

It is true that certain commentators, and even the Courts, have used the "substance over form" principle when considering the application of general Spanish anti-abuse rules, but they have done so basically for illustrative purposes in an international context to show the approach of a different legal system to an abuse of law situation, and have not used it as the principle directly applicable to resolving the case at issue.

This is why the analysis of the applicability of the "substance over form" principle to a particular transaction, from a Spanish perspective, needs to focus on the anti-abuse provisions recognised in Spanish civil and tax law and, more specifically, on the "characterisation principle," the "sham doctrine" and "*fraus legis*"/"conflict in the application of tax law,"[2] as it is a combination of these general anti-abuse approaches that covers the range of content and function of the Anglo-Saxon "substance over form" principle.

A. Spanish characterisation principle

Article 13 of the Spanish General Tax Law provides that tax liability is to be determined "in accordance with the legal nature of the act or contract effectively executed, irrespective of the form or name applied by the parties and regardless of any formal mistake that may affect its validity." Thus, the Spanish "characterisation principle" aims to ensure the application of the relevant tax to the economic capacity derived from the legal nature or substance of the transactions carried out, regardless of the form or name given to the transactions by the parties concerned. The principle is directly concerned with transactions in which a different "legal nature" may result in a different tax treatment[3].

The application of this criterion, therefore, only makes sense when the re-characterisation of the outward name or act used by the parties concerned leads to a modification or non-application of the legal provision concerned, and thus to an alteration of the tax consequences derived therefrom.

The wording of the Spanish law in force since 1995 (when the "economic interpretation" of a taxable event was eliminated from the General Tax Law) refers exclusively to the legal characterisation of a particular transaction, which must be made in accordance with the real legal nature of the contracts entered into by the parties, which real legal nature cannot be disregarded based on a pure economic approach that ignores the legal substance of the agreements concerned.[4]

The judgment issued by the Spanish Supreme Court on June 8, 2002 (and repeated in judgments dated September 28, 2002 and May 24, 2003) should be mentioned here. This judgment rejects the re-characterisation, argued by the Spanish Tax Authorities, of a loan without a maturity date as equity, based on its alleged economic substance. The Supreme Court stated the following:

> In this regard, the ruling by the Court of Instance unnecessarily grants the Authorities the power to judge intention for the alleged purpose of avoiding the prohibition of verifying figures, as referred to above, by using the power to classify, which was and still is granted under the General Tax Law. Unnecessarily, in that to compare an interest-free loan, even if repayable over a long term, to a gift with consideration or, in other words, to state that the person receiving an interest-free loan under such conditions has the same legal position as a person receiving a gift is the same as not legally interpreting an act that is fully compliant with the provisions of the Civil Code with respect to loan and tax provisions on the definition of the taxable event and taxable base, pursuant to applicable amended legislation, which should be the case at any initial stage of an interpretative process and was and still is required under the General Tax Ct in Articles 25 and current Article 23. (. . .)
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> The case at hand *would be dealing with a presumption, with no legal grounds and only supported by the power to interpret acts subject to Property Transfer Tax according to their true nature, of fraud or simulation based on admitted circumstances implying strict compliance with established legal regulations and, in addition, an assumption of fraud without the guarantees or legally established procedure pursuant to the original version of Article 24.2 General Tax Act orthe current version of the same principle following the amendment by Act 25/ 1995.* [Emphasis added.]

In conclusion, the Spanish characterisation principle could be regarded as a general anti-abuse provision that allows the Spanish tax authorities to re-characterise a particular transaction based on its real legal nature. However, because of the characterisation principle's broad and general scope, in cases in which the requirements for the application of the *fraus legis* or sham doctrine are met, the latter would be applied in preference, since they are anti-abuse measures of a more specific nature.

B. Spanish sham/simulation doctrine

As Spanish tax legislation does not define the concept of simulation or the sham doctrine, it is necessary to refer to the general civil law doctrine laid down by the Courts and advanced by commentators, which defines simulation as the wilful attempt to create an apparent business/structure that the parties do not intend to implement. The Supreme Court[5] indicates that contractual simulation exists when "the characteristic cause of the contract does not exist."

For there to be simulation, the following two elements must be present:

- There must be an agreement between the parties to create an apparent business/structure that is not really intended by them; and
- The agreement must be entered into for purposes of obtaining a consequence *vis-à-vis* third parties that would not have been obtained without the simulated act.

Both the Courts and legal experts distinguish between two kinds of simulation, depending on whether there is an actual transaction intended by the parties behind the "apparent transaction."

Simulation is "absolute" when the parties create an apparent business/structure without the intention of implementing any business/structure whatsoever. In this case, the result is that the transaction is null and void and therefore considered never to have taken place.

"Relative" simulation occurs when the parties create an apparent business/structure that is different to that which they actually intend (the "underlying business/structure or act"). In this case, tax is to be levied in accordance with the actual business/structure implemented by the parties.

The Spanish Courts have consistently held that the evidence that simulation exists must be clear and irrefutable. Accordingly, the Courts have repeatedly laid down that, in the event of doubt, the validity of the act or transaction carried out by the parties will prevail over the act or transaction deemed to be simulated.

For instance, the Supreme Court, in a judgment dated February 13, 1995, stated:

> The appellant claims that the purchase agreement is simulated, as the cause is false as the price of the transaction does not exist. This argument can not be admitted as the transaction of reference is supported by a determined and fixed price, payment of which was to be made by the buyer. The alleged fiction lacks evidence, as was admitted by the previous Court, meaning that the onerous contract must be reputed valid and effective, given that the legal title is presumed to be valid.

This means that the tax authorities must prove that there was an intention to create an apparent business/structure[6] and that the cause of the contract entered into by the parties does not exist. In most cases, as these elements cannot actually be proven objectively, the Courts have indicated that proving simulation should be achieved by presumption, in other words, by proving facts that indirectly but clearly show the intention to create an apparent business/structure that is different from that actually desired by the parties, as the case requires.[7]

C. Spanish fraus legis doctrine/ "Conflict in the application of tax law"

Fraus legis was originally defined in the Spanish General Tax Law and was governed by that law until July 1, 2004, when it was replaced by "conflict in the application of tax law,"[8] which exists when the taxable event is totally or partially avoided or the taxable base or tax due is reduced by means of acts or transactions that:

- Individually considered, or as a whole, are "notoriously artificial or inappropriate" for obtaining the pursued result; and
- Do not result in any legal or economically relevant consequences, other than tax savings, different from those that would ensue from the natural way of obtaining such pursued result.

It should be pointed out that "conflict in the application of tax law" is based on previous experience and doctrine regarding the application of *fraus legis* to tax issues.[9]

In addition to the applicable Spanish tax legislation, Article 6.4 of the Spanish Civil Code envisages an anti-abuse regulation and refers to "acts performed under the coverage of the wording of a legal provision aimed at obtaining a result that is forbidden or contrary to the Law."

In general terms, both the Civil Code and the General Tax Law essentially require that the act or transaction under consideration, even if valid, real and intended by the parties, is "abusive," in the sense that it has been performed in an artificial or improper way apparently in accordance with a law, but is against the spirit of purpose of the same or another law.

In the tax field, *fraus legis* situations have been identified essentially when the taxpayer, for purposes of eliminating or reducing its tax burden, uses abnormal or unusual legal forms to obtain the same results as those obtained by the legal forms that are usually employed to obtain such results.

Whereas, in the case of sham or simulation, the transactions concerned are fictitious and never intended by the parties, in the case of *fraus legis*, the transactions are real and meant by the parties, but implemented "in abuse" or in an "artificial or improper manner" to obtain the result desired by the parties and, additionally, tax savings.

It should also be borne in mind that, for *fraus legis* to exist, the "artificial" or "abusive" act or transaction carried out by the parties must allow them to obtain equivalent results to those that could be obtained by the parties through the avoided transaction, but with a lower tax cost. In other words, for *fraus legis* to be considered to exist, the consequences of both acts and transactions (other than tax consequences), i.e. those deemed to be avoided and those implemented by the parties, must be fully equivalent.

The consequence of a transaction begin declared to be performed in *fraus legis* is not its nullity, but the application of the tax consequences of the normal or usual business/structure or act avoided. The main difference in the consequences of a *fraus legis* assessment from the consequences of a sham transaction assessment is that, in the case of the former, no penalties are imposed on the taxpayer.

D. Conclusions

Although the "substance over form" doctrine has never been recognised as such in Spain, the Spanish legislation contains certain general anti-abuse rules to combat tax avoidance or the abuse of law that, in general terms, allow the tax authorities to ignore the form of a transaction provided it lacks economic substance.

II. What are the pre-requisites for a transaction to be considered immune from challenge under Spain's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

As noted above, the Spanish tax authorities can ignore the legal form of a transaction agreed by the parties, provided it lacks economic substance. This means that it can clearly be concluded that, for a transaction to be considered safe from being challenged under the Spanish anti-abuse provisions described above, it must be supported by a business purpose or business grounds.

In practice, it may be said that the Spanish tax authorities are beginning to challenge quite aggressively transactions that lack an economic purpose other than tax saving. In other words, it is possible for the non-existence of a valid economic reason or relevant business purpose to constitute proof of abuse of law, even where a transaction may be based on real economic grounds, where those grounds are of little significance compared to the resulting tax savings.

In particular, in the context of the previous *fraus legis* rule, the courts have usually resorted to a kind of "business purpose" test, in the sense that they have regarded as circumstantial evidence of transactions being purely tax-driven the fact that no other legal, economic or commercial reasons justify the use of the "abnormal" legal forms or acts instead of the usual ones.

For instance, the Supreme Court ruled in a judgment dated November 28, 2003 that:

> We do not face a case of economy of option, *as long as the transactions are not supported by any business reason other than the tax savings*, which is not a consequence of the option for a licit business alternative but a disguise of reality. *The analysis from the perspective of the business purpose leads to this conclusion as long as the entities are empty boxes, almost inactive, used in a disproportionate way in comparison to their material and human resources as a mere pretext for the transaction carried out by the individuals.*[10] [Emphasis added.]

A good example of this doctrine can be found in the judgment delivered by the Spanish National Court on June 1, 2006, where, following the doctrine of the Supreme Court, it was stated that "the economy of choice of the taxpayer involves the need for economic reasons beyond tax savings, with the aim of generating desirable and valid economies of choice."

In that regard, the Higher Court of the Basque Country stated the following in a decision dated April 28, 2006:

> The decisive factor for *fraus legis* is that the transactions made constitute a real abuse of the legal configuration possibilities that the individual possesses, to the extent that the acts or business done do not offer legal or other relevant economic effects or other valid reasons, beyond the pure tax savings.

A recent resolution issued by the Central Tax Court dated June 25, 2009 (among others) deals with a tax planning scheme that was deemed to constitute *fraus legis*. The Tax Court denied the deductibility for Spanish corporate income tax purposes of financial interest paid by a Spanish holding company to another, non-Spanish related company on loans granted to enable the acquisition of other, related company stock. The Tax Court expressly recognised that, although no rule was violated, it was proven that the intra-group transactions and loans granted to the Spanish company were "artificial" because, in the opinion of the Tax Court, there was no other economic or business purpose for acquiring the foreign subsidiaries and granting the loans other than the aim of eroding the Spanish taxable profit base of the Spanish operating company with the financial interest paid by the holding company under the tax consolidation regime.

In its resolution, the Central Tax Court makes a distinction between "tax planning in terms of productive activities in which there is little scope for the design of tax strategies . . . and . . . the planning of financial, intangible goods and holding companies, etc., in which tax reasons are often decisive," and states that "it is in this second area in which international tax planning may be more operational and where there is a higher risk or propensity to easily cross the border from the legitimate economy of choice and incur an abuse of law . . . *Therefore, it is essential to specifically determine the applicable evidence in order to prove the economic or business reasons relied upon for the operation."* [Emphasis added.]

A recent Spanish Supreme Court judgment dated September 25, 2009 analyses the transfer by a US company of 28.45 percent of the shares it owned in a Spanish company. The transfer was subject to an agreement with the purchaser in which, as a prior step, the US company contributed the shares in two of its US subsidiaries, under the restructuring regime referred to in the Protocol to the Spain-United States tax treaty, and the two subsidiaries transferred the shares to the end purchaser. The scheme resulted in no taxation in Spain under the treaty. The Supreme Court concluded that the intermediate transactions had no purpose other than to avoid taxation in Spain, reasoning as follows:

> Subsequently and agreeing with the criteria upon which the resolution is based, the ruling reaches the conclusion that the transaction mechanism employed by the appellant leaves no doubt whatsoever as to the true purpose pursued being to avoid tax payable on the transfer of the appellant's shares to the . . . company, given that if the sale had been made directly by the appellant to . . ., the resulting increase in equity would have been subject to tax in Spain pursuant to Art. 13.4 of the Spain-US Tax Treaty; however by structuring the sale of the shares to . . . by means of an initial contribution to the share capital of its affiliates, such contribution not being intended as such, but rather based on different and proven reasons to the direct purpose of the operations considered individually, the intention was to avoid paying tax in Spain. (. . .)
>
> We are dealing with a strictly legal issue consisting in determining the true nature of the transactions carried out, following acceptance of the offer, which are not considered individually but in the context of the entire business operation; in conclusion, to determine whether or not the appellant, by making the double contribution, actually intended to achieve a different result to the normal purpose of such transactions.
>
> The Court of Instance mentions that we are dealing with an indirect taxable event, as the true taxable event is displaced in order for the relevant tax burden to be adjusted according to the pursued objective, by means of a complex legal operation. However, it would have been more correct to talk of relative simulation, which is a kind of concealment produced by creating a fictitious transaction, which is ultimately not the true intention, to effectively provide a screen for an unlawful act. Simulation is dealt with by the

law by applying the actual legal consequences of the transaction that the contracting parties attempted to elude.

On the other hand, it is an established doctrine of the Spanish Courts that, if the act or transaction is supported by relevant economic or business reasons, the *fraus legis* doctrine can never apply, regardless of the tax savings obtained by the parties.

A good example of this doctrine can be found in the judgment handed down by the Supreme Court on March 30, 1999:

The Court considers that in the case of these proceedings, there is no *fraus legis*, but rather a simple economy of choice: on the one hand, the Civil Code gives the spouses absolute freedom in order to change their matrimonial financial regime, being entitled to decide on the dissolution of the legal partnership of joint ownership of property, whenever they consider it advisable, and on the other hand, Law 39/1988, dated 28 December, regulating the Local Treasury Departments [art. 106.2 a)], declares the distribution of the joint property exempt from the IIVT, whereby Mr. M. . ., did nothing other than take advantage of an executable exemption *ope legis*, . . .

In that regard, more recently, the Higher Court of the Basque Country laid down the following in a holding dated April 30, 2007:[11]

> In our opinion we are dealing with a case of economy of choice, permitted by tax law, asthe claimant has merely opted, from among the various possibilities offered by the tax law applicable at the time that it carried out the investments, for the least costly option, carrying out for such purpose entirely normal and customary transactions or business, without in any way abusing the law.
>
> (. . .) Evasion of the law, and which is now referred to as conflict in the application of Article 15 of the tax law, which requires the essential use of substantive transactions or businesses by the taxpayer that imply an actual alternative to the customary transaction or business which in this case are entirely non-existent, and which may not be combined with typical, normal and regular financial transactions or lead to the simple disqualification by the tax authorities of those legitimate options of the taxpayer which may be advantageous for their tax result on a voluntary basis or due to a mere legislative oversight, thereby turning the tax authorities into the executive censor of any effective situations in the specific application of taxes that are not favourable to them in terms of tax revenues, by means of purely economic interpretations or praxis without any legal grounds whatsoever. Unlike in the case of evasion of the law, which entails the deliberate orchestration by the taxpayer of a fictitious legal structure and is different from a transaction that would normally lead to a specific financial result, in the so-called chosen tax economies of choice, the taxpayer undertakes entirely naturally to carry out a transaction using the customary means for such transaction, although they may have previously taken into account for the purpose of their financial decision the possible tax benefits that such transaction, rather than other possible options, may entail. There is no fraudulent intention of evasion of taxes, and the rejection of such possibility is in no way compatible with the basic principles of economic freedom recognised by our legal system. [Emphasis added.]

In conclusion, it could be said that, when challenging a transaction, the Spanish tax authorities will analyse whether there are legal, economic or commercial factors, apart from tax reasons, for entering into the agreement or performing the transaction in order to decide whether to apply the anti-abuse provisions contained in the legislation.

III. What is the tax result of a determination that a transaction lacks economic substance?

The tax consequences resulting from the application of the anti-abuse provisions described above vary considerably depending on the particular anti-abuse measure applied in each case.

In theory, and in general terms, the tax consequences of the application of an anti-abuse provision (including in relation to tax due, capital gains or losses, the taxable bases of the assets transferred, the application of special tax regimes, etc.) should be those that would have arisen if the transaction had been carried out in an ordinary or legal manner in relation to all the parties entering into the transaction concerned. However, it should be pointed out that the Spanish tax authorities normally simply adjust the tax situation of the taxpayer being audited to whom the anti-abuse provision is being applied and do not take into account the tax consequences for the other parties involved in the transaction.

Both the sham doctrine and "conflict in the application of tax law" have their own particular consequences, which are described below.

As regards the sham doctrine, the tax consequences will vary depending on whether the simulation is "absolute" or "relative" (for which, see I.B., above).

If the simulation is absolute, (i.e., when the parties create an apparent business/structure without the intention of implementing any business/structure whatsoever), the application of the anti-abuse provision will result in the transaction being deemed null and void and therefore considered never to have taken place.

However, if the simulation is relative (i.e., when the parties create an apparent business/structure that is different to what they actually intend), tax will be levied in accordance with the actual business/structure implemented by the parties (the "underlying business/structure").

The Spanish General Tax Law[12] expressly allows the Spanish tax authorities to impose penalties, in addition to the tax due plus the relevant default interest, as a consequence of the application of the sham doctrine anti-abuse provision.

In the case of a *fraus legis*/"conflict in the application of tax law" assessment, the tax consequences will be those that would have arisen if the transaction had been carried out in a ordinary way (i.e., not in the unusual or abusive way), irrespective of the advantages obtained by the parties from the acts implemented "in abuse" or in an "artificial or improper manner."

However, unlike in the case of simulation, a "conflict in the application of tax law" assessment does not allow the Spanish tax authorities to impose penalties, but only to charge the tax due plus the relevant default interest.

It is worth noting that the different penalty consequences of the application of the sham doctrine or "conflict in the application of tax law" could have implications as to determining whether the conduct concerned could constitute a criminal offence. For criminal liability to arise, Spanish Law requires: (1) that the amount actually evaded exceeds a threshold of EUR 120,000; and (2) an intention to deceive, as defined in (among others) the judgment handed down by the Spanish Supreme Court on February 1, 2006, which held that:

> Crime against the Public Treasury as an evasion of tax, is comprised of two elements: a) an infringement of a legally binding duty, such as the filing of a tax return, as duty envisaged in Article 31 of the Spanish Constitution and b) that the duty is omitted with the intention of concealing income from the Tax Authorities

and therefore a wilful offence and illegal motive, requires the intention of not paying tax.

Bearing in mind the requirement of an intention to deceive in order for a criminal offence to exist and that "conflict in the application of tax law" does not allow the Spanish tax authorities to impose administrative penalties, certain legal doctrines, and even the Spanish Courts, have held in the past that a *fraus legis* assessment may in no event imply the existence of a criminal offence (even if the threshold of EUR 120,000 is exceeded), as the intention to deceive requirement can never have been met. This criterion was confirmed by the Constitutional Court in its holding dated May 10, 2005.

The above doctrine is based on the fact that in the case of *fraus legis*/"conflict in the application of tax law," the transactions are real and intended by the parties, though implemented "in abuse" or in an "artificial or improper manner" to obtain the result desired by the parties, whereas in a simulation, the transactions are fictitious and never intended by the parties; whereas, in the former case, the taxpayer "rounds up" the applicable legislation in order to take advantage of a favourable tax treatment, in the latter, there is a direct, "head-on" violation of the law.

Thus, in *fraus legis* cases, no penalties can be imposed by the Spanish tax authorities because the tax adjustment consists in applying a tax provision to an act, business/structure or transaction that is not expressly covered by the wording of the law,[13] while, in simulation cases, the tax adjustment consists in a direct application of the tax rule that the taxpayer tried to avoid.

This criterion is similar to that upheld by the European Court of Justice (ECJ) in dealing with the potential penalties to be imposed in a case of "abuse of law" (which can be compared to the Spanish *fraus legis* concept). For instance, in the holding issued in case C-255/02 (*Halifax, Plc.*) the ECJ stated:

> *For it to be found that an abusive practice exists, it is necessary, first, that the transactions concerned,* notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and of national legislation transposing it, *result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage*.
>
> *It must also be borne in mind that a finding of abusive practice must not lead to a penalty, for which a clear and unambiguous legal basis would be necessary, but rather to an obligation to repay, simply as a consequence of that finding,* which rendered undue all or part of the deductions of input VAT (see, to that effect, Emsland Stãrke, paragraph 56). [Emphasis added.]

Finally, it should be noted that, notwithstanding the above, certain recent Spanish Court rulings have stated that the assessment of *fraus legis* at an administrative level does not preclude the potential existence of a criminal offence, since the Criminal Courts are not bound by the characterisation given at the administrative level.

NOTES

[1] Act 58/2004, dated Dec. 17, 2004.

[2] That is, general anti-abuse provisions. The relevant income tax laws contain a wide variety of specific anti-avoidance provisions.

[3] For instance, a transaction in which an asset is transferred in exchange for money and the right to repurchase may be characterised as a loan of the asset or as a sale, depending on the characteristics of the transaction, and this different characterisation may have different tax consequences.

[4] This doctrine has been upheld by the Spanish Courts, as summarised by the National Court judgments dated Oct. 3, 1997 and Nov. 7, 1997, which state the following:

1. *It is not acceptable to consider economic substance as different to legal substance in order to alter the taxation of a particular legal transaction*. The resolution passed by the Central Tax Court and challenged herein is based on the fact that, according to the criteria thereof and irrespective of the exterior legal form employed, the financial situations and relations that effectively existed allow the taxation of income from non-fixed asset transactions, pursuant to article 25 of the General Tax Act, a principle that «attempts to guarantee the autonomy of tax classifications». If this reasoning is intended to suggest that tax law is able to ignore legal criteria by referring to a hypothetical different financial situation that should be taken into account, this Court cannot accept the criteria. The nature of business transactions must be consistent, even though specific examination in many cases poses serious difficulties and the presiding legal criteria must be applied. (. . .).[Emphasis added.]

[5] Judgments issued on May 15, 1983 and June 2, 1960.

[6] Judgment issued by the Supreme Court on March 15, 1995.

[7] Supreme Court judgments dated Oct. 13, 1987, April 24, 1994 and Oct. 3, 2000, based on Civil Code, Art. 1277.

[8] "Article 15: Conflict in the application of tax law

1. Conflict in the application of tax law would be deemed to exist when the realisation of the taxable event is totally or partially avoided or the taxable base or tax due is reduced though acts or transactions in which the following circumstances occur: (a) that individually considered or as a whole they are notoriously artificial or inappropriate for obtaining the pursued result, and (b) they do not result in legal or economically relevant consequences other than tax savings obtained by comparison with the consequences that would have resulted from usual or appropriate acts or transactions.

2. To declare the existence of conflict in the application of tax law will require a report issued by the consulting Commission referred to in Article 159 of the Act.

3. In the assessment resulting from the application of this article, tax shall be payable through the application of the tax rule that corresponds to the usual or proper acts or transaction, preventing the tax benefits obtained and demanding the overdue interest due, without a penalty."

[9] This conclusion was also reached by the National Court in its judgments (among others) dated Dec. 4, 2006, Nov. 19, 2007 and Dec. 18, 2007. In particular, in the first of these judgments, the National Court stated that:

"The regulation of *fraus legis* introduced in article 15 of the new General Tax Law under the name of "conflict in the application tax rules", even though it contains new features, is not a different legal figure to the "*fraus legis*" construed by legal doctrine and the Courts."

[10] In the same context, one might mention the judgment issued by the National Court dated June 24, 2004, and the resolution of the Central Economic-Administrative Court dated March 5, 2003.

[11] Mention should be made of the precedents of the Supreme Court, which, in its judgments of Nov. 2, 2002, May 11, 2004 and March 21, 2005 stated that:

The economy of choice, based on the principle of autonomy of will in the freedom to contract, established in Article 1255 of the Civil Code, results in tax savings for the parties which are not in violation of our laws. Such concept does not conflict with the intended purpose of the law, although "*fraus legis*" does indeed imply the violation of the law. The difference becomes clear when we consider that the purpose of the fraud referred to in Article 24 of the General Tax Law of 1963 is to evade the tax in question or obtain financial benefits by means of an irregularity in relation to the objective pursued by the parties, normally using the method of a simulated transaction –which is filed with the tax authorities –, which conceals another hidden transaction. Such method is entirely unrelated to those cases in which the most favourable tax treatment is sought through the means that are most in keeping with the provisions of the tax legislation.

The taxpayers may choose from among the various options provided for by the law the option that is most favourable to their interests, provided that it does not infringe the applicable law.

[12] General Tax Law, Art. 16.3.

[13] *Fraus legis*/"conflict in the application of the tax law" is an exception to the general principle stated in General Tax Law, Art. 14, which prevents analogical application of the tax law extending the taxable event beyond its legal definition.

Host Country SWITZERLAND

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I. Will the Swiss tax authorities respect the form of a transaction that, on its face, satisfies each element of existing Swiss law, despite its lack of economic substance?

A. Income taxes

Article 58 paragraph 1 of the Federal Income Tax Act (FITA) states that the taxable income of a corporation corresponds to the result shown in its profit and loss statement. The profit and loss statement (*Handelsbilanz*) reflects accounts prepared in accordance with generally accepted accounting principles (GAAP), as laid down in the Swiss Code of Obligations. Swiss GAAP are a very basic set of accounting rules that have little in common with the much more sophisticated IFRS accounting principles. There is thus a distinction between accounts prepared on the basis of the IFRS rules and those prepared on the basis of Swiss GAAP.

Profit and loss statements prepared in accordance with Swiss GAAP are commercial accounts ("*Handelsbilanz*") and serve as the basis for determining a corporation's taxable income. Taxable income is the result shown in the profit and loss statement, plus any expense items that are not business-related, plus items relating to additional income, capital and liquidation gains, as well as gains resulting from write-ups. As there are no additional tax provisions explaining the meaning of taxable income, it appears that the profit (or loss) resulting from the application of Swiss GAAP is also relevant for tax purposes. Taxation based on the result shown in a corporation's profit and loss statement implies that the form chosen by the corporation and reflected in the Swiss GAAP accounts is also accepted for tax purposes. This is referred to as the "principle of relevance" ("*Massgeblichkeitsprinzip*").

A peculiarity of Swiss GAAP is that they allow the build-up of "silent reserves," i.e., appreciations in value that are not reflected in the profit and loss statement. Swiss companies are for example, allowed to depreciate inventories on a yearly basis by one-thirds of their book value and to reduce taxable income accordingly.

The principle of relevance implies that a corporation has "freedom to arrange its affairs" ("*Organisationsfreiheit*") and may thus engage in reasonable tax planning activities. It is only possible for a form chosen by a corporation to be set aside in exceptional circumstances, such as the occurrence of tax avoidance. The freedom to arrange one's affairs is a "sound business judgment" approach that is different from the notion of a prudent and reasonable business man (*ordentlicher und korrekter Kaufmann*) that applies, for example, under German tax law. The Swiss principle implies that a corporation is allowed to deduct any expenses that are related to its business. The tax authorities are not there to impose their judgment on the manner in which the corporation conducts its business.

Swiss tax law makes a distinction between identifying "tax avoidance" and requiring the tax laws to be looked at from an economic point of view (*wirtschaftliche Betrachtungsweise*). The latter concept allows the tax law provisions to be interpreted not so much in terms of their civil law meaning as in view of their "underlying economic substance." One example of this would be that, while the Federal Merger Law explains in great detail what mergers, split-ups and transfers of property are comprised of, the tax consequences arising from these transactions are based on the underlying economic considerations, which may have little in common with the civil law concepts described in the Federal Merger Law. Another example would concern the conversion of a single proprietorship business into a corporation, which will not necessarily follow the civil law concept as explained in the Federal Merger Law. Such a conversion has a different and more "economic" meaning when looked at from a fiscal point of view. The tax laws will recognise such a conversion and accept it as tax-exempt, always provided the conversion is carried out on the basis of book value rather than fair market value.

The FITA does not define tax avoidance and indeed contains no reference to tax avoidance. The concept of tax avoidance has been developed by the Federal Supreme Court under the *abuse of law* doctrine.

The Swiss concept of tax avoidance is not a substance over form approach[1] but rather an abuse of law concept approach, as applies in most civil law countries. Abuse of law is a fundamental Swiss rule. It is an extremely broad concept that applies in all legal areas, not just the area of taxation. Abuse of law is referred to in Article 2 paragraph 2 of the Swiss Civil Code and derives from the Roman law *"in fraudem legis agere"* concept. The letter of the law is respected, but there is a contradiction with the meaning of the law.

Pursuant to established Supreme Court practice,[2] tax avoidance is considered to have occurred if the following conditions are met:

- The taxpayer has engaged in an unusual or inadequate transaction that lacks economic substance;

- It appears that the unusual method has been chosen only because the taxpayer wishes to achieve significant tax savings; and
- The taxpayer would indeed achieve significant tax savings if the unusual transaction were to be accepted by the tax authorities.

As a consequence, the tax authorities may disregard the form of the transaction chosen by the taxpayer because it lacks economic substance. The best example of tax avoidance is the sale of the shares of a real estate company with the sole purpose of avoiding the payment of the real estate capital gains tax that would have been due had the ownership of the real estate rather than the shares been sold.

According to Swiss law, a substance over form approach will only be applied in special circumstances. The best example is afforded by the 2007 Circular Letter (issued by the Conference of the Cantonal Tax Directors) on the Swiss tax principles applying with regard to trusts. Applying a substance over form concept, Switzerland will disregard the legal ownership residing with the trustee and thus not tax a trust solely because the trustee is a Swiss resident. The trustee will have to pay tax on the fee he receives from the trust, but neither the trust as such nor its nonresident settlor and nonresident beneficiaries will be subject to tax in Switzerland. The principle that the trustee will not attract any taxes on the trust may be looked at differently if the trustee is a tax haven entity that operates out of Switzerland. On March 5, 2009 the Federal Administrative Court ruled that an interposed (non-trust related) British Virgin Islands (BVI) company had infringed the US qualified intermediary (QI) provisions as applied in Switzerland and had therefore also committed a tax fraud if the factual situation was also considered from a Swiss point of view (principle of dual punishability)[3]. The BVI company in question had filed a US form W-8BEN claiming it was the sole beneficiary, while its true beneficial owner had failed to file a US form W-9.

B. Withholding taxes

Withholding tax is levied pursuant to the Federal Withholding Tax Law (FWTL).

In general, the federal withholding tax is imposed at a rate of 35 percent on interest paid on bank deposits, dividends, interest paid on bonds issued by resident corporations, distributions made by domestic mutual funds to resident beneficiaries and certain annuities. Federal withholding taxes are generally deducted at source by the domestic payor of the income concerned, so that payments received are net of tax, usually amounting to 65 out of 100 (the tax rate being 35 percent).

In essence the FWTL operates on a refund basis. Resident taxpayers are entitled to set off the withholding tax against their Swiss income taxes. Nonresident portfolio investors must invoke an applicable tax treaty and engage in a cumbersome refund procedure to reduce the effective tax to tax at the lower treaty rate (usually from 35 percent to 20 percent to 15 percent). Resident corporations controlled by foreign parents and holding a permit issued by the Swiss Federal Tax Administration are allowed to remit tax withheld at the lower treaty rate and to report (rather than pay) the difference between tax at the lower treaty rate and tax at the statutory rate of 35 percent.

Unlike the FITA, the FWTL contains a statutory provision specifying that, in the case of tax avoidance, no refund will be made.[4] A typical example of the application of this provision would concern the foreign shareholders of a Swiss company (“Swissco”) selling their shares in Swissco to Swiss shareholders. It is assumed that the foreign shareholders of Swissco do not receive any dividends (which would have been subject to tax at either 35 percent or the lower treaty rate) and attempt to realise a higher sales price on their shares instead. The Swiss shareholders acquiring the shares of the “cash-loaded” Swissco from the non-resident shareholders wish to liquidate Swissco and reclaim the full 35 percent on the liquidation dividends. Were dividends to have been distributed to the foreign shareholders, the Swiss Federal Tax Authority (SFTA) would have received something in the way of tax; based on the post-acquisition merger of the Swiss target they will not be entitled to any tax. In such circumstances, the SFTA will raise a tax avoidance argument and will therefore refuse to refund the 35 percent tax paid on the liquidation dividends. The absorbing Swiss corporation will not be able to claim any refund of the withholding tax because of the tax avoidance circumstances involved.

C. Value Added Tax (VAT)

Pursuant to a relatively recent Federal Supreme Court decision, the principle of “tax avoidance” has also been established in the area of value added tax (VAT). The Swiss Supreme Court decided in 2007[5] that the interposition of a company whose sole purpose was the acquisition and holding of an aircraft used for private purposes only constituted an unusual legal structure, given the related administrative burdens and expenses. The limitation of liability was not sufficient reason to interpose an entity that did not carry out any commercial activities, in particular as aircraft liability insurance is anyway already required by law. The interposition of the legal entity was considered to be motivated only by the hope of saving taxes and, indeed, it led to substantial tax savings, since input-VAT deductions could be claimed in this way that could not have been claimed if the shareholder had operated the aircraft in his own name. The court concluded that this was a case of tax avoidance. For the purposes of taxation, the Court relied on the legal structure that would have been appropriate to achieve the desired economic objective. It was regarded as legitimate retroactively to delete the interposed company from the VAT register and to claim back the input tax paid.[6]

D. *Fraus Conventionis*

The Swiss Supreme Court recognises an unwritten abuse of law principle that applies with respect to all Switzerland’s treaties.[7]

In the context of tax treaties, there is also a concept of tax avoidance that will be applied in cases in which an entity has been interposed for the sole purpose of securing treaty benefits that would otherwise not be available.

Article 4(11) of the Switzerland-Germany tax treaty contains a provision according to which treaty benefits can be denied if they are attributable not to the claimant but rather to a third person. According to the beneficial ownership concept a person will not be entitled to any treaty benefits if he is only the legal owner and not the actual owner of the income with respect to which treaty relief is sought.

II. What are the pre-requisites for a transaction to be considered immune from challenge under Switzerland's "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

To be considered immune from challenge under one of Switzerland's anti-avoidance approaches, a transaction will have to be economically sound and have a purpose other than just that of saving taxes. For example, the SFTA wishes to impose tax on the realisation of the undeclared silent reserves of Swiss companies. Any transaction in which parties attempt to liquidate such reserves on a tax-free basis will be challenged by the SFTA.

Switzerland has an extensive ruling practice. The best way for a taxpayer to avoid future problems is to request a tax ruling before the transaction concerned takes place. The tax ruling will outline the parameters of the transaction specifying what is and what is not taxable. In Switzerland, tax rulings are considered good business practice and it is better to have one ruling too many (in the sense that a ruling may simply be stating the obvious) than one too few. It is standard practice to arrange for a tax ruling before a transaction takes place rather than waiting until after it has taken place.

It should be noted that there is a Code of Conduct for tax authorities, taxpayers and tax advisers, which became well-known when the OECD acquired an English translation to include in some of its studies.[8] The Swiss Code of Conduct can be downloaded on the Internet from http://www.amcham.ch/members_interests/p_business_ch.asp?s=4&c=1.

III. What is the tax result of a determination that a transaction lacks economic substance?

The tax authorities can take various actions if a transaction is considered to be abusive. An abusive transaction will be set aside and be replaced by one that is characterised by terms and conditions that appear to be commercially sound. This approach will address the question: "What would the parties have done in normal circumstances?" If a merger was effected solely to take advantage of a given tax situation, the utilisation of tax loss carry forwards will be denied. If circumstances of tax avoidance are involved, the refund of withholding taxes and VAT input deductions can be denied. If a taxpayer interposes a tax haven entity that has no function, the SFTA may look through the entity and impose tax on the true beneficial owners. In the case of tax avoidance in the context of the FWTL, the taxpayer may end up paying 35 percent. As this is a significant amount, a taxpayer will wish to have certainty before moving forward with a transaction sound tax rulings will take both the income tax and the withholding tax consequences into consideration. Although each ruling relates to a different law, both may be issued by the SFTA.

On May 9, 1995 the Swiss Supreme Court decided the *Suchard* case. Though it lost out to Nestlé in its bid to acquire Rowntree, Suchard was able to sell its shares in Rowntree for a handsome profit, which ended up in the hands of a Panamanian entity. Suchard argued that the Panamanian entity was a separate entity and was not subject to any Swiss taxes. The Federal Supreme Court applied agency law (*Auftragsrecht*) rather than tax avoidance concepts in order to look through the Panamanian entity, which, in the eyes of the court, was a mere conduit, and thus an agent acting for and on behalf of its Swiss principal. The decision was widely criticised, as scholars detected in it the covert introduction of CFC legislation.

NOTES

1 See in this context the leading U.S. case, *Helvering v. Gregory*, 293 U.S. 465 (1935)

2 ASA 54, 699; ASA 64, 81, BGE 131 II 627 E. 5.2.

3 A-7342/2008 and A-7426/2008, Federal Administrative Court, decision of March 5, 2009 in matters of UBS.

4 FWTL, Art. 21 para. 2.

5 BGE 2C_632/2007

6 BGE2C_904/2008.

7 BGE A-2163/2007, E. 8.

8 OECD Tax Intermediaries Study, Working Paper 6 – The Enhanced relationship, July 2007,

Host Country UNITED KINGDOM

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I. Will the UK tax authorities respect the form of a transaction that, on its face, satisfies each element of existing UK law, despite its lack of economic substance?

English law (including English tax law) does not contain a substance over form doctrine. There is no principle of English tax law which requires a transaction to be disregarded or recharacterised simply because it lacks economic substance.

Moreover, it is a long established principle of English law that taxpayers are not obliged to pay the greatest possible amount of tax but are instead free to arrange their affairs how they choose (see the famous case of *Inland Revenue Commissioners v Duke of Westminster*).[1]

There is, however, a doctrine of statutory construction which has been developed by the courts over the last 30 years or so. This doctrine is not limited to tax-structured transactions (because it is a doctrine of how to construct a statute and therefore applies whether or not a charging provision is in point), but is likely to be particularly relevant to determining the taxation of transactions that lack economic substance.

The first authoritative expression of the doctrine was made by the House of Lords in *WT Ramsay v Inland Revenue Commissioners*[2] (sometimes referred to as "the *Ramsay* principle" or "the *Ramsay* approach"), where it was held that, in determining the fiscal nature of a pre-ordained series of transactions, any steps inserted merely to avoid tax could be disregarded.

In *Ramsay*, the House of Lords said that an off-the-peg tax avoidance scheme designed to create an allowable loss that it could set against its chargeable gain simply did not work. In particular, Lord Wilberforce made it plain, in restating some well-known principles of law, that a person is to be taxed upon the "clear words" of the statute, but:

> what are clear words is to be ascertained upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded.[3]

Then, having established what a provision means, it should be applied to a series of transactions and, if that series of transactions was intended to act as a series or combination of transactions, then the taxing provision should be applied to that series or combination.[4]

This approach was developed in cases such as *Furniss v Dawson*[5] in which the House of Lords found that, in a pre-planned tax saving scheme, no distinction is to be drawn for fiscal purposes, because none exists in reality, between:

- A series of steps that are followed through by virtue of an arrangement which falls short of a binding contract; and
- A like series of steps that are followed through because the participants are contractually bound to take each step.

This approach led the courts in cases such as *Furniss* to disregard steps inserted in transactions which had no purpose other than a tax avoidance one, at least in circumstances in which all the steps were "cut and dried" so that the inserted step was one of a series which followed on from each other as night follows day. Where there was not such a high degree of pre-ordination, the courts were prepared to find in favour of the taxpayer (see, in particular, *Craven v White*[6]). Subject to that important limitation, however, the courts were willing to accept the arguments of the tax authorities that the tax legislation did not need to be applied to each separate step in a series of transactions and, whilst never expressed as a "substance over form" doctrine, the approach of the UK courts was perhaps not very far removed from the approach of courts in jurisdictions which recognised a doctrine of this nature.

Over the last decade or so the doctrine has, however, been refined by the courts in important ways and it is now clear that there is no separate *Ramsay* principle at all. There is merely the rule that the provisions of a statute should be interpreted in a purposive manner.

In the important case of *MacNiven v Westmoreland Investment*,[7] the House of Lords RULED in favour of the taxpayer. In that case, the taxpayer had paid a large sum by way of interest in a pre-planned scheme which had no purpose except to crystallise a deduction for UK tax purposes. The deduction was allowed because the "paramount question always is one of interpretation of the particular statutory provision and its application to the facts" and, on the facts, the court found that the interest payments had been made.

The most recent authoritative versions of the doctrine were articulated in two cases decided by the House of Lords on the same day: *Barclays Mercantile Business Finance Ltd v Mawson*[8] and *Inland Revenue Commissioners v Scottish Provident Institution*.[9]

Under the doctrine as set out in those cases, the test to be applied in determining whether or not tax is due in any given situation is to consider the relevant

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statutory provisions, construed purposively, and ask whether they were intended to apply to the transaction, viewed realistically.

So, in *Scottish Provident*, the court ruled in favour of the UK tax authorities because, for the tax planning to have achieved its objective, a "commercially irrelevant contingency" would have had to be respected and the House of Lords was not prepared to do that.

In *Mawson*, on the other hand, the court held in favour of the taxpayer. In that case, a UK finance company agreed to purchase a pipe line from the Irish Gas Board for USD 91 million, and to lease the pipe line back to the Board for thirty one years. The Board, in turn, subleased the pipe line to a UK subsidiary company. Arrangements were entered into whereby the whole of the purchase price paid by the finance company was deposited with a Jersey company, so that it was not available for use by the Irish Gas Board, but was ultimately paid to the finance lessor's holding company. The UK finance company claimed capital allowances (the United Kingdom's system of depreciation allowances) on the USD 91 million. The UK tax authorities rejected the claim on the basis that the money was not expenditure incurred on the acquisition of plant or machinery within the meaning of the statute. The Court of Appeal allowed the company's appeal and the House of Lords unanimously upheld this decision, notwithstanding the circular flows of monies, because, it said, the only question that it was required to answer in determining whether or not allowances were due was whether the lessor had incurred the expenditure. The use to which those monies were put was irrelevant from the point of view of the statute in question.

In reaching its decision, the House of Lords emphasised that the same principles of statutory construction apply to tax statutes as to any other statute. There is no special regime of construction for tax statutes. The ordinary rules of statutory construction apply. Under the ordinary rules of construction, if the purpose of a statutory provision can be properly discerned and if the language of the statute can fairly be construed to give effect to that purpose, that construction is to be preferred.

Following the approach of the court in *Mawson*, it is clear that the UK tax authorities are not entitled to recharacterise a particular transaction from one form to another with different economic and tax consequences. In particular, where two transactions produce exactly the same economic result, and one transaction has a particular tax result but the other does not, then the UK tax authorities and the courts must respect the tax consequences attached to the actual transaction, notwithstanding that those consequences may be more advantageous for the taxpayer than those under another route (even if that route is economically equivalent).

II. What are the pre-requisites for a transaction to be considered Immune from challenge under United Kingdom's "economic Substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

A transaction will be considered immune from challenge if, considered as a whole and in the round, it falls to be taxed in accordance with the relevant statutory provisions.

So, for example, in *Revenue and Customs Commissioners v D'Arcy*,[10] the taxpayer entered into a gilts repo transaction with the sole purpose of obtaining a deduction for tax purposes. The High Court held that on an ordinary and natural reading of the legislation the deduction was available.

In *D'Arcy* the judge said:

> I am unable to accept [the Revenue's] submission that there is any absurdity in the result in the present case, if by that is meant an absurdity which should influence me to prefer the Revenue's construction of [the section]. I can readily accept that Parliament could never deliberately have intended taxpayers to be able to take advantage of the scheme entered into by Mrs D'Arcy; but the construction of [the section] cannot in my judgment depend on whether the taxpayer happened to have a tax avoidance motive.

Another more recent example of the same approach is found in the Court of Appeal decision in *Tower MCashback LLP v Her Majesty's Revenue and Customs*.[11] In that case, the claim of the taxpayer to capital allowances was upheld, notwithstanding the fact that the taxpayer's expenditure on the equipment in question was funded by monies borrowed (or a non-recourse basis) from the vendors of the equipment so that as had been made clear in the lower courts it was far from clear that the amount on which allowances were claimed bore any real relationship to the market value of the equipment. But that did not matter because, on a purposive construction of the relevant statutory provision, the market value of the equipment was not a material consideration.

Cases such as these illustrate the point that there is no general requirement on the part of the taxpayer to show (for example) a subjective business purpose or a realistic expectation of a pre-tax profit to obtain the desired tax treatment.

That is not to say that, in particular cases, these features may not be important.

For instance, under the United Kingdom's loan relationship code, a UK company that borrows funds can be denied relief for its financing expense if the company has an "unallowable purpose" (that is to say, a purpose which is not a *bona fide* commercial purpose). But that is because there is specific legislation in the loan relationship code which stipulates that relief is not to be given in circumstances in which the taxpayer has a tax avoidance purpose,[12] rather than because of any general anti-abuse doctrine or other doctrine of the construction of taxing statutes.

III. What is the tax result of a determination that a transaction lacks economic substance?

For the reasons given above, the determination that a transaction lacks economic substance does not, in itself, cause any aspect of the transaction to be disregarded.

So where a fiscal advantage has expressly been provided by statute, it is irrelevant whether the taxpayer has a fiscal motive or object.

In *New Angel Court Ltd v Adam (Inspector of Taxes)*,[13] the Court of Appeal held that properties sold intra-group can be acquired as trading stock, regardless of whether the transaction is carried out for group planning purposes. The technical issue was whether a group company had acquired properties as trading stock. The court felt that it was unnecessary to look at the purpose of the group as a whole.

But where, on a purposive approach to statutory construction, the courts find that the characterisation put forward by the taxpayer cannot be supported, then the courts will be prepared (for instance) to deny a loss or treat a profit as arising if the result of so doing is to tax the transaction in accordance with the relevant statute in question.

So, for example, in *Astall v HM Revenue and Customs*,[14] the Court of Appeal found that a taxpayer who had sought to claim a loss for income tax purposes was not entitled to do so. This was because, although the taxpayer had purchased a security which, on its face, was called a "relevant discounted security," there was never any real possibility that in the hands of the taxpayer the security could be sold at a profit. Given this, the court found that the security would not be treated as a relevant discounted security (within the meaning of the relevant legislation) and, accordingly, the loss was denied.

IV. Conclusion

The doctrine of statutory construction developed by the UK courts over recent years has meant that an overly literal construction of taxing statutes is not a permissible basis for effective tax planning.

On the other hand, it is important to emphasise that there is no general requirement in English law that a transaction have a minimum degree of economic substance or that it be supported by business motives in order to achieve its desired tax objectives.

The courts recognise that there are cases "which will inevitably occur from time to time in a tax system as complicated as ours, where a well-advised taxpayer has been able to take advantage of an unintended gap left by the interaction between two sets of different statutory provisions" (Henderson J in *D'Arcy*).

Accordingly, in ascertaining the correct tax treatment of a transaction the only considerations that are relevant are a determination of the facts and a purposive interpretation of the relevant statute. Whether that results in taxpayers being subject to taxation which might be regarded as unfair or, as in *D'Arcy*, being entitled to relief which cannot have been intended by Parliament, does not matter. The result (and therefore the rule of law as laid down by statute) will be upheld irrespective of the economic substance of the transaction or the business motivations of the participants.

NOTES

[1] (1935) 19 TC 490.
[2] (1982) 54 TC 101.
[3] 54 TC 101 at 185E.
[4] 54 TC 101 at 185 A-C.
[5] (1984) 55 TC 324.
[6] 1988 STC 476.
[7] 2001) 73 TC 1.
[8] [2004] UK HL 51.
[9] [2004] UK HL 52.
[10] [2007] EWHC 163 ChD
[11] [2010] EWCA Civ 32.
[12] Corporation Tax Act 2009, Sec. 441.
[13] [2004] STC T19.
[14] [2009] EWCA 1010.

Host Country UNITED STATES

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I. Will the US tax authorities respect the form of a transaction that, on its face, satisfies each element of existing US law, despite its lack of economic substance?

In the United States, the tax authorities will generally disregard the form of a transaction if it has no economic substance (apart from the tax benefits to be derived from the transaction). This doctrine, which in the United States is of judicial i.e., common law origin, is sometimes referred to as the "substance-over-form" doctrine, the "business purpose" doctrine, or the "economic substance" doctrine. It often overlaps with other judicially-developed anti-abuse doctrines, such as "sham transaction" or "step transaction." All, however, are based on common law in the context of arguably abusive facts, as opposed to a literal reading of the statutory scheme, and it is not unusual for courts to interpret them differently. The following is a discussion of the evolution of this doctrine in a few, but by no means exhaustive, types of cases.

The "business purpose" or "form over substance" analysis begins usually with a reference to the 1935 U.S. Supreme Court case *Gregory v. Helvering.*[1] In that case, the taxpayer, Mrs. Gregory, wanted to transfer to herself the stock of Monitor Securities Corporation, which was held by her wholly-owned corporation, United Mortgage Corporation. Instead of distributing the Monitor Securities stock from United Mortgage to herself (which would have generated dividends taxable at ordinary income rates), she instead created a new corporation (Averill Corporation) to which United Mortgage transferred the Monitor Stock. Mrs. Gregory thereafter liquidated Averill Corporation, receiving the Monitor stock in the liquidation that she characterised as part of a [then] nontaxable "reorganisation." She immediately sold the stock for USD 133,333, reporting a capital gain of USD 76,000 on which she paid tax at the much lower capital gains rate. Mrs. Gregory's tax liability would have been much higher if United Mortgage had distributed the Monitor Securities stock to her as a dividend. The Supreme Court found that the transaction, although it satisfied each element of the reorganisation statute, "was, in fact, an elaborate and devious form of conveyance masquerading as a corporate reorganisation."[2]

In assessing the economic substance of a taxpayer's transaction for federal income-tax purposes, the courts will examine "whether the transaction has any practical economic effect other than the creation of income tax losses,"[3] and/or, as in *Gregory v. Helvering*, is undertaken "solely to reduce tax liability."[4]

In *Knetsch v. U.S.*,[5] for example, the taxpayer purchased ten 30-year deferred annuity savings bonds for USD 4,004,000. The bonds bore interest at the annual rate of 2 1/2 percent The taxpayer paid USD 4,000 by check and signed USD 4,000,000 worth of nonrecourse annuity loan notes, bearing interest at 3 ½ percent for the balance. (The discrepancy in these interest rates in effect locked in an economic loss from the inception of the transaction.) The bonds secured the loan. Each year, the taxpayer systematically borrowed virtually the entire cash value of the bonds against them, and made payments back to the insurance company, characterising them as deductible "interest." As described by the Court:

> " . . . Knetsch paid the insurance company USD 294,570 during the two taxable years involved and received USD 203,000 back in the form of 'loans.' What did Knetsch get for the out-of-pocket difference of USD 91,570? In form, he had an annuity contract with a so-called guaranteed cash value at maturity of USD 8,388,000, which would produce monthly annuity payments of USD 90,171, or substantial life insurance proceeds in the event of his death before maturity. This, as we have seen, was a fiction, because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of USD 1,000. Plainly, therefore, Knetsch's transaction with the insurance company did 'not appreciably affect his beneficial interest except to reduce his tax . . .' For it is patent that there was nothing of substance to be realised by Knetsch from this transaction beyond a tax deduction. What he was ostensibly 'lent' back was in reality only the rebate of a substantial part of the so-called 'interest' payments. The USD 91,570 difference retained by the company was its fee for providing the facade of 'loans' whereby the [taxpayers] sought to reduce their 1953 and 1954 taxes in the total sum of USD 233,297.68."[6]

The Court disallowed the interest deductions because there was, in effect, no real "compensation for the use or forbearance of money."[7]

A more recent example of the "abuse" of the interest deduction provisions is illustrated by the leveraged "corporate-owned life insurance" ("COLI") cases.

Corporate-owned life insurance (COLI) is an arrangement in which a business purchases life insurance contracts on the life of one or more of its employees. Although traditionally utilised to insure against the loss of a few key executives (*i.e.*, "key man" insurance), in recent years, large corporations have purchased life insurance contracts that insure the lives of large numbers of their employees. The popular press often refers to these arrangements as "janitors insurance."[8]

Most of these employees were not notified that their employer had purchased life insurance on their lives, and, when the insured employees died, the employers did not pay the proceeds from the life insurance to the employees' surviving family members. Rather, the employers received the proceeds of the policies, sometimes using them to pay for employee benefits, including health insurance for retired employees of the company (thus establishing a potential "business purpose" for the insurance).

In many "leveraged" COLI cases, however, the corporate owner of the life insurance contracts borrows to pay a substantial portion of the insurance premiums a form of "tax arbitrage" in which a taxpayer incurs tax-deductible interest while earning tax-free investment returns. (Both the "inside build-up" *i.e.*, the investment return on the policies and the death benefit are not taxed.) The effect of this arrangement is that the tax savings may exceed the costs incurred in paying for the life insurance.

These economics are illustrated by the facts of *Winn-Dixie Stores, Inc. v. Commissioner.*[9] In this case, the taxpayer (Winn-Dixie Stores) purchased life insurance on the lives of tens of thousands of its employees. In the first year of this arrangement, the taxpayer expected to pay aggregate premiums of USD 114 million. The cash values for the life insurance policies would total approximately USD 120 million at the end of the first year. However, the taxpayer would take out loans from the policies in the aggregate amount of almost USD 108 million, and the taxpayer would pay interest at an inflated rate of 11 percent of approximately USD 12 million on these loans. After taking into account the projected net USD 2 million payable to the company as a result of deaths of its employees, the taxpayer was projected to incur a *pre-tax* loss of more than USD 4 million.

After taking into account the purported tax benefits arising from these transactions, however, the taxpayer would realise a slight *after-tax* profit. The difference between the pre-tax loss and the after tax profit was attributable to:

- The tax savings arising from the deduction of the interest and fees; and
- The nontaxable nature of the loan proceeds and the death benefits.

In subsequent years, the taxpayer was projected to realise much larger pre-tax losses and after-tax profits. During the period from 1993-2052, had the program continued,[10] the taxpayer would have realised after-tax earnings in excess of USD 2.2 billion, while incurring pre-tax losses aggregating more than USD 750 million. The Court found that Winn-Dixie would never generate a pre-tax profit from the program. The Court therefore concluded that this arrangement was a sham transaction and that Winn-Dixie was not entitled to the claimed tax benefits. Other courts, in similar cases, followed suit.[11]

The COLI cases often emphasise the difference between "shams in fact" and "shams in substance." Shams in fact are transactions that occurred only on paper and not in reality, whereas shams in substance are transactions that actually occurred but are lacking in economic substance.[12] In most of the COLI cases, the courts conceded that the transactions were not "shams in fact" because the transactions actually occurred they were not mere bookkeeping entries. However, a few of the lower court opinions in those cases determined that the COLI transactions amounted to shams in fact as well as shams in substance, since the payments of the premiums and the counter-directional loans and withdrawals against the policies occurred simultaneously on the first day of each policy anniversary and "were accomplished literally simultaneously by means of netting transactions." The transactions thus never really occurred and constituted "shams in fact." A finding of either "sham in fact" or "sham in substance," however, is a sufficient basis for disallowance of the claimed tax benefits.

II. What are the pre-requisites for a transaction to be considered immune from challenge under US "economic substance," "anti-abuse," "abuse of law" or similar rules or doctrines?

In the United States, some courts require both: (1) a meaningful change to the taxpayer's economic position (referred to as "objective" economic substance), which usually is interpreted to require the possibility of a pre-tax profit; and (2) a substantial non-tax business purpose (referred to as the "subjective" test), while other courts require only that the objective test be met.

A. Two-pronged test: Frank Lyon Co. v. U.S.

The two-pronged test was first articulated by the U.S. Supreme Court in *Frank Lyon Co. v. U.S.,*[13] which involved a sale-leaseback transaction that was ultimately decided in favour of the taxpayer. Ironically, this case was also the U.S. Supreme Court's last major consideration of the economic substance doctrine. The development of the doctrine, and particularly the extent to which the two-pronged test, as explained below, is "conjunctive" or "disjunctive" has for the most part been left to the lower federal courts for over the last thirty years, with inconsistent results.

Under the facts of that case, a state bank, which was a member of the Federal Reserve System, entered into sale-and-leaseback agreements by which the taxpayer, Frank Lyon Company, took title to a building and leased it back to the bank under a "net" lease for a 25-year period, with options to extend for 40 more years. The transaction was motivated in large part by state and federal banking regulations that made it difficult for the bank to obtain conventional construction and permanent financing by itself. The taxpayer therefore borrowed USD 7.1 million from a commercial lender, and purchased the building then under construction from the bank for USD 7.6 million, investing USD .5 million of its own funds. The bank was obligated to pay rent equal to the principal and interest payments on the taxpayer's mortgage and had an option to repurchase the building at various times during the lease period, at prices equal to the then unpaid balance of petitioner's mortgage and initial USD 500,000 investment. The taxpayer deducted depreciation on the building and interest on the loan, and reported the payments received from the bank as rent.

The Commissioner of Internal Revenue disallowed the deductions on the ground that the taxpayer was not the owner of the building for tax purposes. The Commissioner contended that the sale-and-leaseback arrangement was a financing transaction in which the taxpayer loaned the bank USD 500,000 and acted as a conduit for the transmission of principal and interest to the taxpayer's mortgagee. Ultimately, the Supreme Court held that the claimed deductions were allowable.

Although the Court observed that it was not "condoning manipulation by a taxpayer through arbitrary labels and dealings that have no economic significance," it found that "[s]uch, however, has not happened in this case."

"In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, *and* is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts. It suffices to say that, as here, a sale-and-leaseback, in and of itself, does not necessarily operate to deny a taxpayer's claim for deductions. [Citations omitted.] [Emphasis supplied.]"[14]

B. "Disjunctive" application of the two-pronged test: Rice's Toyota World, Inc. v. Commissioner

In *Rice's Toyota World, Inc. v. Commissioner*,[15] an equipment (computer) leasing case decided in favour of the government with similarities to the sale-leaseback in *Frank Lyon,* the Fourth Circuit Court of Appeals reiterated the two-pronged test set forth by the U.S. Supreme Court in that case. That test requires a finding by a court that both a business purpose and a reasonable possibility of pre-tax profit be lacking.[16]

With respect to "business purpose," the Court noted:

> "The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction. The record in this case contains ample evidence to support the tax court's finding that Rice's sole motivation for purchasing and leasing back the computer under the financing arrangement used was to achieve the large tax deductions that the transaction provided in the early years of the lease."[17]

> "The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction. The record in this case contains ample evidence to support the tax court's finding that Rice's sole motivation for purchasing and leasing back the computer under the financing arrangement used was to achieve the large tax deductions that the transaction provided in the early years of the lease."[17]

Among the facts indicating a lack of business purpose were the fact that Rice's Toyota had paid an inflated price for the computer and "did not seriously evaluate whether the computer would have sufficient residual value at the end of the eight year lease to Finalco [the seller/lessee] to enable Rice to earn a profit on its purchase and seller-financed leaseback."

With respect to the potential for pre-tax profit or objective economic substance the Court noted that the transaction carried "no hope of earning Rice a profit unless the computer had a residual value sufficient to recoup the . . . principal and interest that Rice paid to Finalco on the recourse note less the . . . net annual return to Rice under the lease agreement." The Court found that it did not. The Court therefore found that Rice was not entitled to depreciation and interest deductions (on the non-recourse portion of the financing) that it had claimed.

It did, however, allow interest deductions on the portion of Rice's debt that was represented by a recourse note:

> ". . . *Knetsch*, . . . does not suggest that the debt represented by the note was not genuine because Rice did not borrow his own money to create interest expense as, in effect, did the taxpayer in *Knetsch*" [Citations omitted.]

> "Under *Frank Lyon*, the court may not ignore transactions that have economic substance even if the motive for the transaction is to avoid taxes. . . . [The Internal Revenue Code] does not limit deductibility of installment interest expense depending upon the item purchased by the taxpayer. Therefore, although Rice did not for tax purposes purchase property with the recourse note and may not base depreciation deductions upon it, the note nevertheless represents genuine debt upon which Rice is entitled to deduct interest expense."[18]

Rice's Toyota has come to stand for the view that the economic substance doctrine is a "disjunctive" test *i.e*, that a transaction will be treated as having no economic substance if "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, *and* that the transaction has no economic substance because no reasonable possibility of profit exists."[19] A tainted motive may not be enough in the absence of evidence that the transaction lacked a real potential for economic profit. It also has come to stand for the proposition that a court may bifurcate a transaction and give effect to tax benefits arising out of real economic losses.

C. "Conjunctive" two-pronged test: Klamath Strategic Investment Fund v. US

Klamath Strategic Investment Fund v. U.S.[20] involved a highly complex series of financial transactions known as Bond Linked Issue Premium Structure ("BLIPS"). The transactions were undertaken by two law partners, Cary Patterson ("Patterson") and Harold Nix ("Nix"), who were advised by Presidio Advisory Services ("Presidio").

To implement the strategy, Presidio formed Klamath and Kinabalu (substantially owned, through single-member LLCs, by Patterson and Nix, respectively) as limited liability companies, taxed as partnerships. They funded their respective partnerships with USD 1.5 million in cash. A bank then loaned each company USD 66.7 million, consisting of USD 41.7 million denominated as the "Stated Principal Amount" and USD 25 million as a "loan premium." The loan premium was attributable to Patterson's and Nix's agreeing to pay the bank a higher than market interest rate (17.97 percent) on the principal. Klamath and Kinabalu used these funds to purchase very low risk contracts on U.S. dollars and Euros and to make small forward contract trades in foreign currencies.

On Patterson's and Nix's precipitous withdrawal from Klamath and Kinabalu, they received cash and Euros in liquidation, and they sold the Euros in 2000, 2001, and 2002.

They reported the transaction as follows:

> "On their income tax returns for 2000, 2001, and 2002, Patterson claimed total losses of USD 25,277,202 arising from Klamath's activities and Nix claimed total losses of USD 25,272,344 arising from Kinabalu's. These massive losses occurred because each partner claimed a significant tax basis in their respective partnership. Generally, a partner's basis in a partnership is determined by the amount of capital he contributes to the partnership, and when a partnership loses money the partners can only deduct the losses from their taxable income to the extent of their basis in the partnership. When a partnership assumes a partner's individual liabilities, the liability amount is subtracted from the partner's basis. Patterson and Nix were able to report such high losses because when they each calculated their basis in the partnership, they did not reduce it by the USD 25 million loan premium amount. When Patterson and Nix contributed the USD 66.7 million plus the USD 1.5 million to Klamath and Kinabalu, they would have each had a USD 68.2 million basis in their partnership. However, the Partnerships also assumed the loan obligations, so Patterson and Nix's bases had to be reduced by the amount of the liabilities. Patterson and Nix did not consider the loan premiums to be liabilities, so they only subtracted the USD 41.7 million principal amount. Therefore, each claimed a taxable basis in the partnership in excess of USD 25 million. This meant that when Patterson and Nix sold the Euros, they were able to deduct over USD 25 million from their taxable income."[21]

On these and other facts, the Fifth Circuit Court of Appeals found that the above transaction lacked economic substance and disallowed the deduction. In describing the tests to be applied, the Court stated the following:

> "The law regarding whether a transaction should be disregarded as lacking economic reality is somewhat unsettled in the Fifth Circuit, and a split exists among other Circuits. The Fourth Circuit applies a rigid two-prong test, where a transaction will only be invalidated if it lacks economic substance and the taxpayer's sole motive is tax avoidance. [Citing *Rice's Toyota World,supra*] . . .The majority view, however, is that a lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance. [Citing *Coltec Industries, Inc. v. U.S.*, 454 F.3d 1340 at 1355 (Fed. Cir. 2006); *United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014, 1018 (11th Cir. 2001); *ACM Partnership v. Commissioner, infra; James v. Commissioner*, 899 F.2d 905, 908–09 (10th Cir. 1990).] . . .
>
> We conclude that the majority view more accurately interprets the Supreme Court's prescript in *Frank Lyon*. The Court essentially set up a multi-factor test for when a transaction must be honored as legitimate for tax purposes, with factors including whether the transaction (1) has economic substance compelled by business or regulatory realities, (2) is imbued with tax-independent considerations, and (3) is not shaped totally by tax-avoidance features. . . . *Importantly, these factors are phrased in the conjunctive, meaning that the absence of any one of them will render the transaction void for tax purposes*. Thus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations."[22] [Emphasis supplied.]

Klamath thus illustrates the "conjunctive" application of the two-pronged test first enunciated in *Frank Lyon* (but describes it as a "multi-factor" rather than a "two-pronged" approach). Under this approach, the taxpayer needs both a pure motive and real economic substance.

D. Summary

There is a certain lack of consistency concerning the proper application of the economic substance tests as elucidated in the cases decided since *Frank Lyon*. As the Joint Committee on Taxation has observed:

> "Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (*i.e.* the objective component) and business purpose (*i.e.* the subjective component) in order for the transaction to survive judicial scrutiny.[23] . . . A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction.[24] . . . A third approach regards economic substance and business purpose as 'simply more precise factors to consider' in determining whether a transaction has any practical economic effects other than the creation of tax benefits. . . .[25]"[26]

The proposals to codify the economic substance doctrine, as explained below, probably would clarify the standard (they all adopt the "conjunctive" approach), but also probably would not reduce the need for litigation to apply those standards to the myriad facts of cases that are likely to arise in the future.

III. What is the tax result of a determination that a transaction lacks economic substance?

Earlier cases indicated that a transaction that lacks economic substance "simply is not recognised for federal taxation purposes, for better or for worse."[27] However, the more common view appears to be that "in some circumstances, a sham transaction may have separable, economically substantive elements that give rise to deductible liabilities."[28] This approach was illustrated in *Rice*, *supra*, where interest attributable to recourse (but not non-recourse) notes was deductible. However, the claimed losses or deductions must be separable from the sham aspects of the underlying transaction.[29]

The allowance of some deductions in the context of a broader transaction that is determined to lack economic substance also is illustrated in *ACM Partnership v. Commissioner*.[30] That case is one of a group of similar cases[31] involving the manipulation of the "ratable basis recovery rules" and "contingent installment sale rules" under section 453 of the Internal Revenue Code with the assistance of a tax-indifferent party (in this case a foreign partnership). In these cases, a US and foreign partner form a foreign partnership[32] in a low or non-tax jurisdiction to acquire non-readily marketable property[33] and sell it in exchange for a large fixed payment (receivable immediately) and small contingent payments (the receipt of which is deferred to later years).[34] The gain in the year of sale from the large fixed payment is allocated to the foreign partner, and the later years' losses (incurred after the foreign partner's interest has been redeemed) are allocated to the US partner.[35] In reality, however, the transaction as a whole is a wash: property acquired for USD X is later sold for USD X. No actual gain or loss is realised.

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The Third Circuit Court of Appeals, applying the economic substance doctrine, for the most part disallowed ACM's claimed losses. However, it allowed ACM to deduct approximately USD 6 million of losses that were not attributable to the manipulation of the installment sale rules, but were rather attributable to a real economic decline in the value of certain LIBOR-based notes acquired as part of the transaction. This decline resulted from interest rate fluctuations that were independent of "the ratable basis recovery rule which inflated the tax basis of the LIBOR notes well above their actual cost basis."[36] The taxpayer had also paid taxes on more than USD 2 million in interest generated on the same notes. The Court observed:

> ". . .[I]t is . . . well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, *it will not be disregarded merely because it was motivated by tax considerations*. . . . In analysing both the objective and subjective aspects of ACM's transaction in this case where the objective attributes of an economically substantive transaction were lacking, we do not intend to suggest that a transaction which has actual, objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations."[37] [Emphasis supplied.]

IV. Legislative solution: codification of the economic substance doctrine: P.L. No. 111-152, § 1409 (March 30, 2010)

The foregoing are just a few of the cases and types of transactions that may fall under the general rubric of "economic substance" or "sham transaction."[38] The Treasury and Internal Revenue Service have also issued a number of administrative pronouncements applying the economic substance doctrine.[39] There has been no consensus, however, on how the tests for economic substance should be applied, and no real guidance from the U.S. Supreme Court since 1978.

For the most part, legislative and administrative efforts to date have been directed at attacking each transaction as it arises on a piecemeal basis. Thus, section 267(a)(1) of the Internal Revenue Code now prohibits the deduction of losses incurred between related parties that was the subject of the 1940 application of the economic substance doctrine in *Higgins v. Smith*, n.4, *supra*. Section 264 of the Internal Revenue Code has been amended to prohibit the deduction of interest on indebtedness incurred to purchase or carry a life insurance or annuity contract that was the subject of *Knetsch v. U.S.* Section 264 has been amended and section 101(j) has been enacted largely to put an end to leveraged COLI. Treas. Reg. § 1.701-2 was promulgated to deter (to an extent) the type of avoidance scheme present in *ACM Partnership v. Commissioner.*[40]

In recent years, however, a number of proposals have been advanced that attempt to "codify" the economic substance doctrine on a broader basis. Objections to codification have included claims by its critics that the courts are the proper place to adjudicate complex technical issues, that codification would sweep up common transactions that Congress has specifically allowed, and that designers of tax shelters and other abusive transactions would simply find a way around any such legislation.[41] Supporters counter that much more rigid rules are needed to combat increasingly sophisticated shelters, and that clear rules would simplify enforcement and administration.[42]

Despite articulated objections, and perhaps reflecting a growing need for additional tax revenues, Congress codified the economic substance doctrine in section 1409 of the "Health Care and Education Reconciliation Act of 2010," which was signed by the President as Public Law No. 111-152 on March 30, 2010.[43]

The new provision, embodied in section 7701(o) of the Code, provides that in the case of any transaction to which the economic substance doctrine is relevant, such transaction is treated as having economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, ***and*** (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. Thus, the legislation adopts the *conjunctive test* in determining whether a transaction has economic substance. The doctrine itself is defined, in new Code section 7701(o)(5)(A), as "the common law doctrine under which tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance ***or*** lacks a business purpose. [Emphasis supplied.]

A. Non-tax purpose

A taxpayer's non-Federal-income-tax purpose for entering into a transaction (the second prong in the above analysis) must be "substantial." For this purpose, any State or local income tax effect that is related to a Federal income tax effect is treated in the same manner as a Federal income tax effect. Also, a purpose of achieving a favorable accounting treatment for financial reporting purposes is not taken into account as a non-Federal-income-tax purpose *if* the origin of the financial accounting benefit is a reduction of Federal income tax.[44]

B. Profit potential

The provision sets forth a "special rule" to be applied where a taxpayer relies on profit potential to rebut an argument that a transaction lacks economic substance. If a taxpayer relies on a profit potential, the present value of the reasonably expected pre-tax profit must be *substantial* in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit. In addition, the Secretary of the Treasury is directed to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.[45]

C. Increased penalties

The new provision also amends section 6662 of the Code (concerning "accuracy-related" penalties on underpayments of tax) by imposing a new "strict liability" penalty for an underpayment attributable to any disallowance of a claimed tax benefit by reason of a transaction lacking economic substance.[46] The penalty rate is 20 percent of the underpayment, which amount increases to 40 percent of the underpayment if the transaction is not adequately disclosed in the return on which the benefit is claimed. No exception (including "reasonable cause) to the penalty is available.[47] Thus, a taxpayer may not rely on an opinion of counsel to negate the penalty. Similarly, a claim for refund or credit that is excessive under section 6676 of the Code (concerning erroneous claims for refund for credit) due to a claim that is lacking in economic substance is subject to the 20 percent penalty under that section, and the reasonable basis exception is not available.[48]

The Explanation of the Joint Committee on Taxation that accompanies the new legislation clarifies that, although the provision "provides a uniform definition of economic substance," it "does not alter the flexibility of the courts in other respects."[49] The Joint Committee's Explanation also contains the following caveats:

> The provision is not intended to alter the tax treatment of certain basic business transactions that, under long standing judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalising a business enterprise with debt or equity; (2) a U.S. person's choice between utilising a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organisation or reorganisation under sub-chapter C; and (4) the choice to utilise a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied. Leasing transactions, like all other types of transactions, will continue to be analysed in light of all the facts and circumstances. As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Also, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance."
> "
>
> "The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterise a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits."[50] [Citations omitted.]

Given the foregoing, even with the codification of the doctrine, it is reasonably clear that its application will require continued court involvement to defeat increasingly complicated tax avoidance and reduction arrangements.[51]

NOTES

[1] 293 U.S. 465 (1935). In this case, the Supreme Court also observed that: "The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *Id.* at 469.

[2] *Id. See also Commissioner v. Court Holding,, 324 U.S. 331, 333 (1945):* "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress;" *U.S. v. Cumberland Public Services Co.*, 338 U.S. 451 (1950).

[3] *Jacobson v. Commissioner*, 915 F.2d 832, 837 (2d Cir. 1990), cited in *ACM Partnership v. Commissioner*, 157 F.3d 231, 248 (3d Cir. 1998).

[4] *Higgins v. Smith,* 308 U.S. 473, 476 (1940). In this case, the taxpayer claimed a loss on the sale of stock to a corporation wholly-owned and controlled by the taxpayer, which was effectively determined to be his alter-ego.

[5] 364 U.S. 361 (1960).

[6] *Id.* at 365-366.

[7] *Id.* at p. 365. *See also Merryman v. Commissioner*. 873 F.2d 879 (5th Cir. 1989), which involved a partnership formed by shareholders and officers of a corporation engaged in oil and gas drilling. After the formation of the partnership, the corporation transferred a drilling rig to the partnership in exchange for a promissory note with no down payment. The corporation continued to operate the rig under a management agreement with the partnership. The partnership claimed investment tax credits, which flowed through to the individual partners, with respect to the rig in the year of the formation of the partnership, and later transferred its interest to another corporation controlled by the same individuals. Thereafter, the partnership was dissolved. Although the issue was "not without doubt," the Sixth Circuit in Merryman affirmed the Tax Court's determination that the partnership should be disregarded for tax purposes because it was a sham entity that had no business purpose other than to obtain tax credits for the individuals.

[8] Such insurance is also often more crudely referred to as "dead peasants" insurance. "Dead peasants" insurance was recently featured in Michael Moore's new film, "Capitalism: A Love Story," which apparently portrays scenes of alleged COLI abuses.

[9] 113 T.C. 254 (1999) aff'd 254 F.3d 1313 (11th Cir. 2001).

[10] The Winn-Dixie (and other) leveraged COLI programs fell literally within the interest allowance (and disallowance) provisions of the Internal Revenue Code as they applied prior to 1997. At that time, there was an explicit exception to the general disallowance rule on the deductibility of interest incurred to purchase or carry life insurance that provided that the prohibition did not apply if no part of the annual premium was financed by a policy loan in four of the first seven years. (The "4-of-7" rule.) Winn-Dixie's loans fell literally within the 4-of-7 exception. One of the factors that the Court pointed to in concluding that there was not a business purpose for Winn Dixie's COLI program was that the program was abandoned after 1996, when the law changed.

[11] *See, e.g., The Dow Chemical Company v. U.S.*, 435 F.3d 594 (6th Cir. 2006), *cert. den.* 549 U.S. 1205 (2007), *American Electric Power, Inc. v. U.S.*, 326 F.3d 737 (6th Cir. 2003), *cert. den*. 540 U.S. 1104 (2004), *In re CM Holdings, Inc.*, 254 B.R. 570 (D. Del. 2000), *aff'd* 301 F. 3d. 96 (3d. Cir. 2002).

[12] *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989); TAM 200213010.

[13] 435 U.S. 561 (1978).

[14] *Id.* at 583-584.

[15] 752 F.2d 89 (4th Cir 1985).

[16] *Id.* at 92.

[17] *Id.*

[18] *Id.* at 96.

[19] *Id.* at 90. [Emphasis supplied.]

[20] 568 F.3d 537 (5th Cir. 2009).

[21] *Id.* at 542.

[22] *Id.* at 544.

[23] Citing *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction."). *See also Klamath Strategic Investment Fund v. U.S.*, *supra* (even if the taxpayers are believed to have had a profit motive, the transaction was disregarded because it did not in fact have any realistic possibility of profit and funding was never at risk).

[24] Citing *Rice's Toyota World v. Commissioner, supra*.

[25] Citing *ACM Partnership v. Commissioner, infra; James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.")

[26] "Description of Revenue Provisions Contained In The President's Fiscal Year 2010 Budget Proposal," Part Two: Business Tax Provisions [JCS-03-09 September 2009].

[27] *Lerman v. Commissioner,* 939 F.2d 44 (3rd Cir. 1991). *See also Glass v. Commission*, 87 T.C. 1087 (1986). Both *Lerman* and *Glass* were "option-straddle" cases involving the trading of offsetting positions in silver futures on the London Metals Exchange.

[28] *ACM Partnership v. Commissioner, supra*, at 261.

[29] *Cf. U.S. v. Wexler*, 31 F.3d 117, 122 (3d Cir. 1994).

[30] 157 F.3d 231 (3rd Cir. 1998).

[31] Other contingent installment sale or "CINS" cases include *ASA Investerings v. Comr.*, 201 F.3d 505 (D.C. Cir. 2000), *Saba Investment v. Comr.*, 273 F.3d 1135 (D.C. Cir. 2001), and *Boca Investerings Partnership v. U.S.*, 314 F.3d 625 (D.C. Cir. 2003).

[32] In *ACM* the partnership was formed in the Netherlands Antilles by subsidiaries of Algemene Bank Nederland N.V., a major Dutch bank, Colgate-Palmolive Company, and Merrill Lynch, which designed the transaction and had a minor equity piece.

[33] In *ACM,* this property was approximately USD 200 million of short-term private placement securities that were not actively traded. In the United States, the installment method of reporting, on which the CINS transactions rely, is not available for sales of publicly-traded property.

[34] In *ACM*, the short-term private placement securities were sold for a cash payment in the approximate amount of USD 140 million and floating rate LIBOR-based notes valued at USD 60 million that would generate contingent payments

[35] Under US law in effect at the time, Colgate could carry these losses (of approximately USD 90 million) back to offset capital gains realised in an earlier year on the sale of one of its subsidiaries.

[36] *Id.* at 262.

[37] *Id.* at 248.

[38] *See also IES Industries, Inc. v. U.S.,* 253 F.3d 350 (8th Cir. 2001) and *Compaq Computer Corp. v. Commissioner,* 277 F.3d 778 (5th Cir. 2001) (purchase and immediate resale of American Depository Receipts to generate foreign tax credits)*; Andantech, LLC v. Commissioner,* 331 F.3d 972 (D.C. Cir. 2003) and *CMA Consolidated, Inc. v. Commissioner, T.C. Memo. 2005-16* (lease stripping)*; Long-Term Capital Holdings, v. U.S*., 350 F. Supp.2d 122 (D. Conn. 2004) and *Santa Monica Pictures LLC v. Commissioner,* T.C. Memo 2005-104 (loss shifting using assets with built-in losses); *Black & Decker Corp. v. U.S*. 436 F.3d 431 (4th Cir. 2006) (creating losses through the manipulation of contingent liabilities); *Consolidated Edison of NY v. U.S,* 90 Fed. Cl. 288 (2009) (lease-in/lease-out ("LILO") transaction).

[39] *See, e.g*., In Rev. Rul. 2000-12, 200-1 C.B. 744. Rev. Ruls. 99-14, 1999-1 C.B. 835 and 2002-69, 2002-2 C.B. 760 both involved LILO transactions in which the IRS ruled that a taxpayer may not deduct rent and interest paid or incurred in connection with such transactions where they lacked economic substance. Notice 2005-13, 2005-1 C.B. 630, involved a sale-leaseback transaction (similar to the transaction in *Frank Lyon*) with a tax-indifferent person, and held that such transactions may not be respected.

[40] Another, less direct, tool that the U.S. taxing authorities may employ to discourage transactions lacking in economic substance is the regulations issued under the authority of Internal Revenue Code §§ 6011, 6111 and 6112. These Code sections require the disclosure of certain "reportable transactions" by corporate investors, the registration of confidential corporate tax shelters by their promoters, and the maintenance of investor lists. A "reportable transaction" is one that has a potential for tax avoidance or evasion or that is identified by the Secretary of the Treasury in a published list as a tax avoidance transaction ("listed transaction"). A separate 20% "accuracy-related penalty" (applied to the understatement of tax) under Code § 6662A applies to any listed transaction and to any other reportable transaction that is not a listed transaction, if a significant purpose of such transaction is the avoidance or evasion of Federal income tax.

[41] In a September 11, 2009 letter to the U.S. Treasury, the American Institute of Certified Public Accountants (AICPA) wrote:

"We believe codification of the economic substance doctrine would have a long-term, negative effect on both taxpayers and the government, and would not produce the intended results. In addition to introducing statutory complexity and traps for small businesses and a broad cross section of taxpayers, codifying economic substance would deprive the tax system of the flexibility needed to keep pace with the changing economic environment. As past experiences with abusive tax shelters show, fixed rules are often easy to avoid and can lead to new abuses. In addition, past experiences also show that severe penalties, without a reasonable cause safety net, based on standards that are not clearly defined can unfairly penalise the innocent and unduly burden small business."

[42] See "CRS Review Revenue Raising Proposals of the 108th Congress," 2005 TNT 38-68 (Feb. 7, 2005).

[43] The changes enacted as § 1409 of P.L. 111-152 are set forth in an Appendix to this response.

[44] JCX-18-10, "Technical Explanation of the Revenue Provisions of the 'Reconciliation Act Of 2010,' As Amended, In Combination with the 'Patient Protection And Affordable Care Act,' " p. 154 (March 21, 2010). (Hereinafter "JCX-18-10")

[45] *Id.* at 154-155.

[46] Code §§ 6662(b)(6) and 6662(i).

[47] Code §§ 6664(c)(2) and 6664(d)(2).

[48] Code § 6676(b).

[49] JCX-18-10 at 152.

[50] *Id.* at 152-153.

[51] For a detailed examination of the economic substance doctrine and other judicially developed anti-abuse doctrines, see Keinan, 508 T.M., *The Economic Substance Doctrine*.

APPENDIX TO USA

H.R. 4872

"Health Care and Education Reconciliation Act of 2010"

(As Signed by the President on March 30, 2010)

(Public Law No. 111-152)

SEC. 1409. CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE AND PENALTIES.

(a) IN GENERAL

Section 7701 of the Internal Revenue Code of 1986 is amended by redesignating subsection (o) as subsection (p) and by inserting after subsection (n) the following new subsection:

"(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.

"(1) APPLICATION OF DOCTRINE.

— In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if —

- "(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position,"and
- "(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."

(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL. —

"(A) IN GENERAL. — The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

(B) TREATMENT OF FEES AND FOREIGN TAXES.

Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

(3) STATE AND LOCAL TAX BENEFITS.

"For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) FINANCIAL ACCOUNTING BENEFITS.

For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) DEFINITIONS AND SPECIAL RULES.

For purposes of this subsection

"**(A) ECONOMIC SUBSTANCE DOCTRINE**. — The term 'economic substance doctrine' means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

"**(B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.** — In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

"**(C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.** — The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

"(D) TRANSACTION. — The term 'transaction' includes a series of transactions.".

(b) PENALTY FOR UNDERPAYMENTS ATTRIBUTABLE TO TRANSACTIONS LACKING ECONOMIC SUBSTANCE. —

(1) IN GENERAL. — Subsection (b) of section 6662 is amended by inserting after paragraph (5) the following new paragraph:

"(6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.".

(2) INCREASED PENALTY FOR NONDISCLOSED TRANSACTIONS. — Section 6662 is amended by adding at the end the following new subsection:

"(i) INCREASE IN PENALTY IN CASE OF NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS. —

"**(1) IN GENERAL.** — In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.

"(2) NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS. — For purposes of this subsection, the term 'nondisclosed noneconomic substance transaction' means any portion of a transaction described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

"(3) SPECIAL RULE FOR AMENDED RETURNS. — In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.".

(3) CONFORMING AMENDMENT. — Subparagraph (B) of section 6662A(e)(2) is amended —

(A) by striking "section 6662(h)" and inserting "subsections (h) or (i) of section 6662"; and

(B) by striking "GROSS VALUATION MISSTATEMENT PENALTY" in the heading and inserting "CERTAIN INCREASED UNDERPAYMENT PENALTIES".

(c) REASONABLE CAUSE EXCEPTION NOT APPLICABLE TO NONECONOMIC SUBSTANCE TRANSACTIONS. —

(1) REASONABLE CAUSE EXCEPTION FOR UNDERPAYMENTS. — Subsection (c) of section 6664 is amended —

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;

(B) by striking "paragraph (2)" in paragraph (4)(A), as so redesignated, and inserting "paragraph (3)"; and

(C) by inserting after paragraph (1) the following new paragraph:

"**(2) EXCEPTION.** — Paragraph (1) shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6).".

(2) REASONABLE CAUSE EXCEPTION FOR REPORTABLE TRANSACTION UNDERSTATEMENTS. — Subsection (d) of section 6664 is amended —

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;

(B) by striking "paragraph (2)(C)" in paragraph (4), as so redesignated, and inserting "paragraph (3)(C)"; and

(C) by inserting after paragraph (1) the following new paragraph:

"**(2) EXCEPTION.** — Paragraph (1) shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6).".

(d) APPLICATION OF PENALTY FOR ERRONEOUS CLAIM FOR REFUND OR CREDIT TO NONECONOMIC SUBSTANCE TRANSACTIONS. — Section 6676 is amended by redesignating subsection (c) as subsection (d) and inserting after subsection (b) the following new subsection:

"**(c) NONECONOMIC SUBSTANCE TRANSACTIONS TREATED AS LACKING REASONABLE BASIS.** — For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.".

(e) EFFECTIVE DATE. —

(1) IN GENERAL. — Except as otherwise provided in this subsection, the amendments made by this section shall apply to transactions entered into after the date of the enactment of this Act.

(2) UNDERPAYMENTS. — The amendments made by subsections (b) and (c)(1) shall apply to underpayments attributable to transactions entered into after the date of the enactment of this Act.

(3) UNDERSTATEMENTS. — The amendments made by subsection (c)(2) shall apply to understatements attributable to transactions entered into after the date of the enactment of this Act.

(4) REFUNDS AND CREDITS. — The amendment made by subsection (d) shall apply to refunds and credits attributable to transactions entered into after the date of the enactment of this Act.

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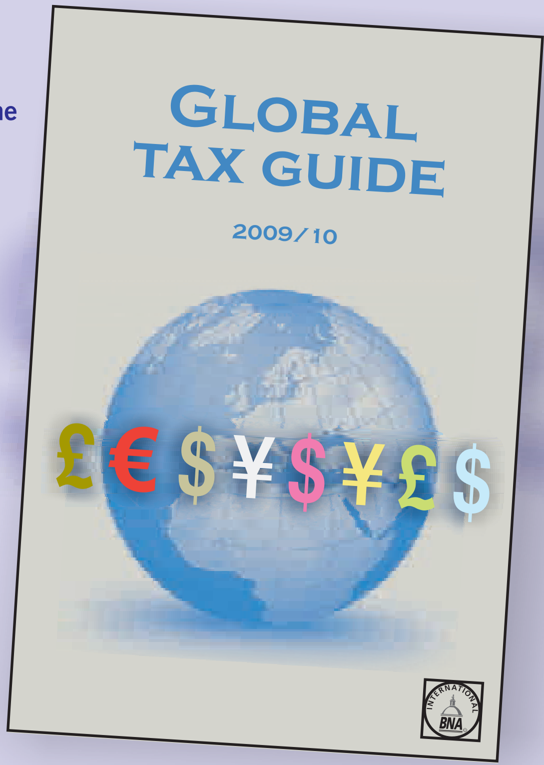

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