Chapter 31

GAARS – STAY AWAY FROM THEM!

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1. THE TRIUMPH OF GAARS

General Anti-Avoidance Rules ('GAARs') are on an unprecedented rise in international tax law. In recent years, many countries have introduced GAARs or at least have seriously considered their creation. Also, the Indian legislators could not resist introducing an anti-abuse rule of a general nature. According to the Indian provision (that came into effect in April 2017), any arrangement could be declared an impermissible avoidance arrangement if its main purpose was to obtain a tax benefit and either is not in line with the arm's length principle, results in the misuse or abuse of provisions of the Indian Tax Act, lacks commercial substance or has no *bonafide* purposes. When the Indian GAAR is applied, the consequences of the arrangement shall be determined in such manner as is deemed appropriate in the circumstances of the case.[1]

This trend towards GAARs has been visible at the international level for some time now. After the EU Commission recommended the introduction of GAARs to its Member States,[2] and proposed such clauses for draft directives[3] or amended

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1. The Indian GAAR is stipulated in Chapter X-A (sec. 95 – 102) of the Indian Income-tax Act 1961.
2. ommission Recommendation of 6.12.2012 on aggressive tax planning, C(2012) 8806 final, pg 4; See Michael Lang, *Direkte Steuern und EU-Steuerpolitik – Wo bleiben die Visionen?*, 22 IStR 365, 367 et seq (2013) for a critical appraisal.
3. See *for example Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)* COM(2011) 121/4, 46, *Proposal for a Council Directive on a Common Corporate Tax Base* COM(2016) 685 final, 48 or *Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax* COM(2013) 71, 28 et seq.

existing directives,[4] the EU inserted a GAAR in its Anti-Tax-Avoidance Directive ('ATAD').[5] According to Article 6(1) of the ATAD, an arrangement shall be ignored when it has "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 ...".

Furthermore, the OECD has (as a result of its BEPS initiative) introduced a GAAR to operate at a tax-treaty level. According to the provision of Article 29(9) of the OECD MC 2017, a treaty benefit shall not be granted "if it is reasonable to conclude ... that obtaining that benefit was one of the principle purposes ...". of the arrangement or transaction. However, this Principle-Purpose-Test (PPT) shall not apply when it is established that "granting that benefit ... would be in accordance with the object and purpose of the relevant provisions..." of the treaty.

I am not going to deal with these specific GAARs, and of course, I would not dare to deal with the details of the abovementioned Indian GAAR. I want to look at the general features of GAARs instead. Since the issue of GAARs is a topical question discussed both on an international level and in India, I hope to have found a topic of interest for this book.

2. THE STRUCTURE OF GAARS

GAARs can be drafted in different ways. They may be quite general or less so. Sometimes they may cover all kinds of taxes, sometimes only specific ones. Occasionally, their application is linked with the competence of a certain authority that has to give approval before a GAAR is applied in a specific case. Sometimes taxpayers who might be covered under a GAAR have access to a specific advance ruling procedure, in order to compensate for uncertainties of the scope of a GAAR.

Most GAARs consist of subjective and objective requirements. They are applicable if the taxpayer had the intention to minimize its tax burden when it arranged its affairs. In addition, the advantage gained by the taxpayer has to be contrary to the object and purpose of the law. Where these requirements are met, the factual situation that had been arranged by the taxpayer is usually ignored. Instead, the tax rules are applied to the situation, which would have been appropriate.

4. See Article 1 of the Council Directive (EU) 2015/121 of 27 January 2015 *amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.*
5. *Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.*

3. THE SUBJECTIVE REQUIREMENT

The subjective criteria can look very different. Not only GAARs but also the case-law of the European Court of Justice ('ECJ') refers to a subjective criterion in cases of abuse.[6] In its judgment in the *Halifax* case, the ECJ requires that for an abusive practice to be found to exist the 'essential aim' of the transactions concerned must be to obtain a tax advantage.[7] This definition was seized upon by the European Commission when it proposed the introduction of a general anti-abuse rule in its recommendation on the fight against aggressive tax planning.[8] Subsequently, it used the same definition in its proposals for the adoption of a directive on the financial transaction tax, and for the amendment to the Parent-Subsidiary Directive.[9] The ECJ, however, did not remain consistent in its terminology and spoke, for instance, of a 'principal aim' in its judgment in the *Part Services* case.[10]

Even the European Commission has changed its terminology from time to time. In Article 80 of its proposal for a directive on CCCTB, the Commission stated that transactions must be "carried out for the sole purpose of avoiding taxation…".[11] The European Parliament voted in favour of withdrawing these requirements and replacing the phrase 'sole purpose' with 'main purpose'.[12] In the proposed directive of a CCTB published in 2016, Article 58 refers to the 'essential purpose'.[13] However, the Interest and Royalties Directive had already referred to the "principal motive or one of its principal motives" in Article 5.[14] Similarly, Article 15 of the Merger Directive refers to the "principal objective or one of its principal objectives".[15] The amended Parent-Subsidiary Directive adopted in 2015 uses the wording "the main purpose or one of the main purposes"[16] and Article 6 ATAD has taken up this terminology.[17] Obviously, this wording makes it easy for tax administrations to assume an abuse.

6. See Michael Lang & Sabine Heidenbauer, *Wholly Artificial Arrangements*, in: Luc Hinnekens & Philippe Hinnekens (eds.), *Liber amicorum in Honor of Frans Vanistendael, A Vision of Taxes within and outside European Borders*, 597, 597 et seq (Kluwer Law International, 2008)
7. ECJ 21 Feb. 2006, (C-255/02), *Halifax*, I-1609, para. 75 (2006).
8. See critical comments on this by Michael Lang, *Aggressive Steuerplanung – eine Analyse der Empfehlung der Europäischen Kommission*, 23 SWI 62, 62 et seq. (2013).
9. See *supra* notes 3 and 4.
10. ECJ 21 Feb. 2008, (C-425/06), *Part Service*, I-897, para. 45 (2008).
11. See *supra* note 3.
12. *European Parliament legislative resolution of Apr. 19, 2012, on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCTB) COM(2011) 0121, C7-0092/2011, 2011/0058(CNS)*, Amendment 28.
13. See *supra* note 3.
14. *Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.*
15. *Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States.*
16. See *supra* note 4.
17. See *supra* note 5.

The PPT in the OECD MC 2017 hits a similar notch. It is by no means required that the 'sole purpose' of the arrangement must consist in obtaining a tax benefit. It does not even have to be an 'essential', 'principal', or even 'main purpose'. Instead, it suffices if *one* of the principal purposes of a transaction is to obtain a benefit.[18] Therefore, the rule assumes that not merely one principal purpose but two or even several principal purposes can exist. So even if the taxpayer succeeds in providing proof that the arrangement it chose is also motivated by reasons other than tax ones, the authorities can respond that, for the anti-abuse rule to apply, it suffices that the taxpayer *also* aimed at the tax benefit. Even if the taxpayer can successfully present his non-tax motives as the principal purpose, this may still not be enough. Since, according to the rule, *several* principal purposes can exist for an arrangement, the accusation of abuse applies even if the taxpayer, apart from one or even several non-tax principal purposes, also aimed at the principal purpose of obtaining a treaty benefit. It remains unclear which criteria must apply in distinguishing between principal purposes and secondary purposes on the one hand, and between different principal purposes on the other.[19]

Although distinguishing between different principal purposes and principal and secondary purposes makes the application of such rules difficult, even identifying just one purpose is not an easy task at all. The difficulty in using such a criterion is obvious – it is impossible to prove a subjective intention.[20] Even if a rule stipulates that 'all relevant facts and circumstances' have to be taken into account, as is the case of the PPT, the explicit objective is to draw conclusions as to the subjective intention of the taxpayers on the basis of such an objective analysis. Subjective criteria can be deduced only on the basis of external facts, yet the truth remains that such motives are impossible to prove.

In such cases, the rules on the burden of proof usually determine the result. If, as part of its official duty of investigation, the *authority* must furnish proof that one of the main objectives of the taxpayer was to obtain the benefit, it is already fighting a losing battle. Vice versa, the *taxpayer* has no chance of fending off the accusation of abuse if it is up to it to furnish evidence that benefiting from one or several treaty provisions was *not* its motive or one of its primary motives.[21]

4. THE OBJECTIVE REQUIREMENT

Most GAARs add a second type of requirement. The GAAR becomes applicable if granting the tax benefit the taxpayer intends to achieve would not be in accordance

18. See Michael Lang, *BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties*, 74 TNI, 655, 659 (2014)
19. *Ibid.*, 659.
20. *Ibid.*, 658.
21. *Ibid.*, 658.

with the object and purpose of the provisions of the tax law. In these circumstances, the tax authorities would look beyond the letter of the law. The taxpayer should not benefit from the fact that formally it would fall under the beneficial law.

For any trained legal expert, it is evident that the object and purpose of legal provisions must always be taken into account in their interpretation.[22] Any interpretation that contents itself with the mere wording of a rule would indeed not correspond to the state of the art of legal methodology. Even those holding the view that the wording of a rule is not just the beginning of the interpretation but also defines its limits have to realize that the wording alone is most rarely so unambiguous as to allow the interpretation of a rule while ignoring its object and purpose. Therefore, the interpretation of all – both favourable and unfavourable – rules must always take into account their object and purpose, and not only when it is assumed that one of the main motives of the taxpayer was to obtain a benefit.

Against this background, however, the question arises as to why, on the one hand, a separate GAAR is required that expressly underscores the relevance of the objective in the interpretation of domestic or treaty provisions while, on the other hand, it seems to attach this to the requirement that the taxpayer is attempting to obtain a benefit from the chosen arrangement. One could be tempted to draw the reverse conclusion and assume for other cases – not explicitly covered by the GAAR – that the object and purpose of the rules have to be ignored in the interpretation of these rules, and that the interpreter must restrict himself to the wording alone.[23] GAARs, therefore, entail the risk of being understood as a positivist interpretation rule, thereby sending us back to the stone age of methodology, and as a deviation from the general rules of interpretation, in which object and purpose of the rules are usually emphasized.

5. LEGAL CONSEQUENCE

If a GAAR is applicable, it seems obvious that the benefit the taxpayer wanted to achieve is denied. But how is the taxpayer treated instead? Many GAARs stipulate that the arrangement has to be ignored. Sometimes it is made explicit that the tax law rules have to be applied to an appropriate factual situation, the situation which would have occurred if the taxpayer had not arranged its affairs to achieve the tax benefit that finally was denied. Even if an explicit statement is lacking in a specific rule, it is in the nature of a GAAR that the tax rules have to be applied to a fictive situation: The tax authorities have to put aside the real factual situation and apply the law to a fictive situation instead.

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22. *Ibid.*, 661.
23. *Ibid.*, 661.

It goes without saying that this is always highly problematic. One can never be certain what the taxpayer would have done if it had known that the tax administration was not going to grant the intended benefits. Would it have done nothing, or would it have arranged its affairs in such a way that it would receive a treatment closer to the one it tried to achieve? If there are several different options, which one would it have chosen? Even the taxpayer might find this question daunting. It is even more difficult for the tax authority to determine on *which* fictive situation it should base the assessment.

Quite often, it is also difficult, or even impossible, to ascertain in which circumstances the tax authority should stop looking at the fictive situation and take again the real situation as a basis for the tax assessment. Let us assume that, according to the rules of a certain tax system, capital gains are only taxable if a taxpayer holds more than 25% of the shares in a corporation. In this example, a taxpayer owns 60% of the shares of a corporation. In order to sell the shares tax exempt, he gives 40% of the participation to his wife, so that he can sell the remaining 20% untaxed. The tax authority considers this to be abusive, and the GAAR is applied. The tax authority levies the tax on the assumption that the taxpayer was still the 60% shareholder. Therefore, capital gains taxation is triggered on the alienation of the 20% shareholding. Let us assume that the taxpayer's wife sells the 40 % participation many years later: Who is taxable? His wife or the taxpayer himself? Or, let us assume the taxpayer dies: Is the fiction relevant for inheritance tax purposes as well? Does his death trigger inheritance tax on the 40% participation, which under private law is owned by his wife and which remains her property? And if the wife dies: Does this mean no inheritance tax is levied on her 40% participation because, for tax purposes, these shares are still deemed to be her husband's property? Whenever the tax authority applies a GAAR and therefore assesses the tax on the basis of a fictive situation, it is completely unclear how long taxation has to be based on the fiction and when one has to return to reality.

6. CONCLUSION

For understandable reasons, in many countries companies have only put up a cautious resistance to a GAAR, resistance which is often directed primarily against its proposed design,[24] but not against the GAAR as such. Many companies obviously assume that a careful design of their arrangements allows them to dispel the impression that an envisaged tax benefit was given priority in the planning of a transaction.[25] The resulting

24. See the numerous and partly detailed statements in OECD, Comments Received on Public Discussion Draft, *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (2014).
25. See *supra* note 18, 663.

additional effort required for tax planning, in turn, is more beneficial to consultants. If they succeed in dispelling the suspicion that obtaining a benefit was a principal purpose or one of the principal purposes, whatever the criterion is, companies and consultants can, on the basis of such a rule, hope all the more to rely on the mere wording of the tax provisions for their tax planning considerations and to ignore the object and purpose of the rules that could pose an obstacle to their envisaged success.

It is precisely for this reason that GAARs are detrimental to legal culture.[26] In cases where it is not certain whether an arrangement chosen by a taxpayer is covered by a tax provision, GAARs will encourage legal practitioners not to question the meaning of the tax provision but to apply a vague provision as a GAAR instead, which seems to make it possible to assess the facts on the basis of the practitioner's legal instinct and not on the relevant legal provisions. *Vice versa*, authorities and courts will be tempted in other cases – viewed as not problematic – to restrict themselves to the – only allegedly – clear wording and to ignore the question of the object and purpose of the legal provisions. The application of the law, however, will eventually be impoverished if it limits itself to the "primitive positivism of the naked word".[27]

The late German Supreme Court judge Ludwig Schmidt, on the basis of the example of the anti-abuse provision of Section 42 German Tax Code, aptly pointed out that a good lawyer never needs to apply an anti-abuse rule,[28] since he will, after all, look beyond the letter of the law and take into account its object and purpose. A weak lawyer, on the other hand, will thankfully clutch at the straw that general anti-abuse rules seemingly offer. He will thus hope to avoid the often painstaking and demanding examination of the object and purpose of the actually, or only allegedly, circumvented rule by resorting to a rule that ostensibly allows him to replace the interpretation of the law with his subjective sense of justice. In his closing arguments in *Cartesio*, former Advocate General Poiares Maduro, in reference to *Gutteridge* described the abuse of rights principle as "a drug which at first appears to be innocuous, but may be followed by very disagreeable after effects".[29] Tax legislators should stay away from them![30]

26. See *supra* note 8, 67.
27. Walter Antoniolli, *Gleichheit vor dem Gesetz*, 11 ÖJZ, 646, 647 (1956).
28. See Wolfgang Schön, *Ludwig Schmidt (1928-2011)*, 93 FR, 1125, 1125 et seq (2011).
29. Opinion of the Advocate General Maduro of May 22, 2008, *Cartesio Oktató és Szolgáltató bt* (C-210/06) [2008], I-9641, point 55 with reference to H.C. Gutteridge, *Abuse of Rights*, 5 Cambridge Law Journal, 22, 44, (1933-1935).
30. On the EU Recommendation, see *supra* note 8, 68.