Economic Substance Around the World

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Panel topic: Economic substance around the world; a review of recent anti-avoidance jurisprudence in the US, the EU and Canada; an important session for cross-border tax planning.

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Belgium

By Werner Heyvaert[1]

1. Introduction

This presentation focuses first on the legislative aspects of economic substance in Belgian tax law, mainly direct (income) tax rather than indirect tax (such as VAT). Next, we highlight those rare provisions in the tax code that embody the Belgian legislature's desire to align tax treatment with economic substance, the most salient being those pertaining to financial leasing operations. We then provide a brief overview of the anti-abuse provisions in the tax law that allow the authorities to disregard the form of certain legal structures or constructions and levy tax in accordance with the substance of a transaction. After this brief report on economic substance, we summarize a number of landmark cases dealing with the issue of substance over form.

2. Economic substance in Belgian income tax law

2.1. The current income tax code (Income Tax Code 1992, or ITC92) was adopted to bring the 1964 Income Tax Code in line with a number of disparate laws containing tax provisions that had been enacted throughout the years. The initial version of ITC92 did not contain an overall "substance over form" provision but was immediately amended after enactment to include *inter alia* a general anti-abuse provision, article 344(1).

2.2. Article 344(1) allows the Belgian tax authorities to recharacterize a transaction or a series of related transactions to arrive at their economic substance. Recharacterization means that the transaction cannot be disregarded and its external effects (i.e., legal effects vis-à-vis third parties) cannot be altered or ignored.

2.3. Article 344(1) is usually described as the functional equivalent of the step transaction doctrine. It allows the revenue authorities to apply their preferred characterization to one, or, more likely, a number of related transactions and levy tax in accordance with such characterization. In doing so, the authorities can

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bypass certain links in the chain, provided such links do not give rights to or impose obligations on third parties.

2.4. An essential condition for invoking article 344(1) is that the primary purpose of the taxpayer's characterization of the transaction is to reduce its tax liability. It suffices for the taxpayer to have one substantial non-tax-driven reason for the initial characterization to prevent recharacterization by the authorities.

2.5. One of the earliest legislative actions to give precedence to economic substance over form was the introduction of the predecessors to current articles 10(2) and 19(1)(2) ITC92. Read together, these provisions provide that the interest component in lease payments made under a real estate financial lease should be treated as "income from personal property" (i.e., interest) rather than "income from immovable property" (i.e., lease rentals). Article 10(2) ITC92 was incorporated as article 7(1)(3) of the 1964 Income Tax Code by the law of December 28, 1983.

2.6. A recent example of legislative action to give precedence to economic substance is the introduction of transparency for tax purposes of qualifying certificates issued in exchange for shares (or convertible bonds) in Belgian companies pursuant to the law of July 15, 1998.

2.7. The most recent legislative change (introduced by the law of March 10, 1999) demonstrating that economic substance can prevail is the introduction of current article 18(3) ITC92, which provides that in the event of a qualifying stock lending, a payment from the borrower to the lender in lieu of a dividend coupon shall be characterized as a dividend (rather than interest or *sui generis* income).

2.8. Aside from the above mentioned exceptions, Belgian tax law tends to follow the form (and hence the documentation) rather than the substance of a transaction. There are a few specific anti-abuse provisions (e.g., debt-equity ratios), however for the purposes of this paper, I do not consider these to be representative of an emerging trend to give precedence to substance over form. As will become apparent from the following overview of the case law, the Belgian authorities can disregard the legal form and documentation provided by the taxpayer if they can prove that the parties to the transaction actually intended to conclude a different agreement or transaction than the one submitted to the tax authorities. This is usually referred to as the sham or simulation doctrine, which is discussed in further detail below.

3. Economic substance in Belgian case law

3.1. The seminal decision in the debate on economic substance is beyond a doubt the *Brepols* case (Court of Cassation, June 6, 1961). Strictly speaking, this was not a case that dealt with economic substance *per se*, as much as the applicability of the sham or simulation doctrine in the field of taxation. The court held that a sham transaction cannot be upheld against the tax authorities; in other words, the authorities have the right to look beyond a sham transaction and impose tax on the basis of the intended transaction, although in order to do so they must first satisfy a heavy burden of proof. Simulation is a civil law concept which essentially will be found where the parties to a transaction show the outside world a set of documents to evidence a specific contract or transaction (for example a loan) while secretly agreeing amongst themselves to enter into a different contract or transaction (for example an equity contribution). Once again, according to the Court of Cassation in *Brepols*, the tax authorities have the right to give precedence to the (undisclosed) transaction that was actually intended by the parties.

3.2. The major obstacle for the tax authorities in successfully applying the sham doctrine is a heavy burden of proof. The courts have consistently required the authorities to positively demonstrate that the taxpayer (and other parties to the contract or transaction) in fact intended to conclude a different agreement than the one disclosed in the transaction documents. Except in those rare cases where the revenue authorities discover written evidence to this effect, it is nearly impossible to prove that the intended transaction is different from the one evidenced by the official documentation. Two alternative means of proof are (i) behavior on the part of one or more parties that is inconsistent with the officially documented version of the transaction and (ii) breach of a compulsory legal obligation flowing from the official contract or transaction.

3.3. In *Brepols*, the Court of Cassation found no simulation or sham since taxpayers are entitled to use freedom of contract, even if their sole or primary purpose is to decrease their tax liability, provided they do not breach any mandatory legal obligations and accept all the consequences of the contract so concluded.

3.4. A second case that should be mentioned in any discussion of economic substance in Belgium is *Au Vieux Saint-Martin* (Court of Cassation, February 23, 1995). The facts of this case are relatively straight-forward. A company by the name of Canterbury operated a restaurant in Brussels. Due to road works in front of the restaurant, Canterbury lost business, was almost forced to declare bankruptcy, and officially closed its doors on June 1, 1973. It sold its principal asset (the building) and was left with a substantial loss carry-forward. Another company by the name of Au Vieux Saint-Martin (Saint-Martin), owned by the same shareholders as Canterbury, was (and still is) successfully running a restaurant in the historic center of Brussels. On December 14, 1973, Canterbury acquired Saint-Martin through a tax exempt business merger and immediately thereafter changed its name to Au Vieux Saint-Martin. After the merger, the new Saint-Martin made significant profits, against which it tried to offset the loss carried forward from Canterbury. The tax administration rejected this proposal. On December 22, 1987, the Brussels Court of Appeal sided with the tax authorities, holding that the merger between Canterbury and Saint-Martin had no economic substance and was purely tax-driven and, therefore, a sham. Saint-Martin appealed to the Court of Cassation, which overruled the lower court's decision, thereby upholding its decision in *Brepols* .

Under the Belgian rules of civil procedure, another court of appeal has jurisdiction to hear a case overturned by the Court of Cassation, and, although this does not occur very frequently, can overrule the

Court of Cassation's decision since the latter can rule only on questions of law rather than fact. Hence, if the Court of Cassation overturns the ruling of an appellate court on a question of law (usually because the court did not provide sufficient grounds for its decision), the second court of appeal may reach the same conclusion as the first but on different grounds or with a better reasoned judgment. This is exactly what happened in the *Saint-Martin* case. The Liège Court of Appeal reached the same conclusion as the Brussels Court of Appeal, namely that Saint-Martin after the merger could not make use of the loss that it had inherited from Canterbury (decision of February 17, 1993),[2] but based its decision on a different rule of law, *i.e.*, the predecessor of current article 79 ITC92, which provides that a taxpayer cannot offset losses carried forward against profits deriving from non-arm's length operations in which it engages with another taxpayer. According to the court of appeal, the merger of the original Saint-Martin (a flourishing company) with Canterbury (a dormant company with no actual business assets or activities) constituted a non-arm's length transaction and would have been unthinkable had Canterbury and Saint-Martin been unrelated. Naturally, Saint-Martin once again took the case to the Court of Cassation (which can rule on both questions of law and fact when it hears a case for the second time). In a widely commented ruling of February 23, 1995, the Court of Cassation sided with the Liège Court of Appeal and confirmed that Saint-Martin was not entitled to carry forward losses inherited from Canterbury against profits generated by the business previously carried on by the original Saint-Martin (which disappeared in the merger). The Court found that the Liège Court of Appeal had validly ruled and provided sufficient grounds for its decision and that the merger between Canterbury and the original Saint-Martin was indeed not at arm's length.

3.5. The most recent landmark case on economic substance is probably *Artwork Systems* (Ghent Court of First Instance, November 14, 2002). Artwork Systems NV (AWS) was created as an operating company (a company limited by shares) by three individual taxpayers in September 1992. On December 6, 1996, the original shareholders sold their shares to a newly formed holding company, Artwork Systems Group (AWS Group), whose sole shareholder was a Dutch foundation acting as administrator of AWS Group shares.[3] The beneficial owners of the foundation were the three original shareholders of AWS. AWS Group had no other substantial assets than the AWS shares. The price of the AWS shares to AWS Group was based on the net book value of the assets of AWS (about €7.2 million). AWS Group entered the AWS shares in its books at cost price. Shortly thereafter, the Dutch foundation brought AWS Group public on EASDAQ (then the European equivalent of NASDAQ) at a price per share that valued AWS at approximately €118 million more than its net book value of €7.2 million, the price at which the original

[2] Under the merger rules in effect at that time, losses carried forward could not be transferred from one legal entity (the absorbed company) to another (the absorbing or surviving company). This rule was established by the Court of Cassation in a ruling of June 8, 1936 (*Charbonnages du Hasard*).

[3] Dutch foundations are frequently utilized in Belgium to bifurcate legal and equitable ownership of shares in a Belgian company. The original shareholders receive certificates issued by the foundation in return for the contribution of their shares to the foundation. A Dutch foundation is a flow-through orphan entity that typically acts as the legal owner of the shares, exercising the voting rights pertaining to the shares, but with an obligation to pass on all income and capital gains deriving from the shares to the certificate holders. Although this technique was not formally regulated prior to the law of July 15, 1998 (see section 2.6. above), it was already widely known and frequently used.

shareholders had sold to AWS Group shortly before the IPO.[4] The tax inspector alleged that the additional €118 million from the IPO constituted income for AWS Group from a non-arm's length transaction and thus should be subject to corporate tax. If the beneficial owners of AWS Group had not been the same as the original shareholders of AWS, the latter would never have sold their shares in AWS for €7.2 million. The court sided with the tax authorities and upheld the tax assessment of €58 million (40.17 per cent of €118 million plus penalties and interest for late payment).

3.6. Based mainly on *Artwork Systems*, the Belgian Commission on Accounting Standards issued two guidelines (Accounting Standards 126/17 and 126/18 of November 2001) that are heavily debated in Belgian accounting and tax circles. These standards invoke the concept of "fair value" as used in IAS 32 and 39 to explain why, in specific situations, the general principle of cost price accounting should no longer be applied. It would go far beyond the scope of this presentation to weigh the pros and cons of this argument, but we believe it is relevant to convey the message that there is a very heated ongoing debate in Belgium as to how shares (or other assets) acquired by a Belgian company below fair market value should be valued and booked.

3.7. In a ruling of February 18, 2004, the Brussels Court of First Instance ruled on a comparable matter. As described in footnote 4, when a Belgian resident individual sells shares in a Belgian company that comprise part of a "substantial shareholding" (*i.e.*, more than 25 per cent of that company's share capital), capital gains tax is due at a rate of 16.5 per cent if such shares are sold to a non-Belgian resident corporation or legal entity. It is common practice in Belgium for the non-resident purchaser (*e.g.*, a US-based multinational) of a Belgian target company to establish a wholly owned Belgian subsidiary to which Belgian individual shareholders can sell their shares without triggering capital gains tax. The share purchase agreement typically includes a prohibition to prevent the buyer of the shares (the wholly owned interposed Belgian subsidiary) from disposing of its shares in the target for a period of 12 months following the initial sale of said shares by the individual shareholders. In the case at hand, the tax inspector challenged this commonly used scheme, alleging that the incorporation of the Belgian subsidiary by the foreign purchaser (a French industrial group) followed by sale of the shares in the target to this same subsidiary constituted a sham transaction (or simulation). In other words, the tax inspector was of the view that the seller and the buyer actually intended to sell or buy (as the case may be) the shares in the target to or through a French company and that the Belgian subsidiary was organized only for the purposes

[4] AWS Group was interposed prior to the IPO since the original shareholders of AWS each owned 33.3 per cent of the shares in AWS, *i.e.*, more than 25 per cent, the threshold for a so-called "substantial shareholding." Capital gains realized by Belgian resident individuals upon disposition of shares in a substantial shareholding of a Belgian company are subject to tax at a rate of 16.5 per cent when sold or otherwise disposed of to a non-Belgian corporation or legal entity (article 90(9) ITC92). By interposing AWS Group, the three original shareholders of AWS wished to avoid the 16.5 per cent capital gains tax by selling their AWS shares to a <u>Belgian</u> corporation (AWS Group), followed by the sale of AWS Group shares to (predominantly) non-Belgian corporate investors through an IPO on EASDAQ. A sale of shares comprising a substantial shareholding to a *Belgian* corporation is exempt from the aforementioned capital gains tax, provided the receiving company does not in turn transfer the shares to a non-resident corporation or legal entity within 12 months following the initial sale by the individual shareholders. In the case at hand, the original shareholders did not want to postpone the IPO for 12 months after interposition of AWS Group.

of tax avoidance. The Brussels court sided with the tax authorities, but it is likely that the taxpayer will appeal and it remains to be seen what the final outcome will be.

3.8. Finally, we briefly discuss hereunder two recent cases dealing with the general anti-abuse provision, article 344(1) ITC92 (see sections 2.1. through 2.4. above).

3.9. The first case was decided by the Brussels Court of Appeal (February 5, 2004). The court held that article 344(1) was correctly applied by the tax authorities. The facts can be briefly summarized as follows. A Belgian individual leased property to a Belgian company (Belco) in which he had a controlling interest and of which he was a director. Pursuant to the lease agreement, the individual received substantial lease payments from the company. At that time, such payments were favorably taxed in the hands of an individual lessor, while the entire amount of the lease payment was tax deductible for the lessee. In 1992, the Belgian legislature drafted a bill to introduce a provision to allow the partial recharacterization of lease payments by a company to one of its directors as earned income (salary), to be taxed accordingly. In order to avoid this new, less advantageous tax treatment, the individual and his Belgian company decided to terminate their lease agreement. The individual subsequently leased the same property to a Luxembourg company (Luxco), of which he was not a director, and Luxco in turn leased the property to Belco.

3.10. This ruling is peculiar because article 344(1) is generally used to recharacterize a contract or transaction (or series thereof) into one or more <u>different</u> contracts or transactions, whereas in the case at hand two lease agreements were in fact collapsed into one. In addition, it is striking that the court found that the connection between the two lease agreements was sufficiently evidenced by the fact that the tax advisor of Belco and of the individual taxpayer had signed the lease contracts on behalf of Luxco.

3.11. A second decision worth mentioning was handed down by a Bruges court on December 23, 2003. This is the latest ruling on a topic that has been the subject of several cases brought under article 344(1). Before the corporate tax reform of December 24, 2002 entered into effect, no withholding tax was due on the distribution of earnings and profits pursuant to the redemption by a Belgian company of its shares at market value, whereas regular dividend distributions by such companies were subject to withholding tax (at a rate of 25 per cent, which can be reduced to 15 per cent if certain conditions are met). For Belgian individual shareholders, this dividend withholding tax, if any, is final. Hence, it is more advantageous from a tax perspective for such individuals to sell their shares back to the company and realize a redemption gain rather than receive a regular dividend distribution. According to article 186 ITC92, a distribution made pursuant to a stock redemption or liquidation falls within the definition of a "dividend" for tax purposes. However, article 264(2) ITC92 (prior to the act of December 24, 2002)[5] explicitly

[5] The act of December 24, 2002 introduced a 10 per cent withholding tax on dividends for distributions made by Belgian companies pursuant to a stock redemption or buy-back or liquidation following dissolution. Consequently, although the gap between a regular dividend distribution (subject to a 15 or 25 per cent withholding tax) and a stock redemption (subject to tax at a rate of 10 per cent) has since diminished, the latter option still remains the more advantageous from a tax perspective.

exempted from withholding tax any dividends distributed pursuant to a stock redemption or liquidation by a Belgian company. The tax authorities repeatedly tried to recharacterize such transactions as regular dividend distributions, subject to withholding tax at a rate of 15 or 25 per cent, alleging that the sole purpose of the transaction was tax avoidance. The court held that article 344(1) allows the tax administration to disregard a taxpayer's characterization but it must fully respect the facts of the case. In the court's opinion, the facts underlying a stock redemption or buyback are so fundamentally different from a regular dividend distribution that recharacterization pursuant to article 344(1) is not possible. In the case at hand, the company had cancelled the shares it redeemed, which the court felt was incompatible with a dividend distribution. In addition, the court found that the company had complied with all relevant provisions of Belgian corporate law, as well as article 186 ITC92, in carrying out its stock redemption.

4. Conclusion and summary

Belgium is still a form-over-substance jurisdiction. However, the tax administration has the right to disregard simulated (or sham) transactions and impose tax on the basis of what the parties actually agreed if their intention differs from the officially disclosed documentation. However, the courts require sufficient evidence of simulation, and the tax administration is only rarely successful in satisfying this burden of proof. Over the years, several provisions have been introduced in the tax code to give precedence to substance over form, *e.g.*, the tax treatment of financial leases and stock lending. In 1992, a general anti-abuse provision was introduced which allows the tax administration to recharacterize a transaction and impose tax accordingly, although the courts are reluctant to permit recharacterization since the underlying facts are often found to be incompatible with the tax administration's position.

Canada

By Thomas B. Akin[1]

Introduction

In many instances of perceived tax avoidance, the Canada Revenue Agency (the "CRA") has, and continues to, reassess taxpayers and determine tax consequences on the basis of the economic effects of the taxpayers' transactions (hereinafter referred to as the "economic substance test") rather than in accordance with the legal substance of those transactions. Although the CRA's reliance on the economic substance test has enjoyed some success before the courts, its use has generally been rejected by the Canadian judiciary even after the enactment of the general anti-avoidance rule (the "GAAR"). In this regard, the courts have consistently reaffirmed the principle that the legally binding relationships created by a taxpayer's transactions cannot be ignored or recharacterized for tax purposes, notwithstanding the fact that those transactions may have been entered into solely for tax purposes and without a *bona fide* commercial purpose.

In a series of cases culminating in *Shell Canada Limited* v. *The Queen*,[2] the Supreme Court of Canada (the "Supreme Court") firmly rejected the proposition that the economic substance doctrine had any application in tax avoidance cases. Recent cases have made it clear that the Canadian judiciary's loyalty to this principle has largely withstood the enactment of the GAAR.

The cases discussed below are important decisions about which much could and, in fact, has been written. However, the following paper is simply intended to provide a brief review of the Canadian judiciary's approach to the economic substance test to counter tax avoidance since the Supreme Court's decision in *Stubart Investments Ltd.* v. *The Queen*.[3]

Legal Substance versus Economic Substance

The success of a taxpayer's tax avoidance plan ultimately depends on the court's recognition of the legal effectiveness of the taxpayer's transactions and relationships created thereby. Accordingly, a court's findings with respect to the legal validity of the transactions upon which the taxpayer relies are critical, as the tax consequences associated with the transactions depend on the court's interpretation and application of the relevant statutory provisions to its findings.

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1 Mr. Aiken is a partner of McCarthy Tétrault LLP, Toronto, Canada. The author acknowledges the assistance provided by his colleague, Stacey Sloan.

2 [1999] 3 S.C.R. 622.

3 [1984] 1 S.C.R. 536.

In this regard, a court's view of its role in tax avoidance cases will always flavour its analysis of the legal effectiveness of relationships and transactions, as well as affect its interpretation of the provisions of the *Income Tax Act* (Canada) (the "Act") and the application of those provisions to its findings. For example, the outcome of a particular tax avoidance case depends heavily on whether the court views its role as one of interpreting and applying the law strictly, with little emphasize on the policy behind the specific provisions at issue, or whether it views its role as one of interpreting and applying the law broadly, in accordance with the object and spirit of the Act and with reference to broad policy objectives.[4] It has historically been the "activist" courts that have attempted to counter tax avoidance through not only the application of specific tax anti-avoidance legislation, but also through the application of judicial anti-avoidance doctrines, including the doctrines of sham, legally ineffective transactions, agency and economic substance.

Before discussing the application of the economic substance test in Canadian tax jurisprudence, it is important to draw a distinction between the doctrines of "legal substance over form", which is solidly entrenched in Canadian tax jurisprudence, and "economic substance over form", which has been repeatedly rejected by Canadian courts.[5]

(a) Legal Substance over Form

The principle of "legal substance over form" refers to the proposition that the true nature of a transaction is to be determined in accordance with the true legal effects and relationships created thereby and not in accordance with the "form" or "nomenclature" used to describe the transaction. Under this doctrine, the form of a taxpayer's transactions will be respected only where that form properly reflects the legal substance of the transactions. Where, however, the legal substance of a transaction differs from its form, the courts will generally conclude that the transaction has been incorrectly characterized and will determine the tax consequences to the taxpayer based on its recharacterization of the transaction.

(b) Economic Substance over Form

The principle of "economic substance over form" refers to the proposition that in determining the tax consequences of a particular transaction, the courts will not recharacterize an otherwise legally effective transaction on the basis of its economic or commercial realities. Thus, so long as the parties negotiate a legally effective transaction, and that transaction is not at law a "sham", the legal form of the transaction

[4] For a more thorough discussion of the connection between the judiciary's view of its role and the outcome of tax avoidance cases, see Al Meghji and Gerald Grenon, "An Analysis of Recent Avoidance Cases," in *Report of Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 66:1-54, at 66:4.

[5] Brian A. Felesky and Sandra E. Jack, "Is There Substance to 'Substance Over Form' in Canada?" in *Report of Proceedings of the Forty-Fourth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993), 50:1-63.

should be respected and the CRA should not be permitted to recharacterize the transaction in accordance with its perceived economic substance.

The Application of the Economic Substance Test in Canadian Tax Avoidance Jurisprudence

(a) Pre-GAAR Transactions

Subsequent to the landmark decision of Supreme Court in *Stubart*,[6] Canadian courts have been more or less consistent in their approach to characterizing the true nature of a taxpayer's relationships. Specifically, the courts have generally refused to apply an economic substance test to recharacterize legally effective transactions on the basis of their economic and commercial substance. Rather, the Canadian judiciary has generally recognized that the legal relationships created by parties in a transaction should be determined in accordance with ordinary legal principles and without regard to the economic substance or commercial reality of the transaction. In other words, the courts support the proposition that a taxpayer is subject to tax on the basis of what the taxpayer legally did, not on the basis of what that taxpayer might have done or on the basis of the economic substance of what was done. Recent Supreme Court rulings on the subject of tax avoidance and, in particular, the application of the GAAR, give every indication that the Canadian judiciary intends to continue this approach.

This approach was derived, in part, from the Canadian judiciary's acceptance of the *Duke of Westminster* principle:

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine that the court may ignore the legal position and regard "the substance of the matter" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.[7]

As the following case summaries demonstrate, despite periodically flirting with the doctrine of economic substance, Canadian courts have generally been consistent in their application of the principle set out in

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6 *Supra*, note 2.

7 [1936] A.C. 1 (HL) at 19-20.

the *Duke of Westminster* that courts cannot ignore the legal realities of a transaction.[8] What the following cases do not expressly reveal, however, is that for a period of time after the Supreme Court's decision in *Stubart*, the Court of Appeal continued to analyze the legal realities of transactions and to apply the economic substance test in tax avoidance cases. As a result, the Supreme Court heard an unusually high number of tax cases during this period, most of which were decided in favour of the taxpayer on the basis that an economic substance test was inapplicable. Interestingly, in its decisions under the GAAR, the Court of Appeal appears more willing to apply the principles first set out in *Stubart* and to reject the application of an economic substance test.

Stubart Investments Ltd.* v. *The Queen

Although *Stubart* is not, strictly speaking, an economic substance case, it is significant in that it provided the first comprehensive direction from the Supreme Court in a tax avoidance case with respect to the proper characterization of legal relationships. In *Stubart*, the Supreme Court was unanimous in its rejection of the proposition that an otherwise legally effective transaction may be disregarded for tax purposes solely on the basis that it was entered into by the taxpayer for the purpose of avoiding tax and without a *bona fide* commercial purpose.

In *Stubart*, the taxpayer sold its assets to a sister corporation with accrued losses ("Grover"), and was thereafter appointed by Grover as its agent for the purpose of carrying on its manufacturing business. At the end of each of the 1966, 1967 and 1968 fiscal years, the taxpayer paid Grover the net income realized from the business and Grover reported this net income in its corporate income tax returns for these years. The Minister of National Revenue (the "Minister") subsequently reassessed the taxpayer for the net income it purportedly made on Grover's behalf. In support of the reassessment, the Minister argued that the transaction should be disregarded on the bases that (i) the transaction was not entered into by the taxpayer for a *bona fide* business purpose, (ii) the transaction was a sham, or (iii) the transfer of assets was incomplete and, therefore, legally ineffective.

The Tax Appeal Board and thereafter, the Federal Court - Trial Division, dismissed the taxpayer's appeal on the basis that the transactions were a "sham". The Federal Court of Appeal (the "Court of Appeal") dismissed the taxpayer's further appeal on the basis that the transactions were legally ineffective. In the course of its reasoning, however, the Court of Appeal was careful to state that it did not consider the purpose of the transaction, namely the reduction of tax liability, to be offensive:

> It was admitted that the transactions were entered into for the purpose of utilizing the tax losses accumulated by Grover. That in itself is not a reprehensible, let alone an illegal, act since every person is entitled to

[8] For an article discussing the decisions of the Supreme Court and its approach to tax avoidance, see Roger Taylor, "The Supreme Court of Canada: Principles of Adjudication of Tax-Avoidance Appeals from Stubart to Shell Canada" in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 17:1-53.

> organize his affairs in such a manner as to minimize or eliminate taxes so long as he does so within the limitations imposed by the law.[9]

The Supreme Court allowed the taxpayer's appeal. After concluding that the transactions were neither a sham nor legally incomplete, the Supreme Court engaged in a comprehensive review of the judicial anti-avoidance doctrines that had developed in Canada, the United States, the United Kingdom, and Australia and determined that, in the absence of express statutory language, the reassessments could not be upheld on the basis that the transactions had no *bona fide* business purpose.

The Supreme Court's rejection of this proposition was based, in part, on the differences between the taxing regimes in the United Kingdom and the United States, on the one hand, and Australia and Canada, on the other hand. In particular, the Supreme Court emphasized that neither the United Kingdom nor the United States, both of which had adopted a *bona fide* business purpose test and other similar judicial anti-avoidance doctrines, had enacted a regime of specific tax avoidance provisions similar to that in Canada and Australia:

> [T]he doctrines developing … reflect the role of the court in a regime where the legislature has enunciated taxing edicts in a detailed manner but has not superimposed thereon a general guideline for the elimination of mechanisms designed and established only to deflect the plain purpose of the taxing provision.
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> …
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> [I]n some jurisdictions, such as Canada and Australia, the legislature has responded to the need for overall regulation to forestall blatant practices designed to defeat the Revenue. These anti-tax avoidance provisions may reflect the rising importance and cost of government in the community, the concomitant higher rates of taxation in modern times, and hence the greater stake in the avoidance contests between the taxpayer and the state. The arrival of these provisions in the statute may also have heralded the extension of the Income Tax Act from a mere tool for the carving of the cost of government out of the community, to an instrument of economic and fiscal policy for the regulation of commerce and industry of the country through fiscal intervention by government. Whatever the source or explanation, measures such as section 137 are instructions from Parliament to the community on the individual member's liability for taxes, expressed in general terms. This instruction is, like the balance of the Act, introduced as well for the guidance of the courts in applying the

[9] 81 DTC 5120, at paragraph 14.

> scheme of the Act throughout the country. The courts may, of course, develop, in their interpretation of section 137, doctrines such as the *bona fide* business purpose test; or a step-by-step transaction rule for the classification of taxpayers' activities which fall within the ban of such a general tax avoidance provision.[10]

The Supreme Court concluded that the incorporation of a business purpose test into Canadian tax jurisprudence would interfere with and inhibit the dual purpose of Canadian tax legislation. Based in part on this reasoning, the Supreme Court held that in the absence of a "sham" or a legally ineffective transaction, Canadian courts must recognize the legal rights and obligations created between the parties:

> I would therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or *bona fide* business purpose.[11]

Despite the Supreme Court's clear rejection thereof, a degree of uncertainty remained with respect to the application of the economic substance test, and certain decisions of lower courts subsequent to *Stubart* reflected continued homage to the economic results test. However, the subsequent decisions of the Supreme Court provided consistent reaffirmation of its rejection of the economic substance test and the business purpose doctrine.

Neuman* v. *The Queen [12]

In *Neuman*, the taxpayer incorporated a holding company to which he subsequently transferred shares with a fair market value of $120,000. As consideration for the transfer of shares, the taxpayer took back a certain number of class G shares of the holding company, and an election was filed pursuant to subsection 85(1) of the Act. The taxpayer's spouse then subscribed for 99 non-voting class F shares of the holding company at a price of $1 per share. Dividends in the amount of $14,800 and $5,000 were subsequently paid on the class F shares and class G shares respectively. The taxpayer's spouse immediately loaned the $14,800 to the taxpayer in exchange for a demand promissory note. The taxpayer was subsequently reassessed on the basis that the dividends received by his spouse on her class F shares were properly attributable to him pursuant to subsection 56(2) of the Act.

In holding that subsection 56(2) did not apply to the dividend income received by the taxpayer's spouse, the Supreme Court emphasized the importance of the statement in *Stubart* that a transaction should not be disregarded for tax purposes because it has no independent or *bona fide* business purpose.[13]

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10 *Supra*, note 2 at 560, 573-74

11 *Ibid.*, at 575.

12 [1998] 1 S.C.R. 770.

***Duha Printers (Western) Ltd.* v. *The Queen*[14]**

In *Duha*, the taxpayer had entered into a complex series of transactions designed to avoid certain loss-utilization restrictions, the application of which would have resulted in the non-capital losses of the unrelated target company becoming unavailable to the taxpayer. The Minister reassessed the taxpayer and denied the deduction of the non-capital losses. The Tax Court of Canada (the "Tax Court") allowed the taxpayer's appeal, but this decision was overturned by the Court of Appeal.

The Supreme Court allowed the taxpayer's appeal. During the course of its reasons, the Supreme Court felt compelled to correct the statements made by the Court of Appeal to the effect that taxpayers should be denied the benefit of the provisions of the Act where the transactions in question are motivated solely for tax planning purposes:

> It is well established in the jurisprudence of this Court that no "business purpose" is required for a transaction to be considered valid under the *Income Tax Act*, and that a taxpayer is entitled to take advantage of the Act even where a transaction is motivated solely by the minimization of tax … Moreover, this Court emphasized … that, although various techniques may be employed in interpreting the Act, "such techniques cannot alter the result where the words of the statute are clear and plain and where the legal and practical effect of the transaction is undisputed".
>
> Although Linden J.A. cites these principles in his reasons, he appears not to have adhered to them in his analysis. At various junctures, he comments broadly about the apparent structuring of transactions, including the one at issue in this appeal, solely for tax purposes, and seems to imply … that the courts will not permit shareholders to attain tax benefits by means of "contrived" transactions … It was entirely open to the parties to use what Linden J.A. referred to as "technicalities of revenue law" to achieve their desired end … [T]his is what they accomplished, and nothing in the "object and spirit" of any of the various provisions can serve to displace this result.[15]

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13 *Ibid.*, at 785.

14 [1998] 1 S.C.R. 795.

15 *Ibid.*, at 839-40.

Continental Bank Leasing Corporation v. *The Queen*[16]

In October 1986, Continental Bank entered into a preliminary agreement with Central Capital Leasing ("Central") for the sale of the shares of its leasing subsidiary, Continental Bank Leasing Corporation ("Leasing"). However, after Central expressed concern with regard to certain liabilities of Leasing and the creditworthiness of certain lessees an alternative structure was proposed to replicate the economic consequences of the share sale and alleviate concerns with respect to the tax liabilities and leases. In accordance with this alternative proposal, Leasing formed a partnership with several Central subsidiaries, transferred the target assets into the partnership in exchange for a 99 percent partnership interest, and then distributed its partnership interest to Continental Bank. Continental Bank then sold its partnership interest to the purchaser's nominees. Leasing filed its income tax return on the basis that it had transferred all of its leasing assets, with the exception of certain leases, to the partnership pursuant to subsection 97(2) of the Act, and transferred its partnership interest to Continental Bank pursuant to section 88 of the Act. The Minister reassessed Leasing on the basis that the partnership transaction was invalid and that the true nature of the transaction was a disposition of assets to Central which gave rise to recaptured capital cost allowance ("CCA") for Leasing.

Leasing's appeal to the Tax Court was allowed and in the course of his reasons, Bowman J.T.C.C. summarized his view of the economic substance doctrine as follows:

> [T]he essential nature of a transaction cannot be altered for income tax purposes by calling it by a different name. It is the true legal relationship, not the nomenclature that governs. The Minister, conversely, may not say to the taxpayer "You used one legal structure but you achieved the same economic result as that which you would have had if you used a different one. Therefore I shall ignore the structure you used and treat you as if you had used the other one".[17]

The Minister's appeal to the Court of Appeal was allowed, but in the course thereof, the Court of Appeal applied an economic substance test.

The Supreme Court allowed the taxpayer's appeal and, as in *Duha*, dismissed the Court of Appeal's economic substance analysis:

[16] [1998] 2 S.C.R. 298.

[17] *Continental Bank of Canada* v. *R.*, 94 DTC 1858 (FCA) at 1871.

> A taxpayer who fully complies with the provisions of the *Income Tax Act* ought not to be denied the benefit of such provisions simply because the transaction was motivated for tax planning purposes. In *Stubart Investments, supra*, this Court unanimously rejected the "business purpose test" and affirmed the proposition that it is permissible for a taxpayer to take advantage of the terms of the *Income Tax Act* by structuring a transaction that is solely motivated by the desire to minimize taxation.
>
> …
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> The Court of Appeal proceeded on the basis that the predominance of fiscal motives or the absence of a concurrent business purpose justifies or compels the Court to disregard the legal form of the transaction which the parties intended.
>
> …
>
> The legal and commercial reality in the present case is that Leasing intended to and did enter into a partnership with Central … The Court of Appeal erred by ignoring the substance of a legally effective transaction.[18]

***Shell Canada Ltd.* v. *The Queen*[19]**

The taxpayer borrowed $150 million in New Zealand currency at an interest rate of 15.4% per annum. Thereafter, the taxpayer concurrently converted the NZ$150 million into United States currency for use in its US business and entered into a forward exchange contract with a foreign bank to hedge the NZ dollar interest payments and principal repayment. The foreign borrowing, coupled with the hedge, was aimed at securing higher interest deductions and a deferred foreign exchange gain upon repayment of the loan. In computing its income for tax purposes, the taxpayer deducted the interest it had paid on the NZ$150 million. In addition, for its 1993 taxation year, the taxpayer reported a capital gain of approximately US$21 million, resulting from the closing out of the foreign exchange contract upon the repayment of the principal then owing. In reassessing the taxpayer, the Minister permitted the taxpayer an interest

18 *Supra,* note 15 at 328, 329-330.

19 *Supra*, note 1.

deduction at the rate it would have paid had it borrowed US dollars, *i.e.*, 9.1% per annum. The Minister also recharacterized the capital gain as being on income account.[20]

The taxpayer's appeal (in respect of both the interest deductibility and the capital gains issues) was allowed by the Tax Court. The Minister's appeal to the Court of Appeal was allowed, in part, on the basis that the Minister's treatment of the interest deductibility issue should be affirmed. Specifically, the Court of Appeal was of the view that based on the economic realities of the transaction, the taxpayer had only paid interest at a rate of 9.1% and that the excess was a repayment of principal.

The taxpayer appealed to the Supreme Court on the issue of the interest deductibility, and the Minister cross-appealed the issue of the foreign exchange gain. As reflected in the following passages, the Supreme Court clearly and expressly reaffirmed its non-interventionist approach to statutory interpretation in tax cases:

> Both the Minister and the Federal Court of Appeal seem to suggest that s. 20(1)(*c*)(i) invites a wide examination of what Linden J.A. referred to (at para. 44) as the "economic realities" of a taxpayer's situation. Underlying this argument appears to be the view that taxpayers are somehow disentitled from relying on s. 20(1)(*c*)(i) if the structure of the transaction was determined by a desire to minimize the amount of tax payable.
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> This Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form . . . But there are at least two *caveats* to this rule. First, this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect . . .

20 As will be discussed in further detail below, the *Canadian Pacific* case also dealt with a hedged weak currency borrowing similar to that in *Shell*. The major difference between the two cases was that *Shell* was decided under the pre-GAAR tax regime whereas *Canadian Pacific* was decided under the GAAR.

> Second, it is well established in this Court's tax jurisprudence that a searching inquiry for either the "economic realities" of a particular transaction or the general object and spirit of the provision at issue can never supplant a court's duty to apply an unambiguous provision of the Act to a taxpayer's transaction. Where the provision at issue is clear and unambiguous, its terms must simply be applied . . .
>
> Inquiring into the "economic realities" of a particular situation, instead of simply applying clear and unambiguous provisions of the Act to the taxpayer's legal transactions, has an unfortunate practical effect. This approach wrongly invites a rule that where there are two ways to structure a transaction with the same economic effect, the court must have regard only to the one without tax advantages. With respect, this approach fails to give appropriate weight to the jurisprudence of this Court providing that, in the absence of a specific statutory bar to the contrary, taxpayers are entitled to structure their affairs in a manner that reduces the tax payable. . . . An unrestricted application of an "economic effects" approach does indirectly what this Court has consistently held Parliament did not intend the Act to do directly.[21]

***Ludco Enterprises Ltd. et al*. v. *The Queen*[22]**

The taxpayer borrowed money to purchase shares in two offshore companies which operated investment funds structured to avoid the application of Canada's foreign accrual property income rules. As a result of the companies' dividend distribution policy, over the eight years they held the shares the taxpayers each received approximately $600,000 in dividends but incurred approximately $6 million in interest charges. Upon disposition of their shares, the taxpayers each realized capital gains of approximately $9.2 million. The Minister reassessed the taxpayers and denied their interest deductions on the basis that the purpose of the transaction was to defer taxes and convert income into capital gains and, therefore, that the borrowing had not been made "for the purpose of earning income from property" as required by 20(1)(c)(i) of the Act. The Supreme Court allowed the taxpayer's appeal and prefaced its reasons with the "modern role of statutory interpretation" that had been cited with approval in *Stubart* and subsequent cases:

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21 *Supra*, note 1 at paragraphs 38-39, 40, 46.

22 [2001] 2 S.C.R. 1082.

> Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament …[23]

In the course of its decision, the Supreme Court also reemphasized its statements from *Stubart* with respect to role of the judiciary in tax cases and, in particular, reiterated that the judiciary should be reluctant to engage in judicial innovation and rule-making:

> [G]iven that the *Income Tax Act* has many specific anti-avoidance provisions and rules, it follows that courts should not be quick to embellish the provisions of the Act in response to concerns about tax avoidance when it is open to Parliament to be precise and specific with respect to any mischief to be prevented. To do otherwise would be to fail to give appropriate weight to the well-established principle that, absent a provision to the contrary, taxpayers are entitled to arrange their affairs for the sole purpose of achieving a favourable position regarding taxation.[24]

In addressing the Minister's argument that the taxpayers' true purpose in entering the transaction should be determined by reference to the nominal amount of income earned compared to the capital gains realized and interest deductions claimed, the Supreme Court had the opportunity to reconfirm its statements in *Shell* with respect to the economic substance test:

> [A] court should not place so much reliance on "economic realities" so as to cause it to stray from the express terms of s. 20(1)(c)(i) and supplement the provision with extraneous policy concerns that are said to form part of its purpose. Rather, where the provision at issue is clear and unambiguous, the court's duty is to simply apply its terms to the transaction at issue.[25]

(b) Post-GAAR Transactions

The GAAR was introduced in 1988 to replace an earlier version of section 245, which attempted to counter perceived abuses associated with the claiming of excessive deductions as a means of unduly or artificially reducing a taxpayer's income.[26] The present version of section 245 is drafted more broadly and

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23 *Ibid.*, at 1100, citing E. A. Driedger in *Construction of Statutes*, 2nd ed., Toronto: Butterworths (1983) at 87.

24 *Ibid.*, at 1101.

25 *Ibid.*, at 1111.

26 Subsection 245(1) of the *Income Tax Act*, R.S.C. 1952, chapter 148 as amended by section 1 of chapter 63, S.C. 1970-71-72 provided: "In computing income for the purposes of the Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly

attempts to counter tax avoidance by permitting the Minister to ignore, for tax purposes, the consequences of "avoidance transactions" and to assess tax liability on the basis of recharacterized transactions.

Subsection 245(2) provides that, if a transaction is an "avoidance transaction", the "tax consequences" are to be determined as is reasonable in the circumstances to deny the "tax benefit" that would otherwise result from the transaction or the series of transactions that includes the transaction. An "avoidance transaction" is defined in subsection 245(3) to be any transaction that, in the absence of the GAAR, would result directly or indirectly in a "tax benefit" or is part of a series of transactions that results in a tax benefit. However, such a transaction is not an "avoidance transaction" if it "may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit". Further, even if a transaction is an "avoidance transaction", subsection 245(4) provides that it will not be subject to section 245 unless the transaction results, directly or indirectly, in a misuse of the provisions of the Act or an abuse of the Act as a whole.

Accordingly, for section 245 to apply, the Minister must identify a transaction that is part of the series of subject transactions, and then the Minister must establish that the transaction results in a tax benefit, that the transaction is an avoidance transaction, and that securing the tax benefit results in a misuse of a provision of the Act or an abuse of the Act when read as a whole.

Under the GAAR, a taxpayer is not entitled to arrange his affairs to minimize tax unless the transaction can be shown to have been carried out primarily for *bona fide* purposes other than to obtain a tax benefit. It is important to keep in mind, however, that the GAAR is not a recharacterization provision. Specifically, the GAAR does not permit the Minister to recharacterize a transaction for purposes of applying the GAAR, but rather, the Minister can only recharacterize a transaction once it has been determined to have been entered into primarily for the purpose of avoiding tax unless the taxpayer can successfully argue that the transaction does not result in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act read as a whole.[27] In other words, the GAAR must be applied to the transactions into which the taxpayer actually entered. If the GAAR is applicable, the taxpayer can then be reassessed as if he had in fact entered into the transactions as recharacterized by the Minister.

Where the transaction can be shown to have been carried out primarily for tax purposes, the Minister is entitled to recharacterize the transaction and reassess the taxpayer on the basis thereof. Based on the foregoing, it is fair to say that the enactment of the GAAR has imposed a qualification on the *Duke of Westminster* principle. As explained in the recent *Imperial Oil* decision:

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or artificially reduce the income." Subsection 137(1) of the *Income Tax Act*, R.S.C. 1952, chapter 148 prior to amendment by section 1 of chapter 63, S.C. 1970-71-72 contained an identical provision.

[27] See Canada, Department of Finance, Explanatory Notes to Legislation Relating to Income Tax (Ottawa: the department, June 1988), clause 186.

> By confining legitimate tax avoidance to schemes that are not inconsistent with the policy underlying the statutory provision invoked by the taxpayer, GAAR effectively limits the scope of the principle in *Inland Revenue Commissioners v. Duke of Westminster* … that "[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it would otherwise be". Indeed, if the scheme considered in the *Duke of Westminster* was used in Canada today it "would probably be caught" by GAAR …
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> [T]he House of Lords itself has recognized that, as an aid to the interpretation of taxing statutes, the famous dictum in the *Duke of Westminster* emanated from an era when statutory interpretation was based on a literal approach. It thus seems out of step with modern jurisprudence which has extended to tax legislation the purposive approach taken to other statutes.[28]

***McNichol et al.* v. *The Queen*[29]**

Although the GAAR became law effective September 13, 1988, it took nearly a decade before a case involving post-GAAR transactions found its way before the courts. *McNichol* involved a "surplus strip", by which shareholders realized the economic equivalent of the surplus in their corporation through the sale of their shares. The taxpayers owned all of the shares in corporation ("Bec"), which owned a building that had been rented out to the taxpayers' former law firm. Bec sold the building, realizing a capital gain, after which the only asset left in Bec was approximately $319,000 in cash. The taxpayers wanted to realize their investments in Bec, and were advised that a share sale could be sheltered by their capital gains exemptions and would result in less tax than a dividend distribution. The taxpayers sought to attract a purchaser for their shares by offering to share the tax savings that would accrue to them as a result of the share sale. The shares were sold for $300,000 to a corporate purchaser controlled by a former client of the law firm. The purchaser had borrowed money from its bank for the purchase of the Bec shares, in effect using the cash in Bec as "security" for the loan. Shortly after the purchase, the purchaser amalgamated with Bec and used the cash to repay its bank loan.

The taxpayers each reported a capital gain of $75,000, and claimed their available capital gains exemption to shelter the gain. The Minister reassessed the taxpayers under the GAAR and taxed them as if they had received taxable dividends of $75,000 each. The Tax Court ruled that the GAAR was applicable to the transaction and upheld the reassessments.

[28] 2004 DTC 6044 (FCA) at paragraphs 32-33.

[29] 97 DTC 111 (TCC).

After determining that the transaction resulted in a tax benefit and that the primary purpose of the transaction was to obtain the tax benefit, the Tax Court concluded that the transaction resulted in a misuse of a provision of the Act or an abuse of the Act read as a whole:

> The transaction in issue which was designed to effect, in everything but form, a distribution of Bec's surplus results in a misuse of sections 38 and 110.6 and an abuse of the provisions of the *Act*, read as a whole, which contemplate that distributions of corporate property to shareholders are to be treated as income in the hands of the shareholders. It is evident from section 245 as a whole and paragraph 245(5)(c) in particular that the section is intended *inter alia* to counteract transactions which do violence to the *Act* by taking advantage of a divergence between the effect of the transaction, viewed realistically, and what, having regard only to the legal form appears to be the effect. For purposes of section 245, the characterization of a transaction cannot be taken to rest on form alone. I must therefore conclude that section 245 of the *Act* applies to this transaction.[30]

In concluding that the transaction must be "viewed realistically", the Tax Court seems to have invoked a form of economic substance test. Viewing the sale of shares "realistically", the court concluded that it was, in effect, a corporate distribution of Bec's surplus and, therefore, should be taxed as income to the shareholders under GAAR.[31]

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30 *Ibid.*, at 121-22.

31 It is interesting to note that the Court had concluded that there had been no distribution of corporate property for the purposes of the Minister's alternative basis for reassessment under subsection 84(2).

***OSFC Holdings Ltd.* v. *The Queen*[32]**

The Court of Appeal decided its first GAAR case in September 2001, and in doing so established the test that the courts have consistently relied upon to determine the applicability of the GAAR. After a mortgage company, ("Standard"), had become insolvent, the liquidator determined that it could maximize the recovery on the disposition of Standard's mortgage portfolio by packaging the mortgage portfolio in a partnership and thereby provide the potential buyer access to the substantial unrealized tax losses which had accrued in relation to the mortgage portfolio. The value of the mortgage portfolio (approximately $33 million) was substantially less than the cost (approximately $85 million). The liquidator caused Standard to incorporate a new wholly-owned subsidiary with which Standard formed a partnership (the "STIL Partnership") and held a 99% partnership interest. Standard then transferred its mortgage portfolio (with the unrealized losses intact) to the STIL Partnership and the liquidator entered into negotiations with the taxpayer for the purchase of Standard's 99% partnership interest. The taxpayer, who was in the business of acquiring, managing and improving upon distressed mortgages, was interested in acquiring the mortgage portfolio, but the amount of the potential tax loss was well in excess of what the taxpayer could use against its own business operations. Accordingly, prior to closing the purchase the taxpayer devised a complicated transaction whereby it spun off a portion of the 99% partnership interest to a number of third-party passive investors and retained 24% of the loss in question and 76% of the potential profits of the mortgage portfolio. Specifically, after its acquisition of Standard's 99% partnership interest in the STIL Partnership, the taxpayer formed a second partnership (the "SRMP Partnership") to acquire its 99% partnership interest in the STIL Partnership interest and then sold 76% of the SRMP Partnership to the third parties. The taxpayer sought to deduct a portion of the loss against its other income in the 1993, 1994 and future taxation years. The Minister disallowed this non-capital loss and the taxpayer appealed to the Tax Court.

The Tax Court dismissed the taxpayer's appeal, and the taxpayer appealed to the Court of Appeal. On appeal, the taxpayer conceded that there was a "tax benefit", but argued that (i) there was no relevant "avoidance transaction" and (ii) even if there was an avoidance transaction", it did not result in a misuse of a provision of the Act or an abuse of the Act as a whole.

During the course of its analysis with respect to the primary purpose of the transactions, the Court of Appeal accepted that there were both business and tax purposes. However, given the "significant disparity" between the potential tax loss of more than $52 million and the expected profit from the acquisition and sale of the mortgage properties of approximately $1 million, the Court of Appeal concluded that the taxpayer's acquisition of the 99% interest in the STIL Partnership was not undertaken primarily for *bona fide* purposes other than to obtain the tax benefit.

With respect to the misuse and abuse analysis, the taxpayer argued that Parliament's intended application of the relevant provisions must be found in the language of the provisions themselves. Accordingly,

[32] 2001 DTC 5471 (FCA), leave to appeal refused 294 N.R. 398 (SCC).

where the provisions in question are clear and unambiguous, the courts must be cautious before finding an unexpressed legislative intention. The Court of Appeal rejected this submission and held that the courts should have regard to the context of the provisions in question. Specifically, in determining whether there is a misuse, the avoidance transactions are to be analyzed considering the specific provisions of the Act at issue and all that lay behind the provisions, whereas the abuse analysis involves a consideration of the avoidance transactions in a wider context, having regards to the provisions of the Act read as a whole and the policy behind them. In so doing, the Court of Appeal held that reference could be made to extrinsic aids to determine the policy. In reconciling this position with the decision in *Shell*, the Court of Appeal stated:

> I do not lightly distinguish the pointed statements of the Supreme Court of Canada in cases such as *Shell* . . . that where the words of the *Income Tax Act* are clear they must be applied. However, in none of the cases in which the Supreme Court has set out this view did the Minister invoke section 245 as it now reads. I agree with the respondent that these statements of the Supreme Court cannot be said to apply to a misuse and abuse analysis under subsection 245(4).[33]

Although the Court of Appeal distinguished *Shell* and concluded that section 245 required the courts to look beyond the clear language of the provisions to determine whether a taxpayer's transactions resulted in a misuse of the provisions of the Act or abuse of the Act as a whole, it did not suggest that the principle in *Shell* that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships, should not apply where the Minister has invoked section 245 of the Act. Further, the Court of Appeal cautioned that the context in which the misuse and abuse analysis is conducted must not be overlooked:

> . . . The avoidance transaction has complied with the letter of the applicable provisions of the Act. Nonetheless, the tax benefit will be denied if there has been a misuse or abuse. This is not an exercise of trying to divine Parliament's intention by using a purposive analysis where the words used in a statute are ambiguous. Rather, it is an invoking of a policy to override the words Parliament has used. I think, therefore, that to deny a tax benefit where there has been strict compliance with the Act, on the grounds that the avoidance transaction constitutes a misuse or abuse, requires that the relevant policy be clear and unambiguous. The Court will proceed cautiously in carrying out the unusual duty imposed upon it under subsection 245(4). The Court must be confident that although the words used by Parliament allow the avoidance transaction, the policy of relevant provisions or the Act as a

33 *Ibid*., at paragraph 65.

> whole is sufficiently clear that the Court may safely conclude that the use made of the provision or provisions by the taxpayer constituted a misuse or abuse.[34]

The Minister's success in *OSFC* may have been a case of "winning the battle but losing the war". Specifically, the misuse and abuse test established by the Court of Appeal contains such a high threshold that the Minister has experienced much difficulty in satisfying it in subsequent cases.

***Canadian Pacific Ltd.* v. *The Queen*[35]**

Canadian Pacific was a weak currency loan case the facts of which were virtually identical to those in *Shell*. The issue in *Canadian Pacific* was whether the GAAR applied to the transactions whereby the taxpayer borrowed money for use in its business in a foreign currency. The taxpayer conceded that there was a tax benefit, but denied that there was an avoidance transaction and, even if there was, that there was any misuse of a provision of the Act or abuse of the Act read as a whole. The Minister argued that the taxpayer abused the provisions of the Act read as a whole because "the borrowing was structured so as to result in the deduction of Canadian dollar principal payments, which is contrary to the policy in the Act prohibiting the deduction of principal in the form of interest".[36] The Court of Appeal dismissed the Minister's appeal on the basis that there was no avoidance transaction and, thus, did not find it necessary to decide whether the Act contains such a policy. However, in the course of its reasons, the Court of Appeal stated that it agreed with the Tax Court's finding that the taxpayer had not, in fact, deducted any amounts in respect of principal. With respect to the misuse and abuse analysis, the Court of Appeal stated in o*biter* that there was "no authority which permits the court to ignore the nature of the relationship between CP and the lender and, in effect, to rewrite the terms of their agreement."[37] The Court of Appeal quoted extensively from the decision of the Supreme Court in *Shell* including the following:

> [T]his Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect.[38]

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34 *Ibid*., at paragraph 69.

35 2002 DTC 6742.

36 *Ibid*., at paragraph 29.

37 *Ibid*., at paragraph 30.

38 *Supra*, note 1 at paragraph 39.

The Court of Appeal explained the relevance of the Supreme Court's statement to a GAAR case as follows:

> This does not mean a recharacterization cannot occur. A recharacterization of a transaction is expressly permitted under section 245, but only after it has been established that there has been an avoidance transaction and that there would otherwise be a misuse or abuse. A transaction cannot be portrayed as something which it is not, nor can it be recharacterized in order to make it an avoidance transaction.[39]

Thus, had it been required to rule on the Minister's misuse and abuse submissions, the Court of Appeal would have rejected the argument, as it depended on the characterization of interest payments as payments of principal.

***Canada Trustco Mortgage Co.* v. *The Queen*[40]**

The taxpayer entered into an agreement to purchase equipment from Transamerican Leasing Inc. ("TLI") for a total purchase price of $120 million. The taxpayer used approximately $25 million of its own funds to purchase the equipment, and borrowed the balance from the Royal Bank. The taxpayer then leased the equipment to a third party who, in turn, entered into an agreement to sub-lease the equipment to TLI. In computing its income for the 1996 and 1997 taxation years, the taxpayer reported leasing income in the amounts of approximately $49 million and $52 million, respectively. In computing its income for the 1996 and 1997 taxation years, the taxpayer deducted CCA in respect of its leasing assets in the amounts of approximately $36 million and $46 million, respectively. The Minister reassessed the taxpayer in respect of its 1997 taxation year and denied CCA in the amount of approximately $31 million on the basis of the GAAR. The Tax Court allowed the taxpayer's appeal on the basis that the transactions in issue did not constitute a misuse of the CCA provisions of the Act, nor any abuse of the Act read as a whole. Likewise, the Minister's appeal to the Court of Appeal was dismissed on the basis that the Tax Court made no reviewable error in concluding that there had been no misuse of the provisions of the Act or abuse of the CCA scheme as a whole.

With respect to the misuse analysis, the Minister argued that the taxpayer had no "real cost" in respect of the equipment because the transactions resulted in no economic risk to the taxpayer. The Tax Court rejected this submission on the basis that it would have required the court to recharacterize the legal form and substance of the transaction. While noting that there are provisions in the Act which require an investigation of the economics of the situation, the Tax Court confirmed that there was no specific provision requiring that cost be determined with reference to an "economic reality test" for the purpose of the CCA regime. Accordingly, the Tax Court confirmed that an economic result is not determinative in

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39 *Supra,* note 34 at paragraph 33.

40 2003 DTC 587 (FCA).

cases of this nature, but rather, it is the legal result that is determinative. The Tax Court concluded that the taxpayer had paid $120 million for the equipment and, therefore, the taxpayer's cost of the equipment was $120 million.

Based in part on the decision in *McNichol*, the Minister argued that the GAAR permitted a recharacterization for purposes of determining a misuse or abuse. The Tax Court rejected this proposition as being an "overly enthusiastic reading" of the statements in *McNichol*, and concluded that the GAAR permits a recharacterization "only at the stage of determining the tax consequences, not at the stage of determining the misuse or abuse":

> GAAR is not to be imposed lightly. It should not permit a recharacterization of a transaction to find the transaction is abusive in its recharacterized form. The transaction must be viewed in its legal context and if found abusive, only then recharacterized to determine the reasonable tax consequences. That is how the GAAR provisions are set out: is there a tax benefit, is there a primary purpose other than obtaining that benefit, and does that avoidance transaction result in an abuse or misuse? All those questions require a review of the transaction, which is otherwise acceptable under all other provisions of the *Act*; that is, the legal transaction.[41]

Conclusion

The conclusion to be taken away from the preceding review of the past several decades of Canadian tax avoidance jurisprudence is that the Canadian judiciary will not generally apply the doctrine of economic substance to recharacterize transactions and determine the tax consequences on the basis of the transaction as recharacterized.

Further, it is now clear that the GAAR has not resurrected an economic substance test. Under the GAAR, a taxpayer's legal relationships will continue to be respected until it has been established that there has been an avoidance transaction and there would otherwise be a misuse or abuse. The economic substance of the taxpayer's transaction cannot displace the legal substance of the transaction for the purposes of determining whether there has been an avoidance transaction or whether there has been a misuse or abuse.

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[41] *Ibid.*, at 605.

Germany

By Oliver Dörfler[1]

I. Introduction

The German anti-avoidance rules are derived from case law as well as statutory law. Central to these rules is the general anti-avoidance provision, section 42(1) of the General Tax Code *(Abgabenordnung)*, which has been interpreted by extensive case law. Many special anti-avoidance rules also exist.

According to sec. 42(1), the legal effects of provisions of the tax code may not be avoided by abusive behavior on the part of the taxpayer. In the event of such behavior, tax will be determined as if the taxpayer had not behaved abusively, i.e. as if he or she had structured the transaction using the "appropriate" form.

Another provision that could be considered an anti-avoidance rule is section 41(2)(1) of the General Tax Code. According to this provision, simulated (or sham) business dealings are disregarded for tax purposes. Simulated business dealings shall be found where the parties in fact agree that the disclosed transaction shall not be carried out; what they intend is only a sham. From a German viewpoint, this provision would not strictly be considered an anti-avoidance provision, as it merely provides that a non-existent business transaction shall be treated as such for tax purposes.

A situation may arise whereby taxpayers have "vested" a certain transaction with another. In such a case, the underlying or "real" transaction intended by the parties shall be taken into consideration for tax purposes pursuant to sec. 41(2)(2). This provision is not a true anti-avoidance provision either since the "real" transaction, even if wrongfully qualified by the parties, is relevant for tax purposes.

II. The substance over form approach

German tax law in general recognizes a transaction as it is structured by the taxpayer (sec. 38 of the General Tax Code) as long as the transaction cannot be regarded as abusive under sec. 42(1) and the requirements of a specific anti-avoidance provision are not met.

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Sec. 42(1) provides that tax cannot be avoided by abusing the planning opportunities of the civil law.

The Supreme Tax Court has repeatedly taken the position (see decision of December 13, 1983, docket no. VIII R 173/83, *Federal Tax Gazette* 1984, part 2, p. 428) that an abuse of legal form shall be found if a legal structure is chosen which is

- inappropriate to reach the pursued goal;
- serves to reduce tax;
- cannot be justified by economic or other relevant non-tax considerations.

All of these criteria must be fulfilled cumulatively (see Supreme Tax Court decision of July 27, 1999, docket no. VIII R 36/98, *Federal Tax Gazette* 1999, part 2, p. 770).

The tax courts emphasize however that the taxpayer has the freedom to choose the most efficient tax structure for a given transaction. Hence, the case law acknowledges the right of the taxpayer to minimize its tax burden by utilizing certain planning techniques.

A certain legal concept is regarded as inappropriate if in light of the facts and circumstances and the desired business goals reasonable parties would not have selected it.

Among the aforementioned criteria, the first is obviously the most difficult to clarify. In this sense, the courts typically regard artificial, unusual and tricky concepts as abusive. Occasionally, an abusive transaction has also been defined as "uncommon" (see Supreme Tax Court decision of October 29, 1997, docket no. I R 35/96, *Federal Tax Gazette* 1998, part 2, p. 235). This case has been heavily criticized by German scholars, as it would mean that an innovative transaction is more likely to be deemed abusive. However, an uncommon transaction may nonetheless indicate the existence of abuse.

If the prerequisites of sec. 42(1) are met, a transaction will be disregarded and replaced by one that would have been appropriate in view of the economic goals of the taxpayers.

While these terms are very vague by nature, it is important to note that efforts of the tax authorities to apply sec. 42(1) can be rebutted by taxpayers if they can prove a good business reason for the transaction.

III. Special anti-avoidance rules

1. Specific anti-avoidance rules versus the general abuse of legal form provision

Apart from the general anti-avoidance clause of sec. 42(1), numerous specific anti-avoidance rules exist in German tax law.

Special anti-avoidance rules generally prevail over the more general provision. Consequently, if a given transaction passes the "test" of a special anti-avoidance rule, it may not be regarded as abusive by application of the general rule (see Supreme Tax Court decision of January 19, 2000, docket no. I R 94/97, *Federal Tax Gazette* 2001, part 2, p. 222).

The legislature, however, recently tried to override this principle by reshaping sec. 42 and adding the following words in sec. 42(2): "Sec. 1 is applicable if its applicability is not expressly excluded by law".

According to the legislature, the new words are only of a "clarifying nature". In fact, it tried to supersede the long-standing case law of the Supreme Tax Court according to which certain structures cannot be challenged under the general anti-abuse rule if they are allowed by more specific rules.

2. Specific anti-avoidance provisions

Among the special anti-abuse rules in German tax law, the following are the most important.

a) Sec. 2a of the Income Tax Code

This provision is designed to limit the use of losses from certain foreign activities, as listed in sec. 2a, against domestic source income, provided these activities are primarily passive in nature.

Consequently, losses derived from such activities may only be offset against income from the same type of activity and deriving from the same source country.

b) Sec. 7 et seq. of the Foreign Relations Tax Code (CFC rules)

The German rules on controlled foreign corporations (CFCs) contained in Sec. 7 et seq. of the Foreign Relations Tax Code were modeled on the US subpart F rules.

In general, a CFC is a foreign resident company which (i) is German controlled (this assumption is satisfied if more than 50% of the ordinary shares or voting rights are held directly or indirectly by German residents), (ii) generates passive income, and (iii) is subject to an effective tax rate of less than 25%.

Passive income covers all items that are not explicitly described as active income in the Foreign Relations Tax Code. Sec. 8 of the Foreign Relations Tax Code contains a list of activities which are deemed to generate active income and the prerequisites which must be met. A CFC can generate both passive and active income (e.g. from manufacturing and industrial activities, merchandising, etc.).

The federal Ministry of Finance has issued a list of jurisdictions that deserve special scrutiny due to their low tax rates and/or specific tax privileges.

If the prerequisites for a CFC are met, passive income as determined by German tax law is apportioned to German resident individual and corporate shareholders on a pro rata basis and taxed at regular rates. Foreign taxes paid by the CFC can either be deducted from the apportioned CFC income or credited against the shareholders' German tax liability.

c) Sec. 8a of the Corporate Income Tax Code

This provision aims to restrain thin capitalization of companies by foreign shareholders. If a loan granted by a shareholder or a related entity to the company exceeds a certain threshold, the interest payments will be recharacterized as dividends and therefore treated as non-deductible at the corporate level. Until recently, companies were accorded a debt-equity ratio of 1.5:1, with an extended safe haven of 3:1 for holding companies.

The European Court of Justice (ECJ) recently declared this provision incompatible with Art. 43 EC (freedom of establishment) (*Lankhorst-Hohorst*, C-312/00), as it targets mainly foreign shareholders.

In reaction to this decision, the thin cap rules have been extended to cover resident shareholders, as well. At the same time, the rules have been tightened in the following manner:

- The extended safe haven of 3:1 for holding companies has been withdrawn.

- The rules are applicable to all corporate entities, including debtors who are subject to only limited tax liability in Germany.

- The financing of a partnership to which the corporation is a partner with a share of more than 25% also falls within the scope of the new rules.

- Recharacterization of interest as dividends under the new rules will always take place for payments on a loan that has been taken out by a shareholder to finance the acquisition of shares within a group.

- The new rules also apply to trade tax.

On the other hand, a *de minimis* threshold of EUR 250,000 has been introduced, i.e. the new rules do not apply if the total amount paid on shareholders loans does not exceed this threshold.

d) Sec. 50d of the Income Tax Code

This is an anti-abuse provision designed to restrict treaty (and EU directive) shopping by means of the interposition of companies resident in tax treaty countries or within the European Union.

Pursuant to sec. 50d(3) of the Income Tax Code, benefits under a tax treaty or Community directive, mainly reductions in withholding tax, are not available to a foreign company if (i) the shareholders of the company claiming the reduction would not be entitled to it had they received the income directly, (ii) there are no economic or other relevant reasons for interposing the company, and (iii) the company does not have a business activity of its own.

IV. Outbound structures

1. General

International tax planning generally requires the use of entities with a view to sheltering the income generated by these entities from domestic tax or to obtaining certain other tax advantages.

Pursuant to German tax law, the tax authorities scrutinize the foreign tax relations of German taxpayers as follows:

(1) They pierce the corporate veil of the foreign base company in accordance with the general abuse of form doctrine (the foreign base-company case law);

(2) They take the position that the place of management of the foreign entity is in Germany if the foreign company is effectively controlled and managed from Germany;

(3) They apply the CFC rules.

2. Piercing the corporate veil

In interpreting sec. 42(1), the Supreme Tax Court has developed extensive case law about the circumstances in which a foreign entity will be disregarded for tax purposes. If a foreign company qualifies as a so-called "foreign base company", it will be ignored for tax purposes and its income attributed directly to its shareholders (i.e., the corporate veil is pierced).

More precisely, the Supreme Tax Court disregards a foreign entity if:

- there are no economic or other non-tax reasons for the establishment of the company, and

- the company does not have a business activity of its own.

Hence, legal structures can only be accepted for tax purposes if an appropriate economic purpose is pursued. If this is not the case, the establishment of the company is described by the Supreme Tax Court as "manipulation" (see Supreme Tax Court decision of March 20, 2002, docket no. I 38/00, *Federal Tax Gazette* 2002, part 2, p. 819).

Based on the above, it is sufficient to avoid piercing the corporate veil if the interposition of the foreign entity either can be justified by economic or other non-tax reasons or the entity has business operations of its own.

In this context, the Supreme Tax Court has accepted the interposition of a foreign entity if that entity owns a number of shareholdings of a certain size and importance (see Supreme Tax Court decision of July 29, 1976, docket no. VIII R 116/72, *Federal Tax Gazette* 1977, part 2, p. 268).

The existence of a legal entity is disregarded if it is found to be a shell company whose "business activity" is carried out exclusively by a controlling entity or affiliate. If the company cannot be classified as a shell (or brass plate) company, the courts decide on a case-by-case basis whether sufficient economic or other relevant non-tax reasons exist for the establishment of the company or if it has significant business activity of its own.

3. Recent case law

In several recent landmark decisions, the Supreme Tax Court has clarified the substance requirement for foreign base companies. These decisions are generally considered taxpayer friendly as the court has rejected the tax authorities' attempts to increase the substance requirements.

a) *Dublin Docks* decisions

The court recently handed down two decisions in the *Dublin Docks* cases (asset management companies established in Ireland) (see Supreme Tax Court decision of January 19, 2000, docket no. I R 94/97, Federal Tax Gazette 2001, part 2, p. 222; decision of January 19, 2000, docket no. I R 117/97, IStR 2000, p. 182). As both fact patterns are similar, reference is made below to decision no. I R 94/97.

Facts

A German company contributed capital to an Irish company having its seat and place of management in the International Finance and Service Centre (IFSC) in Dublin. IFSC companies were subject to corporate tax at a rate of 10% (as approved by the European Community). The purpose of the Irish company was to administer and invest funds contributed by its German parent, from which the Irish company generated mainly interest income. The Irish company's board of directors consisted predominantly of Irish resident individuals. Board meetings were held in Dublin. Apart from this, the company had no employees, office space or telephone lines. Its funds were managed by a third company pursuant to a management contract. The ultimate investment decision was however made by the board of directors in consultation with the German shareholder.

The German company claimed a participation exemption for the dividends distributed by the Irish company under the German-Irish tax treaty. The participation exemption did not stipulate an active trade or business test.

Abuse of legal form doctrine and CFC rules

In principle, the general abuse of legal form provision (sec. 42(1)) prevails over special abuse provisions, such as the CFC rules. The Tax Court however stated that in cases involving foreign subsidiaries in low-tax jurisdictions, the abuse provisions should be viewed in the context of special abuse provisions, such as the CFC rules, and evaluated on the basis of their purpose. Germany's CFC rules are designed to combat the generation of offshore income by assuming a deemed distribution of income rather than piercing the corporate veil of the offshore entity. In this sense, the Tax Court held that the generation of passive CFC income is not abusive per se. In order to ignore the foreign entity on the grounds of the general abuse doctrine further elements are required which indicate abuse, such as the use of shell companies.

Substance requirements

The court held that the Irish company had a function, as demonstrated by its board of directors which made decisions regarding investments with a certain level of risk. The fact that the company outsourced all investment activities to a third party did not change the court's opinion because this is in the very nature of professional fund management. Further, according to the court, outsourcing is inherent in the field of asset management where a German investment company is regulated by German investment law and accordingly a foreign structure should not be treated differently than a domestic one.

Furthermore, the IFSC company was not subject to the German CFC legislation since the CFC income was treated as a deemed dividend distribution. To this effect, a participation exemption in a tax treaty can be applied to such a deemed distribution (former sec. 10(5) of the Foreign Relations Tax Code). Since the participation exemption in the German-Irish tax treaty does not provide for an active trade or business test, the CFC income was effectively sheltered from German tax.

Non-applicability decree of the tax authorities

The tax authorities rejected the Supreme Tax Court's position in *Dublin Docks*. Consequently, they have issued a so-called non-applicability decree, stating that *Dublin Docks* cannot be applied beyond the cases in question (see federal Ministry of Finance decree of March 19, 2001, docket no. IV B 4 – S 1300 – 65/01, IStR 2001, p. 228).

Such a decree can be regarded as a last ditch effort by the tax authorities in cases where the Supreme Tax Court renders decisions which, in their view at least, are not in line with established principles of taxation. The increasing tendency to use such measures has however already raised the question as to whether such actions by the tax authorities are in line with the

German Constitution. In the view of the tax authorities, a non-applicability decree gives the Supreme Tax Court "the opportunity to rethink its position". If, however, the court sticks to its position in subsequent decisions, it is generally expected that the tax authorities should accept this and withdraw the decree.

b) ***Delaware* decision**

In *Delaware*, the Supreme Tax Court (decision of March 20, 2002, docket no. I R 63/99, *Federal Tax Gazette* 2003, part 2, p. 50) further clarified the substance requirements for special purpose companies.

Facts

A German resident company belonging to a US group took out a loan and contributed the funds to a US subsidiary ("US sub"). In turn, US sub extended a loan to another company in the group, resident in the US ("US OpCo") which used the funds to construct an office building. US sub was liquidated immediately after completion of the construction work.

The interest income was subject to tax at the level of US sub at a rate of 34%, while the interest expenses on the bank loan were tax deductible at the level of the German company. As US sub was taxed at a rate of 34%, the German CFC legislation did not apply.

Reasoning

The Tax Court held that the interposition of US sub as a special purpose vehicle was not abusive on the basis of the following considerations:

- Substance requirements

  US sub was not a mere letterbox company; it had own business premises, fax and telephone lines, and personnel. The fact that the personnel of the company were part-time staff was not relevant.

- Special purposes vehicles

  Special purpose vehicles set up for a specific purpose cannot per se be disregarded. The fact that the company was set up for the sole purpose of financing the construction of an office building must be respected. If they so wish, the shareholders can limit the business purpose of a subsidiary.

- Functions and risks assumed

  The company assumed functions and risks according to its (limited) business purpose. It controlled and overviewed the construction process as money was paid out according to various defined milestones. The company therefore acted in its own name and on its own behalf.

  The fact that the main function of the staff consisted of accounting duties was irrelevant. According to the court, it is “in the nature of a company the main purpose of which is to grant loans and to manage funds, that its day-to-day business activity consist of booking its expenditures and proceeds”.

- Business reasons

  Since the company had economic activity of its own, it is not relevant whether there was a specific business purposes for the company.

- International tax arbitrage

  The fact that the structure was designed to achieve tax arbitrage cannot be regarded as abusive.

- General versus specific anti-avoidance provisions

  The court also commented on the relationship between sec. 42(1) and the CFC provisions. The content of the general anti-avoidance provision is determined in light of the CFC provisions. If the CFC rules recognize the tax shield of a foreign company (in the case at hand because the company was not taxed at a rate below 25%), recognition of the foreign company cannot be questioned merely because it derives passive income. As the court pointed out, it follows from the CFC rules that the existence of a foreign company shall only be disregarded if it derives passive income *and* is taxed at a low rate.

  The court also commented in an obiter dictum on the newly introduced sec. 42(2), according to which the general anti-avoidance rule in sec. 42(1) “is applicable, if its applicability is not expressly excluded by law”.

By inserting this new provision, the legislature tried to supersede long-standing case law of the Supreme Tax Court according to which the general anti-avoidance rule should be interpreted in conjunction with the purpose of special provisions, if any. Accordingly, if specific anti-avoidance rules respect certain structures, such structures cannot be challenged by applying the general abuse of form rule. Specific anti-avoidance provisions therefore limit the scope of application of the general abuse rule.

The court confirmed that this new provision did not alter its former case law and thus has no practical effect. In that respect, the court stated that if the general anti-avoidance rule could not be applied because its conditions were not fulfilled, its application could not be based on sec. 42(2).

V. Inbound structures

1. Share rotation decisions

In an outbound scenario, the existence of a foreign base company will be disregarded if there are no economic or other relevant reasons for the establishment of the company and the company does not have its own business activity (see above).

Generally speaking, this does not apply to the interposition of a *domestic* company in an inbound scenario. The Supreme Tax Court has regularly ruled that the interposition of a domestic company should not be regarded as abusive if there is a certain degree of permanency in the domestic establishment. The court developed this holding in the so-called "share-rotation" cases (see decision of October 23, 1996, docket no. I R 55/95, *Federal Tax Gazette* 1998, part 2, p. 90).

Facts

In the share rotation cases, individuals sold their shareholdings in Company A to a holding company owned by them. The capital gain from the sale was tax exempt or subject to a tax break. Company A subsequently distributed its reserves to the holding company.

The (taxable) distribution of reserves could be neutralized by a write-off of the shares in the distributing company, insofar as the income generated from the distribution of profits from Company A could be sheltered from tax (at least until distributed to the individuals).

Reasoning

At the time, capital gains from the transfer of privately owned shares comprising a substantial shareholding (i.e., more than 25% of the share capital of the company) were subject to tax (although at reduced rates). Based on this legislative concept, the court concluded that it was within the discretionary power of the legislature to tax dividends and capital gains differently. Since the legislature had chosen to tax dividends in full and capital gains at a reduced rate or not at all, it was not per se abusive to implement a structure that took advantage of the system.

As a prerequisite, the interposed holding company had to be established on a permanent basis, not just for the purpose of acquiring the shares in Company A.

Although the case was a purely domestic one, the same holds true for interposition of a holding company in an inbound scenario. The court has stressed that the criteria relevant for the recognition of foreign base companies generally cannot be applied to domestic holding companies. According to the court, the main difference is that the taxpayer regularly obtained a definite tax benefit through the ”tax shield” of a foreign base company, whereas in the case of domestic holding companies, taxation is only deferred (Supreme Tax Court decision of December 9, 1981, docket no. VIII R 11/77, *Federal Tax Gazette* 1981, part 2, p. 339).

2. German holding company case

Despite the general rule, the interposition of a German resident company may be abusive under certain circumstances (Supreme Tax Court decision on non-acceptance of appeal as of January 25, 2001, docket no. I B 92/00, not officially published).

Facts

A Swiss company held shares in a German operating subsidiary (“OpCo”). Subsequently, the Swiss company established a German holding company (“HoldCo”) and transferred the shares of the German operating company to the German holding company. The purchase price was financed by a shareholder loan.

HoldCo could offset dividends received from Opco against the interest paid its Swiss parent. Under the full imputation credit system applicable at the time, HoldCo received a full refund of corporate tax paid by the distributing company on its profits.

HoldCo did not have its own business premises or personnel. Furthermore, the company was domiciled at the offices of its German legal advisors. The management of the company was carried out by a director domiciled in Switzerland.

Reasoning

In this case, the court stated that the interposition of the German holding company had to be regarded as abusive since the only business activity of the company consisted in holding the shares of the German operating company.

The court thereby confirmed the lower tax court's position (see Lower Tax Court of Baden-Württemberg decision of April 13, 2000, docket no. 3 K 235/97, juris STRE 200171646), which held that the interposition of the German holding company was purely "formal" and for the sole purpose of claiming a refund of tax credits. It specified, however, that interposition of a German holding company is not usually regarded as abusive.

3. Loss utilization case

The court held in its decision of October 17, 2001 (docket no. I R 97/00, DStR 2002, p. 78) that the implementation of strategies with a view to utilizing existing loss carry-forwards should not be regarded as abusive.

Facts

X AG and Y AG jointly owned all the shares in S GmbH, which in turn owned all the shares in A GmbH. A GmbH had significant loss carry-forwards. It was envisaged to combine the businesses of A GmbH and S GmbH by merging A GmbH upstream into S GmbH. As the loss carry-forward would have been lost in the merger, X AG and Y AG granted interest-free shareholder loans to A GmbH, which in turn deposited the funds with banks and derived interest income. After the loss carry-forwards had been utilized, A GmbH was merged into S GmbH.

Reasoning

The court held that strategies which make use of existing loss carry-forwards cannot be regarded as abusive. By taking a global view, the court stated that loss carry-forwards ensure that profits are only taxed once and hence, avoid the taxation of "deemed" profits. In the court's opinion, the use of loss carry-forwards encourages taxation on the basis of individual capacity, a principle derived from fundamental rights and thus embodied in constitutional law.

As expressly stated by the court, a tax-planning strategy utilizing losses is not considered abusive if it is carried out *exclusively* for tax purposes. The fact that the merger of the loss-generating entity had been postponed solely in order to implement a scheme utilizing existing losses was, in the court's opinion, of no relevance.

4. Foreign holding company case

In its decision of March 20, 2002, the Supreme Tax Court denied a refund of dividend withholding tax pursuant to the Parent-Subsidiary Directive (docket no. I R 38/00, DStRE 2002, p. 1068).

Facts

HoldCo BV, a Dutch company, held all the shares of OpCo GmbH, a German resident company. The only business activity of HoldCo BV was holding the shares of OpCo GmbH. It had no personnel or business premises. The shares in HoldCo BV were held by HoldCo Ltd., a company registered in Bermuda. HoldCo Ltd. also held shares in numerous affiliates in the Netherlands. The business director of HoldCo BV served as the business director for several other affiliates of HoldCo Ltd. The shares in HoldCo Ltd. were owned by individuals resident in Bermuda (85%), the US (7.5%), and Australia (7.5%).

HoldCo BV claimed a full refund of the withholding tax deducted on dividend distributions by OpCo GmbH on the basis of the Parent-Subsidiary-Directive.

Reasoning

According to sec. 50d(3) of the Income Tax Code, a foreign company is ineligible for withholding tax reductions under a tax treaty or a Community directive if (i) the shareholders of the foreign company are not themselves entitled to the reduction, (ii) there are no economic or other relevant reasons for the interposition of the company, and (iii) the company does not have its own business activity.

As HoldCo BV did not have its own business activity and no good business reasons for the interposition of the company could be presented, the court found HoldCo BV to be a shell company. This finding is consistent with the Parent-Subsidiary Directive. Although the Directive does not establish any requirements regarding business activity, the interposition of a mere brass plate company must be regarded as abusive under Community law, leading to denial of the benefits of the Directive.

Sec. 50d(3) is a codification of former case law on sec. 42 (the general anti-avoidance provision) and contains a pitfall for the unwary.

The decisive question in the case was whether sec. 50d(3) warrants a general look-through approach. Answering this question in the affirmative would have meant that the shareholders in the Bermuda-based company could have claimed treaty benefits to the extent they were resident in tax treaty countries (such as the US and Australia).

The court, however, adopted the position that sec. 50d(3) only necessitates disregarding the Dutch company. Hence, the court looked no further than the Bermuda holding company, with the result that no refund could be obtained since Germany has not concluded a tax treaty with Bermuda.

Spain

By Gonzalo Rodés

1. INTRODUCTION

The vast majority of the EU Member States have enacted anti-abuse rules to combat tax avoidance. Many of these rules are the result of the transposition of Community directives into national law. Unfortunately, however, the Member States do not always faithfully observe the terms, criteria and guidelines for transposition and sometimes modify Community rules in the process.

In addition to this body of anti-abuse law, there is a wide diversity of terms defining tax avoidance. These terms are loaded with ambiguity and thus legal insecurity for those who attempt to avoid application of the anti-abuse rules.

2. ANTI-ABUSE RULES IN COMMUNITY TAX LEGISLATION

Most tax legislation in the EU is contained in directives issued by the Council of Ministers. These directives oblige the Member States to follow the guidelines contained therein and to transpose them into national law.

The definitions of tax fraud, tax evasion, tax abuse, and tax advantage are not clear cut as they apply indeterminate legal concepts to specific events not described by the rules. Therefore, it is very difficult to establish a uniform definition of tax fraud as long as harmonisation in the area of taxation remains incomplete.

Most scholars believe that tax fraud exists if the transaction has no economic substance, i.e. it is an "artificial" act with no real business purpose.

Thus, the non-existence of a valid economic reason could constitute proof of tax fraud or abuse, although this will not always be the case as a transaction may have real economic motives that are of little significance when compared with the resulting tax savings.

Consequently, the main criterion used by the Community directives to determine the existence of tax fraud is whether there are “valid economic motives” for carrying out the transaction.

The best example of this criterion can be found in Directive 90/434/CEE of 23 July 1990 on the general tax rules applicable to mergers, divisions, contributions of assets and exchanges of shares (hereinafter, the "Merger Directive") and in the US “business purpose” doctrine.

Effectively, Article 11.1.a of the Merger Directive reads:

> *A Member State may refuse to apply or withdraw the benefit of all or any part thereof (*of the special rules applicable to certain qualifying reorganisations*) where the merger, division, contribution of assets or exchange of shares:*
>
> > *a) has as its principal objective or as one of its principal objectives tax fraud or tax evasion; the fact that one of the operations referred to in Article 1 is not carried out for valid economic motives such as the restructuring or rationalisation of the activities of the companies participating in the operation may constitute a presumption that the operation has tax fraud or tax evasion as its principal objective or as one of its principal objectives.*

The Directive does not define tax fraud or tax evasion as such, although it is presumed to exist if an operation does not have valid economic motives.

We will highlight two judgments of the European Court of Justice (ECJ) to better understand the concepts of tax fraud and tax evasion as used in Community legislation:

- ✓ *Denkavit* established the principle of proportionality, insofar as the measures to combat abuse contained in the national law of the Member States cannot go beyond what is necessary to fulfil the purpose of the Directive, thus leading to a restrictive interpretation of the anti-abuse rules.

- ✓ In *Leur-Bloem*, the ECJ held that:

  - ➢ The tax benefits of the Merger Directive can only be refused if the primary purpose of the transaction is tax fraud or tax evasion.

- Jurisdiction for proving tax fraud or tax evasion lies with the national authorities, which must make a global analysis of every transaction in question, without, to this effect, being able to exclude *a priori* specific transactions from application of the rules where certain circumstances envisaged in the Directive are present.

- The "valid economic motives" concept is wider than the mere seeking of a tax benefit.

- The fact that there is no valid economic motive does not render the transaction tax fraud or tax evasion, but the Member States can establish a presumption to this effect if the transaction is not carried out for valid economic reasons, such as restructuring or rationalizing the activities of the companies in question.

3. THE BUSINESS PURPOSE DOCTRINE

As mentioned, the US business purpose doctrine may also help to clarify the concept of valid economic motives as contained in the Merger Directive and the national laws of the Member States.

This concept was developed by US courts to combat tax avoidance and is one of several doctrines used by the courts for this purpose. Others include the sham doctrine, the step transaction doctrine, and the principle of substance over form.

A sham transaction is equivalent to what Spanish tax law refers to as simulation.

The step transaction doctrine collapses, in specific instances, formally independent transactions.

Finally, the interpretive principle of substance over form provides that the substance of a transaction should prevail over its form, if certain conditions are met.

As mentioned above, the business purpose doctrine was invented by the courts and is a product of the common law system. As such, it contains many different aspects that cannot easily be absorbed by civil law legal systems (such as Spain).

The civil law system led the Spanish legislature to establish conceptualised categories of tax avoidance and tax evasion *(see below)*, different from those in common law jurisdictions, which do not have the same dogmatic need to establish fixed categories. Therefore, tax evasion cases in Spain are interpreted with more discretion than would be the case under the business purpose doctrine.

However, the business purpose doctrine is an extremely useful interpretive tool used by both Spanish legal scholars and the courts.

4. ANTI-ABUSE RULES IN SPANISH LAW

Spain was not an exception among the Member States in introducing new anti-abuse rules. Unfortunately, its definitions of various legal concepts were regrettably loaded with ambiguity, making it very difficult to distinguish one from the other and rendering them practically inapplicable.

4.1. The General Tax Law, in effect until 30 June 2004

In Spain, the tax law *par excellence,* establishing the general principles of taxation, is the so-called General Tax Law (*Ley General Tributaria*, hereinafter the "LGT"), first published in 1963, amended in 1995, and renewed last December, effective 1 July 2004.

Although tax avoidance is a sufficiently well-known concept, which can be defined as the intention to avoid tax liability by using a legal form or construction that does not suit the purpose of the transaction, we will see that the Spanish legislature resorted to indeterminate concepts in order to define it.

Historically, the LGT has distinguished between two legal concepts. The courts have added a third which presumes the existence of tax avoidance.

A simulated or sham transaction shall be found where the parties to a transaction state, consciously and by common accord, an intention that does not reflect economic reality, thereby creating the appearance of a transaction when none actually exists, or a transaction that is different from the one they plan to carry out.

There are two types of simulation:

- ✓ Absolute simulation: the parties reach an agreement to carry out a transaction, but they never intend to do so.

- ✓ Relative simulation: the parties reach an agreement to carry out a certain transaction but intend to carry out a different one.

Fraud in law is defined as any act carried out pursuant to a specific rule of law with the intent to achieve a result that is prohibited by or contrary to another rule. The end result is that the rule one attempts to avoid is ultimately applied.

Indirect business is a concept established by the Spanish courts; it entails carrying out a transaction whose typical purpose is different from the one stated by the parties, although their actual purpose is not incompatible with the transaction in question.

Until 30 June 2004, there will continue to be a distinction between simulation, fraud in law, and indirect business, taking into account that for the Spanish tax authorities to declare the existence of fraud in law there must be a long, complicated legal procedure, meaning few such cases are ever heard.

In addition, in practice it is very difficult to distinguish cases of fraud and simulation in the field of taxation. In theory, simulation is a question of fact (proof of the existence of the sham agreement) whereas fraud in law is a question of interpretation. Furthermore, in the latter case the parties do not use the transaction for its stated purpose but rather for another, frequently hidden, one.

Difficulties regarding the definition and application of the above terms have hindered the fight against tax avoidance in Spain and prevented problems of interpretation from reaching the courts, so there is little case law to shed light on the anti-abuse rules.

4.2. Transposition of the Merger Directive into Spanish law

The first Spanish law to define the concept of tax fraud more specifically is the anti-abuse clause included in the legislation applicable to mergers, divisions, contributions of assets and exchanges of shares, based on Article 11.1.a of the Merger Directive (see above).

Article 110.2 of the Spanish Corporate Tax Act provides:

> *The rules established in this chapter* (for special tax treatment) *will not apply when the principal objective of the transaction in question is tax fraud or tax evasion. In particular, the rules will not apply when the transaction is not carried out for valid economic motives, such as the restructuring of the activities of the participating companies, for the mere purpose of obtaining a tax advantage.*

We can see that transposition of the Merger Directive into Spanish law was not precise. Whereas the Directive permits the Member States to establish a presumption of tax fraud or tax evasion when a transaction has not been carried out for valid economic motives, the Spanish legislation does not establish a presumption but rather includes an emphatic statement to the effect that lack of an economic motive, coupled with a desire for a tax savings, renders the special rules (for deferred taxation) inapplicable.

In our opinion, the Merger Directive does not grant the Member States unlimited authority to establish their own anti-abuse rules. Rather the Member States should adhere to the provisions of the Directive.

Two interpretations of the differences in wording of the Directive and the Spanish legislation are possible:

- ✓ The first provides that three circumstances must occur for the anti-abuse rule to come into play: the existence of tax fraud or tax evasion, the non-existence of valid economic motives, and the fact that the main purpose of the transaction is to obtain a tax advantage.

- ✓ The second holds that the occurrence of tax fraud or tax evasion is not necessary but merely sufficient for there to be no valid economic motives and for the primary purpose of the transaction to be tax savings.

  As far as the second interpretation is concerned, there are those who feel it is sufficient if one of these two conditions is met, i.e., application of the special rules can be disallowed if there are no valid economic motives, even though no tax advantage has been obtained, or if the main objective of the transaction is to obtain a tax advantage even if there are valid economic motives.

Along with other commentators, we feel that both conditions should be met in order for the special rules to be rendered inapplicable, i.e. there must be no valid economic motives and the main purpose of the operation must be to obtain a tax advantage.

However, we could come down in favour of the first interpretation. The existence of tax fraud or tax evasion along the lines of the Merger Directive must be proven, however.

Last but not least, with regard to the possibility of sanctioning these transactions, it is our understanding that except in those cases where tax evasion is blatantly obvious and no economic motives exist, the majority of such transactions give rise to interpretative disputes and thus are rarely sanctioned.

4.3. General Tax Law, effective 1 July 2004

We have already seen that under the former LGT it was very difficult to distinguish between simulation, fraud in law and indirect business. Thus, instead of resorting to use of these concepts, the Spanish courts have traditionally classified the facts according to their nature and effects.

However, the new LGT, which we feel is more in line with the Merger Directive, permits a presumption of tax fraud or tax evasion when the act or transaction is not carried out for valid economic motives. Using what is known in the US as the business purpose doctrine, the new law focuses more on the economic effects of the transaction for the purpose of determining the existence of tax avoidance.

Consequently, the new LGT includes two anti-abuse rules:

Simulation, as defined in Article 16.1:

> *In the acts or transactions where simulation exists, the taxable event will be the one effectively carried out by the parties.*

Furthermore, in the event of a **conflict in the application of the tax rules**, a new legal concept replaces the old concept of fraud in law, and is defined in Article 15.1:

> *It shall be understood that a conflict exists in the application of the tax rules when all or part of the taxable event is avoided or the tax base or tax liability is reduced by means of acts or transactions where the following circumstances occur:*

a) *Taken individually or as a whole, the transactions are recognisably artificial or improper to achieve the end result.*

b) *No relevant legal or economic effects result from their use, other than tax savings and the effects which would have been obtained with the usual or proper acts or transactions.*

This new concept of “conflict in application of the rules” proposes to utilise the new “abuse of law” provision as an effective tool in the fight against sophisticated tax fraud, thereby attempting to overcome the traditional problems of applying this concept in tax matters.

Obviously, we cannot state with certainty the name of this concept ("abuse of law"), as it is liable to give rise to interpretive differences between the tax authorities and taxpayers.

However, in general, an abuse of law will be found if an artificial or improper act or transaction is carried out in order to achieve a particular result and there are no relevant legal or economic effects other than tax savings. Consequently, the new anti-abuse rules purport to overcome the problems inherent in the old law by defining tax avoidance on the basis of objective criteria.

However, Spanish law continues to require that a special consultative commission issue a favourable opinion before the tax authorities can declare the existence of a “conflict in application of the rules." This requirement may once again pose an obstacle to practical application of the law.

4.4. Conclusions

The anti-abuse rules contained in Spanish tax law are evolving towards the concept of “valid economic motives” as contained in the Merger Directive and the US business purpose doctrine, especially after redefinition of the concept of fraud in law, currently known as a “conflict in application of the tax rules”.

Consequently, even when transactions have been effectively carried out, if they are deemed recognisably artificial or improper for achieving the end result, in whole or in part, and do not produce relevant legal or economic effects but simply tax savings, tax fraud will be found.

We believe, however, that Spanish law still needs to progress as far as clarity of these anti-abuse rules is concerned, and the distinction between simulation and a conflict in application of the tax rules should be abolished to make way for a single definition that enables the authorities to determine taxable events in accordance with the results actually achieved by the parties or based on the economic substance of the transaction, regardless of its legal form or the name given to it by the parties.

5. SOME PRACTICAL EXPERIENCE REGARDING APPLICATION OF THE ANTI-ABUSE RULES IN SPAIN

5.1. Tendency to include new anti-abuse rules and toughen existing ones

Although most of the tax benefits under Spanish law include anti-abuse provisions, there is no general policy to promote them.

Some of these rules are detailed below:

A) The Merger Directive under Spanish law (tax deferral): valid economic motives are required

The following examples illustrate the general position of the tax authorities in determining whether a transaction has valid economic motives (as there is no case law on the subject).

The following are considered *a priori* valid economic reasons:

- ✓ To achieve a differentiated, more orderly and efficient management structure and greater flexibility in establishing corporate strategy, new investment projects and potential alliances with third parties (July 13, 2000 enquiry on a complicated subjective split).

- ✓ Takeover by a dormant company of the company constituting its sole asset due to the absorbing company not having a reason for existence taking into account the consequent savings in terms of costs and formal obligations (enquiry of December 12, 2001).

- ✓ To split two totally different activities, such as distribution of foodstuffs to supermarkets and leasing of business premises, with the objective of assigning each activity to a different company and separating their management (enquiry of October 1, 2002).

On the other hand, the tax authorities have ruled that the following are not valid economic motives:

- ✓ Takeover through merger of an entity whose equity has registered losses from earlier years and, for the same amount, to debt from a financial entity, since it seems the only reason for the merger is to offset the negative tax base of the absorbed company (enquiry of January 19, 2001).

- ✓ A partial split and subsequent exchange of shares of the companies concerned between shareholders, leaving each with one company. The tax authorities feel that this transaction produces an equivalent result, from both an economic and a legal point of view, as would have been obtained by carrying out a total split (without branches of activity) and that the primary purpose of the transaction is to avoid the taxable event that would have occurred had the transaction been carried out without applying the special rules (enquiry of May 7, 2001).

- ✓ Total split of a dormant company that owns three real estate properties and is wholly owned by an individual who assigns one of the properties to a company that later sells its shares generating a capital gain, which the individual does not declare since the requisite holding period for the shares was satisfied. The tax authorities are of the opinion that this transaction does not qualify for special treatment since there is no valid economic reason for the transaction. Rather, there is a clear tax advantage when a company is interposed to sell one of the properties (enquiry of November 12, 2002).

B) Abolishment of the thin capitalisation rules

Interest paid on foreign related-party debt in excess of a 3:1 debt-equity ratio is recharacterized as a dividend and, therefore, is not tax deductible.

However, since 1 January 2004, Spanish law has relaxed its thin capitalisation rule by applying the Community principle of freedom of establishment and consequently declared the rule inapplicable if the related foreign lender is resident in an EU Member State.

C) General transfer pricing principles

The Spanish general transfer pricing principles allow the tax authorities to adjust prices when the value given by the related parties to the transaction is determined not to be at arm's length and results in the deferral or reduction of the overall tax due by all the related individuals or legal entities involved in the transaction.

Special rules are provided for specific activities. For example, amounts paid for management services to related entities are deductible only if paid on the basis of a written agreement entered into before the services are rendered. The agreement must specify the kind of services to be provided and must establish the criteria for allocating expenses, which must be consistent and reasonable.

Other transfer pricing rules allow the tax authorities to evaluate at fair market value certain transactions where there is no clear price and the transaction is liable to result in tax avoidance, such as gifts and other transactions entered into with tax haven resident entities or individuals.

D) Safe harbour rules

Specific valuation rules are provided for the sale of shares of unlisted corporations and for contributions in kind by individuals to corporations.

E) Provisions regarding tax havens

Rather than defining the concept of a tax haven, the Spanish authorities publish a "black list" of countries deemed to be tax haven jurisdictions (see below):

Royal Decree 1080/1991 of 5 July 1991, effective from 25 July 1991, lists the following 48 tax havens:

IN THE AMERICAS:
Anguilla; Antigua and Barbuda; Aruba; the Bahamas; Barbados; Bermuda; the British Virgin Islands; the Cayman Islands; Dominica; the Falkland Islands; Grenada; Jamaica; Montserrat; the Netherlands Antilles; Panama; Saint Lucia; Saint Vincent and the Grenadines; Trinidad and Tobago; the Turks and Caicos Islands; the US Virgin Islands;

IN EUROPE:
Andorra; Cyprus; Gibraltar; Isle of Man and the Channel Islands; Liechtenstein; Luxembourg (only in respect of income received by companies subject to the special holding company status); Malta; Monaco; San Marino;

IN AFRICA AND THE MIDDLE EAST:
Bahrain; Jordan; Lebanon; Liberia; Mauritius; Oman; the Seychelles; the United Arab Emirates; and

IN ASIA AND THE PACIFIC:
Brunei; the Cook Islands; Fiji; Hong Kong; Macau; the Mariana Islands; Nauru; Singapore; the Solomon Islands and Vanuatu.

The main anti-tax haven provisions are the following:

- Most benefits regarding tax-free reorganisations and the Parent-Subsidiary Directive are not available to entities located in tax havens.

- Amounts paid by Spanish residents as consideration for services provided, directly or indirectly, by natural or legal persons are not tax deductible, unless evidence is produced that the expense corresponds to a transaction carried out for valid economic motives.

- Residents in tax haven countries are denied the exemption from Spanish withholding tax granted to non-resident individuals or entities (on interest paid on Spanish public securities) or to EU residents (on interest and capital gains attributable to Spanish securities and other Spanish movable property).

- The Spanish CFC legislation contains certain presumptions regarding tax haven entities. In general, a company resident in a tax haven jurisdiction which is controlled by a group of related Spanish shareholders is deemed to meet all remaining conditions to impute its income to said shareholders and to have tainted income (as defined by law) amounting to 15 percent of the acquisition cost of the shares.

- The Spanish participation-exemption regime (for holding companies) is not applicable for subsidiaries resident in tax haven jurisdictions.

5.2. Action of the courts in light of application of the anti-abuse rules

Truth be told, taking into account the ambiguity of the anti-abuse rules and the practical difficulty of applying them, there is little Spanish case law on the subject.

The case law that does exist deals with application of the anti-abuse rules in the area of lesser taxes and, as far as application of the special rules applicable to mergers, divisions, contributions of assets and exchanges of shares is concerned, holds that any justification other than those pertaining to business restructuring or rationalisation of business activities is insufficient to obtain the inherent benefits of the special system.

However, there is no general feeling that the Spanish courts tend to rule in favour of the tax authorities when applying the anti-abuse rules.

Those who have taken a position on the matter, specifically in the area of the special rules applicable to mergers, are the agencies of the tax authorities, particularly the Directorate General of Taxation (hereinafter, the "DGT"), whose opinion can be summarised as follows:

- ✓ The anti-abuse rule of the merger system is in response to the Community legislation to harmonise business reorganisations and provide them with tax neutrality, for which reason this rule must be interpreted in light of the Merger Directive and the case law of the European Court of Justice.

- ✓ *Leur-Bloem* established certain criteria for interpreting Article 11.1.a of the Merger Directive, namely:

    - ➢ To determine the applicability of the system of taxation, the competent national authorities cannot apply predetermined general criteria but must proceed on a case-by-case basis to a global examination of the transaction that might be subject to jurisdictional control.

    - ➢ In the absence of more precise Community provisions (other than Article 11.1.a of the Merger Directive), it is up to the Member States to determine the requirements necessary to apply the anti-abuse rule, always respecting the principle of proportionality.

    - ➢ The common system of taxation established in the Directive applies indiscriminately to restructuring or rationalisation operations, regardless of whether the reasons therefore be financial, commercial or purely fiscal, and presumes the existence of valid economic motives.

- ✓ These criteria are transposed by the DGT for interpreting the Spanish anti-abuse rule in the merger system as follows:

  - ➢ In order for this rule not to apply, the transaction must have a suitable purpose.

  - ➢ The evaluation of whether a transaction has been carried out for the purpose of tax avoidance requires an overall examination of the circumstances of each transaction, which must be carried out in the administrative stage.

  - ➢ The valid economic motive test is broader than the mere seeking of a tax advantage.

  - ➢ Finally, objective criteria subject to general application cannot be used to identify operations carried out for the principal purpose of tax avoidance.

- ✓ There must be sufficient valid economic reasons for carrying out the transaction, such as: restructuring the activities of the companies involved, rationalisation of these activities, separation or arrangement of the management or administration of said companies, etc.

- ✓ Any commercial justification must refer to the companies actually involved in the transaction rather than their subsidiaries or affiliates.

- ✓ Should the transaction produce any tax savings, this advantage must be accessory in nature or derive from the restructuring itself.

- ✓ The creation of a lasting structure as a result of the operation must also reinforce applicability of the system.

- ✓ The fact that the participating companies carried out business activities previously also reinforces the system.

- ✓ The operations prior to and after the transaction must also be analysed, as they may constitute proof of a business restructuring or that a tax advantage is primarily sought.

5.3. Criteria used to determine the existence of tax avoidance

We should reiterate that neither Spanish statutory law nor the courts have established criteria to determine the existence of tax avoidance, although in addition to those referred to above, the DGT considers that:

- ✓ To evaluate the existence of valid economic motives all the circumstances of the transaction must be analysed, including the practical result obtained. If a negative result is produced, i.e. a failed business project, the taxpayer must justify this fact, and if the tax administration feels that the failure of the project has not been sufficiently explained, it has the burden of proving the non-existence of a valid motive.

- ✓ As regards the rule that disallows application of the special system when the transaction is not carried out for valid economic motives but rather for the sole purpose of obtaining a tax benefit, this constitutes a specific case of non-application and the tax administration need not prove the existence of tax avoidance.

  Therefore, the system will not be applicable:

  - ➢ When the primary purpose of the transaction is tax avoidance.

  - ➢ When valid economic motives do not exist and the sole purpose of the transaction is to obtain a tax savings.

  In conclusion, it is not sufficient for there to be <u>any</u> type of restructuring or rationalisation - only those carried out for valid economic motives are eligible for deferred tax treatment, even where there is no tax savings. This is where we find the contradiction, however. A transaction may have no economic motive and yet not have tax avoidance as its primary purpose, yet the tax administration refuses eligibility for the special system.

- ✓ Not only the main transaction but also preparatory transactions and those carried out subsequently must be analysed, as they may constitute proof of a valid business restructuring or that a tax advantage is primarily sought.

- ✓ Finally, and for the purpose of evaluating whether the objective of the transaction is to obtain a tax advantage, the taxation of the parties before and after the transaction must be analysed in order to evaluate the tax savings, if any.

  Consequently, in order to evaluate the main economic reason for the transaction, it appears that the tax burden of each of the companies involved, both before and after the transaction, must be compared so as to determine whether this tax burden has decreased significantly as a result of the transaction.

  Subsequently, the economic advantages (volume of activity and resources, etc.) that the transaction has produced must be identified and it must be determined whether these advantages are proportional to the decrease in the tax burden.

In our opinion, if the economic motive is more relevant than the tax savings obtained, the tax administration should not dispute application of the special system. In contrast, if the tax savings is recognisable and of greater importance than the underlying economic motives, it appears that the special regime may not be applicable.

5.4. Possible sanctions for violation of the anti-abuse provisions

For cases involving "statutory fraud”, the law prohibits sanctions because the conflict is based on a "different interpretation of the law" (the tax administration versus the taxpayer).

On the other hand, in cases involving simulation sanctions can be applied if the administration can prove that the taxpayer is at fault. In this case, the conflict focuses on the act or transaction executed by the taxpayer (rather than an interpretation of the law) to reduce or avoid tax.

Sanctions can be imposed by the tax administration following a separate procedure to prove fault on the part of the taxpayer.

United Kingdom

By Michael McGowan[1]

Introduction

The question of the extent to which UK taxpayers are entitled to arrange their affairs or enter into artificial transactions to reduce their tax bills has not, in recent years, been easy to answer. There is as yet no general doctrine of economic substance over form under English law but, since 1981, the UK courts have, at different times in relation to different taxes, begun to lay some of the foundations of such a doctrine. That said, until the decision of the House of Lords in *MacNiven (Inspector of Taxes) v. Westmoreland Investments Ltd.*[2], the UK taxpayer and its advisers could at least read the cases and come to a reasonably certain conclusion about how each had been decided and structure transactions accordingly.

In *MacNiven*, in a controversial leading speech, Lord Hoffmann suggested two things. First, tax practitioners had misunderstood the findings of many previous landmark decisions of the House of Lords from 1981 onwards. Secondly, in determining what a taxing statute meant, one should adopt a purposive approach to interpretation and should, in particular, consider whether a statutory concept had a "legal" or "commercial" meaning. Broadly speaking, if it had a "legal" meaning, one should usually construe it narrowly and legalistically but if it had a "commercial" meaning, one could give it a much wider meaning. Earlier cases where the courts had found for the Inland Revenue were cases involving "commercial" concepts, to be interpreted broadly. By contrast, in *MacNiven* the concept of "payment" was a legal one which fell to be interpreted narrowly.

The Court of Appeal has admitted to not understanding how to apply Lord Hoffmann's legal/commercial test; one former Law Lord has written critically of Lord Hoffmann's distinction in a leading journal and another has commented critically in a recent Hong Kong stamp duty appeal. Even Lord Hoffmann himself, both extra-judicially and in an even more recent Privy Council case, seems to be backing off aspects of his judgment.

The key question is: where do we go from here? As will be seen, UK thinking in this regard is at an interesting crossroads.

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2 [2001] STC 237

General Anti-Avoidance Rule

Unlike other jurisdictions such as Australia and Canada, the United Kingdom has not yet chosen to adopt a General Anti-Avoidance Rule in statutory form although the idea was the subject of consultation in 1998. The UK Finance Bill 2004 suggests that for the time being at least the idea has been dropped in favour of the introduction of new disclosure rules relating to "avoidance schemes". The draft clauses, which are likely to become law sometime in July 2004, provide for the disclosure of arrangements that have as a main benefit the obtaining of a "tax advantage".

Substance over form

There is no doctrine of "substance over form" as such in UK tax law. Therefore, the starting point is that the legal manner in which a transaction is structured and documented will, provided it is not a "sham" (see below), be respected in determining its taxation.

Two examples illustrate this point. The first example is the distinction between debt and equity. It is possible, under English law, to create "perpetual" debt, i.e. debt which is deeply subordinated and has no fixed repayment date. Economically therefore, this debt closely resembles preference shares. Nevertheless, subject to certain exceptions in anti-avoidance legislation it will generally be respected and taxed as debt.

The second example is the effect of "REPOs" or "sale and repurchase transactions" under UK tax law. A REPO involves a sale of securities by a seller to a buyer together with an agreement by the seller or a related person to repurchase equivalent securities at a specified price from the buyer at a future date. Economically, a REPO is little more than a loan of money secured on specific securities. In the US, REPOs are typically treated as loans on the basis that the legal form (a sale) should be subordinated in favour of the economic reality. However, in the United Kingdom, whilst REPOs are indeed taxed as loans (with the difference between the sale and repurchase price being treated as interest), that is only by virtue of specific provisions in the UK tax legislation (see, in particular, Section 730A UK Income and Corporation Taxes Act 1988), rather than by means of a general "substance over form" doctrine.

Ways in which taxpayers try to reduce their tax bills

The traditional classification of ways in which taxpayers seek to reduce their tax bills is as follows:

- Tax evasion.

- Tax avoidance.

- Tax mitigation.

There is general agreement about what is tax evasion although, as always, there are grey areas at the fringes. A taxpayer who deliberately and dishonestly conceals taxable income or gain from the tax authorities is evading tax. He has committed a crime.

The distinction between tax avoidance and tax mitigation (neither of which is a crime) is, notoriously, much harder to define. However, if one accepts that there is a distinction, the essential difference would be that whilst both tax avoidance and tax mitigation are legal, tax avoidance is "unacceptable" on grounds of artificiality, and is subject to challenge in the courts, whereas tax mitigation is "acceptable" and not subject to challenge. A tax mitigator simply takes advantage of favourable tax consequences offered by Parliament in the way in which Parliament intended them to be exploited. In the words of Lord Templeman, a former Law Lord, writing extra-judicially[3]:

> *the object of a tax avoidance scheme is to enable the taxpayer to enjoy a taxable event without paying the tax [whereas] tax mitigation does not include any artificial step though the motive which inspires a taxpayer may be mainly or wholly the desire to reduce tax.*

So a taxpayer who invests in shares through a UK ISA (a tax "wrapper" which enables gains and income in respect of investments contained within that wrapper to be enjoyed tax-free) is a tax mitigator, as is a person who claims 40% tax relief on his pension contributions but a taxpayer who enters into a scheme involving artificially inserted steps, such as the taxpayer in *Ramsay v IRC*[4], in order to enjoy otherwise taxable capital gains tax-free is a tax avoider.

The problem, of course, with this distinction is that it does not provide in its terms any easy means of applying it to specific situations. Once one has discerned Parliament's "intention" (whatever that is), one can place the action of the taxpayer into one of the categories. But that requires one to discern Parliament's intention as to what structures are acceptable or not. The distinction is not therefore a particularly useful distinction in analysing a particular situation.

Sham doctrine

One should mention in passing the sham doctrine, a concept which is not unique to tax cases. "Sham" is not as such a subset of either "evasion", "avoidance" or "mitigation" although, if anything, it will generally be closer to evasion than avoidance or mitigation. In the leading (and non-tax) UK case of *Snook v London & West Riding Investments Ltd.*[5], Diplock LJ described the sham doctrine as applying to:

> *acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create.*[6]

To attack a tax transaction under the doctrine of sham, it is necessary for the Revenue to prove that the legal transaction, as documented, is in fact different to the implemented legal transaction which the parties adhere to; and that the parties intended third parties to gain a false impression of the real legal rights and obligations between them. The sham doctrine does not focus on economic substance, but on the real legal transaction between the parties.

When the doctrine is applied to a tax case, the sham transaction (as it is documented) will be disregarded with the tax treatment being determined by reference to the real legal transaction (as it actually occurs). It is not possible to treat the transaction as a sham only for tax purposes: the real legal transaction as found by the court must govern in non-tax situations as well. If, for example, the parties entered into an employment contract and the court found in a tax case that the contract was in

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[3] (2001) 117 L.Q.R. Lord Templeman first articulated the distinction between tax avoidance and tax mitigation when giving the opinion of the Privy Council on an appeal from New Zealand, *Challenge Corporation v CIR* [1986] STC [548]

[4] [1981] 1 All ER 865

[5] [1967] 2 QB 786

[6] [1967] 2 QB 786 at 802

fact a contract for services, the effects of this finding would flow beyond tax into areas such as employment law, pensions and vicarious liability in tort.

Furthermore, it is theoretically possible that the real legal transaction as unravelled from the sham could itself be susceptible to challenge under the tax principles developed in the tax anti-avoidance case law described below.

It is difficult to demonstrate sham. However, the Revenue originally argued sham in *IRC v. McGuckian*[7] and the even more recent case of *Hitch v Stone*[8] shows that the Revenue are still in principle willing to challenge a transaction as a sham, albeit that the Court of Appeal held in this case that the transaction was not a sham.

Abuse of rights

There is another doctrine which (to the extent it exists at all) like the sham doctrine, is not unique to tax statutes. It is curious that at around the same time that *MacNiven* was seemingly narrowing the traditional UK judicial anti-avoidance doctrine in tax cases, the UK VAT Tribunals were in a more activist mode. In particular, HM Customs & Excise (the government body until now responsible for administering and collecting VAT) asserted that there was a rule of EC law which could be summarised as counteracting a taxpayer's "abuse of rights"; that it had become incorporated into UK law; and that it applied to limit the right of a taxpayer to deduct VAT "input tax". The meaning of "abuse" in this context seems to be not that the taxpayer commits an illegal or unlawful act in exercising the right, but that the taxpayer does not exercise the right "validly".

The idea that a "right" can be "abused" is a strange one, both logically and conceptually, to a common law audience.

Furthermore, the doctrine is anathema to principles elucidated in previous cases. For example, in *Bradford Corporation v. Pickles*[9] the House of Lords held that "If it was a lawful act, however ill the motive might be, he had a right to do it".

It appears that Customs & Excise see "abuse of rights" as a doctrine which focuses on the nefarious motives and intentions of the UK taxpayer.

Notwithstanding these difficulties, the "abuse of rights" doctrine has recently found some limited favour in the United Kingdom. In the VAT case of *BUPA Hospitals Ltd. v. C&E Commrs*[10], the Tribunal accepted that this principle does exist in EC law. It held that it did not apply in *BUPA* because the rights that were being abused were UK rights, rather than rights based on EC law. The Tribunal did, nevertheless, consider that BUPA had abused their rights which suggests that, if the rights existed under EC rather than UK law, the Tribunal would have applied the "abuse of rights" doctrine against the taxpayer. In the subsequent VAT case of *Blackqueen Ltd. v. C&E Commrs*[11], the Tribunal held that the "abuse of rights" doctrine "should be applied in a uniform manner throughout the Community and that any restrictions on the application of the principle should be kept to a minimum" i.e. it could be applied in relation to UK rights and did apply to the questions in that case.

[7] [1997] STC 908
[8] [2001] STC 214
[9] [1895] AC 587
[10] [2002] BVC 2,155
[11] (LON/00/1178) VTD 17680

The consequence of the application of the abuse of rights doctrine in *Blackqueen* was serious for the Irish appellant and its group. The appellant was a member of a group of companies that had entered into a scheme which it accepted was entirely driven by avoidance of VAT. The scheme was designed to enable (a) input tax to be fully recovered on the purchase of new cars to be used for leasing and (b) output tax on the subsequent retail sale of the cars to be accounted for under the (more favourable) used car margin scheme. The tribunal disregarded every single step under the transaction as an abuse of rights and thus (a) disqualified the recovery of input tax on the purchase of the new cars and (b) held that output tax should be accounted for at the full rate rather than on the margin only.
If *BUPA* and *Blackqueen* suggested that the "abuse of rights" doctrine had taken root in the United Kingdom, the later judgment in *RBS Property Developments Limited and The Royal Bank of Scotland Group plc*[12] went some way to terminating it. On similar facts, the Tribunal held in relation to "abuse of rights" that "there was nothing improper, illegal or artificial about the transactions in question and accordingly the reasoning in *Blackqueen*, with which we would not wish to be taken as agreeing, has equally no relevance in the present situation". In other words, the Tribunal felt that the "abuse of rights" doctrine is a step too far for English law. This decision does, at least for the time being, appear to set out the predominant view on the issue.

A brief history of the major English tax anti-avoidance cases from *Duke of Westminster* to *MacNiven*

A discussion of the current status of tax avoidance case law in the United Kingdom can only make sense in the light of the ebb and flow of previous cases. The development of UK case law in this area is charted below although the following discussion does not purport to be an exhaustive history of all the relevant cases.

IRC v Duke of Westminster[13]

This case confirmed two things. First, there is no doctrine of substance over form. Secondly, there is no moral obligation on a taxpayer to pay any more tax than he has to. The facts were simple. The Duke paid his employees £3 per week. Only £1.10 of this was actually paid to the employee as a wage each week, although the employee was legally entitled to the full £3. The remaining £1.90 was provided for under a deed of covenant with each employee which entitled that employee to receive annuity payments, irrespective of whether or not the employee remained in the Duke's service. The annuity payments were deductible in calculating the Duke's income for surtax purposes, whereas sums paid as wages were not.

The House of Lords held that the payments made under the covenants were deductible payments. This decision was made on the basis of the true legal facts and the legal substance of the actual transaction, and not of a transaction that would achieve the same economic effect at a higher rate of tax. It was stated famously by the court that the role of the Revenue was not to decide that tax should be levied on a transaction, as they wish to interpret it, but that:

> *Every man is entitled if he can to arrange his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure that result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.*

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12 (EDN/01/30,40,46,73,89,90&128) VTD 17789

13 [1936] AC 1, 19 TC 490

Essentially the same principle was put more colourfully by Lord Clyde in *Ayrshire Pullman Motor Services v CIR*[14] in the following terms: "No man . . . is under the least obligation, moral or otherwise, so to arrange his . . . business as to enable the Inland Revenue to put the largest possible shovel into his stores . . .".

The decision in *Duke of Westminster* was not unanimous. Lord Atkin, dissenting, did agree that the legal substance of the transaction should determine its tax treatment but believed that the documented transaction did not fully embody the true legal nature of the transaction. This is not to say that the documents were a sham – the rights and obligations documented were those the parties intended to create – but that the labels attached to the Duke's obligations were wrong. The annuity payments were wages for current services, no more and no less. They were not properly characterised as payments made for past services. Interestingly, in the same year as the House of Lords decision in *Duke of Westminster*, the US courts were adopting a much more activist approach to tax avoidance in *Helvering v. Gregory*.

***Ramsay v IRC*[15]**

The *Ramsay* case in 1981 is the starting point of a new judicial approach in the UK to complex tax avoidance. *Ramsay* threw some doubt on the *Westminster* decision, although the House of Lords expressly declined to overrule *Westminster*.

In *Ramsay*, an "off-the-peg" tax avoidance scheme designed to generate a capital loss was implemented by the taxpayer in order to offset an exciting capital gain. The scheme was a circular transaction which included a number of self-cancelling steps. There was no question of the transaction being a sham: each of the steps was, as a matter of fact, carried out as legally documented. The House of Lords chose to look at the end result of the admittedly circular transaction and ignore the inserted but self-cancelling steps. On this basis, the allowable loss supposedly generated by the inserted steps was ignored.

Lord Wilberforce gave the leading speech and held that the approach of the court:

> *does not introduce a new principle: it would…apply to new and sophisticated legal devices the undoubted power and duty of the courts to determine their nature in law and to relate them to existing legislation. While the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still.*

Even if *Ramsay* did not overrule *Duke of Westminster*, it marked a dramatic change in approach. The courts would now be prepared to ignore legally effective but commercially self-cancelling steps, as part of their duty to apply tax legislation. They would not necessarily be bound to respect each and every inserted step in complex tax avoidance arrangements.

***Furniss v. Dawson*[16]**

This case went further than *Ramsay*. The overall transaction involved a linear series of steps with enduring legal consequences and a commercial "end result" (a company sale), as opposed to steps of a circular, self-cancelling nature as in *Ramsay*.

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14 (1929) 12 TC 754
15 [1981] 1 ALL ER 865
16 [1984] AC 474

Additional steps were inserted into a transaction whereby a shareholder wished to sell Company A to and unrelated third party, Company C. The shares in Company A were exchanged (supposedly tax-free under the then "reorganisation" rules in the UK capital gains tax code) for shares in a newly-formed tax haven company, Company B. Company B then sold the shares in Company A to Company C for cash payable to Company B. The House of Lords saw this, however, as a direct sale by the shareholder of shares in Company A to Company C in return for cash consideration being paid to Company B. They accepted that all the steps involved were genuine but that the courts were able to ignore those steps that had been inserted for no commercial purpose (notably, the supposedly tax-free share exchange between the selling shareholder and Company B). The whole scheme, in effect, was recharacterised as a sale by the shareholder to Company C, with Company B only becoming involved at the end of the transaction when the consideration became due and was paid to it.
In coming to his decision, Lord Brightman formulated the courts' new approach post-*Ramsay* as follows:

> *First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end . . . Secondly, there must be steps inserted which have no commercial (business)* ***purpose*** *apart from the avoidance of a liability to tax – not "no business effect". If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.*[17]

For many years, Lord Brightman's formulation has been regarded as the classic summary of the *Ramsay* principle, subject in recent years to the caveats introduced by Lord Hoffmann in *MacNiven*. As applied in *Furniss v. Dawson*, Lord Brightman's statement shows how *Ramsay* is (whatever the courts would say) a recharacterisation doctrine as well as a principle of interpretation. In *Furniss* itself, the parties were treated as entering into a transaction (a direct sale to Company C by the selling shareholder) which was definitely not what they had contemplated.

Craven v. White[18]

Craven v White was one of three associated appeals heard alongside *IRC v Bowater Property Developments Ltd.* and *Baylis v Gregory*. The facts of each of the cases were very similar to those involved in *Furniss v Dawson*. In *Craven v White*, the transaction involved preliminary steps of exchanging, share for share, the shares held by the taxpayer in Q for shares in a purpose-formed Isle of Man company. At the time this transfer took place, there was a possibility of either a merger of Q with another company, C or a sale of Q to a third party, O. It was fully intended to follow the merger route until the sale to O emerged as the more desirable option.

On the basis that the sale, as opposed to the merger, had in fact taken place, the facts became, ex post facts, entirely analogous to those in *Furniss*. However, the House of Lords took the view that the shareholder should not be taxed as if the sale of the Q shares had been directly from the taxpayer to O, with the Isle of Man company simply receiving the consideration. The acquisition of the Q shares by O was deemed to be from the Isle of Man company to which Q had been transferred by way of a share-for-share exchange (which was tax-free under the then law).

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17 55 TC 324 at 401
18 [1989] AC 398

There was much discussion in the case as to the meaning of a pre-ordained transaction, as defined by Lord Brightman in *Furniss v. Dawson*. Lord Keith distinguished the nature of this case from *Furniss* on the basis that at the time the initial share-for-share exchange transaction was entered into with the Isle of Man company, the taxpayer was not in a position to enter into the second transaction (i.e. the onsale to O). It had, in fact, not even been decided whether the target company, Q, was going to be the subject of a merger or a disposal. On this basis, the transaction could not be said to be pre-ordained.

Lord Oliver gave the lengthiest decision in the case with much of his speech being devoted to analysing whether a transaction is pre-ordained. He used a "double negative" test of pre-ordination. For pre-ordination to exist, at the time the intermediate transaction was entered into, it was necessary:

> *that there was at that time no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life.*

When this test was applied to the facts of the *Craven v. White* appeals (as opposed to *Furniss* there was no pre-ordination). In his speech, Lord Oliver also states that the *Ramsay* doctrine is not an all-purpose anti-avoidance rule.

> *It has been said in the course of argument on the present appeals that Dawson is 'judge-made law'. So it is, but judges are not legislators and if the result of a judicial decision is to contradict the express statutory consequences which have been declared by Parliament to attach to a particular transaction which has been found as a fact to have taken place, that can be justified only because,* ***as a matter of construction of the statute****, the court has ascertained that that which has taken place is not, within the meaning of the statute, the transaction to which those consequences attach.*

Lord Templeman dissented on *Craven v White* but not on the other two appeals. He dissented from the three major speeches by arguing that they served to narrow *Furniss* and re-open the scope for tax avoidance. He felt that the facts of the appeal in *Craven v. White* prevented the case from being distinguished from *Furniss*.

Ensign Tankers (Leasing) Ltd v Stokes[19]

Ensign Tankers marks, in many ways, the high-water mark of Lord Templeman's activist school of thinking on tax avoidance.

The taxpayer in that case formed a limited partnership with other companies with the intention of financing the production of the film "*Escape to Victory*". The taxpayer provided approximately 25% of the production cost from its own resources with the remainder being provided by a non-recourse loan made to the general partner of the limited partnership by the film company. The film company was solely liable for any cost overrun and the partners had no personal liability.

The intention behind the scheme was to allow the taxpayer, as limited partner, to claim capital allowances on the full cost of production (approximately US$13 million) for a contribution of only US$3.25 million. The Revenue argued that not only was the taxpayer not entitled to capital allowances on amounts exceeding its US$3.25 million contribution. It was not even entitled to

[19] [1992] STC 226

capital allowances on US$3.25 million on the grounds that the transaction was not a "trading" transaction, because it was "denatured" by tax avoidance.

The Special Commissioners (the UK equivalent of the US Tax Court) agreed with the Revenue, holding that the paramount object of the transaction was to obtain a fiscal advantage; that this prevented it from being a trading transaction and therefore the taxpayer was not entitled to capital allowances at all. The High Court said that the taxpayer was entitled to capital allowances on the full cost but this decision was reversed by the Court of Appeal.

In contradistinction, the House of Lords held that the taxpayer was entitled to capital allowances on its undoubted economic contribution of US$3.25M but not on the balance. This was on the basis that the lessor was clearly trading. Lord Templeman held that "the principles of *Ramsay* and subsequent authorities do not apply to the expenditure of US$3,250,000 because that was real and not magical expenditure". By contrast, no allowances were permitted in respect of the expenditure funded by non-recourse loan.

To the extent that *Ensign Tankers* requires the court to approach a transaction by considering the true legal character of a transaction, it is uncontroversial.

Nevertheless, the decision was quite a radical one because it concluded that expenditure "incurred" by the partnership using non-recourse finance was not really "incurred" for the purposes of capital allowances. To a large degree, this conclusion was driven by the facts of the case and was not a blanket condemnation of non-recourse debt. Yet the decision perhaps comes closest of all the UK cases to determining tax settlement on the basis of the perceived "economic substance".
Lord Templeman's language suggests that he found against the taxpayer precisely because the scheme implemented by the taxpayer involved "the planning and execution of a raid on the Treasury using the technicalities of revenue law and company law as the necessary weapons".

Pigott v. Staines[20]

Pigott v. Staines involved transactions between a parent company, its newly-interposed subsidiary and its pre-existing sub-subsidiary. The sub-subsidiary paid a dividend to the subsidiary within a "group income election", thereby avoiding having to pay "advance corporation tax" under the then law. That subsidiary in turn paid a dividend to the parent company outside a "group income election". This triggered an "advance corporation tax" liability at the level of the subsidiary. Under the then law, this could be used by the subsidiary, given its tax history, to obtain a large refund of corporation tax paid in earlier years. The Revenue tried to treat the dividend paid by the sub-subsidiary to the subsidiary as being paid straight to the parent company, bypassing the subsidiary. Alternatively, the Revenue agreed that the subsidiary had not really paid a dividend to the parent company.

In *Pigott v. Staines*, a ten-month period elapsed between the insertion of the subsidiary into the structure and the payments of dividends to and by the subsidiary. The High Court held that the *Ramsay* principle applied because, notwithstanding the ten-month delay, the transactions were pre-ordained. Lord Oliver had previously held in *Craven v. White* that the *Ramsay* doctrine could not apply where there was a "sensible and genuine" interruption between the relevant transactions on the grounds that the existence of a time delay could mean that there was a practical likelihood of the later step not occurring. In *Pigott*, Knox J. stated that he did not believe that Lord Oliver wished to lay down a universal principle in *Craven v. White* regarding the significance of lengthy intervals. This is

[20] [1995] STC 114

clearly correct: the steps in *Pigott* were undoubtedly preconceived, despite the delay in execution. In that case, they were preconceived not to sidestep the *Ramsay* doctrine but instead to ensure that, for the purposes of other UK anti-avoidance rules, the dividends were not paid out of earnings arising after the subsidiary was interposed.

However, whilst confirming the wide approach of *Ramsay* on the meaning of "pre-ordination", Knox J. put a limitation on *Ramsay* in terms of taxing the "end result". He held that if the Revenue wished to argue that a transaction should be taxed on the basis of an end result, that "end result" had to be a sensible and legally credible end result. On the facts of the case, the Revenue's approach involved:

> *a recharacterisation of a perfectly normal and straightforward commercial transaction into a thoroughly abnormal and unusual transaction whose only merit (if that is the right word) is that it attracts a tax advantage.*

Therefore, it was not possible to apply the *Ramsay* principle on the facts so as to disregard the bask-to-back dividends. The two types of recharacterisation for which the Revenue were arguing were rejected. For the Inland Revenue, this decision marked a significant retreat by the courts from the position which they thought had been reached post-*Furniss* and *Ensign.* In particular, the courts were distinctly uneasy about developing the recharacterisation implications of the *Furniss* case. A similar reluctance had already been apparent in the House of Lords' decision in *Fitzwilliam v IRC* [1993] STC [502], where (with the very vocal, exception of Lord Templeman!) their Lordships were reluctant to endorse the Inland Revenue's proposed recharactarisation of a complex inheritance tax avoidance scheme.

IRC v McGuckian[21]

After a period in the mid-1990's when the *Ramsay* doctrine had seemed to develop little, *McGuckian* essentially paved the way for *MacNiven*, providing a judicial green light to explore statutory interpretation further in the area of tax avoidance and allow for development.

The taxpayer (M) wanted to reduce the value of shares in an Irish company (B) of which he and his wife were the only shareholders for the purposes, of Irish wealth tax. The scheme that he implemented involved the following steps: (a) the payment of large sums by way of dividend to the shareholders; (b) the establishment of a non-resident trust under which the shares in B would be held for the benefit of M and his wife; and (c) the sale by the trustees of their rights to dividends expected to be paid by B, to a company resident in the UK. The scheme, as proposed, would avoid wealth tax for M and would also enable the trust to extract the profits from the company in tax-free capital form by selling the dividend rights in advance of payment.

In effect, the Revenue were trying to use the *Ramsay* doctrine in *McGuckian* to recharacterise a capital payment for the sale of the dividend rights as an income payment. They argued was that the only reason for the assignment of the right to the dividend by the trust was tax avoidance and therefore the sale proceeds could be recharacterised.

All five speeches by the Lords concluded in the Revenue's favour but two distinct strands of thought were apparent. Lord Steyn's and Lord Cooke's approach was to identify the *Ramsay* doctrine as being based firmly on purposive statutory construction. The courts were not limited to a literal interpretation of tax legislation but could and should take into account its purpose and the context of the transaction to which it was being applied. On this basis, Lord Steyn and Lord Cooke saw the

21 [1997] STC 908

payment to the trust for the right to the dividend as an income, rather than a capital receipt, even though, on a conventional analysis, this receipt would be regarded as capital. Once classified as income, the payment to the trust became taxable under the wide-ranging rules in Section 739 et seq UK Income and Corporation Taxes Act 1988.

Lord Browne-Wilkinson and Lord Clyde gave more narrowly analytical speeches. They agreed with the argument of the Revenue that the assignment by the trust of the right to a dividend had only been included as a means of gaining a tax advantage. On that basis, it could be disregarded and in doing so, the payment to the trust fell to be categorised as one of income under the relevant statutory provision. Here we see that the *Ramsay* analysis serves not only to disregard the artificially-inserted intermediate step but also to tax the end result in a slightly more radical way by relabelling as income a receipt of the trust which would more conventionally be regarded as capital.

MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd.[22]

Westmoreland (WIL) was an insolvent property company which owed £70m, including £40m arrears of interest, in respect of pre-existing loans from a UK pension fund, which was also its sole shareholder. If WIL was to pay the arrears of interest, it would be able (under the then law) to treat that payment under Section 338 UK Income and Corporation Taxes Act 1988 as a deductible "charge on income" thereby creating a tax loss which could be set off against any profits which it earned in later years. Under the then law, no tax relief was available if the arrears of interest remained accrued, but unpaid.

WIL raised the amount necessary to pay off the arrears of interest by borrowing it from the pension fund. It then paid that money back to the pension fund by paying off the arrears of interest. As the transactions ultimately gave WIL an allowable loss without altering its overall economic position, a tax advantage was achieved from a flow of funds which was essentially circular. On this basis, the Revenue denied WIL the loss by invoking the *Ramsay* doctrine.

The House of Lords dismissed the Inland Revenue's appeal. Lord Hoffmann gave the main speech in which he identified four steps in the analysis: (i) the relevant legislation dealing with "charges on income" necessitated a decision as to whether there had been a "payment" of interest; (ii) statutory terms which fall to be construed "juristically" had to be distinguished from those which should be interpreted "commercially"; (iii) given the context and structure of the "charges on income" legislation, the term "payment" was to be construed juristically as opposed to commercially; and (iv) therefore, in this case, there was a "payment" of interest for tax purposes if the legal obligation to pay interest had been discharged, even if the discharge was achieved by borrowing the necessary cash from the lender. Lord Hoffmann held that there had been a "payment" and WIL was therefore entitled to the tax deduction even though the flow of funds was essentially circular. Lord Hoffmann specifically quoted from the speeches of Lords Steyn and Cooke in *McGuckian* and approved of their "broad purposive approach" to statutory interpretation. All the other Lords concurred with Lord Hoffmann's speech, although, in separate speeches, Lord Nicholls and Lord Hutton did not explicitly adopt themselves Lord Hoffmann's distinction between "juristic" and "commercial" concepts.
Lord Hoffmann then went on to reconcile, somewhat controversially, his analysis with previous cases:

> *My Lords, it seems to me that what Lord Wilberforce was doing in Ramsay was no more (but certainly no less) than to treat the statutory words "loss" and "disposal" as referring to commercial concepts to which a juristic analysis of the transaction, treating each step as*

22 [2001] STC 237

autonomous and independent, might not be determinative. What was fresh and new about Ramsay was the realisation that such an approach need not be confined to well-recognised accounting concepts such as profit and loss but could be the appropriate construction of other taxation concepts as well.

So, for example, Lord Hoffmann ruled that the word "paid" in the context of the "charges on income" legislation in *MacNiven* had a "commercial" meaning. By contrast, the words "loss" in the capital gains tax legislation in *Ramsay* had a "commercial" meaning, as did the word "disposal" in *Furniss v. Dawson*. As an example of where a narrower "legal" meaning of a word might be appropriate, Lord Hoffmann gave the example of the expression "conveyance or transfer on sale" in the stamp duty legislation, although he failed to mention that the High Court ruled, in *Ingram v. IRC* [1985] STC 835, that the *Ramsay* principle was capable of applying to stamp duty.

In *MacNiven*, the word "paid" was attributed a "legal" meaning in the context of the legislation as a whole. However, Lord Hoffmann accepted that this was not an area for absolutes and that "although a word may have a "recognised legal meaning", the legislative context may show that it is in fact being used to refer to a broader commercial concept". Indeed, the Court of Appeal, in the first case to consider *MacNiven*, *DTE Financial Services v. Wilson*[23], held that for the purposes of the "pay as you earn" employee withholding legislation, the concept of "payment" was a commercial concept. This illustrates the practical problems which arise when applying Lord Hoffmann's legal/commercial distinction.

In *MacNiven*, the House of Lords held that the *Ramsay* approach was merely an aid to purposive interpretation of tax legislation. It was not a free-standing anti-avoidance principle.
At the heart of Lord Hoffmann's speech is his heartfelt belief that the House of Lords is constitutionally not entitled to invent law. The Inland Revenue had put its case in *MacNiven* in the following terms:

> "*When a Court is asked*
>
> *(i) to apply a statutory provision on which a taxpayer relies for the sake of establishing some tax advantage*
>
> *(ii) in circumstances where the transaction which is said to give rise to the tax advantage is, or forms part of, some preordained, circular, self-cancelling transaction*
>
> (iii) *which transaction though accepted as perfectly genuine (i.e. not impeached as a sham) was undertaken for no commercial purpose other than the obtaining of the tax advantage in question then (unless there is something in the statutory provisions concerned to indicate that this rule should not be applied) there is a rule of construction that the condition laid down in the statute for the obtaining of the tax advantage has not been satisfied*.

One may sympathise with Lord Hoffmann's retort:[24]

> *My Lords, I am bound to say that this does not look to me like a principle of construction at all. There is ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute. All other "principles of construction"*

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23 [2001] STC 777

24 Although, as will be seen later, Lord Hoffmann may subsequently have retreated somewhat on this point.

can be no more than guides which past judges have put forward, some more helpful or insightful than others, to assist in the task of interpretation. But [counsel's] formulation looks like an overriding legal principle, superimposed upon the whole of revenue law without regard to the language or purpose of any particular provision, save for the possibility of rebuttal by language which can be brought within his final parenthesis . . . the courts have no constitutional authority to impose such an overlay upon the tax legislation and, as I hope to demonstrate, they have not attempted to do so.

The problem would seem to be that at least some of the Lords who had decided cases on tax avoidance believed that they did have such constitutional authority. One of the more trenchant criticisms of Lord Hoffmann's interpretation of the *Ramsay* approach came from Lord Templeman who (in retirement) expressed his disapproval of the decision in *MacNiven* in an article in the October 2001 issue of the Law Quarterly Review in which he criticised the idea that "the considered pronouncements of an eminent generation of modern Law Lords applying principles to tax avoidance be downgraded to a mere aid". He went on to say:

Lord Hoffmann sought to reduce Ramsay to a principle of statutory construction and asked what it is. The principle is that when Parliament enacts tax legislation, Parliament intends all taxpayers to be treated the same whether they insert artificial steps into transactions or not and irrespective of the type of artificial step… Lord Brightman in Furniss . . . reaffirms the duty of the courts to judge a scheme as a whole and to disregard artificial steps which have no commercial purpose apart from the avoidance of a liability to tax which would otherwise be payable.

Lord Templeman's interpretation of *MacNiven* was that the taxpayer had entered into a wholly-artificial transaction involving a circular flow of payments, the overall effect of which amounted to a re-labelling of obligations without altering the taxpayer's economic position. At the end of the transaction, the taxpayer owed the pension fund the same amount of money but none of this debt consisted of accrued interest. In Lord Templeman's opinion, the Inland Revenue's view of the role of the court in that case had been legally, morally, judicially and constitutionally correct, and the taxpayer should have been denied an interest deduction. He drew a direct comparison with the decision in *IRC v Burmah Oil* [1982] STC 30, the first House of Lords decision post – *Ramsay*, where the taxpayer was denied an allowable capital loss on shares subscribed by it in order to fund a loss-making company, so that the latter could repay non-performing loans owed to the taxpayer on which losses would otherwise have been non-deductible.

Judicial legislation and statutory interpretation

Lord Hoffmann's speech and Lord Templeman's comments thereon draw attention to constitutional debate about whether judges should interpret legislation or whether they are entitled also to "create law". The general view, at least as expressed in public, is that judges should limit themselves to the former:

judges are not legislators and if the result of a judicial decision is to contradict the express statutory consequences which have been declared by Parliament to attach to a particular transaction which has been found as a fact to have taken place, that can be justified only because, as a matter of construction of statute, the court has ascertained that that which has taken place is not, within the meaning of the statute, the transaction to which those consequences attach. [25]

[25] Lord Oliver in *Craven v White* [1989] AC 398

However, whilst it is not appropriate to go into detail on the point in this paper, the process of judicial interpretation is to some extent, one of creation, even in a jurisdiction such as the UK where Parliament is sovereign. Lords Hoffmann and Templeman do not necessarily see eye to eye regarding the legitimate scope for such creativity. Indeed, whereas Lord Templeman seems to regard the *Ramsay* doctrine as one which only the Inland Revenue can deploy, it is less clear whether this would be Lord Hoffmann's view. If, in his view, *Ramsay* is merely an aid to purposive interpretation of tax legislation, then it should surely be open to a taxpayer, as well as the Inland Revenue, to invoke this doctrine. This is an issue which has yet to be resolved, although to date, the courts have not been receptive to the idea of the taxpayer using the *Ramsay* doctrine to assert a tax treatment based on ignoring steps inserted into a transaction of the taxpayer's own making: see *Whittles v Uniholdings (No. 3)* [1999] STC 914.

The post-MacNiven crossroads

It is fair to say that *MacNiven*, and in particular Lord Hoffmann's speech, has considerably unsettled the UK tax community. The reasons for this include:

- The facts of the case. The transaction was clearly motivated solely by the desire to increase the value of the company by generating tax reliefs and the cashflows were circular.

- Lord Hoffmann's subsequent extra-judicial suggestion that the tax fraternity had failed to understand the *ratio* of *MacNiven*, by over-emphasising the distinction between "legal" and "commercial" concepts.

- The retired Law Lords prepared openly to dissent from *MacNiven* whether in periodicals (Lord Templeman) or in the Hong Kong Final Court of Appeal (Lord Millett).

- The problems experienced by the Court of Appeal in applying Lord Hoffmann's distinction between "juristic" and "commercial" concepts.

It is worth looking at recent decisions of the Court of Appeal, the Hong Kong Final Court of Appeal and the Privy Council to attempt to shed some light on the future post-*MacNiven*. It would be a brave tax adviser who stated categorically where the courts will go next.

Barclays Mercantile Business Finance Ltd v Mawson[26]

The case of *BMBF v Mawson* is almost certain to produce interesting comments on *MacNiven* when it is heard by the House of Lords in autumn 2004, together with the Inland Revenue's appeal from the Court of Session decision in *Scottish Provident v. IRC*[27]. BMBF was a finance lessor which bought an asset (a pipeline under the Irish Sea) from X which it then effectively leased back to X. The sums involved were significant and to ensure that the credit risk to BMBF was minimal further transactions were put in place to ensure that all the relevant lease payments were collateralised. Both a guarantee and a cash collateral arrangement under which there was enough cash available to meet the terms of the guarantee were put in place. The end result was that payments under the lease were fully "defeased" and X placed on secured deposit with an affiliate of BMBF the pipeline sale proceeds. One of the key questions was whether or not BMBF had "incurred expenditure" on the pipeline for the purposes of the capital allowances legislation. The Inland Revenue argued that, owing to the fact that BMBF was exposed to virtually no credit risk and retained effective control of the pipeline sale proceeds, it could not be said to have "incurred expenditure"; that no fresh money had been advanced to X under this leasing transaction; and that the various steps had been inserted purely so that the parties could share the benefit of capital allowances without any new money being advanced to X.
The Special Commissioners and High Court found against the taxpayer on numerous grounds but two points appeared to be central to their conclusions. First, the payment flow in respect of the pipeline sale proceeds followed (or at least appeared to follow) a circular route. Secondly, in the words of Park J, X "could not get its hands on the money". Rather than incurring expenditure in the course of a trade, "the transaction was really about creating a complex and sophisticated structure which enabled [the lessee] every year to receive payments representing its share of the tax savings (or group relief payments) received by BMBF from the capital allowances". In this way, the Special Commissioners and High Court viewed the position of the parties in very much the same way that Lord Templeman viewed the position of the parties in *Ensign Tankers*.

There was strong disagreement by the Court of Appeal with the earlier rulings of Park J and the Commissioners. The Court of Appeal found in favour of the taxpayer. In so doing, it ruled post-*MacNiven*, that "incurring expenditure" in the capital allowances legislation was a "legal" concept. Park J had found it to be a commercial one. Unlike Park J, the Court of Appeal considered that BMBF had "incurred expenditure" despite the "defeasance" arrangement.

An interesting aspect of the case was the Court of Appeal's clear difficulties in applying the statements about "legal" and "commercial" concepts in *MacNiven*. These observations were *obiter* because the Court added that, ultimately, it made no difference whether "incurring" had a commercial or legal meaning: BMBF had, in fact, "incurred" expenditure. Nevertheless, Peter Gibson LJ said that:

> *I do not doubt that it is due to my own failing that I find Lord Hoffmann's dichotomy of concepts a difficult one to apply . . . whether a transaction is of an income or capital nature is normally treated as a question of law. Yet income and capital are described by Lord Hoffmann as business concepts.*

The decision of the House of Lords is awaited with interest. If (as one would expect) Lord Hoffmann sits, one presumes that he will want to clarify his speech in *MacNiven*, especially in the light of the *Arrowtown* and *Carreras* decisions discussed later in this paper. He may well play down the

26 [2003] STC 66
27 [2003] STC 1035

“legal”/“commercial” distinction indicating, as he did at a conference in 2003, that he was just trying to draw a contrast rather than lay down a rigid dichotomy.

It will be interesting to see to what extent the House of Lords remains willing to disregard or relabel steps in a transaction seemingly inserted purely to obtain a tax advantage. On the facts in *Mawson*, applying such an approach to a fully-defeased finance lease of plant and machinery will not be straightforward.

Collector of Stamp Duty v Arrowtown Assets Limited

It has been said that Lord Millett made known to Lord Hoffmann his not entirely complimentary thoughts on Lord Hoffmann’s draft speech in *MacNiven*, but that Lord Hoffmann did not take on board Lord Millett’s concerns. Lord Millett, following his retirement from the House of Lords, has now had his opportunity (in late 2003) to make public his concerns about Lord Hoffmann’s speech in *MacNiven*.

The facts of *Arrowtown* (a Hong Kong Stamp Duty appeal) are complicated but can be summarised as follows. A joint venture company created and issued almost worthless ‘B’ non-voting shares, in the context of a sale of development land to that company. This was done solely in order to obtain stamp duty group relief on the sale of that land, even though control of the land was in essence being ceded to a third-party developer which owned all the “real” equity share capital in the joint venture company. The ‘B’ shareholders had limited rights: their economic rights were heavily deferred and they had a right to appoint a director of the joint venture company). The ordinary shareholders of the company had full control over the company’s business in addition to the rights to almost the whole of the company’s capital and profits. If the ‘B’ non-voting shares were taken into account, then the stamp duty group relief provisions would technically apply to the sale of the development land to the joint venture company. The argument that was advanced by the Commissioners was that the ‘B’ non-voting shares should be disregarded under the *Ramsay* principle in determining what was the company’s ‘issued share capital’. If this argument succeeded, stamp duty group relief would be denied.

The taxpayer relied on Lord Hoffmann’s speech in *MacNiven*.

Sitting as a temporary judge of the Hong Kong Final Court of Appeal, Lord Millett articulates the concerns many have had regarding Lord Hoffmann’s legal/commercial distinction:

> *The supposed dichotomy between legal and commercial concepts has caused great difficulty. In Barclays Mercantile neither Peter Gibson LJ nor Carnwath LJ could understand it, and counsel were unable to explain it. Nor is its source discernible. It makes no previous appearance in the many authorities in which Ramsay has been applied or distinguished. It does not appear in the speeches of Lord Nicholls or Lord Hutton in MacNiven. It leads Lord Hoffmann to the conclusion that the word “payment” embraces a legal rather than a commercial concept, a conclusion which I respectfully regard as questionable. And it would seem to lead to the conclusion that the result would have been the same even if the [original] liability to pay interest [to the pension scheme] had been created as part of the scheme, a conclusion which I find difficult to accept.*

Lord Millett did agree with Lord Hoffmann that statutory language must be construed in the light of its purpose and should not be construed too narrowly.

However, Lord Millett goes on to state that:

> *the question is not whether "share capital" is a legal or commercial concept, but whether share capital with the characteristics of the "B" non-voting shares and issued for the sole purpose of complying with the statutory formula [for stamp duty group relief] was within the contemplation of the legislature when enacting s.45 of the Ordinance.*

He is at one with Lord Templeman's extra-judicial assertion that "when Parliament enacts tax legislation, Parliament intends all taxpayers to be treated the same whether they insert artificial steps into transactions or not". On that basis, he ruled that the "B" non-voting shares were to be disregarded, (notwithstanding that they were a permanent feature of the structure), when applying the Hong Kong stamp duty "grouping" rules. Stamp duty relief was therefore denied. This is quite a radical departure which, if adopted by the UK courts, would have major implications for many transactions where steps of a legally permanent nature are inserted to achieve a tax benefit. Before changes made in 1995, grouping structures of the kind in *Arrowtown* were commonplace in the UK and were never challenged vigorously under *Ramsay*/*Furniss v. Dawson.* It will be very interesting to see what the House of Lords makes of Lord Millett's thinking when it hears the *Mawson* and *Scottish Provident* appeals later this year. In the light of the *Carreras* case (see below), Lord Hoffmann may be more receptive than previously thought to Lord Millett's approach, although the decisions of the Hong Kong courts are not binding precedent in the UK.

Stamp Commissioner v. Carreras Group Ltd

A very recent Privy Council decision on a tax appeal from Jamaica, in which Lord Hoffmann gave the leading speech, provides some evidence that he might have also found against the taxpayer in *Arrowtown* and that he may have had further thoughts about some of his statements in *MacNiven*.

The judgment in *Stamp Commissioner v. Carreras Group Ltd* was delivered on 1 April 2004. In that case, the Jamaican taxpayer entered into a written agreement to transfer all the issued ordinary share capital and most of the preference shares in its subsidiary to an unrelated third party. The consideration was expressed to be a "debenture" issued by the third party, rather than cash. The terms of that debenture were that it would not be secured or transferable; that it would carry no interest; and that it would be repayable two weeks after its issue. It was in fact repaid a few days after its stated repayment date.

The intention of the taxpayer was to avoid a liability to Jamaican transfer tax on the grounds that the transaction was a "reorganisation" within the meaning of the relevant statute, because the consideration took the form of a "debenture", not cash. The Privy Council considered that the question was whether the issue of the debenture in exchange for shares could properly be characterised as a "reconstruction". Looking at the transaction from a narrowly legal perspective, a "debenture" (i.e. documented corporate indebtedness) was indeed issued for shares. Looking at the statutory context and the wider picture, the story was different. The relevant Jamaican relief was modelled on the UK relief from capital gains tax in relation to "reorganisations". However, the UK relief is merely a deferral: if any debenture issued as part of the "reorganisation" is redeemed or otherwise disposed of, the deferred gain is then brought into charge. By contrast, if the taxpayer in *Carreras* was correct, the issue of a "debenture" with a two-week life was the key to a permanent relief from, and not a mere deferral of, Jamaican transfer tax. This was clearly a concern for the Privy Council.

Ultimately, the Privy Council held that the taxpayer was not entitled to the tax relief because, in this particular context, the consideration could not be properly characterised as a "debenture". As might be expected of a judgment given by Lord Hoffmann, there is much made of statutory construction. The Privy Council says "whether the statute is concerned with a single step or a broader view of the acts of the parties depends upon the construction of the language in its context". This is all well and good and consistent with *MacNiven*. Then there are the following statements:

> *But ever since Ramsay . . . the courts have tended to assume that revenue statutes in particular are concerned with the characterisation of the entirety of the transactions which have a commercial unity rather than the individual steps into which such transactions may be divided. This approach does not deny the existence or legality of the individual steps* ***but may deprive them of significance for the purposes of the characterisation required by the statute*** *. . . Are there any reasons why Parliament should have contemplated a narrower definition of the transaction which has to be considered in deciding whether it is an exchange of shares for debentures?*

This may mark a shift from Lord Hoffmann's thinking in *MacNiven*. It certainly downplays the "legal" side of the "legal"/"commercial" dichotomy in *MacNiven*.

It is telling that Lord Hoffmann made no reference to legal or commercial concepts although he did refer briefly to *MacNiven*. It is also significant that Lord Hoffmann disposed of the history of the case law since *Ramsay* by saying that the approach had been rehearsed "so often that citation of authority since *Ramsay*'s case is unnecessary".

Quite how far Lord Hoffmann's thinking has moved is nevertheless hard to tell. In *Carreras*, the Privy Council relabeled as cash, not a debenture, an inserted and undoubtedly transitory step. Arguably, this was less radical than Lord Millett's approach in *Arrowtown*. It is also unclear that Lord Hoffmann would have determined the *Pigott* case differently, bearing in mind that in that case, there were two formal distributions of dividends: one by the sub-subsidiary and the other by the subsidiary. Neither of these had any of the oddities associated with the so-called "debenture" in *Carreras*. Nevertheless, it would take a brave commentator to state categorically at this stage what the implications of the *Carreras* case are.

Conclusion

The case of *Carreras*, coupled with his extra-judicial comments, confirm that Lord Hoffmann may be retreating somewhat from the position which he appeared to set out in *MacNiven*. The era of the legal/commercial dichotomy, to the extent it ever really existed, may be coming to an end.
The really interesting question will be how this influences the House of Lords when it comes to decide *Mawson* and *Scottish Provident*.

United States

By Stanley C. Ruchelman[1]

A. Introduction

In Palmer v. Commr., 62 T.C. 284(1974), affd. 523 F.2d 1308 (8th Cir. 1975), the Tax Court recited various incantations of a basic premise of U.S. tax law – tax is determined based on the substance of a transaction, rather than its form.

" The incidence of taxation depends upon the substance of the transaction and not mere formalism.[2]

" Taxation is not so much concerned with refinements of title as it is with actual command over the property.[3]

" A mere transfer in form, without substance, may be disregarded for tax purposes.[4]

" A given result at the end of a straight path is not made a different result because reached by following a devious path.[5]

" Where a taxpayer has embarks on a series of transactions that are in substance a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction.[6]

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2 Commr. v. Court Holding Co., 324 U.S. 331, 334 (1945).

3 Corliss v. Bowers, 281 U.S. 376, 378 (1930); see also Commr. v. P. G. Lake, Inc., 356 U.S. 260 (1958); Helvering v. Clifford, 309 U.S. 331 (1940); Griffiths v. Commr., 308 U.S. 355 (1939); Sachs v. Commr., 277 F. 2d 879, 882-883 (8th Cir. 1960), affirming 32 T.C. 815 (1959).

4 Commr. v. P. G. Lake, Inc., supra; Commr. v. Court Holding Co., supra; Commr. v. Sunnen, 333 U.S. 591 (1948) Helvering v. Clifford, supra; Corliss v. Bowers, supra; Richardson v. Smith, 102 F. 2d 697 (2nd Cir. 1939); Howard Cook, 5 T.C. 908 (1945); J. L. McInerney, 29 B.T.A. 1 (1933), affd. 82 F. 2d 665 (6th Cir. 1936).

5 Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

- Transactions that are challenged as intermediary steps of an integrated transaction are disregarded only when found to be so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series.[7]

- A taxpayer cannot insulate himself from taxation merely by assigning a right to income to another.[8]

- If the putative assignor performs services (Lucas v. Earl), retains the property (Helvering v. Horst), or retains the control over the use and enjoyment of the income (Commr. v. Sunnen; Corliss v. Bowers), the liability for the tax remains on his shoulders.

- If the entire interest in the property is transferred and the assignor retains no incidence of either direct or indirect control, then the tax on the income rests on the assignee.[9]

Old as the cases may be, the principle remains in force. They were developed at a time when tax planning was directed to specific transactions inherent in a taxpayer's business or plan of charitable giving. In other words, the taxpayer had several ways to accomplish a business goal and chose one in particular in order to maximize after-tax income. In recent years, transactions have changed significantly as investment banks, accounting firms and law firms have developed generic financial products designed to reduce tax no matter what the business of the taxpayer. These generic transactions may involve leases, partnerships, installment sales, or securities transactions in which facts are, in essence, brought to a taxpayer. In this manner, a principle that appears in one section of the Internal Revenue Code is applied to create an extremely favorable result; whether the taxpayer would have considered entering the transaction in the absence of the tax result is the issue that gives rise to litigation.

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6 Redwing Carriers, Inc. v. Tomlinson, 399 F. 2d 652, 654 (5th Cir. 1968); May Broadcasting Co. v. U.S., 200 F. 2d 852 (8th Cir. 1953); Whitney Corporation v. Commr., 105 F. 2d 438 (8th Cir. 1939), affirming 38 B.T.A. 224 (1938); Commr. v. Ashland Oil & R. Co., 99 F. 2d 588 (6th Cir. 1938), reversing sub nom. Swiss Oil Corporation v. Commr., 32 B.T.A. 777 (1935), certiorari denied 306 U.S. 661 (1939); Kuper v. Commr., 61 T.C. 624 (1974); Kimbell-Diamond Milling Co. v. Commr., 14 T.C. 74 (1950), affirmed per curiam 187 F. 2d 718 (5th Cir. 1951), certiorari denied 342 U.S. 827 (1951).

7 American Bantam Car Co. v. Commr., 11 T.C. 397, 405 (1948), affirmed 177 F. 2d 513 (3rd Cir, 1949), certiorari denied 339 U.S. 920 (1950); see Scientific Instrument Co. v. Commr., 17 T.C. 1253 (1952), affirmed per curiam 202 F. 2d 155 (6th Cir., 1953).

8 Commr. v. Sunnen, supra; Helvering v. Horst, 311 U.S. 112 (1940); Corliss v. Bowers, supra; Lucas v. Earl, 281 U.S. 111 (1930).

9 Blair v. Commr., 300 U.S. 5 (1937); Carrington v. Commr., supra; Behrend v. U.S., supra; DeWitt v. U.S., supra; Humacid Co. v. Commr., 42 T.C. 894 (1964);Winton v. Kelm, supra; Apt v. Birmingham, supra.

This article will initially examine recent cases involving the substance of tax advantaged investments. It will then review the principles of older cases that address principles of substance, form, and step transactions.

B. Current Theory of Economic Substance

Any analysis of the more recent cases on economic substance begins with Frank Lyon Co. v. U.S., 435 U.S. 561 (1978) and Rice's Toyota World v. Commr., 752 F.2d 89 (4th Cir. 1985).

1. Frank Lyons Co.

In Frank Lyons Co., a state bank was in the process of arranging the construction of a headquarters building. Because of various state and Federal regulations, the building could not be financed by conventional mortgage and other financing. It engaged investment bankers to arrange an alternative and a sale-and-leaseback was ultimately recommended. After negotiations with various potential investors, the bank entered into a sale-and-leaseback with the taxpayer, Frank Lyon Co. It believed that the bank building was a proper way to diversify its portfolio. Ultimately, the taxpayer took title to the building and leased it back to the bank for long-term use. The bank was obligated to pay rent equal to the principal and interest payments on the taxpayer's mortgage. It had an option to purchase the building at various times at prices equal to the unpaid balance of the mortgage and the taxpayer's initial $500,000 investment. Consequently, the taxpayer had only limited upside potential during the term of the loan. The taxpayer obtained both a construction loan and permanent mortgage financing under arrangements provided by the bank.

On its Federal income tax return for the year in which the building was completed and the bank took possession, the taxpayer accrued rent from the bank and claimed as deductions depreciation on the building, interest on its construction loan and mortgage, and other expenses related to the sale-and-leaseback transaction. The I.R.S. disallowed the deductions on the ground that petitioner was not the owner of the building for tax purposes but that the sale-and-leaseback arrangement was a financing transaction in which petitioner loaned the bank $500,000 and acted as a conduit for the transmission of principal and interest to petitioner's mortgagee.

The Supreme Court held for the taxpayer. Although the rent agreed to be paid by the bank equaled the amounts due from the petitioner to its mortgagee, the sale-and-leaseback transaction was not a simple sham by which petitioner was but a conduit used to forward the mortgage payments made under the guise of rent. The construction loan and mortgage note were found to be obligations of taxpayer without any specific guarantees from the bank. The obligation was reported on the financial statements of Frank Lyon Co. and impaired its ability to obtain additional financing. Moreover, Frank Lyon Co. – and not the bank – was found to be the owner of the building in a common sense meaning of that term. It was the only party that invested capital in the building. Consequently, the taxpayer was the owner for income tax purposes and was entitled to claim deductions for interest and depreciation.

The Court acknowledged that the transaction took shape according to the bank's needs. Throughout the negotiations between the bank, the investment bankers that structured the transaction, and the perspective investors, the bank evaluated the proposals in terms of its own cost of funds. But that was natural for parties contemplating entering into a transaction of this kind. The bank needed a building for its banking operations and necessarily had to know what its cost would be. The investors were in business to employ their funds in the most remunerative way possible. A transaction must be given its effect in accord with what actually occurred and not in accord with what might have occurred. Here, Frank Lyons Co. was at risk with regard to its investment if the bank did not renew its lease at term's end.

The Court concluded that, where a genuine multiple-party transaction with economic substance exists that is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features to which meaningless labels are attached, the Government should honor the allocations of rights and duties effectuated by the parties. So long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. The fact that favorable tax consequences were taken into account by the taxpayer on entering into the transaction is no reason for disallowing those consequences. Courts cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.

The dissenting opinion pointed out that Frank Lyon Co. assumed only two significant risks. First, like any other lender, it assumed the risk of the bank's insolvency during the 25-year lease period.. Second, it assumed the risk that the bank might not exercise its option to purchase at or before the end of the original 25-year term. In the view of the dissent, those risks were insufficient to make the taxpayer the owner.

2. <u>Rice's Toyota World</u>

<u>Rice's Toyota World</u> involved another sales-and-leaseback transaction. The property under lease consisted of used computer equipment.

Rice was an auto dealership. Its principal officer learned about computer purchase-and-leaseback transactions through a friend. The friend entered into a similar transaction through Finalco, a corporation primarily engaged in leasing capital equipment. Rice's accountant contacted Finalco and Finalco mailed Rice literature describing potential transactions. The literature noted that the transactions were expected to generate large tax losses in early years because of deductions for accelerated depreciation and interest expense. The transactions were expected to produce income in later years as depreciation deductions decrease.

Rice purchased a used computer from Finalco for a total purchase price of approximately $1.5 million, giving a recourse note in the amount of $250,000, payable over three years, and two nonrecourse notes payable over eight years. Rice leased the computer back to Finalco for a period of eight years. Under the lease, rental payments exceeded Rice's obligations on the nonrecourse debt by $10,000 annually. However, Finalco's obligations to pay rent were contingent on receiving adequate revenue in subleasing the computer. Finalco had arranged a five-year sublease of the computer. Thereafter, Finalco was entitled to 30% of the proceeds generated if it arranged release or sale of the computer after expiration of the five-year sublease.

The taxpayer claimed accelerated depreciation deductions based upon its ownership of the computer, and interest deductions for its payments on the notes. The Tax Court upheld the I.R.S. disallowance of all the depreciation and interest expense deductions based on both the recourse and nonrecourse notes because the court found that the sale-and-leaseback constituted a sham transaction that could be ignored for tax purposes. The Appellate Court affirmed on the issue of sham transaction, but reversed on the issue of the interest expense deduction.

The Court interpreted the holding in Frank Lyon Co. v. U.S. to mandate a two-pronged inquiry to determine whether a transaction is a sham for tax purposes. To treat a transaction as a sham, (i) a taxpayer must be motivated to enter the transaction for no business purposes other than obtaining tax benefits and (ii) the transaction must have no economic substance because no reasonable possibility of a profit exists. The former is known as "the subjective test" and the latter is known as "the objective test."

Regarding the subjective test, the Court found that the taxpayer did not have a business purpose other than the reduction of tax. The only way the lease transaction would produce a profit was if the computer could be subleased or sold for a profit at the conclusion of the five-year sublease. Thus, residual value of the computer was a crucial element in making a profit, and it would be logical to anticipate that an investor with a business purpose would have taken steps to inquire into projections of residual value. However, Rice's principal officer knew virtually nothing about computers, and relied almost exclusively on the representations of a salesperson. Rice did not pursue the representative's offer to provide an expert appraisal of likely residual value.

Several other facts indicated that tax avoidance was the sole purpose of the transaction. Finalco's literature emphasized the large tax deductions the transaction would produce, not the potential for profit. Rice paid an inflated purchase price for the computer and was obligated to pay Finalco 30% of any revenue at the conclusion of the five-year sublease.

At trial, the taxpayer produced a report which highlighted the fact that the tax benefit in the early years would be offset by reduced benefits in the later years of the leaseback to Finalco when phantom income would be generated. However, the Court was of the view that the taxpayer would likely walk away from the nonrecourse notes and the computers under lease rather than operate at a phantom profit. With the heavy early-stage tax deductions taken and the prospect of achieving equity in the computer slim due to the inflated purchase price paid by the taxpayer, it would have every incentive to attempt to avoid reporting phantom income.

The same facts satisfied the objective test. The transaction carried no hope of earning a profit unless the computer had residual value sufficient to recoup the principal and interest paid Finalco, less any lease income received.

Rice's Toyota World, as it interprets Frank Lyon Co. has established the standard by which Courts review tax advantaged financial products that are generic in nature, rather than directed to the business of the taxpayer.

C. Generic Financial Products

The transactions involved in these cases are financial products designed to generate losses or deductions which may be used to offset income from other sources. These products have been developed by the promoters without a particular client in mind, and once the product is completed, it is marketed to potential clients, even if no prior history exists. One common theme of these products is that the likelihood of positive cash flow or profits from these transactions is next to nil and that these transactions make economic sense for the participants only after factoring in the tax benefits they generate.

A partnership has traditionally been the vehicle of choice for carrying out these transactions due to the relative flexibility within partnership to allocate income and loss among investors. In addition, many of these products are designed so that accelerated gains or profits are allocated to non-U.S. taxpayers who are not subject to U.S. income tax. Through changes in ownership, losses are allocated almost exclusively to U.S. taxpayers.

The I.R.S. has attacked these transactions on two fronts – either the vehicle through which the transaction is carried out should be disregarded or the transaction itself should be disregarded for lack of economic substance.

1. The Merrill Lynch Transactions

Merrill Lynch developed a financial product designed to create capital losses that could be used by companies deriving substantial capital gains. Capital gains of corporations can be offset by capital losses. The net gain is subject to a maximum rate of U.S. Federal tax of 35%.

The basic element of the plan was to utilize rules in the installment sales regulations which artificially accelerate the timing for recognizing capital gains. These rules apply when an installment sale involves contingent consideration, such as a note with variable interest. In those circumstances, gain recognition is accelerated, but the accelerated gain is offset by deferred loss. Over the life of the note, the loss and the gain balance one another, generating very little economic gain or loss. Under the plan, the gains are allocated to the foreign partner who is not subject to U.S. income tax on the gains and the losses are allocated to the U.S. corporation to be used to shelter its income from other sources.

The plan devised by Merrill Lynch generally involves the following steps:

a. A partnership is formed in a tax-favorable jurisdiction, whose partners comprise of the U.S. corporation (approx. 10%) and a foreign entity (approx. 90%). Both the U.S. corporation and the foreign entity contribute cash to the partnership.

b. The partnership then uses the contributed cash to purchase corporate bonds and shortly thereafter, sells the bonds to a financial institution for cash and variable-rate installment notes, accelerating gain recognition. The risk of changes in the interest rate connected with the variable-rate notes is protected by hedges.

c. The majority of the gain is allocated to the foreign entity, which is not subject to U.S. income tax on the allocated gain.

d. The U.S. corporation increases its stake in the partnership and becomes a majority partner by purchasing a portion of the foreign entity's interest and by contributing additional assets.

e. The partnership then distributes cash, in partial redemption, to the foreign entity which is not subject to U.S. income tax. This further reduces the stake of the foreign entity in the partnership.

f. The partnership distributes the installment notes to the U.S. corporation which then sells the notes at a loss.

These Merrill Lynch transactions have been held to be shams by the courts, and consequently, are to be disregarded. The courts have held that while taxpayers are free to structure their business transactions in such a way as to minimize their tax, the transactions must have a legitimate non-tax avoidance business purpose to be recognized for tax purposes. In these Merrill Lynch transactions, the parties did not intend to join together to conduct business activities in a partnership because:

i. The foreign entities were formed contemporaneously with the formation of the partnerships; they were owned by banks deriving significant fees incident to the transactions.

ii. The foreign entities served no function other than as accommodation parties for the transactions;

iii. The transactions gave rise to significant costs borne exclusively by the Merrill Lynch customer. Yet, the customer had virtually no prospect of recovering the costs other than from the anticipated tax savings;

iv. Minimal due diligence and business negotiations took place; and

v. The Court did not believe the taxpayer's business purpose to be believable. The U.S. corporations could have engaged in the transactions directly without the partnerships at a far lower transactional cost. These transactions made economic sense only after factoring in the tax losses they generated.

These Merrill Lynch transactions have been struck down as shams by the Tax Court,[10] the D.C. Circuit Court of Appeals[11] and the Third Circuit Court of Appeals.[12]

2. Computer Equipment Leasing

Comdisco Investment Group, Inc. is a subsidiary of Comdisco, Inc. ("Comdisco"), a lessor, dealer and remarketer of IBM computer equipment. It devised a cross-border equipment leasing transaction that involved the following steps:

a. A partnership was formed by two foreign individuals. The partnership then purchased a portfolio of computer equipment from Comdisco and the computer equipment was immediately leased back to Comdisco, which then subleased the equipment to the end users of the equipment;

b. The partnership then sold to a bank the right to receive the rents payable by Comdisco under the lease, thus accelerating all of the rental income from Comdisco. The income was allocated to the foreign individuals.

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10 Saba Partnership, et al. v. Commr. (T.C. Memo. 2003-31) (The existence of the partnership was not recognized).

11 ASA Investerings Partnership v. Commr., 201 F.3d 505 (D.C.Cir. 2000) (The existence of the partnership was not recognized); Boca Investerings Partnership v. U.S., 314 F.3d 625 (D.C. Cir. 2003) (The existence of the partnership was not recognized).

12 ACM Partnership v. Commr., 157 F.3d 231 (3rd Cir., 1998). (The transaction was not recognized for Federal tax purposes.)

c. Shortly thereafter, a U.S. corporation acquired 98% of the interest in the partnership and was allocated 98% of the depreciation deductions relating to the computer equipment. As the rental income had been realized prior to the U.S. corporation's becoming a partner, no income would be allocable to the U.S. corporation.

The D.C. Circuit Court of Appeals[13] affirmed the Tax Court's ruling that the partnership would not be recognized for tax purposes because the records showed that parties did not intend to carry on the business as a partnership and that the partnership served no business purpose other than generating deductions for the U.S. taxpayer:

i. The transaction was carried out exactly as proposed by the promoter.

ii. The foreign individuals served no function other than as an accommodating parties to the transaction to strip the income from the lease;

iii. Minimal due diligence and business negotiations took place; and

iv. While taxpayers are entitled to structure their transactions in such a way as to minimize tax, the absence of a non-tax business purpose for a partnership is fatal to its validity.

Nicole Rose Corp. is another case involving computer equipment lease demonstrates the lack of business purpose and economic substance in transactions that make no economic sense in the absence of the tax losses that they generate.[14]

Quintron Corp. ("Quintron"), a closely-held corporation, was engaged in the design, manufacture, sale and service of aircraft flight simulators and other electronic equipment. Loral was a major defense contractor and was engaged in the design, manufacture, sale and service of communications and satellite equipment. Loral had expressed an interest in purchasing Quintron's assets while Quintron's shareholders wished to sell the stock of Quintron instead.

QTN Acquisition, Inc. ("QTN"), previously a shell corporation, came into the picture and served as a facilitator in the above purchase. QTN purchased the stock of Quintron with funds raised from a borrowing and then merged downstream into Quintron. Immediately thereafter, Quintron sold its assets to Loral in a transaction that generated approximately $11 million in income. The loan was repaid with the sales proceeds.

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13 Andantech L.L.C. et al. v. Commr., 331 F.3d 972 (D.C. Cir. 2003).

14 Nicole Rose Corp. v. Commr., 320 F.3d 282 (2nd Cir., 2002).

Approximately two months after the stock purchase and asset sale above, Quintron acquired, through a series of tax-free transactions under Code §351, an interest in a computer lease/sublease arrangement involving equipments used in Europe. The equipment was valued at approximately $22 million. However, the lessee under the equipment lease/sublease previously prepaid all rentals due for the term of the lease. The proceeds were placed in a trust formed to secure the borrowings used to acquire the property by the company that subsequently transferred the assets to Quintron.

On the same day, Quintron transferred to a Dutch bank its interest under the lease/sublease valued at approximately $22 million, $400,000 of cash and stock in an unrelated corporation in exchange for the Dutch bank's assumption of Quintron's obligations under the lease/sublease. The taxpayer retained the right to participate in any lease revenue at the end of the term of an underlying lease to the extent the revenues exceeded a certain level. Quintron then claimed approximately $22 million in business expense deductions which was equal to the value of the lease/sublease transferred to the Dutch bank. The deductions were used to shelter the income from the asset sale to Loral and were also carried back to prior tax years and formed the basis of a claim for refunds.

The Second Circuit Court of Appeals affirmed the Tax Court's decision denying Quintron's deductions on the ground that Quintron's participation in the computer lease/sublease was a sham:

i. Quintron never had any significant interest in or genuine obligation with respect to the computer lease/sublease or in the trust funds which guaranteed the payments under the lease/sublease;

ii. Minimal due diligence was performed by Quintron throughout the transaction; and

iii. The transaction had no business purpose other the creation of tax deductions. Because the evaluations of the property were suspect, the possible interest of Quintron in participating in residual income of the equipment if that income exceeded a specified target was not a reasonable business purpose.

3. Trades of American Depository Receipts

Taxpayers have had success both with the Fifth Circuit Court of Appeals[15] and with the Eighth Circuit Court of Appeals[16] with respect to tax-motivated trades of American Depository Receipts ("ADRs") of foreign corporations to generate capital losses and foreign tax credits. Twenty-First Securities Corporation, an investment firm specializing in arbitrage transactions, was the promoter in both cases.

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15 Compaq Computer Corp. v. Commr., 277 F.3d 778 (5th Cir., 2001).

16 IES Industries Inc. v. U.S., 253 F.3d 350 (8th Cir. 2001).

The transaction generally involves the following steps:

a. The promoter identifies ADRs whose companies previously announced dividends;

b. An intermediary then borrows ADRs owned by tax-exempt entities which are not able to take advantage of the foreign tax credits arising from dividend withholding taxes (generally at 15%);

c. The intermediary then sells the ADRs short to the taxpayer;

d. The purchase price for the ADRs would equal the market price plus 85% of the ADRs' expected gross dividends. The tax-exempt lender would also receive a deposit of cash (or cash equivalent) generally at 102% of the market value of the borrowed ADRs.

e. The taxpayer purchases ADRs with a settlement date before the record date for the dividend, so the taxpayer will be the owner of record and entitled to be paid the dividend;

f. The ADRs would be sold generally within hours of their purchase, with a settlement date after the record date;

g. The taxpayer thus incurs a capital loss on the purchase and sale of the ADRs as the sale price of the ADRs ex-dividend is lower than the purchase price of the ADRs cum-dividend; and

h. The taxpayer claims foreign tax credits for the dividend withholding tax paid on the dividend from the ADRs.

The Courts held that these ADRs transactions had economic substance because:

i. The taxpayers actually made profits on a pre-tax basis (the gross dividend income before foreign withholding taxes exceeded the capital loss);

ii. The I.R.S. contention that economic benefit must be measured on a cash basis, excluding foreign tax credits, was rejected. Under this view, the taxpayer would be entitled only to 85% of the dividend payable on the ADRs. When the issuer of the stock withheld 15% of the dividend proceeds and used that amount to satisfy the U.S. corporation's tax liability abroad, additional income resulted for the taxpayer – thus the taxpayer's income equaled cash received plus foreign tax withheld;

iii. The transactions were made at arm's length between unrelated parties;

iv. The lack of more than minimal risk was not in and of itself proof of sham. The taxpayers in IES Industries went through the process of evaluating the economic risks of the underlying transaction and that analysis resulted in a transaction with minimal risk; and

v. The ADR transactions had both a reasonable possibility of profit attended by a real risk of loss and an adequate non-tax business purpose. The transaction was not a mere formality or artifice but occurred in a real market subject to real risks. The transaction gave rise to a real profit whether one looks at the transaction prior to the imposition of tax or afterwards.

This foreign tax credit aspect of this tax shelter has effectively been shut down by a legislative amendment to the minimum stock holding period requirement for purposes of the foreign tax credits.[17]

D. Directed Tax Planning

1. Restructure of Existing Operations

When a taxpayer restructures an existing bona fide business practice to reduce its tax liability, the courts tend to respect the transaction because it has business purpose.

United Parcel Service of America, Inc. ("UPS") is in the package shipping business. It had a policy of reimbursing customers for lost or damaged packages up to $100 in declared value. Customers could insure packages for above this level ("excess value") if they paid 25 cents for each additional $100 in declared value. UPS self-insured the claims, taking in the premium revenue and paying out the claims due when and as payments were made. The excess value business was very lucrative for UPS as the receipt of excess value "premiums" paid by its customers far exceeded the claims UPS paid.

At the suggestion of its insurance broker, UPS restructured its excess value business:

a. UPS formed a Bermuda subsidiary ("OPL") and distributed the shares of this subsidiary to its shareholders;

b. UPS purchased an insurance policy, for the benefit of UPS customers, from a third-party insurance company. The premiums for the policy were the excess value charges that UPS collected; and

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[17] I.R.C. § 901(k)(1).

c. The third-party insurance company then entered into a reinsurance policy with OPL. The premiums under this reinsurance policy would equal the excess value payments that the third-party insurance company received from UPS minus commissions, fees and excise taxes.

The Tax Court concluded that the income generated by the insurance activities belonged to UPS and not OPL. It found that the same activities that were performed by UPS in 1983 continued to be performed in 1984. The mere signing of a reinsurance contract with no change in risks, functions, or responsibilities could not cause $77 million to be removed from a U.S. tax return and into a tax-free environment in the hands of an affiliate. According to the Court, there was no economic substance to distinguish the 1983 procedures from those followed in 1984.

The Eighth Circuit Court of Appeals ruled that the excess value business restructuring had economic substance and was not a sham because:

i. The transactions comprised genuine exchanges of reciprocal obligations among real, independent entities. Here, the third party insurance company took on risk, even though most of that risk was passed on to OPL. Even as to the passed on risk, the Court was not willing to disregard the separate existence of OPL;

ii. OPL was an independently taxable entity which was not under UPS's control;

iii. There were real economic effects from the transaction as UPS genuinely lost the stream of income from the excess value charges because it was obligated to make payments to the third-party insurance company. This situation distinguished it from shams where the taxpayer continued to retain the benefit of the income it had ostensibly foregone; and

iv. The transaction had a business purpose because UPS was a going concern and the transaction figured in a bona fide, profit-seeking business. The law did not prohibit tax-planning.

2. Choosing a Favorable Transaction

When taxpayers have a choice of how to implement a transaction, there is no requirement that they choose the steps that will result in the greatest amount of tax.

In one case,[18] a taxpayer was the sole shareholder of a chiropractic school that was run in the form of a profit-making corporation. This limited the schools ability to obtain grants and it was decided to convert

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18 Palmer v. Commr., supra.

the school to a not-for-profit entity. In order to maximize the tax benefit inherent in the conversion, the shareholders formed a charitable foundation and contributed the shares of the corporation to the foundation. Thereafter, the foundation caused the corporation to be dissolved and received the school assets as part of the liquidation transaction. Under the law at the time, the corporation did not recognize gain in connection with the liquidation. By adopting this order for the steps of the conversion, the taxpayer was entitled to a charitable deduction for the shares of stock contributed without having to recognize capital gain. The I.R.S. challenged the order of the steps because the taxpayer controlled the foundation in his role as director and knew that the corporation would be liquidated shortly after the contribution. Thus, the I.R.S. contended that, in substance, the liquidation preceded the charitable contribution. Under this view, the shareholder realized both a capital gain and a charitable contribution. The Tax Court disagreed.

Recognizing that the taxpayer controlled the foundation, the Court determined that the taxpayer was subject to the responsibilities and duties of a fiduciary when he acted as its director and trustee and the record contained no indication that he exercised command over the use and enjoyment of property of the foundation in violation of his fiduciary duty. When the foundation received the gift of stock, no vote for the redemption had yet been taken. Although the vote was anticipated, that expectation is not enough to rearrange the order of the steps adopted by the taxpayer. The foundation was not a sham, was not an alter ego of the taxpayer, and it received his entire interest in the shares of the corporation stock with no pre-existing obligation to adopt a plan of liquidation.

In other cases, too many outstanding arrangements were in existence before or at the time the gift was made and the Courts restructured the steps involved. In one case,[19] the corporation whose shares were contributed previously adopted a plan of liquidation. The taxpayer was treated as if he received the liquidation proceeds which were contributed to the charity. In another case,[20] the taxpayer owned shares of marketable stock with high value and low basis and a yacht with relatively high basis and low value. The taxpayer entered into negotiations to contribute his yacht to a charity associated with the Merchant Marine Academy so that the yacht could be used as a training vessel. However, before the gift of the yacht was made, the taxpayer contributed the shares of stock to the same charity, which sold the shares. The charity used a portion of the proceeds to purchase the yacht from the taxpayer at what turned out to be an inflated price. The question presented was whether the taxpayer sold the yacht and contributed marketable stock or whether he sold the marketable stock and contributed cash and the yacht. The Court determined that, when the shares were received by the charity, an understanding existed that it would acquire the yacht. Where an understanding exists, it will be treated a contribution of the asset -- at whatever its then value is -- with the charity acting as a conduit of the proceeds from the sale of the stock.

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19 Hudspeth v. U.S., 471 F. 2d 275 (8th Cir.1972).

20 Blake v. Commr., 697 F.2d 473 (2nd Cir. 1982).

3. Step-Transaction Doctrine

No discussion of economic substance would be complete without at least a brief discussion of the step-transaction doctrine. Under this theory of the law, which is akin to economic substance, various purportedly independent transactions may be treated as one integrated transaction for income tax purposes.

The basic premise of the step transaction doctrine is that an integrated transaction cannot be broken into independent steps in determining tax consequences. The separate steps must be looked at together to determine the tax consequences of the transaction.[21] The step transaction doctrine treats an interrelated series of transactions together as component parts of an overall plan, rather than treating each transaction in isolation.[22] The step transaction doctrine will not apply if each step (i) has independent economic significance (ii) is not a sham, and (iii) is undertaken for valid business purposes other than the avoidance of Federal income taxes.[23]

In determining whether several transactions constitute an integrated transaction, three tests most often applied are the end result test, the interdependence test, and the binding commitment test.[24] The end result test is most frequently used. Under this test, separate business transactions can be collapsed when it is determined that they were intended to be component parts of a single transaction, designed for the purpose of reaching the ultimate result. The interdependence test focuses on whether each of the purportedly independent transaction have business significance or whether they have meaning only as part of the larger transaction. If the legal relations created by one transaction would be fruitless without completion of the series, the steps are collapsed. The binding commitment test provides that there must be a binding legal commitment to take the latter steps before an earlier step can be collapsed.[25] Accordingly, several transactions will be integrated into one transaction only if a binding commitment existed as to the second and later steps at the time the first step was taken. Because this test eliminates judicial discretion, it has

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21 King Enterprises, Inc. v. U.S., 418 F.2d 511 (Ct. Cl. 1969); see also Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942); Helvering v. New Haven & Shore Line R.R. Co., Inc., 121 F.2d 985 (2nd Cir. 1941), cert. denied, 315 U.S. 803; Thurber v. Commr., 84 F.2d 815 (1st Cir. 1936).

22 Crenshaw v. U.S., 450 F.2d 472 (5th Cir. 1971), cert. denied, 408 US 923; Security Industry Ins. Co. v. U.S., 702 F.2d 1234 (5th Cir. 1983); Brown v. U.S., 789 F.2d 559 (6th Cir. 1986).

23 Rev. Rul. 79-250, 1979-2 C.B. 156; Rev. Rul. 83-142, 1983-2 C.B. 68; Kuper v. Commr., 533 F.2d 152 (5th Cir. 1976); McDonald's Restaurants of Ill., Inc. v. Commr., 688 F.2d 520 (7th Cir. 1982).

24 Redding v. Commr., 630 F.2d 1169 (7th Cir. 1980),cert. denied, 450 US 913; Commr. v. Gordon, 391 U.S. 83 (1968), on remand, 51 T.C. 1032 (1969), affd., 424 F.2d 837 (2nd Cir. 1970), affd. mem., 450 F.2d 198 (9th Cir. 1972), cert. den., 400 U.S. 849; South Bay Corp. v. Commr., 345 F.2d 698 (2nd Cir. 1965) appeal dismissed, (2d Cir. Jan 27, 1965); American Bantam Car Co. v. Commr., 177 F.2d 513 (3rd Cir. 1949), cert. den., 339 U.S. 920; Anheuser- Busch, Inc. v. Helvering, 115 F.2d 662 (8th Cir. 1940) cert. den., 312 US 699.

25 Commr. v Gordon, 391 U.S. 83 (1968), on remand, 51 T.C. 1032 (1969), affd. 424 F.2d 837 (2d Cir. 1970), affd. mem., 450 F.2d 198 (9th Cir. 1972), cert. den. 400 U.S. 849.

been given limited application except when a binding commitment is present. In the absence of a legal commitment, Courts remain willing to apply the other tests.[26]

When the step transaction doctrine applies, the separate tax effects of each step are ignored and the overall tax effect is based on a comparison of the facts in existence prior to the first step with those that exist after the last step. The tax consequences are determined based on the most direct way of proceeding from the former to the latter.

E. Conclusion

U.S. tax law places a premium on the importance of economic substance, and in principle, tax is computed based on that substance rather than on self-serving documents, offsetting transactions, financial accounting presentation, transactions with accommodation parties, and other arrangements. Whether a transaction is characterized as a sham, or lacking economic substance, or part of an integrated transaction, the issue put before the Court is whether the form of the transaction complies with its substance. Each of the tests described in this article attempts to provide a standard upon which that analysis can be made on a rationale basis. History illustrates, however, that when a Court crafts a standard, it provides a roadmap that can be used for aggressive tax planning. Perhaps that is a reason why such a simple concept – substance must prevail over form – requires so many different tests.

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26 McDonald's Restaurants of Ill., Inc. v. Commr., 688 F.2d 520 (7th Cir. 1982); Redding v. Commr., 630 F.2d 1169 (7th Cir. 1980),cert. denied, 450 US 913; Commr. v. Gordon, 391 U.S. 83 (1968), on remand, 51 T.C. 1032 (1969), affd., 424 F.2d 837 (2d Cir. 1970), affd. mem., 450 F.2d 198 (9th Cir. 1972), cert. den., 400 U.S. 849; but see, Cal-Maine Foods Inc. v. Commr., 93 T.C. , No. 19 (1989).