



**23RD ANNUAL  
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TAX PRACTICE TRENDS  
CONFERENCE  
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**Purpose and process:**

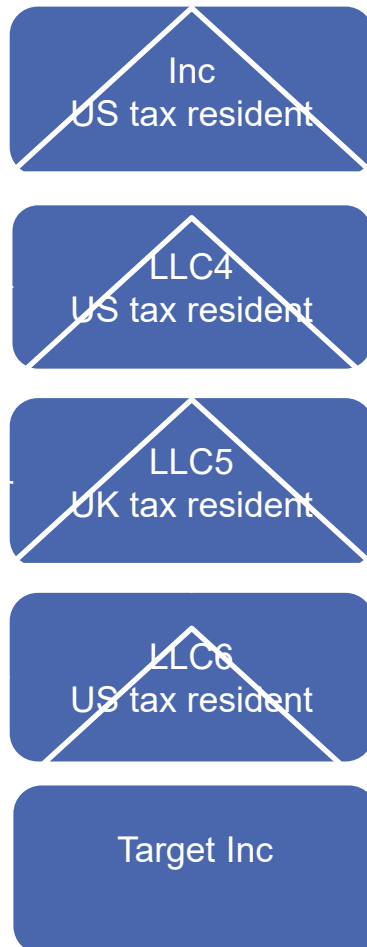
The increasing importance of substance and process in tax controversy, and its effect on outcomes

**30 March 2023**



# **View from the UK**

# Unallowable purposes – loan relationships



- ❑ Acquisition of a North American investment management business
- ❑ Financed by way of debt
- ❑ UK company included in the stack
- ❑ Is the UK company barred from obtaining deductions on interest as a result of the “unallowable purpose” rules?

# How is purpose determined and priced?

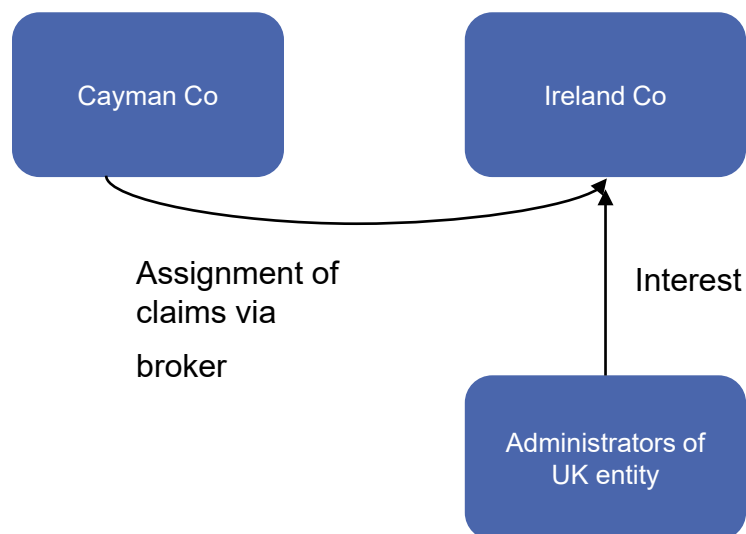
## □ Is there a main unallowable purpose?

- Advice given by tax advisors
- Briefings given to the board
- What was in the mind of the board at the time of taking the decision, and board minutes
- Beyond motive and stated intentions – what is the inevitable and inextricable consequence of the transaction?

## □ If there is both an allowable and an unallowable purpose, how is value apportioned?

- Apply an objective approach
- Use a “but for” test
- Just and reasonable apportionment in this case was all to unallowable purpose

# Purpose and tax treaties



- Ireland Co purchases claims against the administrators of a UK entity from a third party
- Withholding tax applied on interest payments to Ireland co by administrators
- Refund claimed under DTT
- HMRC refuse refund on the basis that the assignment had a tax purpose

# Determination of purpose

## □ View from Cayman

- Knew that they would suffer WHT and others might not, but were agnostic as to identity of purchaser
- Cayman wanted to realise the best price on the best terms

## □ View from Ireland

- Ireland knew that the value of the claim to Cayman was 80% if unsold and that it had greater value to Ireland
- Ireland wanted to purchase cash flows and realise an IRR
- They knew that there were others for whom UK WHT would not be a permanent cost

# Conclusion

- No main tax avoidance purpose *but*
- Must be distinguished from conduit and treaty shopping cases

# **View from Germany**



# Germany - Introduction

- Changing landscape for more than a decade
  - Transition from tax-optimization to risk mitigation
- Environment heavily impacted by the fallout from cum/ex investigations
- Increased scrutiny of tax structures, including plain vanilla transactions, under anti-abuse rules
  - Tax court precedents: “Bad cases make bad law”
  - Administrative guidelines increasingly focus on anti-abuse considerations

# Germany - Examples - cum/ex and cum/cum transactions

- Cum/ex transactions: double (or multiple) refund of withholding taxes only levied once
  - Short sale of securities triggering manufactured dividend payment
  - Effectively ended by German legislation only from 2012
- Cum/cum transactions: Tax-optimization – increasing withholding tax refund level
  - Example: transfer of shares by non-German lender to German borrower over dividend record date

# Germany - Examples - cum/ex and cum/cum transactions

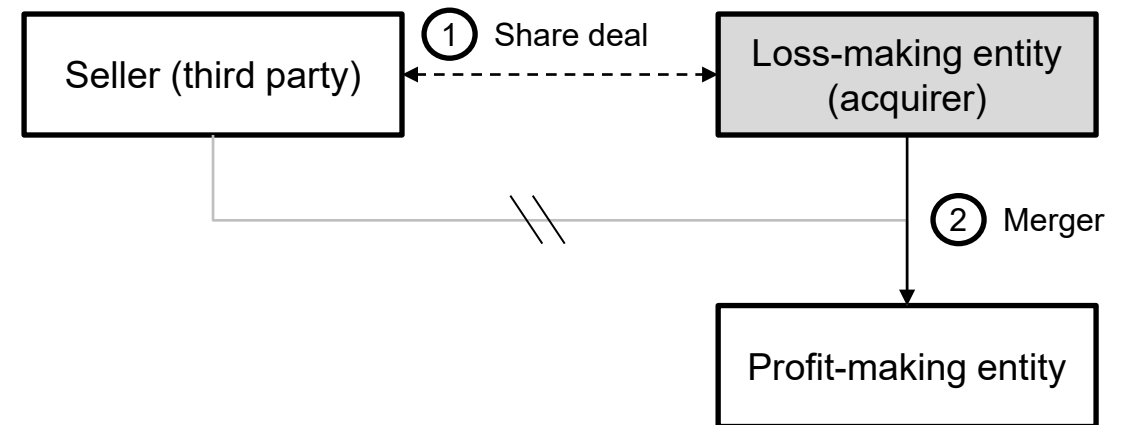
- Tax treatment of **cum/cum transactions**: Case law and administrative guidelines
  - Plethora of tax court decisions dealing with economic ownership allocation rules and/or anti-abuse test
    - Starting point: Federal Tax Court case I R 88/13 (Structured Lending)
    - Overall picture view: harmful contractual framework?
  - Administrative guidelines: Shift from anti-abuse considerations to economic ownership test
    - Finance Ministry's circular of 17 July 2017 vs. circular 9 July 2021
    - Economic ownership allocation as “disguised anti-abuse test”

# Germany - Examples - Domestic (Targeted) Anti-Abuse Rules

- German tax law provides for both
  - (1) targeted anti-abuse rules (**TAAR**) and
  - (2) a general anti-abuse rule (**GAAR**, *Sec. 42 Abgabenordnung*)
- Number of tax court precedents recently dealt with interaction between (1) and (2)
  - “Blocking doctrine”: Principally no recourse to GAAR if and to the extent TAAR is fulfilled
  - However, GAAR can be applied taking TAAR intention into account (cf. Federal Tax Court, case no. I R 2/18)
- Result: More recent legislation introducing specific anti-abuse rules often explicitly provide for recourse to GAAR

# Germany - Examples - Domestic (Targeted) Anti-Abuse Rules

- Loss-making entity (plaintiff, a manufacturer and seller of cars) acquired a profit-making entity from a third party with the purpose (inter alia) to strengthen its liquidity position
- At the end of the fiscal year 2008, plaintiff suffered a liquidity crunch and faced insolvency
  - Typically available sources of cash such as financial injections from the shareholders or loans from banks were not considered to increase liquidity
  - Instead, Seller offered the plaintiff to acquire a wholly-owned subsidiary of Seller (profit-making entity) for the purpose of refinancing
- Capital gain achieved by Seller remained effectively 95% tax-free, acquired entity was merged upstream.
  - The transferred assets by upstream merger were recognized at tax book values at transferor level and continued at plaintiff level (i.e. tax-neutral)
  - Result: Offsetting acquirer's losses with profits from the acquired and subsequently merged entity
- Federal Tax Court upheld the offsetting position as not abusive, but discussed interaction between SAAR and GAAR

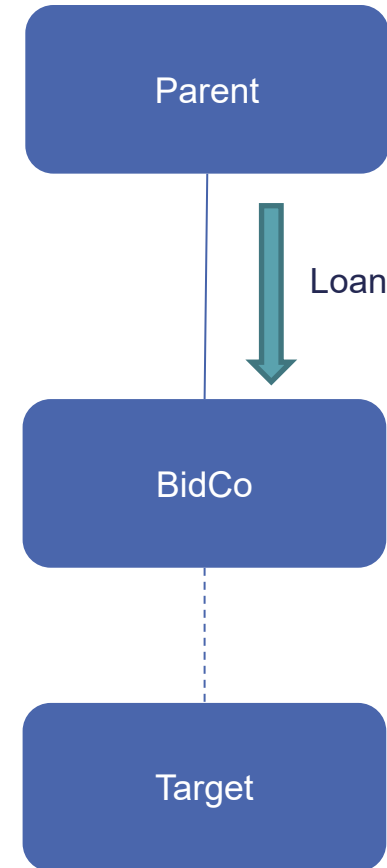


# **View from the Netherlands**

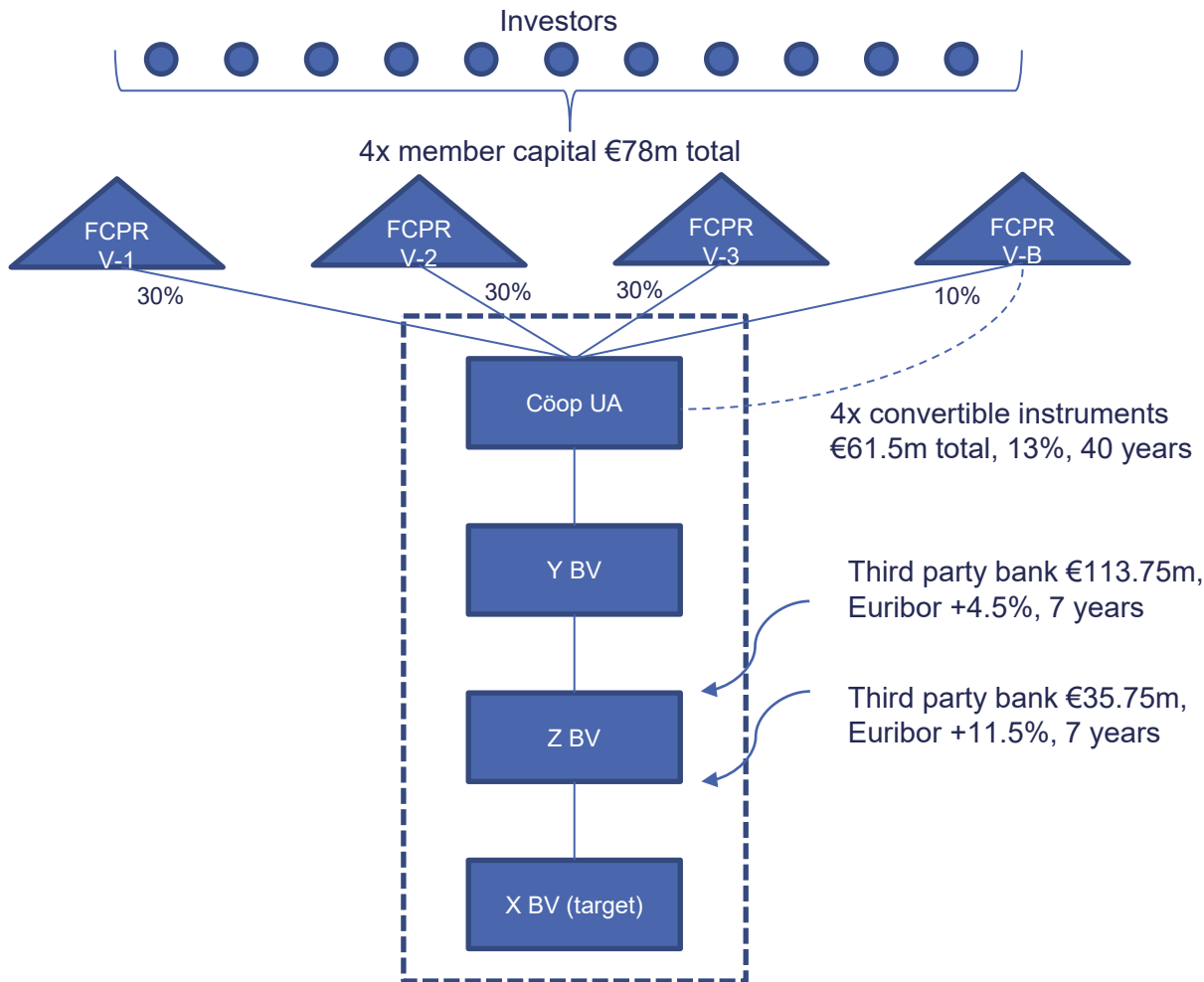
# The Dutch perspective

- **Purpose** (or “business reasons”) relevant for several provisions
- Anti-base erosion provision (article 10a CITA)
  - Related party loan (or deemed related party loan), including “cooperating group”
  - Tainted transaction
  - Business reasons (*purpose*) for (i) transaction and (ii) debt financing thereof
  - Alternatively, compensating levy for the lender (i.e. presumption of non-tax motivated financing)
  - Counterproof possibility tax authorities
- Supreme Court case law – allowable purpose and unallowable purpose
- In addition (or instead?) general abuse of law (“*fraus legis*”)

- **Simple example**



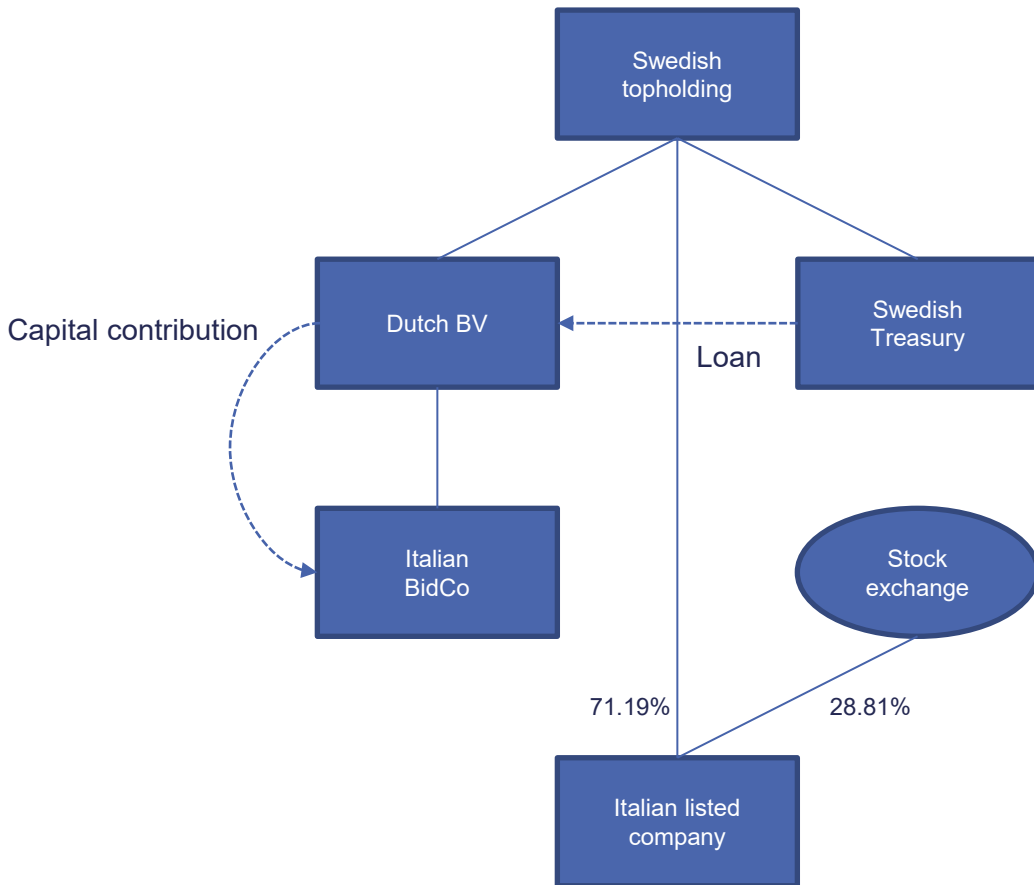
# The Dutch perspective



- Funding of hybrid mutual funds which grant proportionate loans to Dutch borrower
- Not in scope of article 10a CITA old law (**no related party lender**)
- However, Supreme Court ruled that interest deduction could be denied based on **general abuse of law**
- Under current law this would be in scope of article 10a CITA (**cooperating group of lenders**)
- Business reasons for transaction, but likely no business reasons for debt financing (i.e. **artificial = unallowable rerouting of funds**)



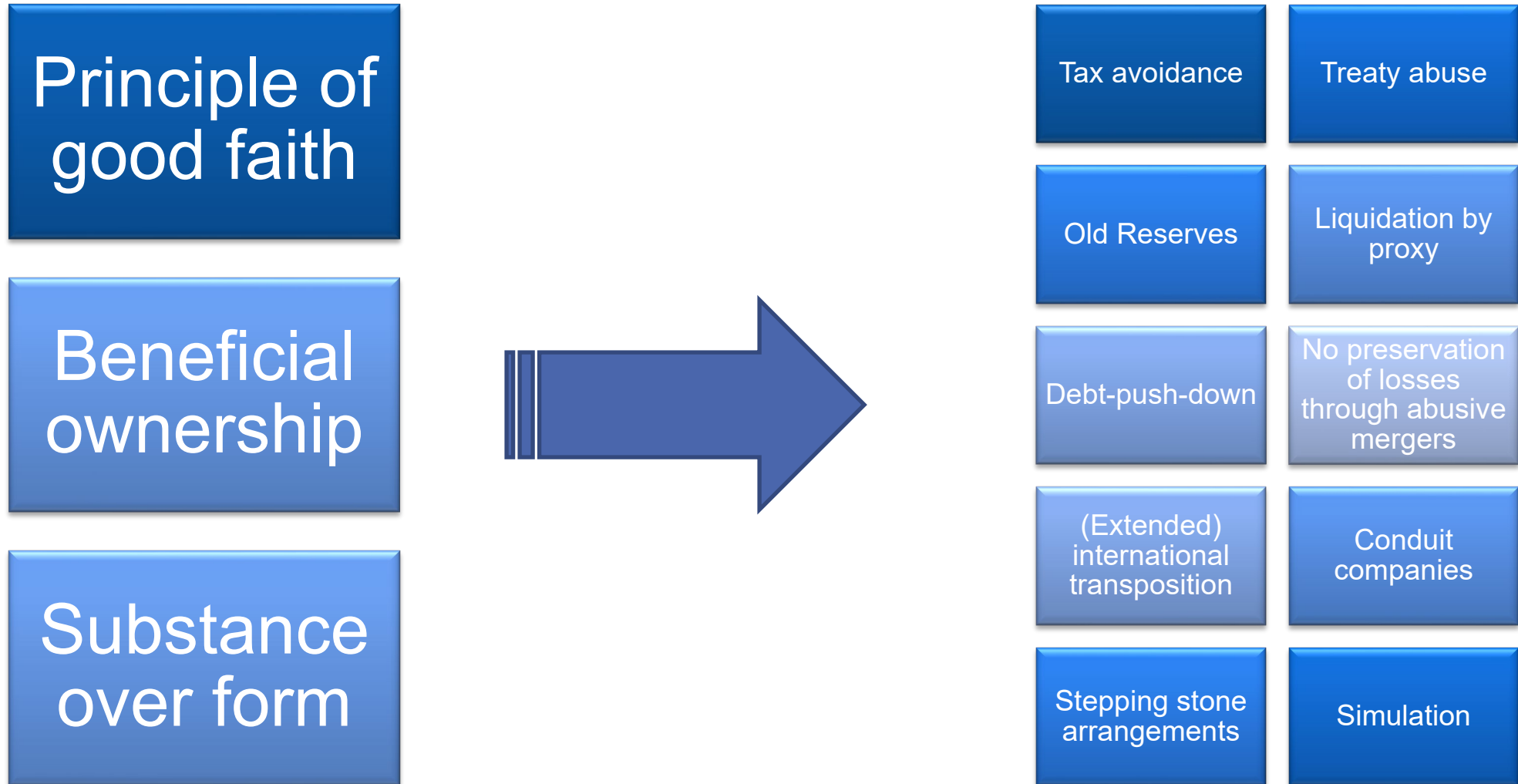
# The Dutch perspective



- Loans from related parties and tainted transaction, i.e. in scope of article 10a CITA
- Business reasons (i.e. **allowable purpose**) for the transaction
- Also business reasons for debt financing thereof?
- Lenders part of **treasury** function within the group
- Artificial (i.e. **unallowable**) re-routing of funds?
- Supreme Court decides:
  - Treasury has financial key function in the group
  - No need for taxpayer to proof source of loans
  - Higher Court to decide whether business reasons for debt financing were present

# View from Switzerland

# The Swiss perspective



# The Swiss perspective

## □ Principle of good faith and treaty abuse

- Art. 26 of the Vienna Convention on the Law of Treaties:

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

- Thus the interdiction of treaty abuse is an implicit element of every double tax treaty (Swiss Federal Tribunal, 2A.239/2005)

## □ Beneficial ownership

- Is a requirement built in double tax treaties in order to benefit from treaty benefits (especially refund of WHT)
- Beneficial ownership serves to determine the intensity of the relationship between a taxpayer and the income, viewed from an economic point of view
- The beneficial owner retains the right to decide on the use of the income
- Beneficial ownership may be denied if recipient must pass on the payment received
- If there is a reciprocal interdependence between the income and the duty to pass it on, this may be an indication that there is no beneficial ownership
- (Winning streak for Swiss tax authorities: e.g. Swiss Federal Tribunal, 2C\_364/2012, 2C\_895/2012, 2C\_209/2017, 2C\_880/2018)

# The Swiss perspective

## □ Substance over form and tax avoidance

Tax avoidance is constituted if:

- the legal structure or transaction chosen is **unusual, inappropriate or inadequate** to its economic purpose (objective element);
- tax motives are the **only reason** for the structure or transaction chosen (subjective element); and
- were it accepted by the authorities, the legal structure or transaction would lead to **significant tax savings** (effective element).
- → **tax planning is not prohibited**

□ **Generally be careful if a treaty position (e.g. WHT refund) is enhanced through a transaction**

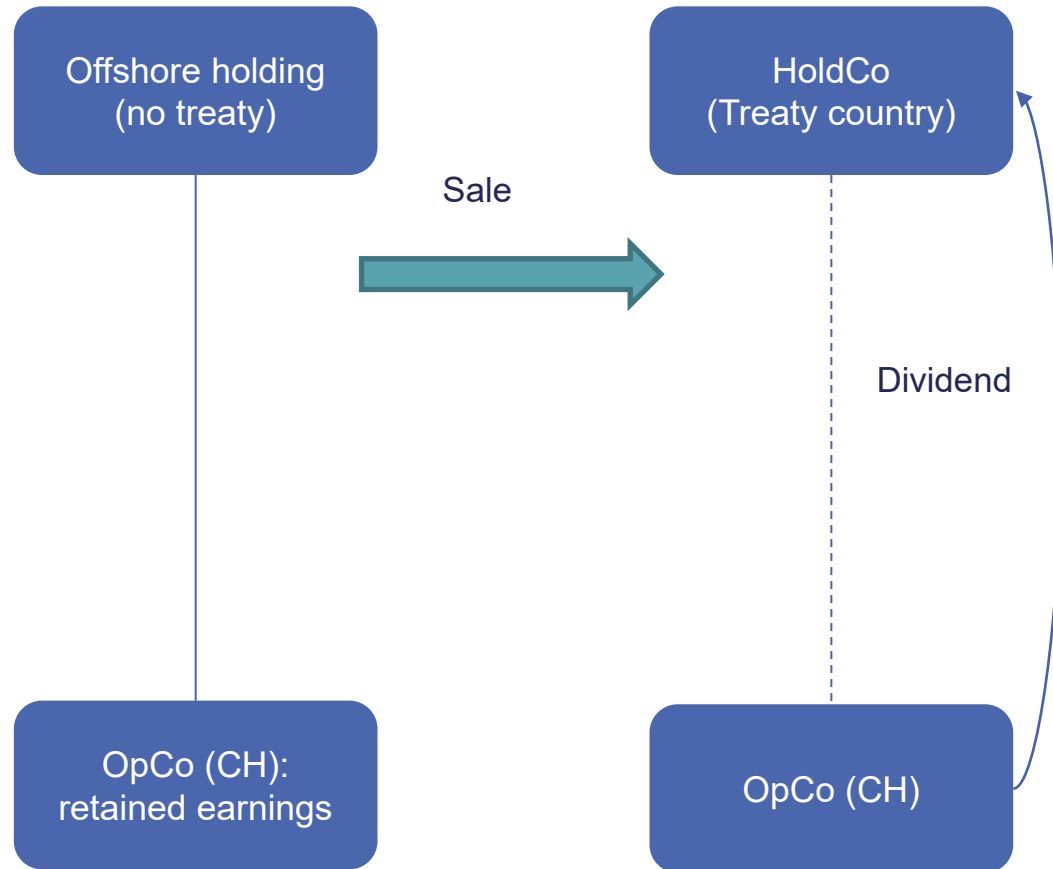
□ **Also applies to third party transactions**

□ **Legal arrangements must reflect economic reality**

□ **Difficult - if not impossible - to apply transparency to legal persons in the structure (no look-through approach)**

# The Swiss perspective

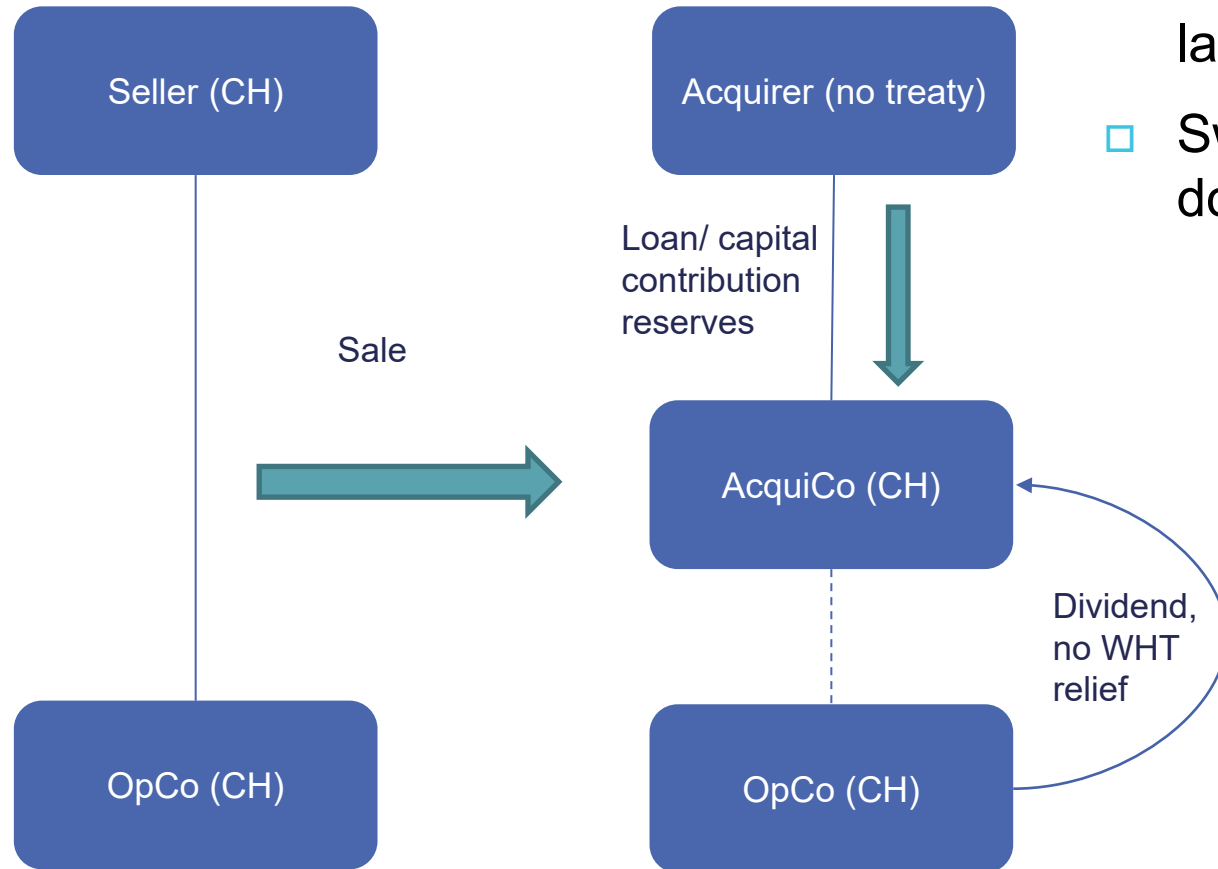
## □ Old Reserves Theory



- Sale leads to an enhancement of WHT position of OpCo's reserves
- WHT relief denied under treaty as long as reserves existing at sale are being distributed

# The Swiss perspective

## Extended International Transposition



- Transaction is not unusual
- Parties make use of tax relief foreseen by law
- Swiss Federal Tax Administration challenges domestic payment (no treaty situation)

# **View from the US**



# The US technical perspective

## The proper role of purpose almost always depends on context in US tax

- **Good business purposes are generally required**
- Business purposes need not be the principal purpose for a transaction, but rather a “significant” or “substantial” purpose when compared to tax avoidance purposes.
- The Code and regulations shift the balance to “a principal purpose” or “the principal purpose” standard in certain contexts, such as:
  - GILTI avoidance transactions, see Treas. Reg. 1.951-1(e)(6)
  - Acquisition of control of a corporation to secure the benefit of a deduction, credit, or loss, see IRC § 269
- **But sometimes purely tax-motivated transactions survive review**
- *E.g.*, federal tax elections, such as “check-the-box” transactions
- Courts have also blessed purely tax motivated transactions, such as so-called “*Granite Trust*” corporate loss transactions
- Consider whether the economic substance doctrine is “relevant”
- Avoidance of state or foreign taxes can be a good business purpose for US federal income tax purposes

# Practical impacts

# What does an increased focus on purpose mean in practice?

- Criminalisation of tax
- Impact of “purpose” arguments on mutual agreement procedures
- Risks of losing a case for purpose reasons
- Benefits of advance rulings and administrative resolutions

# Practical implications - Netherlands

- Business purpose of transaction rather than legal documentation
- No more “safe harbor rules” but rather rebuttable presumptions
- Focus on anti-abuse leads to complicated legislation, creating more disputes and less room for advance certainty

# US Practical Considerations

- Tax-motivated transactions almost always draw strict scrutiny on audit, which can mean engagement from IRS Counsel, technical specialists, and coordinated management teams.
- Regardless of technical analysis, it is almost always better to locate tax planning transactions inside larger business transactions, integrations, dispositions, etc.
- Penalties raise the stakes, including a 40% strict liability penalty for transactions that fail the economic substance doctrine.

# IRS Economic Substance Doctrine Administrative Guidance

1. Recent guidance removed “executive level” approval previously required for examiners to assert the economic substance doctrine. LB&I-04-0422-0014.
2. Coordination with IRS Counsel is still generally required, and IRS Counsel must review notices of deficiency asserting the economic substance doctrine and associated penalties.
3. Most of the factors tending to show that the application of the economic substance doctrine is appropriate are carried over from prior administrative guidance. (LB&I-04-0711-015.)
  - a) Updated guidance drops one factor: “[t]ransaction is promoted/developed/ administered by tax department or outside advisors.”
  - b) Updated guidance also drops all factors tending to show that economic substance doctrine is not appropriate.
4. “Notwithstanding existence of the [factors], the economic substance doctrine may not be appropriate if the transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives.”

# Economic substance doctrine – current IRS factors

- Transaction is promoted/developed/administered by tax department or outside advisors
- Transaction involves a tax-indifferent counterparty that recognizes substantial income
- Transaction is highly structured
- Transaction is outside the taxpayer's ordinary business operations.
- Transaction includes unnecessary steps
- Transaction has no credible business purpose apart from federal tax benefits
- Transaction is not at arm's length with unrelated third parties
- Transaction has no meaningful potential for profit apart from tax benefits
- Transaction creates no meaningful economic change on a present value basis (pre-tax)
- Transaction has no significant risk of loss
- Taxpayer's potential for gain or loss is artificially limited
- Tax benefit is artificially generated by the transaction
- Transaction accelerates a loss or duplicates a deduction
- Transaction is pre-packaged
- Transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)
- Transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years
- Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction

# The Swiss perspective

## □ **About advance tax rulings**

- Still an important and tested feature of the Swiss tax system: Protection of good faith
- No obligation to ask for an advance ruling
- However: if complicated structure was not covered by an advance ruling, this may raise eyebrows...
- Usually better to submit an advance ruling request, but one must be able to live with the answer!

## □ **About the “Purpose” and “Abuse” argumentation by the tax authorities:**

- It is suitable for almost every situation
- It may come in very different shapes or forms
- It has a very powerful ring in the ears of the Swiss courts
- ... it's the Swiss Army Knife in the arsenal of the Swiss tax authorities!



# Germany - Tax procedures involving abuse considerations

- Increased number of participants involved
  - Tax auditors, tax investigation units, public prosecutors, others
- The “Bifurcation Dilemma”: Separate tax procedures and criminal procedures
  - Two separate legal arms, not necessarily harmonized
  - Potential deviation between tax court and criminal court decisions
  - “Purpose test” from different perspectives

# Germany - Outlook and conclusions

- Duration of procedures significantly protracted (retroactive introduction of prolonged limitation periods)
- Multi-front disputes with difficulties to achieve settlements
- Mitigating risks: Disclosure and documentation of purpose/economic backgrounds of transactions with tax implications
- Silver lining: (Tax) authorities and taxpayers intend to find a balance and overcome historical burdens

# UK

- Serious concern about reputational risk
- Change of law often framed as anti-avoidance even when technical
- Reluctance to litigation enhanced when anti-avoidance rules are in play
- Potential for some clearances, but access is not an even playing field

**Questions?**