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GAAR under BEPS and MLI

Panel

- Chair: Philippe Martin (France)
- Peter Cools (Netherlands)
- Malcolm Gammie (United Kingdom)
- Pramod Kumar (India)
- Vesa-Pekka Nuotio (Finland)
- John Owen (Canada)
- Jacques Sasseville (UN-Guest)

Outline

- Part I: Multiplication of domestic GAAR provisions and international GAAR instruments
- Part II: Issues for tax courts

The notion of GAAR refers to a general anti-avoidance rule that is designed as a catch-all provision, usually based on legal tests related to the existence of an arrangement that leads to a tax benefit, with most often a test based on the intent of the taxpayer (tax or non-tax purpose) and the degree of violation of the object and purpose of tax law.

Part I

- Old GAARs: Netherlands, France, Finland, Canada
- New statutory GAARs: India, United Kingdom
- New international instruments: OECD, UN, EU

GAAR IN THE NETHERLANDS

Peter Cools
Supreme court of the Netherlands

GAAR IN THE NETHERLANDS

- Statutory GAAR → richtige heffing
- Court developed GAAR → fraus legis
- Regarding the application richtige heffing and fraus legis are more or less equal.
- Differences:
  - richtige heffing only applicable to direct taxes
  - richtige heffing does only ignore transactions
  - richtige heffing requires an approval of the Minister of Finance

As from August 1987 the Minister of Finance no longer gives approvals. The reason is that the HR had decided that within the concept of fraus legis "substition by elimination" is possible, and that gives the same result as ignoring transactions.

GAAR IN THE NETHERLANDS

- Three requirements to apply fraus legis
  - Objective requirement → Dutch taxes are (partialy) avoided
  - Subjective requirement → the essential motive (the only or by far the most important motive) for entering into a legal act or a set of legal acts is to avoid Dutch taxation
  - Normative requirement → the arrangement is contrary to the object and purpose of the Dutch legislation

Result of fraus legis → substitution by nearby taxable legal act or

→ substitution by elimination of the legal act

GAAR IN THE NETHERLANDS

- Limitations fraus legis
  - no other remedy against tax evasion
    - normal means for determining the law are used (e.g. teleological interpretation).
    - the facts are determined and requalification of the facts doesn't help you
    - the legal act exists in real → apparant existence of the legal act is not at stake

    In addition:
  - the principle of legal certainty is a very strong principle → the taxpayer may rely on the tax-law

GAAR IN THE NETHERLANDS

- The judge does not apply fraus legis officially → the tax-inspector has a declaration duty and the burden of proof is on his shoulders
  - subjective requirement → the legal act or set of legal acts give rise to the presumption that the act(s) do not lead to a genuine change (artificial) and is (are), except for the fiscal benefits, senseless (foreseeable disadvantage)
  - the taxpayer can provide evidence to the contrary → additional commercial reasons
  - normative requirement → not an issue of ethics, but an explanation of the meaning of the legislator

GAAR IN THE NETHERLANDS

- Fraus legis and tax treaties → no way, unless the treaty explicitly provides for a provision on the application of fraus legis.

- Fraus legis and EU law?

- Fraus legis is successful?

French GAAR: abus de droit

- Statutory GAAR rewritten by case law
  - Statute 1941
  - Case law 1981 rewrites legal tests
  - Case law 2006 expands the scope and fine-tunes the tests
  - Parliament 2008 copies case law into new abuse of law provision in tax code

French GAAR: abus de droit

- Covers fictitious acts (including simulation) + acts made for the sole motive of reducing the normal tax burden by applying the letter of the law against its purpose
- Legitimacy of GAAR and application to tax treaties
  - ✓ Statutory GAAR can be seen as application of general principle of law: in the *Janfin* case (27 September 2006), the *Conseil d'Etat* justifies the abuse of law doctrine (specifically *fraude à la loi*) by the general principle of law according to which fraud can have no acceptable consequences in law
  - ✓ Application of domestic (statutory) GAAR to tax treaties if no relevant treaty provision (*Conseil d'Etat, 25 October 2017, Nr 396954, Verdannet*)

French GAAR: abus de droit

- Tax advantage must be real: if scheme doomed to fail because of « regular » tax provisions, GAAR is not applicable because no tax advantage

(*Conseil d'Etat, 5 March 2007, Nr 284457, Pharmacie des Challonges*)

- Calculation of tax advantage may require hypothetical verifications: when the tax administration recharacterizes a French-Netherlands transaction as a French-US transaction, the tax treaty between France and the US must be taken into account in order to check whether taxpayer gained something by switching to the France-Netherlands treaty (*Conseil d'Etat, 21 July 2017, Nr 392908, Thermo Electro Holdings*)

French GAAR: abus de droit

- Sole tax purpose (with exception in case law for negligible financial gains)
- Compare ECJ case law: essential (not exclusive) tax objective, (22 November 2017, C-251/16, Cussens, § 53 and 60)
- Purpose of the law: *travaux préparatoires* in domestic legislation
- Treaties: artificial arrangements may often be seen as going against the purpose of tax law: in the *Verdannet* case (25 October 2018, Nr 396954), the artificial interposition of a Luxembourg company was seen as a violation of the spirit of the France-Luxembourg tax treaty that allocates the right to tax for transactions that are really done by Luxembourg companies

French GAAR: abus de droit

- Burden of proof on tax administration, but may shift for procedural reasons
- Strong judicial oversight, even by supreme administrative court *(Conseil d'Etat)*, on points of law (the legal tests) and the facts of the case

GAAR under BEPS and MLI

Finnish GAAR

The Finnish regulations on tax avoidance – income taxation

- The Act on Tax Assessment includes a general rule on tax avoidance.
  - The rule originates from the 1940's and it is applicable to income taxes (private & business).
- The rule can be applied, if the taxpayer has used such a legal form which does not correspond to the true nature and purpose of the transaction OR if the purchase price or other consideration is not at arm's length and the intention has been to avoid taxes.
  - The application of the rule has in many cases been based on overall view of the transaction(s).
  - An unusual legal form and/or lack of other motives than tax reasons are indications of tax avoidance.
  - The rule should not be applied if the transaction is based on genuine business reasons.
- There is substantial amount of published case law based on which it can be concluded in which kind of situations the rule is usually applied.

The Finnish regulations on tax avoidance – income taxation

- The Business Income Tax Act includes a special rule concerning company reorganizations based on the merger directive of the EU.
- There are also special regulations which by their nature are regulations on tax avoidance such as
  - rule on hidden dividend distribution,
  - rule based on which the transfer prices between related parties have to be at arm's length (in force starting from January 1, 2007),
  - rule on the limit on the deductibility from business income of interest payments to related parties (in force starting from fiscal year 2014) &
  - rules which prohibit trade on the shares in a loss making company.
- In some cases the tax benefits of artificial arrangements can even be denied by the application of the basic rule on the deductibility of expenses or other standard tax rules.

The Finnish regulations on tax avoidance – other taxes

- Over the years similar rules have also been enforced concerning other taxes than income taxes (transfer tax, gift and inheritance tax, taxes that the taxpayer has to pay on the own initiative of the taxpayer such as VAT, insurance taxes, social security charge, salary withholding etc.).

- For the part of the other taxes the rules on tax avoidance have been applied very seldom – some of them have not (yet) been applied at all.

THE CANADIAN GAAR

JOHN R. OWEN
TAX COURT OF CANADA

THE CANADIAN GAAR

- Enacted in September 1988 and amended in 2004 with retroactive effect to the date of enactment
  - 2004 amendment explicitly extended application of GAAR to Tax Treaties
- Three Supreme Court of Canada Judgments interpret the GAAR:
  - *Canada Trustco* (2005)
  - *Lipson* (2009)
  - *Copthorne* (2011)

THE CANADIAN GAAR

- The GAAR applies a three prong test:
  - Is there a tax benefit?
  - Is there an avoidance transaction?
  - Is it reasonable to consider that the avoidance transaction results directly or indirectly in a misuse or an abuse of a provision of
    - the *Income Tax Act*
    - the *Income Tax Regulations*
    - the *Income Tax Application Rules,* or
    - any other enactment relevant in computing tax or any other amount payable or refundable under the *Income Tax Act*

THE CANADIAN GAAR

- A tax benefit exists if there is a reduction, avoidance or deferral of tax or an increase in a refund of tax
  - The quantum of the tax benefit is not relevant
- An avoidance transaction exists if
  - the transaction, or a series of transactions that includes the transaction, results directly or indirectly in a tax benefit, and
  - it may reasonably be considered that the transaction was not undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit
- The definition of avoidance transaction requires an objective assessment of the relative importance of the driving forces of the transaction

THE CANADIAN GAAR

- Whether a tax benefit or an avoidance transaction exists is a question of fact for the judge to determine
- The Minister of National Revenue may assume facts that establish the existence of a tax benefit and an avoidance transaction
- The burden is on the taxpayer to prove facts that support the conclusion that there is no tax benefit and/or no avoidance transaction

THE CANADIAN GAAR

- The Supreme Court has condensed the statutory "misuse or abuse" test into a single question:

  Is the impugned avoidance transaction abusive?

- The question of whether an avoidance transaction is abusive is a mixed question of fact and law
- An avoidance transaction is abusive if the transaction viewed in context frustrates the object, spirit or purpose of the provision(s) giving rise to the tax benefit

THE CANADIAN GAAR

- The Minister of National Revenue must identify the object, spirit or purpose (*ie*, legislative rationale) of the statutory provision(s) and must clearly establish abuse
- To assess the Minister's position, the court must first employ a unified textual, contextual and purposive (TCP) interpretation of the statutory provision(s) to determine object, spirit or purpose
  - The search is for the rationale that underlies the words that may not be captured by the bare meaning of the words themselves
  - The heart of the analysis is a contextual and purposive interpretation of the provisions
- The court must then determine whether the avoidance transaction falls within or frustrates the identified object, spirit or purpose

THE CANADIAN GAAR

- The court must conduct an objective, thorough and step-by-step analysis of the provision(s) and explain the reasons for its conclusion regarding whether or not the avoidance transaction is abusive
- The abusive nature of the avoidance transaction must be clear and the benefit of the doubt is given to the taxpayer

THE UK GAAR

MALCOLM GAMMIE

HISTORIC UK ANTI-AVOIDANCE APPROACHES

- Historically certain taxes have included a general anti-avoidance rule, e.g. excess profits tax under the Finance Act 1941
- Otherwise the UK historically adopted specific anti-avoidance rules or attached general anti-avoidance language to specific provisions of the Act
- General anti-avoidance language has tended to use one of two formulations:
  - The main benefit to be expected from the transaction is the avoidance or reduction of a liability to tax, or
  - The main purpose or one of the main purposes of the transaction is the avoidance or reduction of a liability to tax

JUDICIAL APPROACHES TO TAX AVOIDANCE

- Starting with *W T Ramsay Ltd v IRC* [1982] AC 300, the Courts began to take a more 'pro-active' approach to defeating tax avoidance arrangements
- The 'modern' statement of the *Ramsay* principle is found in *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51, as follows:

  "The driving principle in the *Ramsay* line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically"

  (Adopting Ribeiro PJ's statement in *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46)

THE DEVELOPMENT OF THE UK GAAR

- The Tax Law Review Committee of the Institute for Fiscal Studies initiated a debate in 1997/98 as to whether the UK should adopt a GAAR. The Inland Revenue was against the idea (perceiving that it might have to implement a rulings procedure) and the Labour Government decided against the introduction of a GAAR
- The 2010 Coalition Government (Conservatives and Liberals) asked Graham Aaronson to review the position. Mr Aaronson had been the Chairman of the TLRC in 1997/98
- His Report paved the way for the introduction of a General Anti-ABUSE Rule in the Finance Act 2013

THE FA 2013 GAAR

- Applies to all the main direct taxes
- Applies to any arrangement where it is reasonable to conclude that the obtaining of a tax advantage (broadly any tax saving or benefit) was one of the main benefits of the arrangement
- The arrangement must be “abusive” i.e. the entering into or carrying out of the arrangement cannot reasonably be regarded as a reasonable course of action (the “double reasonableness” test) having regard to all the circumstances, including
  - the principles and policy objectives of the legislation
  - Any contrived or abnormal steps, and
  - The exploitation of any legislative shortcomings

GAAR GUIDANCE AND GAAR PANEL

- The GAAR can counteract arrangements that would otherwise be effective for tax purposes if found to be ‘abusive’ (as defined)
- The Revenue must follow a special procedure to invoke the GAAR, including seeking the opinion of the GAAR Advisory Panel (“GAP”) comprising independent individuals appointed by the Revenue, as to whether the arrangements are a reasonable course of action or not (a “single reasonableness” test). The GAP is not a judicial body. Its opinions are published.
- The GAP also reviews and approves the Revenue’s published guidance on the GAAR

GAAR COUNTERACTION AND PENALTIES

- GAAR counteraction allows the Revenue to make such adjustments as are just and reasonable, including imposing or increasing a liability to tax
- The Revenue consider that the GAAR overrides the UK's tax treaties
- If the GAP opinion in any case concluded that the arrangement was not a reasonable course of action but the taxpayer chooses to pursue an appeal and loses, the taxpayer may suffer a 60% penalty in addition to the additional tax
- The taxpayer's advisers may face penalties in any event under the "Enablers of Tax Avoidance" legislation if they failed to advise the taxpayer against the course of action in question

POST-GAAR DEVELOPMENTS

- The enactment of the UK's GAAR has not led to a reduction in anti-avoidance legislation. In particular, most measures (including those implementing BEPS measures) are covered by wide ranging general anti-avoidance provisions, known a "RAARs" (Regime Anti-Avoidance Rules) or "TAARs" (Targeted Anti-Avoidance Rules).
- For example, the UK's anti-Hybrids legislation in FA 2016 negates any arrangements that are inconsistent with the principles and policy objectives of the legislation and regard can be had to the OECD BEPS report on hybrids to determine the principles and policy
- For example, the UK's extension of its taxing jurisdiction over IP royalties in FA 2016 overrides any treaty provision where a main purpose of the arrangement is to obtain a treaty advantage contrary to the object and purpose of treaty

GAAR in India

Pramod Kumar
IATJ Ottawa * September 28-29, 2018

Doctrine of substance over form or judge made GAAR - a precursor to GAAR legislation in India

•Doctrine of substance over form is a judicial creation. It is invoked in cases in which taxpayer has conducted a scheme of transactional relationships in documents and has a view on tax advantages that flow from tax reporting based on such transactional relationships, rather than on the substance of arrangement. The economic reality is thus hidden and transaction exists in form only. This doctrine allows tax authorities to ignore the legal form of an arrangement and to look at its actual substance, so as to prevent artificial structures from being used for tax avoidance purposes.

•In its pure form, when, on the basis of evaluation of evidence and analysis of facts, judicial authorities find that tax motivation outweighs business purpose or profit objective, it is held that the taxpayer's efforts of form does not reflect the substance of economic transactions, and intended tax benefits are declined.

Doctrine of substance over form or judge made GAAR - a precursor to GAAR legislation in India……*cont*

- The controversy, however, started with the judicial rulings proceeding on the basis that substance prevails over form only when the form has no commercial justification whatsoever and is completely tax driven.

- Vodafone decision by Indian Supreme Court, in a way, was the turning point. Many believe that it marked a radical departure in departing from the dominant purpose test. Although there is a mention of ‘dominant purpose’ of the scheme in the judgment, there are observations which suggest that a structure can be discarded only when it has “no commercial/ business substance” whatsoever.

- As to whether doctrine of substance over form could be invoked only when the form of transaction is completely tax driven is, at the minimum, highly controversial. Vodafone decision supported the former approach, but there is little conceptual justification, on the first principles, in its support.

The problems with judge made GAAR

- The role played by judges while handling tax cases is too much of a tight rope walk. On the one hand, they should be entirely neutral towards the parties, even if not value neutral, and, on the other hand, their judgments should be objective, fair, reasonable and unaffected by their ideologies.

- Not everyone in the judiciary is, or can be, really confident in meeting the challenge of looking through the complex maze of contrived transactions, and understanding the core economic and business realities of such transactions. Many believe that judiciary prefers to go by the form and prone to err on the side of excessive caution at the cost of the exchequer.

- The controversy whether judiciary be content with foundationalist approach to interpretation of tax statutes by implementing its plain meaning, intent or purpose, or whether judges should approach the tax statutes purposively by exploring for most sensible policy option.

(Additional slides placed at the end on the Indian rulings on judge made GAAR)

GAAR legislation in India

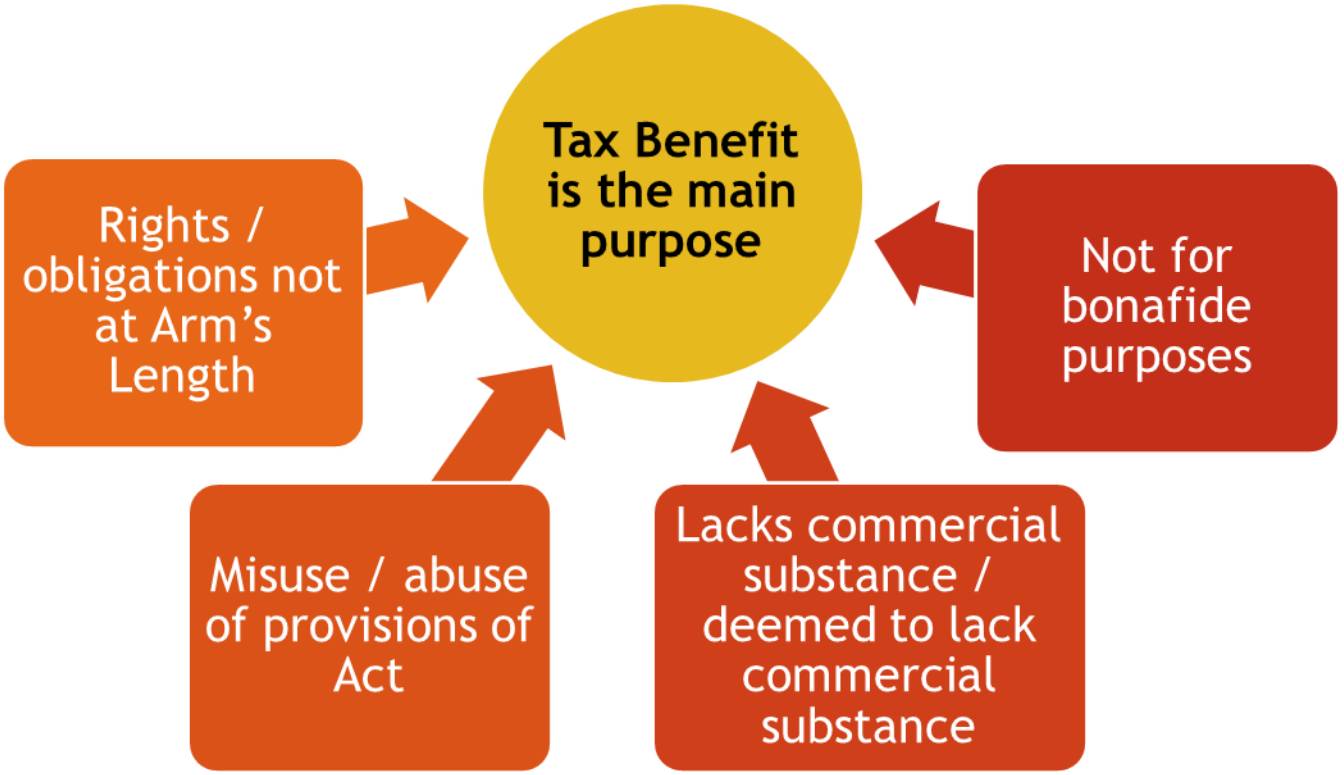
- Initially introduced by Finance Bill, 2012 but, in response to concerns raised by the taxpayers, the bill was dropped and referred the GAAR legislation for a review by the Shome Committee

- Introduced by the Finance Act, 2013, incorporating changes suggested by Shome Committee, with effect from 1st April 2015 but deferred the implementation for two years in view of taxpayer sentiments

- Finally, came into force w.e.f. financial year beginning 1st April 2017 with three important safeguards- namely (a) monetary threshold for application of GAAR (currently INR 30 million in tax benefit- USD 4,00,000 million approx); (b) exemption of FIIs not availing the tax treaty benefits and subject to certain conditions; and (c) non applicability of GAAR to investments made prior to GAAR coming into force

- It is distinct in scope from targeted anti avoidance rule and specific anti avoidance rules such as transfer pricing, thin capitalization rules etc

The basic GAAR thrust: Impermissible avoidance arrangement



It is for the taxpayer to prove that main objective of arrangement is not to obtain tax benefit (if the main purpose of any step in such arrangement is to obtain tax benefit)

Some of the terms used in defining impermissible avoidance arrangements

- Tax benefit includes –(a) reduction, avoidance or deferral of tax (b) increase in refund of tax, (c) reduction of total income (d) increase in loss - under domestic law or the tax treaty.

- Lack of commercial substance refers to the situations in which (a) substance of arrangement differs from its form; or (b) arrangement involves or includes round trip financing, accommodating party, offsetting / cancelling elements, transaction disguises value/location /source /ownership / control, transaction / location of asset / place of residence of any party merely to obtain tax benefit (no commercial purpose), and (c) it has no significant impact on business risks / net cash flows except tax benefit.

- Accommodating party refers to a party to the transaction if main purpose of direct or indirect participation of a party is to obtain the benefit, directly or indirectly, to the taxpayer- whether or not there is any relationship between the taxpayer and such a party.

Consequences of Impermissible avoidance arrangements

- Disregard, combine or recharacterize any step in, or a part or whole of, IAA
- Ignoring the IAA altogether as *non-est*
- Disregard accommodating parties and treat all the parties as one
- Deeming connected persons as one for determining tax treatment
- Reallocation, amongst the parties, any accrual or receipt of capital or revenue incomes, expenditure, deduction, reliefs or rebate
- Treatment of place of residence of a party to the arrangement, or situs of an asset or of a transaction, at a place other than as provided under IAA
- Disregarding the corporate structure and looking through the arrangement

- **As a consequence of IAA, (a) a debt may be treated as equity, and *vice versa;* (b) any accrual or receipt of capital nature may be treated as revenue, and *vice versa*; and (c) any expenditure, deduction, relief or rebate may be recharacterized**

GAAR implementation – assurances by the Central Board of Direct Taxes, India

- GAAR not to be invoked if (a) Sufficient anti-abuse provisions in DTAA; (b) Tax implications explicitly and adequately considered by Court sanctioning the arrangement (c) Merely because entity is located in tax efficient jurisdiction if non-tax commercial considerations exist and main purpose is not to obtain tax benefit (d) Arrangement held as permissible by the Authority for Advance Ruling; (e) the arrangement is considered by Commissioner approving panel as permissible in any one year (f) Claiming provisions of DTAA or Act whichever is beneficial on year on year basis

- GAAR shall not take away right of tax payer to choose method of implementing transaction; Capital Gains on Investments prior to 1st April 2017 grandfathered, but lease contracts and loan agreements not grandfathered

- GAAR and SAAR can co-exist; even if SAAR exist, GAAR can be applied – depends on facts and circumstances; o corresponding adjustment to other assessee

The parting thoughts…….

- The GAAR law has just come into force; no issues before the Court as yet. Many consider the GAAR law, in effect, only strengthening of doctrine of substance over form and defining it by legislative means

- The observations made in the context of pre GAAR legal position in India are on the additional slides appended to this presentation.

- The formal GAAR law adds flexibility to the law in dealing with these situations which can not be neatly defined in advance because of dynamism of, and innovations in, business and commerce.

- It will always be a challenge for the judges to take a call on the impermissible avoidance arrangements.

Thank you !

Indian judicial precedents- judge made GAAR

- “It is true that apparent must be considered real unless it is shown that there are reasons to believe that apparent is not real. If all that an assessee, who wants to evade tax, is to have some recital made in documents either executed by him or executed in his favour, then the door will be left wide open to evade tax. …….The taxing authorities were not required to put on blinkers while looking at the documents produced before the9m. They were entitled to look into surrounding circumstances to find out reality of recitals made in those documents….”

CIT Vs Durga Prasad More

82 ITR 540 - Supreme Court

- “Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage the belief that it is honourable to avoid tax by resorting to subterfuges. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges

McDowell & Co Ltd Vs CTO (154 ITR 148)

Indian judicial precedents- judge made GAAR

- "……It is well established that in a matter of this description the Income- tax authorities are entitled to pierce the veil of corporate entity and to look at the reality of the transaction. It is true that from the juristic point of view the company is a legal personality entirely distinct from its members and the company is capable of enjoying rights and being subjected to duties which are not the same as those enjoyed or borne by its members. But in certain exceptional cases the Court is entitled to lift the veil of corporate entity and to pay regard to the economic realities behind the legal facade. For example, the Court has power to disregard the corporate entity if it is used for tax evasion or to circumvent tax obligation."

  - CIT Vs Meenakshi Mills Ltd (63 ITR 609)

- **If the Court finds that notwithstanding a series of legal steps taken by an assessee, the intended legal results have not been achieved, the Court might be justified in overlooking the intermediate steps**, but it would not be possible for the Court to treat the intervening steps as *non est* based on some hypothetical assessment of 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*

Union of India Vs Azadi Bachao Andolan
(263 ITR 706 – Supreme Court)

Vodafone decision…… Indian Supreme Court

- "..a clear cut distinction between tax avoidance and tax evasion is still to emerge in England and in the absence of any legislative guidelines, there is bound to be uncertainty" ……"When it comes to taxation of a holding structure, the burden is on the Revenue to allege and establish tax abuse, in the sense of tax avoidance in the creation and/ or use of such structure(s)."

- "In the application of a judicial anti avoidance rule, the Revenue may invoke the "substance over form" principle or "piercing the corporate veil" test only after it is able to establish, on the basis of facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant."

Vodafone decision….. Indian Supreme Court

- “To give an example, if a structure is used for circular trading or round tripping or to pay bribes then such transactions, though having a legal form, should be discarded by applying the test of fiscal nullity. Similarly, in a case where the Revenue finds that in a Holding Structure an entity which has no commercial/business substance has been interposed only to avoid tax then in such cases applying the test of fiscal nullity it would be open to the Revenue to discard such interpositioning of that entity. However, this has to be done at the threshold. …..“It is the task of the Revenue/Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach.”

- “...we are of the view that every strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner. While doing so, the Revenue/Courts should keep in mind the following factors: the concept of participation in investment, the duration of time during which the Holding Structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; the continuity of business on such exit. In short, the onus will be on the Revenue to identify the scheme and its dominant purpose.”

The treaty GAAR:
A Not-So-New Development

Capacity Building Unit
Financing for Sustainable Development Office
Department of Economic and Social Affairs

Abuse of treaties in international law

- Article 26 *Vienna Convention on the Law of Treaties*:

Every treaty in force is binding upon the parties to it and must be performed by them in good faith

- Commentary

"There is much authority in the jurisprudence of international tribunals for the proposition that in the present context the principle of good faith is a legal principle which forms an integral part of the rule *pacta sunt servanda.*"

Abuse of treaties in international law

- Commentary

"…Some members felt that there would be advantage in also stating that a party must abstain from acts calculated to frustrate the object and purpose of the treaty. The Commission, however, considered that this was clearly implicit in the obligation to perform the treaty in good faith and preferred to state the *pacta sunt servanda* rule in as simple a form as possible."

Abuse of treaties in international law

- Doctrine of abuse of rights is a principle of international law:
  - M. Byers, *Abuse of Rights: An Old Principle, A New Age*, (2002) 47 McGill LJ., 389
- The application of that principle to tax treaties is not a new development:
  - David Ward, “Abuse of Tax Treaties”, in Alpert, H.H. and K. van Raad (eds.), *Essays on International Taxation* (Deventer/Boston: Kluwer, 1993), Series on International Taxation No. 15.
- Abuse of rights principle is not a rule of interpretation; it restricts the application of clear words in the treaty

Tax treaties are not so special…

Trans-Pacific Partnership Agreement

Article 9.15: Denial of Benefits

1. A Party may deny the benefits of this Chapter to an investor of another Party that is an enterprise of such other Party and to investments of that investor if the enterprise:

(a) is owned or controlled either by persons of a non-Party or of the denying Party; and

(b) has no substantial business activities in the territory of any Party other than the denying Party.

TPP Article 9.15: Denial of Benefits

2. ***A Party may deny the benefits of this Chapter to an investor of another Party*** that is an enterprise of such other Party and to investments of that investor if persons of a non-Party own or control the enterprise ***and the denying Party adopts or maintains measures*** with respect to the non-Party or a person of the non-Party that prohibit transactions with the enterprise ***or that would be violated or circumvented if the benefits of this Chapter were accorded to the enterprise or to its investments.***

2017 addition to UN and OECD Models

- The new general anti-abuse rule of Article 29(9) is identical in the OECD and UN models

Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that ***obtaining that benefit was one of the principal purposes*** of any arrangement or transaction that resulted directly or indirectly in that benefit, ***unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions*** of this Convention.

- Results from the work on BEPS Action 6 (Preventing the granting of treaty benefits in inappropriate circumstances)

New treaty GAAR is merely a codification of a previously-recognized principle

- Commentary on Art. 1 of both models:

A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions. ***That principle applies independently from the provisions of Article 29, paragraph 9, which merely confirm it.***

- This guiding principle has been expressly recognized in both models for more than 15 years

MLI GAAR

- The MLI is merely a way to have the new Article 29(9) apply to bilateral treaties
- Art. 7(1) MLI is identical to Article 29(9) of the UN and OECD Model (except for the replacement of “Convention “ by “Covered Tax Agreement”)
- It is one of the few MLI provisions that has been accepted by almost all signatories
- This is because it is the only method provided by the MLI that ensures that a treaty meets the minimum standard on treaty-shopping

MLI GAAR

- Only possible way not to have the MLI treaty GAAR is:
  - If a signatory country reserves the right to apply the detailed limitation-on-benefits (LOB) provision and either rules to address conduit financing structures or a principal purpose test (*not a single signatory of the MLI has made that reservation*)
  - If two treaty partners disagree on the inclusion of the simplified LOB

Effect of the MLI GAAR

- Para. 13 Explanatory Statement: MLI "…will not function in the same way as an amending protocol to a single existing treaty, which would directly amend the text of the Covered Tax Agreement; instead, it will be applied alongside existing tax treaties, modifying their application…"
- Art. 17(2): "Paragraph 1 shall apply in place of or in the absence of provisions of a Covered Tax Agreement that deny all or part of the benefits …"
- Art. 7(17)a): "…paragraph 1 … shall supersede the provisions of the Covered Tax Agreement only to the extent that those provisions are incompatible with paragraph 1"

Interpretation of the treaty GAAR

- The Commentary on Art. 29(9) UN Model quotes the Commentary on Art. 29(9) OECD Model (with an additional example related to the assignment of a contract to avoid having a service- PE)
- The Commentary is clearly relevant to the interpretation of Art. 29(9)

Interpretation of the MLI GAAR

Paragraph 12 of the MLI Explanatory Statement:

Accordingly, the provisions contained in Articles 3 through 17 should be interpreted in accordance with the ordinary principle of treaty interpretation, which is that a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose. In this regard, the object and purpose of the Convention is to implement the tax treaty-related BEPS measures. ***The commentary that was developed during the course of the BEPS Project and reflected in the Final BEPS Package has particular relevance in this regard***.

Thank you

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Part II

- Issue 1: Application of domestic GAAR to abuse of tax treaties
- Issue 2: Combination of domestic/OECD/EU GAARs
- Issue 3: Interpretation of two-step wordings in OECD/UN and ATAD
- Issue 4: Relationship between GAARs and other anti-avoidance rules
- Issue 5: Judicial scrutiny of GAAR application by tax administration

Issue 1(Application of domestic GAARs to abuse of tax treaties)

- Present situation? Does domestic GAAR apply to tax treaties?
- When treaty has OECD-type GAAR provision? Would treaty GAAR rule out the application of domestic GAAR to treaty?
- What if domestic GAAR carries a tax penalty? Could there be a treaty GAAR without penalty and a domestic GAAR with penalty, both applied to abuse of the treaty?
- When pre-BEPS treaty (without treaty GAAR) is applied after BEPS? More likely or not to apply domestic GAAR to fill the gap? Is there an “underlying treaty GAAR” in public international law?

Issue 1(Application of domestic GAARs to abuse of tax treaties)

Finland: The domestic GAAR does apply to tax treaty situations. If the treaty had an OECD-type GAAR, the treaty GAAR takes preference to the domestic one.

Issue 2 (Combination of domestic/OECD/EU GAARs)

- Should tax judges aim at a common interpretation inside each country? Attempt to align interpretation of domestic GAAR + OECD/UN + ATAD, because the wordings are different but the goals are similar? Would simplicity be a valid argument?
- Or should judges apply separate interpretations with three categories of tests, because different scope, different wording, different interpretation tools?
  - Tests for domestic GAAR
  - Tests for OECD/UN GAAR (with OECD/UN Commentaries: what would be the impact of BEPS Action 6 Report and Commentaries on OECD/UN Models?)
  - Tests for ATAD directive, with ECJ case law
- How would non-EU courts react to ECJ « harmonization »?

Issue 2 (Combination of domestic/OECD/EU GAARs)

Finland: In theory there can be different categories of tests, but in practice the field of scope of the domestic GAAR will likely become similar to the ATAD.

Issue 2 (Combination of domestic/OECD/EU GAARs)

- Art 29(9) OECD and UN Models (2017), similar to art 7(1) MLI - Principal Purpose Test

« Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention »

Issue 2 (Combination of domestic/OECD/EU GAARs)

- Anti-avoidance directive (ATAD) 2016/1164 of 12 July 2016, applicable from 1 January 2019 for corporate income tax

Article 6 (General anti-abuse rule):

« 1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality. »

Issue 3: Interpretation of two-step wordings in OECD/UN and ATAD

- Two-step wording:
  - one of the principal/main purposes (step 1 OECD and ATAD);
  - benefit in accordance with the object and purpose of tax treaty/genuine arrangement put into place for valid commercial reasons which reflect economic reality (step 2 OECD and ATAD)
- Taxpayer's purpose :
  - how should the purpose test be applied ?
  - how would tax judges weigh the relative impact of taxpayer's purposes: binary approach (tax vs. non-tax, which is predominant?) or more complex approach? Would the existence of a tax purpose, among other purposes, be enough to deem the arrangement abusive (many taxpayers seem to fear this outcome)?
- Should step 2 in international wordings be seen as an escape clause? With burden of proof on taxpayer?
- Object and purpose of tax legislation and tax treaties: where would tax judges find that? Especially for tax treaties…Would an artificial arrangement likely be against the object and purpose of a tax treaty?

Issue 3: Interpretation of two-step wordings in OECD/UN and ATAD

Finland: The existence of a tax purpose as such does not make the arrangement abusive. However, if the tax benefit is exceptional, there will have to be a lot of evidence on the business reasons.

Issue 4: Relationship between GAARs and other anti-avoidance rules

- Would the rise of GAAR influence the view on the relationship between GAARs and other anti-avoidance rules (SAARs, TAARs, LOB provisions)?
- Would a GAAR apply regardless of the coexistence with such other anti-avoidance rules, because it covers all situations?

Issue 4: Relationship between GAARs and other anti-avoidance rules

Finland: There are situations in which the domestic GAAR may have to be applied in spite of the fact that there is a special anti-avoidance rule

Issue 5: Judicial scrutiny of GAAR application by tax administration

- Would the rise of the GAAR in domestic legislations and international instruments lead to greater judicial deference regarding the use of the GAAR by tax administrations, because of the weight of public interest in fighting tax avoidance?
- Or to greater judicial scrutiny, in order to avoid excessive and subjective tax adjustments?
- Or judicial work as usual?

Issue 5: Judicial scrutiny of GAAR application by tax administration

Finland: Due to the relevance of the EU law the future will have more juridical scrutiny.