Tax Insights
from Tax Controversy and Dispute Resolution

Recent global developments in general anti-avoidance rules

October 14, 2016

In brief

General anti-avoidance rules (GAARs) continue to play a pivotal role in tax regimes around the world as a safeguard intended to thwart incidents of tax avoidance. While differing in various aspects, the tax laws of many countries have adopted generally similar principles to empower revenue authorities to deny taxpayers the benefits sought for arrangements deemed to have an impermissible tax-related purpose.

Below we examine key legislative, judicial, and administrative developments with respect to GAARs that are operative, or soon to be operative, across a number of jurisdictions, in particular:

- Australia
- Canada
- China
- European Union (EU)
- India
- The Netherlands
- New Zealand
- Poland
- United Kingdom (UK)
- United States of America (US).

Although some of these regimes have been in place for a considerable length of time, uncertainty persists in relation to the scope of the GAAR's application, interaction with specific anti-avoidance rules (SAARs), and application in a treaty context. This uncertainty presents significant difficulties for taxpayers seeking to obtain assurance on the appropriateness of their filing positions and creates substantial risk with respect to the potential for future adjustments and associated penalties in the event of later challenge.

With the advent of the OECD's Base Erosion and Profit Shifting (BEPS) project and the increased desire of governments to curtail the erosion of their domestic tax base, GAARs are set to play an even greater role in future compliance enforcement. As noted in our Tax Insight dated October 4, 2016, the OECD has vigorously advocated the need for expanding the prevalence and application of legislative GAARs to address avoidance behaviors in a treaty context. This, in turn, has led to the EU calling for member states to uniformly adopt a minimum standard domestic GAAR as part of a raft of proposals aimed at tax avoidance.

Multinational companies seeking to operate an effective global tax governance regime should understand the current developments in this area and be prepared to address the future application of GAARs, particularly when transacting cross-border.

In detail

AUSTRALIA

Background

Since its introduction in 1981, Australia's GAAR, located in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936), has operated as an effective means to challenge arrangements that are deemed to be entered into with an impermissible Australian tax motivation.

The significant number of cases elevated for judicial review has contributed to a developed understanding of how and when Part IVA should apply. Despite this, the complexities with certain elements of the regime — and the critical importance of supporting evidence to the conclusions called upon — mean the GAAR often is a difficult area to both navigate and advise upon.

Following a series of decisions in the Australian Federal courts in 2010 and 2011, the Government enacted a number of legislative modifications to address 'technical deficiencies' that were considered to detract from the Part's effective operation (the 2013 Amendments).[1]

The 2013 Amendments primarily focused on the 'tax benefit test,' being one of three components needed to be satisfied before the GAAR may apply. However, the accompanying guidance materials also suggest an intention to change the sequence of when each component necessarily is addressed.[2] While this later objective presents some conceptual difficulties, it reflects the clear desire of the Government to return the 'dominant purpose test' as the key component, or indeed 'the fulcrum,'[3] upon which the application of Part IVA turns.

For further background on the 2013 Amendments, and the decisions that precipitated their introduction, please refer to our prior Tax Insight dated May 24, 2013.

Subsequent to enactment of the 2013 Amendments, the Australian courts have decided a number of additional cases that concern arrangements (schemes) relating to the pre-amendment period.

These cases have served to contribute to an understanding on other aspects of the GAAR's operation — in particular:

- How Part IVA can apply to schemes involving Australia's tax consolidation regime; and
- How the 'dominant purpose test' applies to schemes that achieve a tax benefit in conjunction with a broader economic benefit for the taxpayer involved.

Commentary on the background and corresponding impact of these recent decisions follows below.

Basics of the legislative regime

For a Part IVA determination to be engaged, three principal elements must exist:

- A scheme must be identified;
- The scheme must give rise to a tax benefit for a taxpayer; and
- The sole or dominant purpose of one or more parties to the scheme was to obtain that tax benefit for that taxpayer.

Scheme

Broadly, a scheme may encompass any action (unilateral or otherwise) and may include only part of a wider transaction that takes place. See s 177A of ITAA 1936.

Tax benefit

For Part IVA to apply, it must be found that a taxpayer's conduct in connection with a scheme results in a favorable tax outcome being achieved (e.g., a lesser amount included in assessable income or a greater deduction afforded) and that such an outcome 'would' or 'might reasonably be expected' not to have occurred in the absence of the scheme. See s 177C(1) of ITAA 1936.

By its very nature, the test calls upon a comparison of the taxpayer's actual conduct (the scheme) against the conduct otherwise expected to have occurred (the alternate postulate).

Sole or dominant purpose

Where a taxpayer obtains a tax benefit in connection with a scheme, one must determine the purpose of the parties to the scheme. If any party is found to have participated in the scheme for the sole or dominant purpose of enabling either itself or another taxpayer to obtain the tax benefit identified, Part IVA will apply to cancel that tax benefit.

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[1] *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*

[2] Explanatory Memorandum to *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013,* paragraphs 1.122 – 1.125

[3] *Commissioner of Taxation v Hart* (2004) 217 CLR 216 at [92], per Callinan J

The conclusion required is made on an objective basis having regard to eight specified factors for consideration. See s 177D(2) of ITAA 1936.

Impact of recent court findings

'Macquarie Bank Limited' and 'Channel Pastoral Holdings'

Under Australia's tax consolidation regime, certain entities may be 'grouped' and treated for all purposes as a single taxpayer. Where applicable, the regime effectively treats all Australian subsidiaries that join a consolidated group as thereafter being part of the Australian parent (it being the one recognised taxpayer that fulfils all compliance obligations on behalf of the group).

The decisions in *Macquarie Bank Limited*[4] and *Channel Pastoral Holdings*[5] examined the application of Part IVA in the context of the tax consolidation regime.

On both occasions, the schemes concerned subsidiary entities (MALLC and CCC, respectively) joining a consolidated group and then immediately disposing of a major asset. It was acknowledged that had those disposals been made at a time prior to joining the respective consolidated groups, both MALLC and CCC (as stand-alone, individual taxpayers) each would have been subject to a significant capital gains tax liability.

The major issue before the courts was whether on either occasion there was a tax benefit capable of cancellation due to the interaction of Part IVA and tax consolidation. The complexity surrounded the Commissioner's identification of the alternate postulates and, in turn, the appropriate entity upon which any determination would be served in the event that Part IVA applied in either scenario.

In both cases the Commissioner's alternate postulate alleged that, absent the schemes, both MALLC and CCC would have made the disposals as stand-alone taxpayers (i.e., not as members of a consolidated group). By adopting such an approach, the court held in each of these cases that it could not be established that either of the Australian parents of the consolidated groups had themselves obtained a tax benefit. This was because neither parent would have had a greater amount included in their assessable income under a postulate that proposed the disposals being made at a 'pre-joining' time.

While this effectively foreclosed a Part IVA determination being imposed upon the Australian parent entities, the Full Federal Court in *Channel Pastoral Holdings* (by split decision) held that, despite the 'grouping' impact of tax consolidation, CCC (as a subsidiary member) nonetheless had obtained a tax benefit in accordance with the statutory criteria and was itself capable of receiving a Part IVA determination to cancel that tax benefit.

Observation: Although questions remain with respect to the technical approach adopted, these findings would appear consistent with the desire for tax consolidation to not wholly immunise a scheme against the potential application of the GAAR.

While taxpayers now are on notice that schemes involving the interaction of tax consolidation may, on occasion, come within the ambit of Part IVA's reach, it should be remembered that any successful Part IVA determination necessarily must "be consistent, in all material respects, with the postulate upon which that determination is predicated...." In this respect, the identification of the offending scheme and the alternate postulate remain of paramount importance for identifying a tax benefit that ultimately may be subject to cancellation.

'Orica Limited'

The recent decision in *Orica Limited*[6] required the Federal Court to examine the potential operation of Part IVA to a scheme that resulted in a commercial benefit together with an Australian tax benefit. The case focused exclusively on the 'dominant purpose test.'

The context to the dispute surrounded a large amount of accumulated tax losses in Orica's US Group and their inability to be recognised as a deferred tax asset (DTA) on Orica's consolidated balance sheet. The DTA could not be recognised until it was 'virtually certain' that the US Group would generate sufficient taxable income to utilise those losses accumulated.

As a result, the taxpayer explored options whereby the DTA could be recognised by generating a stable stream of assessable income into the US Group. Orica considered that having the DTA recognised would result in an increase in its consolidated profits and

[4] *Commissioner of Taxation v Macquarie Bank Limited* [2013] FCAFC 13

[5] *Channel Pastoral Holdings Pty Ltd v Commissioner of Taxation* [2015] FCAFC 57

[6] *Orica Limited v Commissioner of Taxation* [2015] FCA 1399

correspondingly improve investor perceptions, increase its share price, and reduce the risk of a hostile takeover.

The scheme ultimately enacted involved:

- Orica's Australian Treasury company (OFL) making a AUD 590 million interest-bearing loan to another member of the Australian Group (OCI) which held a direct shareholding in the US Group;
- OCI applying those borrowed funds to make a preference share investment in the US Group; and
- The US Group using those proceeds to both repay outstanding interest-bearing loans owed to OFL and to place funds on deposit (at interest) with OFL.

From an Australian tax perspective, the scheme effectively resulted in the Australian Group claiming a deduction for the interest incurred on the newly placed deposit and receiving non-assessable dividends on the preference share investment.

From a US tax perspective, the scheme resulted in the US Group including the interest derived on the deposit in its assessable income, utilising its accumulated losses to absorb that income, and claiming no deduction for dividends paid on the preference shares.

While the court agreed that the scheme ultimately had the effect to recognise the DTA and, in turn, result in a cumulative increase in Orica's consolidated profit, the means by which it was achieved were considered of paramount importance. Notably, the scheme impacted consolidated profit in the following manner:

- It reduced profits by increasing income tax expense referrable to the assessable US interest income;
- It increased profits by an equivalent amount upon recognising the DTA; and
- It increased profits by reducing income tax expense referrable to the Australian interest deduction.

While the scheme's overall commercial objective was achieved through a combination of the above, the court held that the Australian deductions were 'an essential element' by virtue of the other two effectively neutralising each other.

Having regard to the eight factors, the court considered the dominant purpose of the parties to the scheme was to obtain a tax benefit for the Australian Group, meaning Part IVA applied. The Court reached such a conclusion because, in its view, there "would have been no point to utilise the losses in the [US] by the creation of internally generated income without a corresponding benefit to the group: the use of the US tax losses in the US was commercially valuable to the Orica Group because its economic effect was enjoyed through the tax deductions in Australia."

Observation: Overall, the 'Orica' case serves as another example of where the Australian courts have had to assess and evaluate the tension between a scheme's commercial benefits and the tax benefits that are produced in conjunction thereto. This difficult balancing act was held, in this instance, not to be in the taxpayer's favor. Going forward, all taxpayers should be prepared for an increased focus on the commerciality of their chosen arrangements (both from an individual entity and 'whole of group' perspective), particularly where a wholly internal transaction also gives rise to a beneficial Australian tax outcome.

CANADA

Background

The Supreme Court of Canada (SCC) has articulated that a high threshold must be met for Canada's GAAR to be applied to override the normal operation of federal tax legislation and treaties. The GAAR cannot be applied unless the Minister satisfies its burden to prove "that there was abusive tax avoidance in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer."[7] Whether the GAAR can be applied requires "an objective, thorough and step-by-step analysis."[8]

Despite the high threshold articulated by the SCC, and the fact that Canada's GAAR has been in place since 1988, there remains considerable uncertainty in many respects, including:

- The interaction between the GAAR and SAARs; and
- The application of the GAAR in the treaty context.

Below is an update on recent developments regarding these uncertainties associated with the regime, together with an update on

[7] *Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54 para 66*

[8] *Copthorne Holdings Ltd. v. Canada, 2011 SCC 63 para 68*

some specific SAARs, how they interact with the GAAR, and observations concerning the extent to which the Canadian courts have allowed the GAAR to fill the 'legislative gap' on specific issues.

Also below is additional detail on some administrative aspects to the GAAR, including the likelihood of the Commissioner being forthcoming with the basis for applying the GAAR during audit, and some current proposals to enhance taxpayer disclosure for certain transactions.

Interaction between the GAAR and SAARs to date

Issues persist in relation to the interaction of the GAAR and the various SAARs that operate under Canada's domestic law.

The Canadian tax authorities have repeatedly attempted to expand the GAAR into the realm of domestic SAAR regimes. There have been divergent views as to how the separate regimes are intended to operate. Historically, the Canadian Revenue Agency (CRA) has considered that the GAAR may apply in circumstances where a SAAR has been circumvented or frustrated as a result of taxpayer conduct, or where taxpayers succeed in using SAARs to their advantage in order to obtain a tax benefit that may not have been contemplated by the legislators.

Observation: Administering the GAAR in this manner has drawn considerable criticism from the tax community, which has expressed concern with the inherent uncertainty this approach creates. In addition, the courts generally have been reluctant to apply the GAAR to back-fill a 'legislative gap.' Despite this, the CRA continues to test the bounds of the GAAR's application in circumstances where taxpayers manage to avoid the application of SAARs or where they use SAARs to derive a tax benefit that was not contemplated as a result of deliberate and measured conduct.

Where the CRA has challenged taxpayers' transactions both on the basis of a particular SAAR and, as an alternative, using the GAAR, the courts generally have applied the more specific SAAR in practice. Moreover, despite the CRA's effort to apply the GAAR on the misuse or abuse of some broad, general tax policy, the courts generally have preferred an approach that focuses the GAAR analysis upon the direct policy underlying the particular tax provision at issue.

How will newly introduced SAARs interact with the GAAR?

The Government continues to add to the prevalence of SAARs under the Canadian domestic law and recently has:

- Introduced a new SAAR — a corporate loss trading rule to counter transactions that seek to avoid the restrictions on the deductibility of losses in an arm's-length acquisition of control of a corporation; and
- Added to the application of an existing SAAR — extending the thin capitalisation rules to partnerships, trusts that are residents in Canada, and Canadian branches of non-resident corporations and trusts.

In relation to the former, the new SAAR will deem an acquisition of control to have occurred where a person or group of persons acquire shares that represent more than 75 percent of the fair market value of all the shares, and where it is reasonable to conclude that one of the main reasons *de jure* control was not acquired was to avoid the loss restriction rules. To the extent a transaction is entered into with a purpose of circumventing the new SAAR, it is expected that the CRA will continue to try to invoke the GAAR to challenge such transactions based on an assumption that there is a general policy against arm's-length 'loss trading.'

With respect to loss utilization transactions, the CRA previously voiced its intention to challenge a broad range of transactions using the GAAR, but appeared reluctant to do so following the decision in *Duha Printers (Western) Ltd. v. R.,* [1998] S.C.J. No 41, where the SCC confirmed that in the absence of an acquisition of legal control, a taxpayer's entitlement to use losses incurred in prior years is unrestricted. The CRA was successful in one 'loss utilization' case in *Birchcliff Energy Ltd. v. R.,* 2015 TCC 232; however, the Court did not address the policy issue and instead relied on a narrow deeming rule that may apply on an amalgamation. This case is under appeal to the Canadian Federal Court of Appeal.

In relation to the changes to other existing SAARs (the extension of the thin capitalisation regime), the rules essentially operate to close a gap in the Act to which the GAAR, in all likelihood, nevertheless could not apply. Despite this, it remains to be seen whether the CRA will be deterred from using the GAAR in future circumstances where an abuse is alleged to have occurred in relation to the proposed new rules.

Application of the GAAR to treaty benefits

A further element of uncertainty persists in relation to the able and effective operation of the GAAR to counteract benefits obtained under international tax treaties. Canada amended its GAAR in 2004 with retroactive effect to expressly apply the GAAR to deny benefits otherwise available under Canada's tax treaties. Whether the GAAR could have applied to override tax treaties prior to this legislated amendment was unclear.

So far, the CRA largely has been unsuccessful in using the GAAR to challenge residence-based treaty shopping.[9] It also has been unsuccessful in its attempts to counter treaty shopping by attacking matters of beneficial ownership.[10]

Despite this, the Canadian government continues to be proactive in seeking to address a legislative solution to treaty shopping. A government consultation process led to the tabling of a number of proposals in 2013, but which were subsequently shelved pending the outcome of the OECDs BEPS project. Despite the release of the OECD's recommendations in October 2015, the Canadian Department of Finance has not indicated whether it intends to pursue the previously announced measures.

Have courts allowed the GAAR to fill a 'legislative gap'?

Historically, the Canadian courts have been reluctant to find that the GAAR should be used to fill a legislative gap in cases where the rules are clear and of a long-standing nature. [11] This also generally is the case where the provisions are very complex and a choice can be considered to have been made by the legislators as to when the rules do and do not apply.[12]

In its most recent GAAR ruling in *Copthorne Holdings Ltd. v. R.,* [2011] 3 S.C.R. 721, the SCC confirmed that the very nature of a GAAR meant that it was intended to apply where the legislation did not otherwise prevent the tax outcome from being achieved. The court further confirmed the principles established in its earlier seminal GAAR decision, *Canada Trustco Mortgage Co. v. R.,* [2005] S.C.J. No. 56, that determining whether a transaction is abusive must be founded upon a consideration of the scheme of the Act rather than any moral judgment of the appropriateness of the taxpayer's actions in using the provisions in a creative way. Despite this, on the facts of that case, the GAAR was found to apply to certain transactions in which the taxpayer's paid-up capital (PUC) (which the Act permits to be returned to non-resident shareholders free of withholding tax) was found to have been duplicated in an abusive manner, notwithstanding that as a technical matter the planning was effective.

Despite the reluctance of the courts to apply the GAAR to close legislative gaps in complex and technical rules, the SCC recently refused to hear several Federal Court of Appeal decisions in which the court had found that despite the non-application of certain stop-loss rules as a technical matter, the taxpayer's conduct created an unduly artificial loss that was abusive in nature. Overall, the current state of play is cause for taxpayers to remain vigilant concerning the possibility of the CRA further testing the bounds of the GAAR's application.

Is making a decision an 'avoidance transaction'?

In *Spruce Credit Union v. The Queen*, the Minister sought to apply the GAAR to deny a deduction applicable to dividends thereby excluding the dividends from taxable income. The Minister asserted that the decision to pay dividends, which were not taxable, rather than issuing a refund of premiums, which were fully taxable, gave rise to avoidance transactions. In contrast, the Tax Court found that "the act of choosing or deciding between or among alternative available transactions or structures to accomplish a non-tax purpose, based in whole or in part upon the differing tax results of each, is not a transaction." The Tax Court also stated that tax considerations may play a primary role in the choices a taxpayer makes without the chosen transaction being primarily tax motivated. The Tax Court decision was upheld by the Federal Court of Appeal.

Recent changes to the GAAR's administration

Disclosing the basis of a GAAR assessment upon audit

A recent procedural motion is of particular interest to the changing GAAR landscape in Canada.

In *Birchcliff Energy Ltd. v. R*, 2012 Carswell Nat 5540, the Tax Court of Canada dealt with a demand by the taxpayer under that court's rules for particulars of the Minister of National Revenue's allegations of abuse or

[9] *R. v. MIL (Investments) S.A., 2007 FCA 236 (Federal Court of Appeal)*
[10] *Prévost Car Inc. v. R., 2009 FCA 57 (Federal Court of Appeal)* and *Velcro Canada Inc. v. R, 2012 DTC 1100 (Tax Court of Canada)*
[11] *Lehigh Cement Ltd. V. R., 2010 5 CTC 13 (FCA)*
[12] *Landrus v. R., 2009 4 CTC 189 (FCA)*. However see *Birchcliff*, discussed above, currently under appeal to the Federal Court of Appeal

misuse of 10 sections of the Act. The court ultimately found in favor of the taxpayer, ruling that the taxpayer was entitled to know what assumptions the Crown had relied on in issuing the subject reassessment. This decision then meant that the Crown had to expressly disclose its view of the policy underlying each provision of the Act relied upon to assess the taxpayer.

Observation: While the exact administrative impact of this decision remains unclear, the increased disclosure requirements may encourage the CRA to be more forthcoming about the basis of a GAAR assessment during an audit or during the review of a Notice of Objection at the internal CRA Appeals levels.

Governments seeking enhanced disclosure

More jurisdictions across Canada are looking at mechanisms for enhanced disclosure of transactions considered to constitute aggressive tax planning or tax avoidance. The Province of Quebec was the first to adopt such requirements, followed by somewhat different federal measures in the 2010 Federal Budget.

The federal reporting rules have, as their main objective, the identification of certain types of potentially abusive tax avoidance transactions that otherwise are not subject to any specific information-reporting requirements under the Act. Under the regime, a transaction is reportable if it is an avoidance transaction (as defined under the GAAR), or if it is a transaction that is part of a series of transactions that includes an avoidance transaction and if at any time two of the following come into existence:

- An advisor or promoter is entitled to a fee in relation to the avoidance transaction or series of transactions that includes the avoidance transaction.
- An advisor or promoter obtains confidential protection in respect of the details or structure of an avoidance transaction or series of transactions that includes the avoidance transaction.
- An advisor, promoter, or person who entered into an avoidance transaction or series of transactions has contractual protection in respect of the avoidance transaction or series, otherwise than as a result of a fee.

This reporting regime provides a due diligence defence for persons who could be subject to the reporting requirements. The federal rules apply in respect of avoidance transactions that are entered into after 2010, as well as to avoidance transactions that are part of a series of transactions that commenced before 2011 and are completed after 2010.

Canada's role in the BEPS project

Like many other countries, the Canadian government continues to be engaged in the broader global dialogue on addressing the complexities of BEPS. Given Canada's role as an active participant in the global discussions taking place on BEPS, we expect increased scrutiny with respect to cross-border transactions to continue. The role of the GAAR remains unclear as part of the CRA's response. However, the CRA is likely to increase its enforcement capabilities in this area and appears likely to do so through the increased use of its GAAR where considered appropriate.

CHINA

Background

The GAAR was introduced into the Chinese Corporate Income Tax (CIT) Law effective 1 January 2008. Pursuant to the CIT Law, the Chinese tax authorities have the right to adjust and impose tax on arrangements entered into by an enterprise that is without reasonable commercial purpose and that results in an elimination, reduction, or deferral of taxable income.

Expanding scope of the GAAR

To date, the main focus of the Chinese GAAR has been to counteract the indirect transfer of Chinese companies by non-residents through the disposal of interposed offshore companies (so-called 'offshore indirect equity transfers').

In 2009, the China State Administration of Taxation (SAT) issued a circular Guoshuifa [2009] No.698 (Circular 698) addressing the use of such arrangements as a means by which taxpayers may avoid Chinese withholding tax on the transfer gain. While Circular 698 was not written as a specific GAAR measure, it served to give rise to a reporting requirement such that the Chinese tax authorities then might receive relevant information and assess whether to invoke the GAAR in relation to an offshore indirect equity transfer.

In circumstances where the GAAR is invoked, the Chinese tax authorities might look through the intermediate holding company and re-characterize the gain on disposal as Chinese-sourced to apply a withholding tax that otherwise would not apply. This administrative stance has wide-spread impact as non-residents may invest into China via a foreign intermediate holding company, sometimes without a clear commercial purpose and/or without economic substance in doing so.

In February 2015, the SAT released Public Notice [2015] No. 7 (Public Notice 7) to supersede Circular 698. Public Notice 7 introduces a new tax regime that differs significantly from that under Circular 698. It widens the scope of the Chinese GAAR to cover not only offshore indirect equity transfers, but also transactions involving either the transfer of immovable property in China or the transfer of assets held under the establishment and place in China by a foreign company via an offshore transfer of a foreign intermediate holding company.

Overall, Public Notice 7 is seen as an improvement over Circular 698 because it offers clearer guidance concerning the criteria and features of tax avoidance schemes in addition to providing more practical reporting procedures for foreign parties to comply, and requires more stringent processes for Chinese tax authorities when examining and assessing the GAARs potential application.

More stringent procedural guidelines

To apply the GAAR in a more consistent and transparent basis, in December 2014 the SAT released the Administrative Measures on the GAAR (the Measures) in the form of SAT Order No.32. The Measures provide comprehensive guidance on the implementation of the GAAR, including an elaboration on certain key principles, adjustment methods, procedures throughout the GAAR lifecycle, and relevant documentation requirements.

In the Measures, the characteristics of a 'tax avoidance scheme' are considered satisfied where:

- The sole or main purpose of the tax arrangement is to obtain a tax benefit; and
- The tax benefit is obtained via an arrangement whose form is permitted in accordance with the tax rules, but is not consistent with its economic substance.

Both the 'purpose test' and 'substance test' therefore must be assessed when determining whether a tax avoidance scheme exists. Consequently, multinationals must take both considerations into account when planning or reviewing their Chinese investment structures, and further, prepare and retain detailed documentation recording the rationale and economic substance of the chosen structure in seeking to withstand any potential GAAR challenge.

The Measures are intended to provide sufficient guidance to ensure a transparent, fair, and consistent procedural framework for the GAAR's operation. They also reflect the SAT's position and approach that the GAAR would be taken as the last resort to counter aggressive cross-border tax avoidance schemes, rather than a general means to increase China's tax collection. Indeed, the SAT has since reaffirmed that it is only where the tax benefits arising from a tax arrangement cannot be eliminated through the application of SAARs that tax authorities then may initiate a GAAR investigation and potential GAAR adjustment.

Prudent application of GAAR to challenge cross-border tax avoidance schemes

Although the GAAR provision under the CIT Law does not distinguish the application of the GAAR between domestic and cross-border arrangements, the Measures state that the GAAR shall only apply to cross-border arrangements.

While to date, the Chinese authorities have mainly used the GAAR in the context of offshore indirect equity transfers, they appear to have taken a more prudent approach in not seeking to aggressively invoke the GAAR to other types of cross-border schemes in light of the stringent reporting processes already in place and the high standard of proof prescribed within the GAAR Measures. Despite this, in light of the growing international concerns with BEPS, it remains to be seen whether the Chinese tax authorities will seek to use the GAAR more extensively moving forward.

GAAR principle to be introduced in other tax rules?

In recent years, there have been a number of reported cases where the Chinese local-level tax authorities challenged an offshore indirect transfer of a Chinese company by foreign natural persons and consequently collected Individual Income Tax (IIT) in China. The current IIT Law does not contain a GAAR provision that otherwise would offer a legal basis to challenge such transactions. Nonetheless, Chinese local-level tax authorities may escalate their effort in investigating and scrutinising similar cases in the future. Moreover, it remains to be seen if the IIT Law, which currently is under amendment, will introduce the GAAR principle in the near future.

Key observation

While the scope of the Chinese GAAR application is still developing, there is an increasing need for multinationals operating or investing in China to review and take into account its potential operation to their contemplated structures.

European Union

Background

On 28 January 2016, the EU Commission (EC) presented the second draft of its European Union (EU) Anti-Tax Avoidance Package (ATAP). The ATAP consists of a series of proposed measures designed to prevent aggressive tax planning, increase tax transparency, and "create a level-playing field of minimum protection for all Member States' corporate tax systems."[13]

One component of the ATAP was an anti-tax avoidance (ATA) Directive containing six elements to target tax avoidance practices that the EC believes directly affect the functioning of the internal market. Notably, one element proposed to establish a minimum standard corporate tax general anti-abuse rule across each of the 28 EU Member States.

Although the EC's Explanatory Memorandum noted that the ATA Directive is partly a response to the OECD's BEPS project, a number of its elements (including the GAAR proposal) go beyond the BEPS recommendations. Note: Some EU countries are not members of the OECD or G20.

Implementing a GAAR in the EU

Under EU law, individual Member States retain sovereign legislative power in respect of direct taxation. Consequently, harmonisation in respect of corporate tax throughout the EU generally is possible only if there is a unanimous consensus by the Economics and Financial Affairs Council (ECOFIN), where each of the 28 Member States vote in favor of the directive in question.

A compromised version of the ATA Directive was approved on 20 June 2016, albeit retaining the minimum standard corporate tax GAAR proposal as initially envisaged. Consequently, the ATA Directive will now be submitted to a forthcoming Council meeting for formal adoption.

As a result of this latest development, all Members States will be required to adopt measures to implement a compliant GAAR into their domestic laws by 1 January 2019. Other aspects of the ATA directive enable an expanded timetable for adoption.

Operation of the proposed GAAR

The EC has proposed that all Member States adopt a principles-based GAAR to counteract tax avoidance that would apply both between Member States and between a Member State and non-Member State.

Broadly, the GAAR will allow tax authorities to disregard arrangements where the essential purpose is to obtain a tax advantage that defeats the object or purpose of a tax provision of a Member State and where the arrangements are considered to be non-genuine.

While advocating adoption of a broadly uniform corporate tax GAAR by each Member State, the EC recognises the need for flexibility in appropriate circumstances.

The EC provides the following explanation of how the EU GAAR would work in practice:

"This Directive aims to achieve a balance between the need for a certain degree of uniformity in implementing the BEPS outputs across the EU and Member States' needs to accommodate the special features of their tax systems within these new rules. The text thus lays down principle-based rules and leaves the details of their implementation to Member States, on the understanding that they are better placed to shape the precise elements of the rules in a way that best fits their corporate tax systems."[14]

In crafting its model GAAR, the ATA Directive suggests that an arrangement (or series of arrangements) shall be regarded as non-genuine to the extent they are not put into place for valid commercial reasons that reflect economic reality.

While the ATA Directive will require a minimum standard GAAR to be enacted, it does not, however, prohibit adoption of other specific anti-avoidance rules designed to give greater protection to a Member State's corporate tax base.

Impact for companies operating within the EU

The proposals contained within the approved ATA Directive will be the first real step toward Member States harmonising their approach to counteracting corporate tax avoidance.

Observation: Given that the GAAR is a principles-based framework that can be applied equally across the EU, uncertainty is likely to remain around how the Directive will work in practice until such time that it is ultimately enacted into law by Member States. Evaluating the Directive's effectiveness will take even longer.

[13] European Commission, *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functions of the internal market*, released in Brussels on 28 January 2016, page 4.

[14] European Commission, *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functions of the internal market*, released in Brussels on 28 January 2016, page 4.

INDIA

Background

Since its incorporation into domestic law in 2012, the Indian GAAR has occasioned much controversy and conjecture. As a result, the Indian Government constituted an expert committee (the Committee) to consult and advise on amendments. At its conclusion, the Committee made several pragmatic suggestions through a Press Release issued on 14 January 2013.

Many of the suggestions from the Committee have since been accepted by the Government and the majority incorporated into law by the Finance Act 2013.

Details regarding the major developments to the GAAR follow below.

Date of commencement

The commencement date for the GAAR has been deferred on several occasions and now will come into effect from the tax year beginning 1 April 2017.

The decision to defer GAAR's introduction was based on several concerns remaining on certain aspects of the regime proposed. Furthermore, as India was an active participant in the OECD's BEPS project, it was considered desirable that the GAAR be implemented as part of a comprehensive legislative package at a time after the BEPS project had been finalised.

The scope of the GAAR

The Indian GAAR is limited in its application and will apply only to an arrangement that may be declared an impermissible avoidance arrangement (IAA) and that satisfies at least one of the four tainted element tests (one being a lack of economic substance).

Under the earlier version of the GAAR, an arrangement could be declared an IAA if 'the main purpose or one of the main purposes' was to obtain a tax benefit. The current amended version now limits an IAA to only those arrangement where 'the main purpose' is to obtain a tax benefit.

An arrangement will be deemed to be lacking commercial substance if the arrangement does not have a significant effect upon the business risks or net cash flows of any party to the arrangement (apart from the tax benefit). The assessment is made having regard to a number of listed factors for consideration.

To what arrangements will the GAAR apply?

Under the Indian GAAR, an arrangement is widely defined to include any step in, a part of, or the whole of the arrangement. Therefore, if any discrete part of the arrangement has the main purpose of obtaining a tax benefit, but the main purpose of the arrangement as a whole is commercial, the relevant test still may be satisfied. In circumstances where only part of the arrangement is declared an IAA, the tax consequences of invoking the GAAR, however, will be limited to only that offending portion of the arrangement entered into.

Notably, there also are a number of safe harbor provisions that preclude certain arrangements from coming within the scope of the GAAR. A safe harbor exists where the quantum of the tax benefits are below a de minimis level or where the arrangement involves certain transactions with Foreign Institutional Investors (FIIs).

Onus shifted to the taxpayer

The Finance Minister initially clarified that the onus of proof would be entirely on the Indian Revenue Service (the Revenue) to establish that the requisite conditions are satisfied before the GAAR could be engaged. The current amended version reverses this position, such that the taxpayer now bears the onus in disproving the view concluded by the Revenue.

Approval panels

Under the earlier provisions, the directions of the Approving Panel (a specialist Panel convened to adjudicate the administration of the GAAR) were binding only on the Revenue. As a result of the amendments, the directions are equally binding on the taxpayer. Such measures do not, however, prevent the taxpayer from appealing the tax officer's order passed pursuant to the Panel's directions before the Tax Tribunal.

Procedure for invoking GAAR inquiry

If the tax officer during the course of regular audit considers it necessary to declare an arrangement to be an IAA, the officer must refer the matter to the Commissioner. If the Commissioner is not satisfied with the taxpayer's explanation, he or she may refer the matter to the Panel.

The taxpayer will have an opportunity to prove that the arrangement is not an IAA at each stage. The prescribed forms require detailed reasons to arrive at a conclusion to invoke the GAAR or otherwise to be provided by the revenue authorities at each level of the GAAR proceedings.

While the GAAR inquiry can be initiated during the course of a regular audit, it appears that the tax officer and the Commissioner can recommend invoking the GAAR not only for the tax year for which proceedings are pending, but also for other tax years (both earlier and future years).

As a means of obtaining appropriate assurance, it is possible for the taxpayer to approach the Revenue for an advance ruling to determine if the GAAR is applicable in its case.

Unresolved issues

Despite several amendments made to the GAAR to date, some important issues are yet to be fully addressed and resolved.

Grandfathering

The Committee has recommended that all investments (though not all arrangements) existing on the date of the GAAR's commencement be grandfathered, such that on later exit (e.g., sale of such investments) the GAAR cannot be invoked.

Under the current provisions, only certain types of income from certain arrangements will be afforded grandfathering and not be subject to the GAAR's application. This result ultimately will depend on the type of the arrangement, when the tax benefit was obtained, and when the arrangement was first entered into.

Interaction of the GAAR with SAARs and treaty provisions

Under the existing provisions, the GAAR will override other provisions of the Act, as well as the tax treaty provisions. The Finance Minister in his public announcement stated that "[w]here GAAR and SAAR are both in force, only one of them will apply to a given case, and guidelines will be made regarding the applicability of one or the other."

The Committee has recommended that the GAAR not be invoked in circumstances where a SAAR is applicable. Similarly, the limitation of benefit (LOB) clause contained in applicable Indian tax treaties is suggested to be similar to a SAAR and therefore equally should not be overridden by the GAAR provisions.

Approach of the Indian Revenue ahead of the GAAR being introduced

Though the introduction of the statutory GAAR has been deferred, the Revenue continues to closely scrutinise transactions, especially those among group companies.

Observation: With the impending GAAR, it is expected that the Revenue will continue to closely examine arrangements that produce outcomes contrary to the intent of the Indian tax laws and that possess an avoidance-like element.

HOLLAND

Background

The Dutch tax law has contained a statutory GAAR for direct taxes since 1925. Despite this, the statutory GAAR has become effectively obsolete and has not been invoked since 1987.

Instead, the statutory GAAR has been surpassed by the judicial doctrine of 'fraus legis' ('fraude à la loi', 'abuse of the law'). The doctrine has a wider application than the statutory GAAR such that it may apply to all taxes (not just direct taxes) and enable transactions to be disregarded or recharacterised in appropriate circumstances.

Below we examine the key aspects to the judicial doctrine and its application in addressing avoidance behavior.

The basics of the judicial GAAR

Requirements

The doctrine of 'fraus legis' has emerged from case law, which has determined its content and scope of application.

For the doctrine to apply, two conditions should be met:

1. The avoidance of tax was the sole or prevailing motive of the taxpayer in entering into a particular set of interrelated legal actions and factual operations ('the arrangement'); and
2. The (fiscal) outcome of the arrangement is contrary to the object and purpose of the provisions of the tax law concerned.

Motive

The first condition is called the 'motive requirement' or 'subjective requirement'. It presupposes a deliberate intent of the taxpayer aimed at tax avoidance. The Tax Inspector must prove this condition.

According to the established case law, the Inspector may demonstrate that the motive requirement is satisfied by showing that it was reasonably foreseeable that the arrangement would only be profitable because of the planned tax savings and otherwise would have a negative result such that (at least part of) the arrangement does not have any economic significance. It is, on the other hand, for the taxpayer to provide proof to the contrary by showing that objectives other than tax avoidance (e.g., commercial or business reasons) played a more than merely incidental role in the decision to enter into the subject arrangement.

Object and purpose of the tax law

The second condition is called the 'normative requirement' or 'objective requirement'.

Whether the outcome of the arrangement is contrary to the object and purpose of the provision of the tax law concerned has to be answered on the basis of the wording and the system of the law and the parliamentary papers. In examining this condition, a judge also will take into account the motive of the arrangement and whether the arrangement lacks any real, practical importance for those involved. In recent cases, the relative artificiality of the arrangement also has been taken into account as an aggravating circumstance.

In 2012, the Tax Chamber of the Supreme Court stated that a taxpayer is free to select the most profitable arrangement, but this freedom does not enable the taxpayer to enter into an arrangement that is both artificial and devoid of any real importance and that amounts to a breach of the object and purpose of the law.

Observation: For practical purposes one may conclude that taxpayers are, in principle, free to enter into an arrangement that produces the lowest tax burden, but the more artificial and devoid of any real importance an arrangement is, the more likely the arrangement will be deemed contrary to the object and purpose of the law and be struck down as a result. A number of cases concerning 'unlimited' tax deductions and arbitrary and repeatable tax deductions have been considered by the courts in this context.

The effect of 'fraus legis'

When the doctrine of 'fraus legis' applies, taxation will take place either by substituting the disputed arrangement for another or by ignoring (part of) the disputed arrangement and denying its fiscal consequences.

Application of the judicial GAAR

SAARs

In addition to the doctrine of 'fraus legis', the Dutch tax law includes an increasing number of statutory SAARs to protect the Dutch tax base, especially against erosion via interest deductions and misuse of the participation exemption. The SAARs provide a more robust and certain safeguard against undesirable behavior when compared to the less predictable outcome of the judicial GAAR.

Moreover, the proliferation of SAARs has considerably diminished the importance of the doctrine of 'fraus legis,' especially for matters concerning the corporate income tax law. If a SAAR applies, the doctrine does not. However, the doctrine potentially is applicable in circumstances where the operation of a SAAR has been circumvented as a result of taxpayer behavior.

Ultimum remedium

The doctrine of 'fraus legis' also is otherwise an ultimum remedium — meaning it may only be invoked if the 'normal' interpretative methods fail and other 'abnormal' interpretive methods similarly fail.

In this respect, the doctrine operates, similar to other regimes throughout the globe, as a provision of last resort to address and alter the tax outcomes that otherwise would be achieved.

Treaty abuse

The doctrine of 'fraus legis' is a part of Dutch national law and, because of Constitutional prescriptions, cannot override the operation of a tax treaty in most circumstances.

Consequently, some recent treaties (e.g., with Germany) expressly prescribe that the treaty allows the national GAARs and SAARs to apply and alter the outcome that otherwise would be achieved by that treaty. For treaties with developing countries, the Dutch government recently has proposed to introduce a general anti-abuse provision, similar to that advocated in the OECD's BEPS Action Plans.

Administrative policy

There is no specific administrative guidance on the application of the doctrine of 'fraus legis.' It is, in principle, open for the individual Tax Inspector to decide whether to invoke the doctrine. However, on occasion there may be a wider policy of the tax authority to adopt the doctrine to address a particular tax arrangement.

In 'fraus legis' cases, or in cases of treaty abuse, a Tax Inspector may refuse a request for a pre-filing consultation or to continue the consultation with the taxpayer concerned. Recently this policy has been extended to situations in which internationally accepted principles would be disregarded if the point of view of the taxpayer would be followed (e.g., arrangements exhibiting BEPS-like characteristics).

No changes expected

There is no current expectation that the judicial GAAR will be replaced by an updated version of the now obsolete statutory GAAR or by a completely new statutory GAAR.

Observation: The Dutch tax authorities remain satisfied with the judicial GAAR and prefer the existing SAARs above a statutory GAAR. The recent BEPS proposals of the OECD and the EU anti-avoidance proposals have not changed that view. However, due to the inability of the judicial GAAR to operate as a treaty override, the Dutch tax authorities are seeking to address instances of treaty abuse by introducing a general anti-abuse provision within its treaties of the kind advocated in Action Plan 6.

NEW ZEALAND

Background

New Zealand has had a statutory GAAR since 1878, even before income tax was introduced. The legislation has become one of the world's broadest and most frequently applied anti-avoidance rules and prioritises the need for flexibility in combating tax avoidance, as opposed to prioritising the desire for commercial certainty.

In the past 10 to 15 years, the Commissioner of Inland Revenue (Commissioner) frequently has invoked the GAAR. The 2015 Commissioner Annual Report noted that the targeting of aggressive tax planning utilising the GAAR resulted in the collection of amounts equating to approximately 27 percent of the total discrepancies identified in 2015. The GAAR also continues to produce an impressive return on investment for the Commissioner. In 2015 the Commissioner achieved a return of $34.10 in tax for every dollar spent examining the potential application of the GAAR in respect of 'complex finance and trust losses.'

Despite the GAAR being in existence for such an extended period, uncertainty remains with respect to the scope of its application. The job of interpreting and applying the findings of the court-decided cases has been made more complicated as a result of changes to the structures of the appellate courts in New Zealand.

Legislative regime

Where the New Zealand GAAR is engaged, the Commissioner may void a 'tax avoidance arrangement' for income tax purposes. See Section BG 1 of the Income Tax Act 2007 (ITA). In such circumstances, the Commissioner may adjust the taxable income (or credits) of any person to counteract the tax advantage obtained.

A 'tax avoidance arrangement' is defined in section YA 1 to mean:

"an arrangement [which is itself very broadly defined], whether entered into by the person affected by the arrangement or by another person, that directly or indirectly —

- has tax avoidance as its purpose or effect; or
- has tax avoidance as one of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental."

Observation: The definitional scope is very broad and on a literal interpretation captures a wide range of ordinary commercial transactions. Therefore, the courts over the past century have applied various glosses to the interpretation of the GAAR to limit its application. The interpretation of New Zealand's GAAR is greatly affected by judge-made law, which provides for flexibility, but consequently has created significant uncertainty for taxpayers.

Approach of the New Zealand courts

In 2004, the Supreme Court replaced the Privy Council as New Zealand's highest court. That change has resulted in considerable uncertainty as to how the GAAR is to be applied and the extent to which decisions that pre-date the establishment of the Supreme Court remain relevant.

Since 2004 there have been at least two High Court (New Zealand's lower-level court) decisions involving structured financing transactions that indicate a significant change in the way the GAAR is to be interpreted and applied. Those decisions were not appealed by the taxpayers concerned.

In contrast, and more relevantly, the interpretation since adopted by the Supreme Court in *Ben Nevis Forestry v. CIR, [2008] NZSC 15*; *Glenharrow Holdings Ltd v CIR (2009), 24 NZTC 23,236 (SC);* and *Penny and Hooper v CIR* [2011] 1 NZLR 433 more easily reconcile with those cases decided prior to 2004. Despite this, it appears that the Supreme Court is less inclined to interpret the GAAR in favor of the taxpayer than the Privy Council was in the past.

A key feature of all three Supreme Court decisions was the existence of significant artificiality or contrivance. This was identified by the Court as a relevant factor in each case, and potentially a deciding factor on each occasion.

Notably, however, the leading New Zealand authority on the interpretation of the GAAR is the Supreme Court in *Ben Nevis*. The judicial approach established has become known as the 'Parliamentary Contemplation test,' articulated as follows:

"When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole. If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement is a tax avoidance arrangement."

The Parliamentary Contemplation test is a two-stage analysis. The first step is to identify Parliament's purpose at the time it enacted the relevant provisions. The taxpayer must satisfy the court that the use made of the specific provision is within its intended scope.

The second step requires an analysis of the commercial reality and economic effects of the arrangement. The facts, features, and attributes required to be present (or absent) to give effect to Parliament's purpose for those provisions must be identified. The use of the specific provision is to be viewed in the light of the arrangement as a whole.

Approach of the Commissioner

In June of 2013, the Commissioner released an Interpretation Statement to clarify the framework that the Commissioner will use to consider applying the GAAR.

A question remains as to how to determine the purpose or contemplation of Parliament when it enacted the relevant provision. In some cases, the focus will be on the literal wording of a provision, while in others a broader examination of the ITA will be needed. Extrinsic materials and case law also may be relevant for this purpose.

In the Interpretation Statement, the Commissioner listed a number of factors that the Commissioner will consider in determining whether a tax avoidance arrangement exists (none of which derive from the statute or directly from the decided case law).

If an arrangement is deemed to have a tax avoidance purpose or effect under the Parliamentary Contemplation test, then it is necessary to determine whether this purpose or effect is merely incidental. If the tax avoidance purpose is merely incidental compared with the non-tax avoidance purposes, then it is unlikely the arrangement will be challenged via the GAAR.

However, where a tax avoidance arrangement is found to have arisen, it is void against the Commissioner. Section GA 1 grants the Commissioner the power (but not the obligation) to reconstruct the arrangement to counteract the impermissible tax advantage obtained.

This broadly empowers the Commissioner to make three types of adjustments to parties or persons affected. First, the Commissioner can negate the tax avoidance purposes or effects that have not been countered by the arrangement being void against the Commissioner. Second, the Commissioner can reinstate legitimate tax outcomes. Third, the Commissioner can make appropriate consequential adjustments.

In addition, taxpayers that have received impermissible tax advantages may also be liable for shortfall penalties under the civil penalties regime. The liability imposed for taking an 'abusive tax position' is 100 percent of the impermissible tax advantage that has been counteracted using the GAAR. The penalty may be imposed when the taxpayer has taken both an unacceptable tax position and done so with a dominant purpose of avoiding tax.

Observations

As all cases considered by the Supreme Court to date have involved high levels of artificiality and contrivance, considerable uncertainty remains on the future interpretation of New Zealand's GAAR.

Without doubt the Government must achieve the right balance between protecting the tax base and providing for a tax system that encourages trade and investment. Most practitioners would agree that the GAAR, as it is currently being applied, is effective in preventing tax avoidance, but in turn creates considerable uncertainty for New Zealand taxpayers. The New Zealand Parliament has no current intention to amend the GAAR notwithstanding these concerns.

Overall, the Commissioner's success in the courts over the last six years has caused the GAAR to be invoked more frequently and consequently resulted in New Zealand taxpayers becoming more cautious in their tax planning.

POLAND

Background

In December 2015, the Polish government published a new draft version of amendments to the Tax Ordinance Act, which would re-introduce a GAAR into the Polish tax law.

The first version of the Polish GAAR was in force for the period 2003 through 2004, but subsequently was repealed following a ruling by the Polish Constitutional Tribunal.[15] The Tribunal ruled the GAAR unconstitutional because the provisions used ambiguous phrases.

The draft amendments were accepted by the Council of Ministers on 15 March 2016. On 27 April 2016, the

[15] See *K 4/03, OTK 2004, no 5a*

Public Finance Committee subsequently approved a new version of the draft, which remains current at the time of writing.

The draft amendments stipulate that the revised legislation will come into force 30 days after the date of their promulgation. The amendments are intended to take effect in the second half of 2016.

Scope of the legislative regime

The re-introduced GAAR will apply to all types of taxes (apart from value-added tax (VAT), as to which other provisions are proposed to prevent VAT avoidance). According to the published draft, legal transactions with the main purpose of obtaining a tax advantage contrary to the tax regulations will result in a tax benefit being potentially subject to cancellation.

The draft amendments stipulate that if tax authorities detect artificial transactions designed mainly to gain a tax benefit, the tax consequences of such transactions will be assessed as if an alternative 'appropriate' transaction instead had taken place. Moreover, if transactions carried out by a taxpayer do not have any real economic or business rationale, other than tax avoidance, tax authorities may completely disregard them.

Transactions shall be deemed artificial if they would not be carried out by a taxpayer acting in a reasonable manner and whose objectives are not contrary to the purpose of the tax law. When determining if the transactions are artificial, the tax authorities should take into account whether:

- The transactions are split in an unreasonable way;
- There are intermediaries engaged in the transactions without any business rationale;
- The transactions are undertaken to achieve results identical or similar to those existing prior to their implementation;
- The transactions include actions that compensate or exclude each other; and
- The economic risks of the actions taken by the taxpayer exceed the planned benefits (excluding the tax benefits).

However, the draft amendments would provide certain exemptions where the GAAR will not apply.

Those exemptions will be available if a tax benefit, or the sum of tax benefits, achieved by a taxpayer from an artificial transaction does not exceed a de minimis threshold. The GAAR also will not apply if the tax avoidance transaction may be counteracted using other legal measures (e.g., a SAAR) available under the Polish tax law.

In circumstances where the GAAR applies, the recently modified transitional provisions will enable tax authorities to modify the tax effects of offending transactions and cancel tax benefits obtained after the law comes into force, notwithstanding that the arrangements themselves may have been entered into prior to the GAAR taking effect.

Administration of the new GAAR

According to the draft amendments, the Minister of Finance will have exclusive jurisdiction over tax assessment proceedings in which the GAAR may be applicable. This means that in circumstances where a local tax authority identifies an artificial transaction while conducting a tax audit, the Minister of Finance will take over the proceedings.

From an administrative perspective, the application of the GAAR will be overseen by an independent expert body (the Council for Tax Avoidance) consisting of tax experts predominately recruited from government administrative bodies. The advisory role to be played by the Council is intended to ensure that a consistent administrative approach is adopted with respect to the GAAR.

Upon requests submitted by a taxpayer or the Minister of Finance, the Council will issue legal opinions outlining its view on the potential application of the GAAR at a time when appellate proceedings before the Minister have commenced. The Minister also will be entitled to submit such a request before any first instance decision is reached.

Taxpayers will have a right to apply for a 'securing opinion' from the Minister of Finance. The securing opinions will have similar functions to advance tax rulings and will provide a means for taxpayers to obtain assurance on the GAAR's potential application.

When applying for a securing opinion, the taxpayer should include a description of the planned transactions and their economic purpose desired. The Minister will, in turn, examine the application and decide whether those transactions described are designed with the purpose of obtaining a tax benefit within the meaning of the Tax Ordinance Act.

Observations

The primary objective of the impending GAAR, as announced, is to target multinational companies which minimise their tax liabilities in Poland by applying tax avoidance measures. While the new measures are anticipated to take effect from the second half of 2016, currently it is difficult to assess the precise breadth of their scope, and ultimately their likely impact, once the GAAR is introduced.

UNITED KINGDOM

Background

The GAAR was introduced only recently introduced into the UK tax code, following a Government-commissioned independent study led by Graham Aaronson QC. Prior to then, the UK traditionally had counteracted tax avoidance by challenge in the courts under SAARs and a targeted disclosure regime first introduced in 2004.

In its report published in 2011, the Aaronson study concluded that a targeted regime, aimed at abusive schemes, would be a significant aid in counteracting aggressive tax avoidance in the UK. Following the conclusion of a subsequent consultation process, the GAAR legislation then was included in the Finance Bill 2013 and ultimately came into force on 17 July 2013. Supporting 'Guidance Notes' also were published at this time and will continue to be refined on an annual basis.

To date, there are no cases yet referred to the GAAR Advisory Panel for consideration. It is expected that a case may be referred before the end of 2016.

Since coming into force the Government has moved to introduce a new penalty regime and sought to introduce some additional changes on how the GAAR will be administered by Her Majesty's Revenue and Customs (HMRC).

Scope of the GAAR

The UK GAAR differs from other GAARs operative throughout the globe as it is not a broad spectrum rule; rather, it is intended to deter taxpayers from entering into the most abusive and contrived schemes, while leaving the clear centre ground of tax planning undisturbed.

In this respect, the GAAR only applies to 'tax arrangements' that are 'abusive.' A tax arrangement will exist in circumstances where, objectively viewed, the arrangement has a main purpose or one of the main purposes of obtaining a tax advantage. This is considered a low threshold, with the real filter being whether the arrangement is abusive; this is at the core of the GAAR.

Arrangements are abusive if, considering all the circumstances, they cannot reasonably be regarded as a reasonable course of action (the 'double reasonableness' test).

There are a number of circumstances that may be considered (e.g., the commercial context), but the legislation sets out the following specific circumstances for consideration:

- Whether the results of the arrangements are consistent with the policy and principles underpinning the legislation;
- Whether there are any contrived or abnormal steps; and
- Whether the arrangements are intended to exploit any shortcomings in the legislation.

Although the legislation does not prioritise these circumstances, the Guidance Notes indicate that consistency with the underlying policy and principles is "particularly important in determining whether or not arrangements are abusive." It often will not be possible to identify this from the legislation alone, and reference also may be made to non-legislative materials where appropriate. If it is not possible to determine the policy and principles clearly, the other circumstances will need to be considered.

There is little direction as to what would constitute contrived and abnormal steps. The Guidance Notes consider that shortcomings in the legislation typically will be met where there are unanticipated consequences with new legislation, perhaps because the drafters did not anticipate a particular transaction.

Observation: The legislation includes some indicators of abuse and suggests it will typically exist where the tax and economic consequences of a transaction differ. Despite this, it is clear that these are only indicators and the list is not comprehensive. Of greater help is a legislative indicator that a transaction is not abusive where the tax arrangements are in line with 'established practice' and HMRC has indicated its acceptance of this practice. It is expected that the precise scope of the 'abusive' criteria may become clearer as the law continues to develop.

Critically, the newly introduced GAAR will apply to the main direct taxes, as well as to inheritance tax, stamp duty land tax, the annual tax on enveloped properties, national insurance contributions, and the recently enacted diverted profits tax (discussed further in our Tax Insight dated October 14, 2016). The only major tax not to be covered by the GAAR is VAT, which operates under an abuse-of-law doctrine.

Procedures and taxpayer safeguards

Taxpayers must self-assess whether or not the GAAR applies, with no specific GAAR clearance procedure.

Notably, there are a number of taxpayer safeguards in place including an Advisory Panel, which is a non-judicial body, independent of HMRC. There is a small core Panel with responsibility for reviewing and approving the Guidance Notes. The other role of the Advisory Panel is to form an opinion on GAAR cases.

Where HMRC invokes the GAAR, the case will be referred to an Advisory Panel of three members who will form an opinion as to whether the arrangements entered into are a reasonable course of action. Note that the Panel does not give an opinion as to whether the GAAR should apply.

HMRC must consider the Panel's opinion before deciding whether to proceed with a GAAR challenge. Although the opinion is not binding on HMRC, legislation provides that it will be taken into account should the case go to court, and thus it is intended to deter HMRC from invoking the GAAR lightly.

Observation: While it is too early to judge how the GAAR will operate in practice, there is a clear intention from the Guidance Notes that the GAAR will be applied consistently (not invoked on a whim), with transparency sought at every stage. To ensure this, the legislation and the Guidance Notes include procedural requirements that HMRC must follow. These include a review of potential GAAR cases at senior level in both HMRC's Anti-avoidance Group and the relevant business area. If a formal GAAR challenge arises, a designated officer is appointed to ensure consistency in the application of the GAAR.

Recent amendments of GAAR guidance materials

Revised GAAR guidance was approved by the Advisory Panel with effect from 30 January 2015, and applies to transactions taking place on or after that date. There are no significant substantive amendments to the original guidance published, with amendments being made to update examples and to eliminate inconsistencies in the original guidance.

Observation: It is expected that the guidance will be further updated in 2016 to add appropriate observations on a new penalty regime and also will be the subject of a 'plain English review.' A more comprehensive review is expected in 2017, and changes may be the subject of public consultation.

Finance Bill 2016 measures

Finance Bill 2016 was published on 24 March 2016 containing draft legislation for proposals previously consulted on by the Government to strengthen the GAAR in three respects:

- The introduction of GAAR penalties;
- The ability for HMRC to take 'provisional counteraction' measures; and
- The ability for HMRC to issue 'binding notices' to taxpayers that have entered into tax arrangements which are equivalent to other tax arrangements that already have been the subject of a counteraction notice.

The Bill subsequently received Royal Assent on 15 September 2016 with the measures taking effect as of that date.

GAAR penalties

The newly introduced regime will result in a penalty equal to 60 percent of the 'counteracted advantage' whenever:

- A return, claim, or other document is submitted to HMRC on the basis that a tax advantage arises from tax arrangements;
- HMRC gives notice that the tax advantage is to be counteracted; and
- All or part of that advantage is later counteracted under the GAAR.

The amount of the penalty is not adjustable to reflect culpability, although HMRC will have discretion to mitigate a penalty. However, there will be no GAAR penalty if a taxpayer makes the GAAR-related adjustments specified by HMRC prior to the arrangements being referred to the GAAR Advisory Panel. A taxpayer may also appeal against a penalty in the event that one is ultimately applied.

Relevantly, the newly introduced GAAR penalty will only apply to tax arrangements entered into on or after Royal Assent.

Provisional counteraction notices

As a result of the recent amendments, HMRC will also now have the power to issue a provisional counteraction notice if an officer has reasonable grounds for believing that a tax advantage arises to a taxpayer from tax arrangements that are abusive. The officer then will be able to make the adjustments specified in the provisional counteraction notice in order to counteract the tax advantage.

There will be a right of appeal against the adjustments. The making of an appeal triggers a process that may result in the adjustments being cancelled, the provisional counteraction notice being withdrawn, or the issue of a counteraction notice under Schedule 43 paragraph 3 Finance Act 2013.

Binding notices

Finally, the recent amendment now also empower HMRC to issue a binding notice to counteract abusive tax arrangements entered into by one taxpayer that are equivalent to abusive tax arrangements entered into by another taxpayer that already have been the subject of a counteraction notice under Schedule 43 paragraph 3 Finance Act 2013. This final amendment is considered to better enable the GAAR to be administered on a consistent basis.

UNITED STATES

Background

The United States does not have a GAAR regime. Rather, US taxpayers are subject to a set of judicially created common-law doctrines that, if applicable, can deny tax benefits arising from certain arrangements.

The doctrines most commonly applied are the economic substance and business purpose doctrines. The application of these doctrines historically has involved a certain degree of uncertainty, but a series of recent decisions by US trial courts have applied the doctrines, in view of many, more broadly than have courts in the past. Accordingly, while many observers may have hoped these decisions would be reversed or narrowed on appeal, the US Courts of Appeals for the Second Circuit and the Federal Circuit affirmed the trial court decisions in favor of the government. The US Supreme Court has declined to consider any subsequent appeals.

The appellate court decisions in these cases — each examined below — evidence a trend that the technical analysis of what constitutes economic substance or a valid business purpose may be supplanted, with the courts applying these doctrines in a way that seems indistinguishable from a GAAR, but without the procedural safeguards that ordinarily would accompany its operation. This is especially significant given that economic substance decisions relating to tax years prior to the effective date of the codification of the economic substance doctrine (set forth in Section 7701(o) of the Internal Revenue Code and effective for transactions entered into after 30 March 2010) will remain relevant for cases brought before courts pursuant to section 7701(o).

Appellate court decisions

The *Bank of New York Mellon Corp. v. Commissioner*, 801 F.3d 104 (2d Cir. 2015) (*BNYM*) and *Salem Financial Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015) (*BB&T*) cases each involved transactions undertaken by certain US finance companies, pursuant to which the US taxpayers generated and claimed foreign tax credits (FTCs). These cases each involved the 'structured trust advantaged repacked securities' (STARS) transaction developed by Barclays.

In each circumstance, the structured financing transactions produced a larger cost to US revenues than pre-tax economic benefit to the taxpayer. The US Treasury subsequently made the foreign taxes paid in these types of transactions non-creditable by promulgating specifically targeted regulations. The trial and appellate courts in these cases, nevertheless, denied tax benefits to transactions entered into before the effective date of these regulations and did so by reinterpreting the concepts of business purpose and economic substance doctrines.

The STARS transactions

The STARS transactions entered into between Barclays, a UK tax resident, and various US banks, was developed to generate a UK tax benefit for Barclays, which was shared with the US banks through below-market financing. Between 2001 and 2005, Barclays entered into STARS transactions with six US banks. Each transaction involved some variation of the transaction described below.

In essence, the STARS transaction was a structured financing of a US bank by Barclays in the form of a repurchase agreement over interests in a UK resident trust established by the US bank and into which the US bank transferred income-producing assets. Barclays purchased an interest in the trust pursuant to a subscription agreement that entitled Barclays to 99 percent of the trust income and required Barclays to re-contribute any distributions it received; the US bank simultaneously entered into a forward sale agreement with Barclays to repurchase the trust interest. The net effect of the agreements provided Barclays with significant UK tax savings, approximately half of which Barclays shared with the US bank by reducing the financing costs under the repo agreement through a so-called 'Bx payment.'

Decisions by the courts

The government disallowed the tax benefits arising from each of these transactions, asserting that, among other things, the transactions lacked economic substance and business purpose, despite satisfying the technical requirements of the Internal Revenue Code and Treasury regulations in existence during the years at issue. In response, each US taxpayer asserted that the transaction had economic substance and business purpose because it was entered into to obtain low-cost financing (i.e., a core function of its financing business) and was reasonably expected to generate a pre-tax profit.

The trial courts in *BNYM* (the US Tax Court, 140 T.C. 15 (2013); T.C. Memo. 2013-225)) and *BB&T* (the US Court of Federal Claims, 112 Fed. Cl. 543 (2013)) each decided in favor of the government, holding that the relevant transaction lacked economic substance. The trial courts determined that foreign taxes are economic costs to be taken into account in evaluating pre-tax profit potential for purposes of the economic substance analysis. As a result, the courts concluded that there was no reasonable expectation that the relevant transactions would produce a pre-tax economic profit.

The trial courts also did not accept the rationale that all or a portion of each relevant arrangement had business purpose, rejecting the assertion that the arrangement was instrumental in achieving 'low-cost financing.' As explained by the Tax Court in *BNYM*, in the court's view, "[t]he STARS transaction in essence . . . was an elaborate series of pre-arranged steps designed as a subterfuge for generating, monetizing and transferring the value of foreign tax credits among the STARS participants."

On appeal, the Federal Circuit upheld the decision in *BB&T* and the Second Circuit upheld the decision in *BNYM*. Both appellate court decisions affirmed the application of the economic substance doctrine to the relevant transactions and, in part, held that foreign taxes are economic costs to be taken into account as an expense for purposes of evaluating a transaction's pre-tax profit potential. This is a notable stance given the contrary holdings by the Fifth Circuit in *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) (*Compaq*) and the Eighth Circuit in *IES Industries Inc. v. Commissioner*, 253 F.3d 350 (8th Cir. 2001) (*IES*). The Second Circuit, after explicitly rejecting *Compaq* and *IES*, added further complexity to the pre-tax profit analysis by stating that "[e]ven if there is some prospect of profit, that is not enough to give a transaction economic substance if the prospect of a non-tax return is grossly disproportionate to the tax benefits that are expected to flow from the transaction."

Observation: In addition, certain statements made by the Second Circuit relating to the purpose of the economic substance doctrine may be viewed as troublesome — in particular, the court's view that "[t]he economic substance doctrine exists to provide courts a 'second look' to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit," as "[e]ven the smartest drafters of legislation and regulation cannot be expected to anticipate every [tax avoidance] device." Furthermore, in discussing the subjective analysis to be applied in economic substance cases, the Second Circuit added that for such purposes "[t]he focus is the reasonableness of the transaction and can be articulated as: would 'a prudent investor,' absent tax benefits, 'have made the deal?'"

The AIG case

The Second Circuit's decision in *BNYM* was issued in a joint opinion with another case, *American International Group, Inc. v. United States* (*AIG*), in which the government sought to deny FTCs generated by six structured financing transactions entered into by American International Group, Inc. (AIG). The AIG transactions involved a repo financing between AIG and a foreign bank with respect to preferred shares in a special purpose vehicle (SPV) owned by AIG. The SPV would use, *inter alia*, the proceeds from the sale of the preferred shares to the foreign bank to purchase assets that generated a steady flow of income, paying taxes on such income to its country of residence and distributing the net proceeds on the preferred shares.

Under foreign law, the purchase of the preferred shares was treated as an equity investment in the SPV (i.e., treated the SPV as a subsidiary); as a result, the foreign bank paid little tax on the dividends distributed to it by the SPV because such distributions were not taxable. Under US law, the arrangement was treated as a loan to AIG from the foreign bank; the SPV was treated as AIG's subsidiary; and the repo was treated as a financing secured by a pledge of the preferred shares. AIG claimed FTCs for the foreign tax paid by the SPV.

The trial court in *AIG* (No. 09 Civ. 1871 (S.D.N.Y. 2013)) denied AIG's motion for partial summary judgment, disagreeing with AIG's contention that the transactions had economic substance because they were expected to generate in excess of $168.8 million of pre-tax profit. AIG appealed the decision to the Second Circuit, which upheld the trial court's denial of AIG's motion for partial summary judgment. The US Supreme Court subsequently declined to consider AIG's appeal of the Second Circuit's decision.

What's next?

After the US Supreme Court's subsequent refusal to consider the decisions in *BNYM*, *AIG*, or *BB&T*, taxpayers and practitioners are left to grapple with the decisions by the Federal and Second Circuits, which some would view as broadening and adding complexity to the potential application of the economic substance doctrine and what will be respected as an adequate non-tax business purpose.

At least for now, whether taxpayers and practitioners will obtain any degree of clarity depends on the *AIG* case — which continues to be litigated in the US District Court for the Southern District of New York and is scheduled for trial in 2017 — and two remaining STARS transaction cases: *Santander v. United States*, currently on appeal to the US Court of Appeals for the First Circuit after the US District Court for the District of Massachusetts entered a judgment in favor of the taxpayer; and *Wells Fargo* *v. United States*, currently being litigated in the US District Court for the District of Minnesota and scheduled for trial on October 31, 2016.

Other jurisdictions — at a glance

For completeness, we note that at the time of writing a number of additional jurisdictions have newly introduced or expanded the scope of their domestic GAAR regimes. These jurisdictions include:

- Belgium
- Chile
- Hungary
- Ireland

Given the short passage time, the precise scope and application of these new regimes remains somewhat unclear and no judicially developed case law has yet been established.

Consistent with the recent experiences across other regimes throughout the globe, we expect the above GAARs will continue to take shape over the coming years. For an update on the ongoing judicial, administrative, and legislative developments in relation to these regimes (and the others mentioned above) please look out for additional TCDR Insights in the future.

The takeaway

To date, many countries have developed legislative GAARs and similar judicial doctrines intended to safeguard against what is viewed as impermissible taxpayer behavior.

While many of these measures have been in existence for a considerable length of time, uncertainty persists in relation to the scope of their operation, their interaction with domestic SAARs, and their application in a tax treaty context.

With the advent of the OECD's BEPS project, coupled with recent pronouncements by the European Commission, GAARs are set to play an even greater role in future compliance enforcement.

Multinational companies seeking to operate an effective global tax governance regime should appreciate and understand the current developments in this area and be prepared to address the future application of GAARs, particularly when transacting cross-border.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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