Current Notes

The financial crisis, tax avoidance and an EU GAAR

The extent to which the functioning of an EU Member State’s tax system is perceived as exclusively its own responsibility has, in practice at least, changed significantly in recent times. Perhaps the single most important reason for the change is the financial crisis and the necessity for financial assistance to be given to states under the European Financial Stability Facility,¹ the European Financial Stabilisation Mechanism² and the Treaty on the Functioning of the European Union.³ If national tax systems contain structural faults, for example, because they fail to impose tax effectively or facilitate its collection, or because they lack tools to prevent anti-avoidance or ensure compliance, then that has a direct impact on the potential need for EU financial assistance. Such failures are the legitimate concerns of the EU and every Member State.

The concerns resulted in Greece having to undertake what amounts to an overhaul of large parts of its tax system. Its obligations included the creation of “a progressive tax scale for all sources of income” and “a law repealing all exemptions and autonomous taxation provisions in the tax system.”⁴ Other provisions required the adoption of “legislation to improve the efficiency of the tax administration and controls”⁵ and the introduction of “an anti-evasion plan which includes quantitative performance indicators to hold revenue administration accountable.”⁶

Portugal’s obligations encompassed matters such as the reduction of tax deductions and action “to fight tax evasion, fraud and informality.”⁷ It was also obliged to “modernise the revenue administration by creating a single administration” and to address “bottlenecks in the tax appeal system.”⁸ Ireland was required, amongst other things, to adopt revenue raising measures to reduce pension tax relief, and reform capital gains tax and capital acquisitions tax.⁹

The legislation on financial assistance may be seen as a development of the work of the European Commission in relation to the stability programmes of Member States within the Eurozone and the convergence programmes of Member States outside the Eurozone. Last year’s

⁴Council Decision addressed to Greece with a view to reinforcing and deepening fiscal surveillance and giving notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation of excessive deficit (re-cast) of July 12, 2011 (Council Decision addressed to Greece) [2011] OJ L296/38, Art.2.1(a) and (b).
⁵See Council Decision addressed to Greece, above fn.4, Art.2.2(d).
⁶See Council Decision addressed to Greece, above fn.4, Art.2.4(c).
⁸See Council Implementing Decision of May 30, 2011, above fn.7, Art.3.6(g).
Council Recommendation on the stability programme of Cyprus recommended, for example, that the country should “[i]mprove tax compliance and fight against tax evasion.”\textsuperscript{10} The Council Recommendation on the convergence of Poland also recommended that the country should “improve tax compliance”.\textsuperscript{11}

The significance of EU financial assistance in the context of tax is well demonstrated by the fact that it is expressly referred to at the beginning of the Commission’s Communication, “An Action Plan to strengthen the fight against fraud and tax evasion” of December 6, 2012.\textsuperscript{12} As may be expected, this wide-ranging document covers not just fraud and evasion but also avoidance and other measures, such as the introduction of an EU taxpayer identification number on which a consultation is now open. It refers also to two Commission Recommendations of December 6, 2012. One Recommendation concerns measures intended to encourage third countries to apply minimum standards of good governance in tax matters.\textsuperscript{13} The other is on aggressive tax planning. It contains draft clauses establishing a GAAR.\textsuperscript{14}

**The Recommendations and third countries**

The Recommendation relating to third countries and good governance in tax matters seeks to ensure that Member States take action against those third countries which do not comply with minimum standards of good tax governance. That concept covers availability of access to and exchange of information as well as an absence of harmful tax measures in business taxation. The Commission recommends that Member States draw up blacklists and renegotiate, suspend or terminate double tax treaties in appropriate circumstances.

The Recommendation on aggressive tax planning also contains proposals which affect third countries. The Commission recommends that where a Member State agrees in a double tax convention not to tax specified income, the commitment should apply only where the income is taxed by the other contracting party. A draft of a clause for insertion in a convention reads:

“Where this Convention provides that an item of income shall be taxable only in one of the contracting States or that it may be taxed in one of the contracting States, the other


\textsuperscript{11} Council Recommendation of July 10, 2012 on the National Reform Programme 2012 of Poland and delivering a Council Opinion on the Convergence Programme of Poland, 2012–2015 [2012] OJ C219/65, Recommendation 1. Recommendations concerned with the effectiveness of tax compliance or tax evasion have been made in relation to a number of states including Bulgaria, the Czech Republic, Estonia, Italy and Malta.


contracting State shall be precluded from taxing such item only if this item is subject to tax in the first contracting State.”

Treaty negotiators are used to having their agendas set by national governments. Increasingly, they will not be able to ignore the EU whichever country they represent. The recommendations which have attracted most attention, however, are those concerning aggressive tax planning and the introduction of a GAAR on which this note concentrates.

Aggressive tax planning and the GAAR

Issued only five days before HMRC issued their consultation draft of GAAR guidance, the Commission states in its Recommendation on aggressive tax planning, that:

“To counteract aggressive tax planning practices which fall outside the scope of their specific anti-avoidance rules, Member States should adopt a general anti-abuse rule, adapted to domestic and cross-border situations confined to the Union and situations involving third countries.”

Plainly, the recommendation applies to domestic situations, intra-EU situations and those involving countries outside the EU. There can be no surprise about that. A Member State that can adequately enforce its tax charges in a cross-border situation may, nevertheless, cause itself and its fellow Member States significant financial problems if its tax system malfunctions domestically.

At first sight, some may be sceptical about the coverage of domestic situations. It is worthwhile, therefore, recalling the terms of Article 5.3 of the EU Treaty on subsidiarity. It requires that in areas outside its exclusive competence, the EU shall act only if and so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, at whatever level, but can be better achieved at EU level by reason of the scale or effects of the proposed action. There would seem little doubt that the pre-conditions for EU action are met. On February 15, 2013, the Financial Times of London published a letter from the UK’s Chancellor of the Exchequer, the French Finance Minister and the German Federal Finance Minister. In it the three ministers declared their intention to act in concert against tax avoidance saying: “We are taking steps to clamp down on tax avoidance in our own countries. But acting alone has its limits.”

It would be difficult to formulate a more succinct justification for the Commission’s action. The Commission is clearly conscious of the fact that individual Member States are attempting to limit tax planning. Its general approach is not so dissimilar to that adopted in the UK. The report by Mr Graham Aaronson QC of November 11, 2011 on the UK GARR concluded that the anti-avoidance tools specifically designed for the UK system are not up to the task of protecting it from unacceptable avoidance. He stated:

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15 European Commission, above fn.14, Art.3.2.
17 See European Commission, above fn.13, para.4.1.
18 TFEU Art.5.3.
19 “We are determined that multinationals will not avoid tax.” Letter to the Financial Times from Mr George Osborne, Chancellor of the Exchequer, UK, Mr Pierre Moscovici, Minister of Finance, France, and Mr Wolfgang Schäuble, Federal Minister of Finance, Germany (February 16, 2013).
“Regrettably, however, it is clear that purposive interpretation, specific anti-avoidance rules and DOTAS are not capable of dealing with some of the most egregious tax avoidance schemes.”

The Commission, for its part, put the matter this way:

“Member States find it difficult to protect their national tax bases from erosion through aggressive tax planning, despite important efforts. National provisions in this area are often not fully effective, especially due to the cross-border dimension of many tax planning structures and the increased mobility of capital and persons.”

Whereas Mr Aaronson had to consider national interests, the Commission was concerned with the internal market as well, as it makes clear in a later recital to the Recommendation as follows:

“As tax planning structures are ever more elaborate and national legislators are frequently left with insufficient time for reaction, specific anti-abuse measures often turn out to be inadequate for successfully catching up with novel aggressive tax planning structures. Such structures can be harmful to national tax revenues and to the functioning of the internal market. Therefore, it is appropriate to recommend the adoption by Member States of a common general anti-abuse rule, which should also avoid the complexity of many different ones.”

The substance of the GAAR

Turning to the substance of the Recommendation, the terms of the suggested GAAR are that:

“An artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of avoiding taxation and leads to a tax benefit shall be ignored. National authorities shall treat these arrangements for tax purposes by reference to their economic substance.”

The definition of “tax” for the purposes of the Recommendation encompasses income tax, corporation tax and “where applicable” capital gains tax, and withholding taxes of an equivalent nature. The definition is narrower than that contained in the draft UK legislation for a GAAR which covers also Inheritance tax (IHT), Petroleum Revenue Tax (PRT), Stamp duty land tax (SDLT) and an annual residential property tax. Nevertheless, the Recommendation is not confined to the taxation of business activity and employees; in some countries gifts are subjected to income tax.

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21 European Commission, above fn.14, Recital (3).
22 European Commission, above fn.14, Recital (8).
23 European Commission, above fn.14, para.4(2).
24 European Commission, above fn.14, para.2(a).
Arrangement

Some of the terms used in the recommended clause are defined. “Arrangement” is to mean

“any transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event. An arrangement may comprise more than one step or part.”

The definition of “arrangement” in the UK draft legislation merely states, more succinctly, what the term includes. That is, perhaps, a more cautious approach than that taken by the Commission, but there would seem to be little likelihood of the Commission’s definition proving too narrow.

Purpose

The arrangement has to be put in place “for the essential purpose of avoiding taxation”. This may be compared with the draft UK legislation which requires that a tax advantage is “the main purpose or one of the main purposes” of the arrangements. Avoiding taxation is the “essential purpose” of an arrangement

“where any other purpose that is or could be attributed to the arrangement or series of arrangements appears at most negligible, in view of all the circumstances of the case.”

Accordingly, where arrangements have a purpose which is more than negligible in addition to the purpose of avoiding taxation, the GAAR proposed by the EU Commission will not apply. In contrast, arrangements which have a main purpose other than tax avoidance could be caught by the UK GAAR.

The purpose of avoiding taxation exists where

“regardless of any subjective intentions of the taxpayer, [the arrangement or series of arrangements] defeats the object, spirit and purpose of the tax provisions that would otherwise apply.”

It is understandable that the subjective intentions of the taxpayer are not dominant in relation to tax. As we have seen, however, subjective intentions are not to be totally disregarded. Where a taxpayer has or could have, to a non-negligible degree, a purpose other than tax avoidance then the arrangements in question will not have the avoiding of tax as their “essential” purpose. The EU GAAR will not then apply. The formulation advanced by the EU Commission has, therefore, a safeguard based on intention. Interestingly, Mr Aaronson’s illustrative GAAR contained a safeguard based on intention which the UK draft legislation did not include.

25 European Commission, above fn.14, para.4(3).
27 European Commission, above fn.14, para.4(2).
28 HMRC, above fn.26, cl.9.
29 European Commission, above fn.14, para.4(6).
30 European Commission, above fn.14, para.4(5).
31 See the Report, above fn.20, 45 onwards: “Safeguard 2—arrangements without tax intent”.

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Artificiality and commerciality

It has to be established that the arrangement, or the series, in question is “artificial”. This requirement will be met where “it lacks commercial substance”. It will be for national authorities to determine whether or not as a matter of fact commercial substance is lacking. In making that determination they are given a number of matters to consider. The first of these is whether or not the legal characterisation of the individual steps of the arrangement is “inconsistent” with the legal substance of the arrangement as a whole. Whether or not elements in the arrangement offset or cancel out each other, or are circular, is to be considered. So too is whether or not a tax benefit is obtained which is not reflected in the taxpayer’s business risks or cash flows. A further matter to be borne in mind is whether or not the expected pre-tax profit is insignificant in comparison to the amount of the expected tax benefit.

The relationship between these factors and commercial substance is plain. The existence of commercial substance will not necessarily be easy for national authorities and courts to determine. It is, therefore, understandable that another matter to which they are to have regard is whether or not

“the arrangement or series of arrangements is carried out in a manner which would not ordinarily be employed in what is expected to be a reasonable business conduct;”

Although it may be helpful in principle that reasonableness is introduced into the assessment of commerciality this provision is not free from ambiguity. What is “reasonable business conduct” and from the standpoint of which person is it to be judged? It is safe to say that the expectations of a reasonable banker will probably be different from those of a reasonable politician, while a reasonable judge may well have different expectations from both and each will regard themselves as a reasonable person. In the light of this provision any who have had doubts about the “double reasonableness test” and the role of the GAAR Advisory Panel in the draft UK law may look on them with some relief.

Tax benefit

The final element on which the Recommendation goes into detail is the concept of “tax benefit”. National authorities are invited to compare the amount of tax due by a taxpayer, having regard to the arrangements, with the amount that the same taxpayer would owe under the same circumstances in the absence of the arrangements. The Commission goes on to say that it is useful to consider in this context whether an amount is not included in the tax base, the taxpayer benefits from a deduction, a loss for tax purposes is incurred, no withholding tax is due, or foreign tax is offset. This list is less broad than the definition of tax advantage in the UK draft legislation, but it is the comparison between the tax liabilities with and without the arrangements which is the primary focus of the attention of national authorities.
Counter-measures

It is notable that, unlike the UK’s draft legislation, the Recommendation does not deal in any detail with the manner in which tax avoidance arrangements are to be countered. No doubt the Commission thought it sufficient to state that arrangements should be taxed by reference to their economic substance. The difficulties which have been faced by domestic courts and tribunals in giving effect to the doctrine of abuse of law in the field of value added tax would indicate that national authorities and courts may well require more guidance than that.

Conclusion

Member States are to inform the Commission of the steps taken to comply with its Recommendation and the Commission is to publish a report on the implementation of the Recommendation within three years after its adoption. Not every national government in the EU can sensibly look three years ahead. The great political advantage of the Commission is that it can. It is likely already to have given a little thought to its next move. There has been much consideration of general anti-avoidance rules in the UK since Mr Aaronson was asked to consider the introduction of a GAAR in December 2010. In view of that, one would hope that those interested in taxation in the UK will contribute to the debate in the EU on this Recommendation. It is a debate which may be profoundly important for EU taxpayers and tax authorities alike.

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