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## APPLYING THE GENERAL ANTI-AVOIDANCE RULE IN COMPLEX TAX AVOIDANCE SCHEMES: PRACTICAL EXAMPLES

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Recent discussions have increasingly focused on the practicality of applying the principle of substance over form in complex tax avoidance schemes. This article follows a case of good practice in Lithuania.

## Application of the general anti-avoidance rule

International tax practice has recently tended to strengthen the application of tax rules against tax avoidance. Unfortunately, business practice often involves complex corporate structures with tax avoidance as one of their main objectives. This leads to the adoption of supplements to the relevant Directives in the EU legislation. For example, Council Directive (EU) 2015/121 of 27 January 2015 amending Council Directive 2011/96/EU, aimed to ensure that the Council Directive 2011/96/EU provisions on dividend exemptions from corporation tax are not to be misused. This provision in the Directive derives from the recommendations of the Organization for Economic Co-operation and Development.

Alongside international tax law, states have also adopted national anti-avoidance rules to combat tax avoidance.

The general anti-avoidance rule refers to the principle of substance over form, according to which the substance of the activities of the participants in a tax relationship takes precedence over the formal expression of those activities. This principle has been adopted and applied by multiple states in the European Union and worldwide.

This article follows a case of good practice in Lithuania: the complex situations uncovered by the Lithuanian tax authorities, the circumstances which revealed tax avoidance, and how these situations were taxed.

When assessing such situations, it is important to stress that should the actual factual circumstances, evidence based on objective documents and data, justify that the subject, its actions and economic operations are not only aimed at taking advantage of tax benefits, but also at economic benefits, earning income, developing a business, developing a business plan, generating real added value, etc., then the principle of the primacy of substance over form does not apply. Otherwise, it applies.

The article therefore highlights those circumstances which help identify the grounds for applying the principle of substance over form.

## Practical case analysis: understanding the difference between tax benefits and economic logic

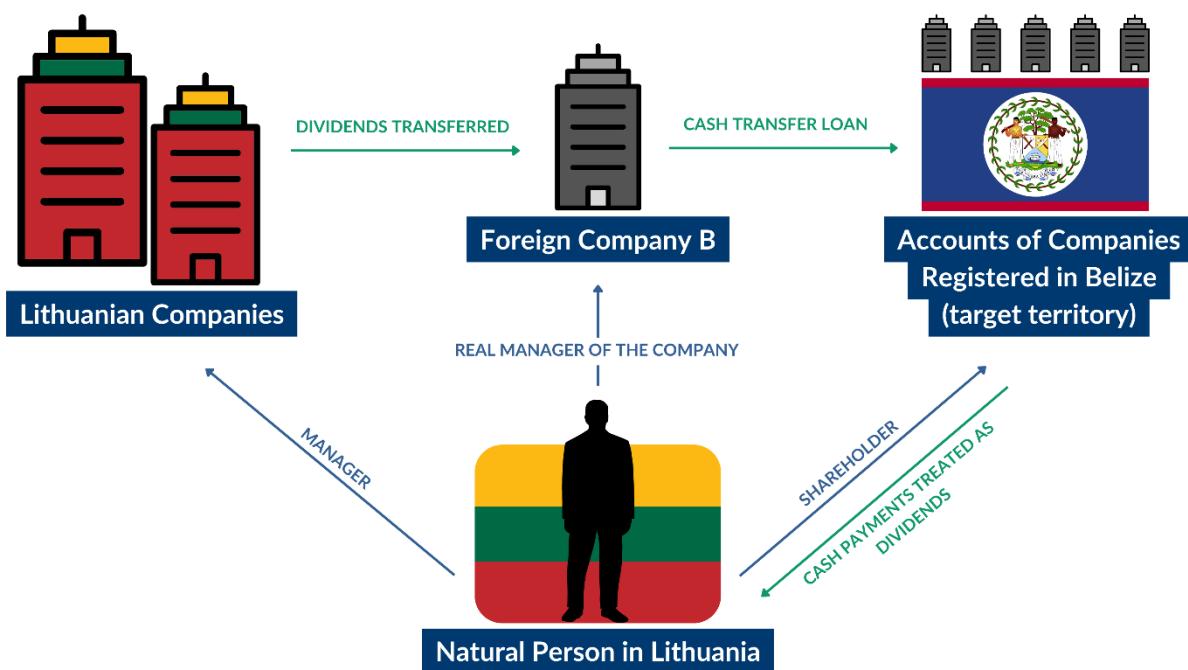
In one of the complex tax avoidance schemes, the facts of the situation were that a company established in Lithuania was 100% held by foreign company B. A Lithuanian company paid a very large amount of dividends to its sole shareholder over a period of several years, which were not subject to corporate income tax (under the Law of the Republic of Lithuania on Corporate Income Tax, dividends paid to foreign entities holding at least 10% of the voting shares for at least 12 continuous months, including the moment of distribution of the dividends, are not subject to tax).

Foreign company B is 50% held by two other foreign companies in the same foreign state. However, company B did not pay dividends to its holding companies, nor did it receive any revenue from companies registered in other states. It should be noted that company B receives only passive income (dividends, interest) from the Lithuanian companies it manages. Moreover, company B is not registered as an employer and has no premises.

An important circumstance is that, after receiving the dividends, within a few days, company B transferred them to a natural person to the accounts of a company registered in Belize (which is not a shareholder of company B), indicating the purpose of the payments as dividends. This natural person is the manager and shareholder of the above-mentioned Lithuanian company, which is managed by company B.

Therefore, the real manager of foreign company B was a natural person, the manager of the Lithuanian company. This person actually took the decisions on the transfer of funds from company B to the company in Belize.

The following figure illustrates this case:



Therefore, the Lithuanian tax authorities decided that the dividends of the Lithuanian company were in fact received by the manager of that company. In accordance with the principle of substance over form, the obligation to withhold income tax on dividends paid out falls on the Lithuanian company.

What is the evidence for this?

The key considerations include:

- foreign company B is not registered as an employer, has no premises, no lease agreement for the premises and no employees;
- the director of foreign company B is a formally appointed person who is the representative of more than 100 other companies registered in that foreign country, in most of which this person is also the director;

- foreign company B received only passive income (dividends, interest) from the management of companies registered in Lithuania. It did not receive any income from shareholders and did not pay any dividends to these companies, did not receive any income from companies registered in other states and did not invest the cash received in assets or shares in new companies, did not grant loans to controlled companies or to other companies not related to the company;
- all decisions regarding the use of dividends received by foreign company B were taken not by foreign company B itself but by the natural person acting as the manager of the Lithuanian companies who arranged the transfer of funds from foreign company B to the company in Belize, the bank accounts of which were temporarily at the disposal of this natural person.

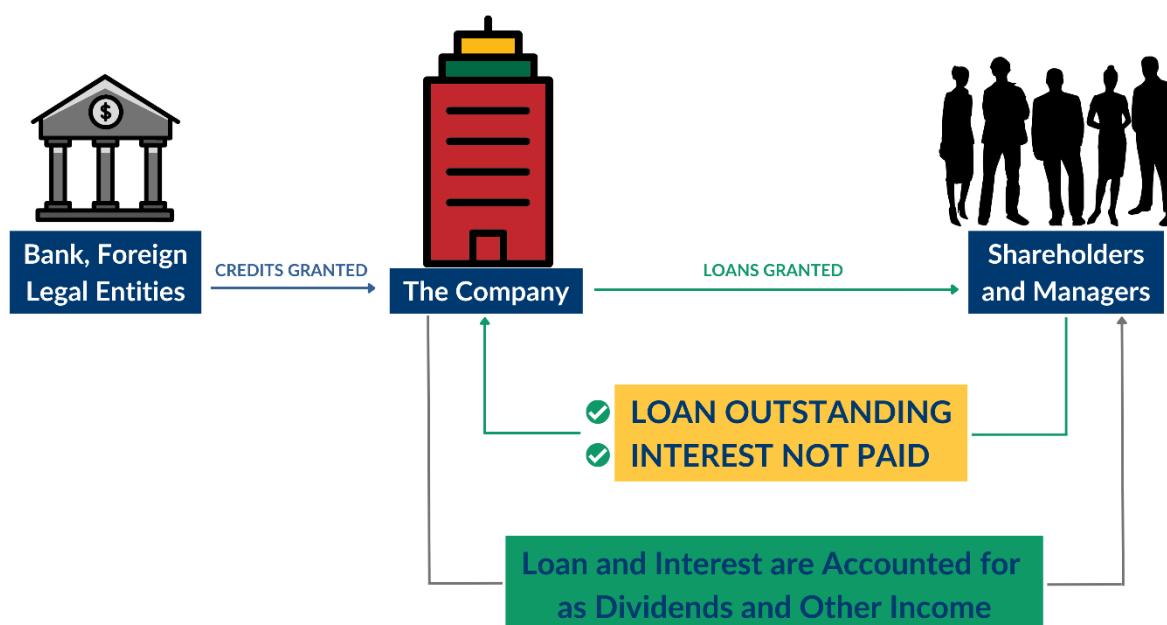
These considerations substantiate that foreign company B was set up and used in the business structure not for commercial reasons reflecting economic reality, but as an intermediate link for the sole purpose of avoiding tax liabilities. Therefore, the insertion of foreign company B in the group structure between the Lithuanian company paying dividends and the natural person, who is the beneficial owner of the income, avoided income tax.

Therefore, from a tax law perspective, under the Law of the Republic of Lithuania on Corporate Income Tax, dividends are only considered exempt from taxation if the shareholder receives and uses the payments for their own benefit and not as an intermediary. A formal shareholder, who is not free to dispose of the funds received, cannot be recognized as the real recipient of the dividends for tax purposes.

The article goes on to examine another tax avoidance scheme.

Since its incorporation, another company has been profitable but has not distributed any profits to its shareholders. This company has granted substantial loans to its past and present shareholders and manager over a period of several years. The debtor does not pay the interest calculated and does not repay the loan. The company compensates for the lack of working capital by taking out loans from banks and foreign legal entities.

The following figure illustrates this case:



Taking into account the performance indicators of this company (the balance of retained earnings, the low salary paid to the manager, the assets acquired in the name of the company, the amount of loans granted, the increase in debt, the ability of the borrowers to repay their debts, the fact that the loans granted are not economically advantageous to the company), it is concluded that the company has created a formal loan relationship for the sole purpose of obtaining tax benefits and transferred payments not subject to personal income tax in the form of loans to a person related to a company shareholder.

Given that the lender and the borrowers are related persons, it is likely that the formal loan agreements, which were concluded for tax purposes, were not loans, but rather dividends paid to the company shareholders, who are natural persons, as well as other gains not related to the employment relationship or individual activities paid to the manager, on which personal income tax is to be calculated and paid to the budget. This position is based on the circumstances and the application of the principle of substance over form:

- the company was profitable but did not distribute profits to shareholders;
- the company made loans to shareholders, making up for its own lack of working capital with bank loans;
- the loans granted to the company are not economically viable (no interest is paid, loans are not repaid);
- performance indicators of the company: retained earnings balance, low salary paid to the manager, assets acquired in the name of the company, amount of loans granted, increase in debt, ability of the borrowers to repay debt.

Therefore, the article describes tax avoidance schemes in Lithuania which are arguably relevant for other states as well. Since these schemes use foreign entities, this justifies that similar schemes exist in other states.

In this article, the author has highlighted the particular circumstances that have contributed to the identification of tax avoidance, with a view to sharing with other states good practices on how tax avoidance schemes may be identified on the basis of international as well as national legislation.

Arguably, the Lithuanian practice presented in this article will be of interest and relevance to tax administrations in other states assessing potential tax avoidance schemes.