General Anti-Avoidance Rule in Latvian Tax Law

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Abstract: The tax law systems of the EU Member States differ strongly; one is based on the specific anti – avoidance provisions governed by the general principle of prohibition of abuse stated in court jurisprudence, the basement of the other is a written judicial rule which prohibits the abuse – general anti – avoidance rule. General anti-avoidance rules are needed because of conflicts of laws in the borders of one state as well the conflicts of different state's jurisprudence. There is no legal definition of tax avoidance in the EU law nevertheless the notion of tax avoidance is firmly connected to the concept of abuse of law – a general principle of EU law which has got its prompt development in the resent tax case law of the Court of Justice of the European Union (CJEU). The UK practice is undoubtedly the positive example of methodologically precise legal ruling in the sphere of complicated abstract issues of abuse in tax law. This paper aims to describe the concept of general anti avoidance rule, comparing theoretical cognitions, regulation in Latvia and UK and also tax case law of the Court of Justice of the European Union.

Keywords: tax avoidance; general anti avoidance rule; harmonization of the anti–abuse provisions

1. Theoretical Background

The inspiration for this article has been found in the works of the professor of Australian National University John Braithwaite which are devoted to specific issues of taxation; more precisely – tax avoidance issues. The core line of his tax research is the argument that tax law needs the deep integration between rules and principles more than other areas of law. Using the Joseph Raz definition: *"Rules prescribe relatively specific acts; principles highly unspecific actions"* (Braithwaite 2005, p.144), Braithwaite shows the problems of tax law in respect to

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tax avoidance regulation efficiency by the example of the traffic rules. *"The speed limit gives us a bright-line rule, but keeping under the limit will not protect us if we drive too fast in unusually dangerous conditions, like fog. There is no safe harbor in this law; meeting the bright – line standard does not shelter us from prosecution for excessive speed; it only tells us hoe to keep out of trouble with the law in normal circumstances. Moreover, road safety authorities put a lot of effort into educating us of the need to honor the underlying principle of cautions driving that is watchful for special hazards. It is that principle that trumps the foot-fault rule the law has given us to guide our driving."* (Braithwaite 2005, p.144).

This example in a very realistic way shows us the role of the principles in law in general as well as in tax law in specific. Commercial activities are developing all the time taking different forms and structures; precise tax provisions aiming combating tax avoidance often fail to cover the business arrangements never used before. So, the question is what kind of tax law structure could in most effective way ensure the legal balance between the states right to tax all kind of commercial activities and person right to choose the tax consequences of its business arrangements.

2. General Anti – Avoidance Rule for Latvia: Creation

The tax law systems of the Member States differ strongly; one is based on the specific anti – avoidance provisions governed by the general principle of prohibition of abuse stated in court jurisprudence, the basement of the other is a written judicial rule which prohibits the abuse – general anti – avoidance rule (GAAR). *"Specific anti – abuse rules, namely if they contain irrefutable presumptions or legal fictions, contributing to achieving legal certainty as they reduce or even eliminate administrative and judicial discretion, whereas GAAR and the principle of abuse do this to a much lesser extent (GAAR and the principle of abuse have to be progressively defined by courts)"* (Dourado, 2011, p. 478)

Till year 2012 Latvian tax law didn't contain general anti – avoidance rule; tax law structure was based only on specific anti – avoidance rules like the transfer pricing provisions, thin capitalization rules, the arm's length principle concerning sales income which intended to prevent tax avoidance through sales transactions below of above usual market price and others. With the amendments to the law on Taxes and Duties from December 13 2012, the section 23 "Adjustment of the Amount of Tax Payment" was amended by the paragraph 14 consisting GAAR: *"The tax*

administration shall assess the amount of tax liabilities based on the economic nature and substance of the individual transaction or a set of transactions carried out by the taxpayer rather than only on the basis of their legal form"[1]. According to the annotation to these amendments the GAAR is needed firstly because of conflicts in laws in the borders of one state as well the conflicts of different state's jurisprudence, as a second reason the terminological differences and inconsistency in the interpretation of tax laws are mentioned. The legislator mentions that the specific anti – avoidance institutes of permanent establishment and connected entities often have been used in abusive forms for the sole tax avoidance aims. No further explanation why the existing system of specific anti – avoidance rules doesn't work isn't given. Such a poor background is not efficient for the further effective implementation of this rule and is valuated very critically. The legislator was asked to give the legal background why the existing civil law concepts of *bona fide* could not be used in the areas of tax law, then the legislator was to review the anti – avoidance concepts developed in the jurisprudence of the European Court of Justice and give the explanation why the concept of substance over form is chosen as a GAAR and show the general legal lines of how to implement it. Otherwise the content of the newly created rule is not precise and could not be used effectively. Further analysis is aimed to analyze the theoretical and practical concepts of abuse of tax law on EU level in order to get the answer what is the content of the GAAR on the national level.

3. The Concept of Substance over Form in Latvian law

Prior to the adoption of GAAR the anti – avoidance concept used in Latvian tax law jurisprudence was not clearly formulated. The absence of GAAR has raised many problems: the abusive manipulations with the inconsistencies of the civil law constructions and the specific tax law institutes and the interpretation of the civil law provisions using the specific categories of tax law in the absence of the precise legal ground for such an interpretation.

The Supreme Court of Latvia analyzing the case law of administrative courts in interpretation and application of standards of the law "On Value Added Tax"

[1] Law on Taxes and Duties adopted at 02.02.1995. (with amendments to 05.06.2014) official translation of State Language Center. Retrieved from: http://www.vvc.gov.lv/advantagecms/LV/tulkojumi/dokumenti.html?folder=&currentPage=12, date 15.03.2016.

mentioned the principle of business reality[1] in regard of evaluation of possible abusive practices. This criteria has been used in several Supreme Court cases[2], which allowed Court to ignore the form of transaction chosen by the taxpayer because the Court has had an evidance of abuse of form. Even that its not mentioned in the Courts decisions the legal basment for the use of the substance – over – form doctrine before the adoption og GAAR in 2012 still can be found in tax law – Annual Accounts Law[3] the section 25. valuation Rules, paragraph 8 stated that "*economic activities of an undertaking shall be recorded in the books and reflected in the annual accounts, taking into account their economic content and nature, not just their legal form."*[4] This regulation existed from November 6 1996 – the date the Annual Accounts Law was amended by this regulation.[5] So, it could be concluded that GAAR in specific form existed in Latvian tax law from early 1996; the wording of this regulation is arguable because it did not give the tax administration and the court the unconditional right to reevaluate the character of taken arrangements. Nevertheless such a rule prescribes the imperative obligation to taxpayer which has been used by the tax authorities as valuable argument in legal disputes on tax avoidance matters.

There was a common opinion among tax law specialists that the civil law concept of *bona fide* which explicitly shown in Civil Law section 1439: "*When the transaction is with serious intent, but is concealed by another transaction, then the former shall be in effect, unless there has been an intention to deceive a third person thereby or to do something illegal in general; but the latter transaction, entered into for appearances only, shall remain in effect only insofar as deemed*

[1] The Supreme Court of Republic of Latvia. Compilations of Court Decisions/Administrative Law/2008/2009. Case-law of administrative courts in interpretation and application of standards of the law "On Value Added Tax" para. 9. Retrieved from:
http://at.gov.lv/en/court-proceedings-in-the-supreme-court/compilations-of-court-decisions/administrative_law/
date: 15.03.2016; term "business reality" is translation from „saimnieciskās realitātes princips" in Latvian).

[2] For example: The Decision of the Supreme Court of Republic of Latvia 25.02.2008. SKA-196/2008, The Decision of the Supreme Court of Republic of Latvia 28.03.2008. SKA-112/2008.

[3] Annual Accounts Law adopted at 14.10.1992. (with amendments to 22.05.2014.) official translation of State Language Center. Retrieved from: http://www.vvc.gov.lv/advantagecms/LV/tulkojumi/dokumenti.html?folder=%2Fdocs%2FLRTA%2FLikumi%2F
Date: 15.03.2016.

[4] Ibid.

[5] Amendments to the Annual Accountants Law from 06.11.1996. Retrieved from: http://likumi.lv/ta/id/53038-grozijumi-likuma-par-uznemumu-gada-parskatiem- date:15.03.2016.

necessary in order to maintain the former in effect."[1] It could be used as a legal basement for the implementation of the substance – over – form concept in the absence of the GAAR. Such a position is arguable because the tax disputes are solved under administrative law procedure; so no the tax administration or administrative courts have a right to deal with the issues of private law. In order to use the civil law concept of substance – over – form the tax law administration should firstly challenge the arguable case in the civil court under ordinary civil law procedure. And only if the civil court declares the claimed transaction or action of taxpayer as invalid in civil law contest, the tax authority could implement tax law rules and disregard the tax consequences of transaction in matter.

All the above mentioned reasons undoubtedly prove the theoretical and practical necessity of adoption of GAAR as a written Latvian tax law provision. By amending law on Taxes and Duties with the GAAR the new tax law hierarchy has been created: now the substance – over – form concept is a general principle of Latvian tax law and all other anti – avoidance provisions of tax law (specific anti – avoidance rules) should be implemented in line with the spirit of the general principle. The next question to clarify is what the legal content of the substance – over – form concept which lies in the basement of GAAR is in the CJEU jurisprudence in order to ensure the harmonized implementation of the Latvian GAAR on national level.

4. Jurisprudence of the Court of Justice of the European Union in understanding GAAR

There is no legal definition of tax avoidance in the EU law nevertheless the notion of tax avoidance is firmly connected to the concept of abuse of law – a general principle of EU law which has got its prompt development in the resent tax case law of the Court of Justice of the European Union (CJEU). Tax law of the Member states should be in line with the concept of prohibition of abuse of law developed in the CJEU jurisprudence. It should be taken into account that national anti – abuse rules have to be tested, exactly like any potentially discriminatory or restrictive rule, against the principle of abuse of EU law: *"As they operate in the interpretation sphere of EU law and do not aim at qualifying a legal transactions as a tax offence, and as they requalify the legal transactions, the Court tests whether those clauses qualify the facts within the framework of the principle of*

[1] Civil Law adopted 28.01.1937.Retrieved from: http://www.vvc.gov.lv/advantagecms/LV/tulkojumi/dokumenti.html?folder=%2fdocs%2fLRTA%2fLikumi%2f&currentPage=18 date: 15.03.2016.

abuse of EU law – i.e. whether there is an abuse of EU law." (Dourado, 2011, p. 479)

The content of the CJEU's concept of abuse of EU law is not uniform; it is still not clear how many concepts of abuse actually are used in the CJEU's tax case law and could they form the clear concept regardless the obvious contradictions between them. The concept of abuse developed in *Cadbury Schweppes* [1] crucially differs from the one developed in *Part Service*[2] (the cases concerned different tax areas), the differences are also considered in the same tax area cases: *Halifax*[3] and *Part Service* (e.g. the notion of the "*sole aim*" in *Halifax* (paragraph 60) versus "*essential aim*" in *Part Service* (paragraph 29)).

According to the CJEU doctrine the national tax avoidance provisions and measures must be defined in accordance to the fundamental freedoms of the EC Treaty; it is the general line. The case law of the CJEU establishes the test for the national anti – avoidance measures (written rules or judicial doctrine); which involves subjective and objective elements. So, the GAAR is not the exception, it also should meet the requirements of the test.

The case of *Emsland- Starke* [4] states that the abuse of tax law should be verified on the basis of 1) the objective circumstances from which it appears that the envisioned objective of EU law cannot be attained (objective test); 2) the subjective abuse intention (subjective test) (Weber, 2011, p. 396). The implementation of the above mentioned test could cause the range of problems on the national level of the Member States. The objective element means that there must be a combination of objective circumstances which show that regardless of formal observance of the conditions of the EC rule, the taxpayer's actions frustrates the object of the rule.[5] The criteria for the evaluation of the objective element stated by the CJEU are vague; the general aspect in the verification process is a contrariety to the purpose of the Community rule in question. That means that the substance of the legal regulation affected by the alleged abuse is the core of the assessment process. Such an interpretation vector may not get its effective implementation on the national

[1] Case C – 196/04 Cadbury Schweppes plc, Cadbury Scweppes Overseas Ltd pret Commissioners of Inland Revenue [2006] ECR I–7995.
[2] **Case C – 425/06.** Ministero dell'Economia e delle Finanze v Part Service Srl. [2008] ECR I-00897
[3] Case C – 255/02 Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v Commissioners of Customs & Exercise [2006] ECR I–1609.
[4] Case C – 110/ 99 Emsland-Stärke GmbH v Hauptzollamt Hamburg – Jonas [2000] ECR I – 11595.
[5] Case C – 110/ 99 Emsland-Stärke GmbH v Hauptzollamt Hamburg – Jonas [2000] ECR I – 11595. para 52.

level; it's vague and comes in obvious contradiction to the principle of legal certainty and prohibition of analogy in tax matters.

The aim of subjective test is to evaluate *"the intention to obtain an advantage from the Community rules by creating artificially the conditions laid down for obtaining it."*[1] The motives of the parties in *Emsland-Stärke* were to get the export refund and to pay higher wages to their employees, but reaching these aims the parties abused the Community export refund system. *"Abuse of Community law is a purpose oriented notion n in the sense that there must be a clear and logical connection between the objective facts of the case that are directed at obtaining a benefit under Community law*." (De Broe, 2007, p. 765). In practice the subjective part of the test faces a range of problems, one of which is the evaluation of the aims; *"(...), actions often have more than one aim. For example, a transaction may be motivated predominantly by a desire to avoid taxes but also by other considerations. (...). It seems that if the aim is "principally" to obtain advantage, an abuse may be found. This is rather low threshold and an easy one to apply*." (Snell, 2011, p. 227).

So the opinion that the two stage *Emsland- Starke* test *"(...) may not deal with all the permutations that abuse of rights may take."* (Snell, 2011, p.230) is totally shared.

According to the Commission recommendation on aggressive tax planning[2] states that national provisions in the area of aggressive tax planning are often not fully effective due to the cross – border dimension of many tax planning structures and to the increased mobility of capitals and persons. So, the Commission recommends the Member States adopt a common general anti–abuse rule, which should avoid the complexity of many different specific anti avoidance rules. The general anti avoidance rule should apply to domestic and cross-border situations. The proposed definition is very broad, it reads: *"An artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of avoiding taxation and leads to a tax benefit shall be ignored. National authorities shall treat these arrangements for tax purposes by reference to their economic substance."*[3] We see that Commission partly repeats the concept stated in *Emsland-*

[1] Ibid, para 53.
[2] Commission recommendation of 6.12.2012. on aggressive tax planning. Brussels. Retrieved from: http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8806_en.pdf date: 15.03.2016.
[3] Ibid para 4.2.

Starke which presumes the evaluation of the aims of transactions not prescribing any detailed explanation by what legal criteria should it been done.

In this aspect the practice of the United Kingdom should be verified positively; the UK GAAR introduces the system of precise legal methodology based on step-by-step basis. UK GAAR is based on the principle of "double reasonableness test" which classifies the circumstances to be taken into account in determining whether arrangements are abusive. Applying a "double reasonableness test" tax administration *"(...)asked to show that the arrangements 'cannot reasonably be regarded as a reasonable course of action' and recognize that there are some arrangements which some people would regard as a reasonable course of action while others would not. The 'double reasonableness' test sets a high threshold by asking whether it would be reasonable to hold the view that the arrangement was a reasonable course of action. The arrangement falls to be treated as abusive only if it would not be reasonable to hold such a view."* [1]

The "double reasonableness test" classifies the circumstances to be taken into account in determining whether arrangements are abusive. The abusiveness of the arrangements should be checked in the following legal framework:

- whether the substantive results of the arrangements are consistent with the principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions;
- whether the means of achieving those results involves contrived or abnormal steps;
- whether the arrangements are intended to exploit shortcomings in the relevant tax rules.[2]

The UK practice is undoubtedly the positive example of methodologically precise legal ruling in the sphere of complicated abstract issues of abuse in tax law. In the vagueness of CJEU case law and the poor regulation of the Latvian GAAR on the national level; the absence of any case law, the legal background and methodology of implementation, UK GAAR can be effectively used by the Latvian national courts as a theoretical background in cases concerning the implementation of GAAR.

[1] HM Revenue and Customs (HNRC) General Anti Abuse Rule (GAAR) guidance (Approved by the Panel effected from 30 January 2015) Available in: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/399270/2__HMRC_GAAR_Guidance_Parts_A-C_with_effect_from_30_January_2015_AD_V6.pdf date: 15.03.2016.
[2] Ibid.

5. Conclusion

The harmonization of the anti–abuse provisions in tax area on the Community level should be based on the shared national understandings of the notion of abuse in tax matters. The CJEU case law is vague and does not form the uniform concept of prohibition of abuse. GAAR could not be efficiently developed on the Community level; the not consistency of the CJEU case law in this matters and the poor theoretical background of the anti-avoidance rule in Commission proposal proves that.

The GAAR rise on a Community level strictly connected with the legal quality of the concepts developed on the national level of the Member States – in the bottom-up initiatives; activity of the national courts in developing the common understanding and implementation of GAAR. The practice of the UK should be verified as a positive example of national activity in developing complex legal concepts.

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