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Foreseeing the Impact of X GmbH (Case C-135/17), II: A Reasonable Understanding of the PPT Standard under OECD Guidelines and US Case Law

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The text represents the personal views of the author, which do not purport to represent the view of Poland's Ministry of Finance.

In the judgement in *X GmbH* (Case C-135/17), on 26 February 2019, the CJEU for the first time examined a compatibility of CFC rules with the EU primary law to the extent of their application to companies established in third countries. Although the judgment addressed several interesting issues, including stand still clause, this three part piece primarily focuses on the two fundamental findings of the Court:

1. Lowering an abuse standard from wholly artificial arrangements (WAA) used for tax avoidance purposes to arrangements with primary objective or one of their primary objectives (PPT) to artificially transfer of the profits made by way of activities carried out in the territory of a Member State to third countries with a low tax rate;
2. The importance of the genuine exchange of tax information with third countries for justifying a restrictive effect of CFC rules on free movement of capital to third countries.

This second part deals with the issue indicated in point (1) above, by taking into account the guidelines of the OECD and US case law on the PPT standard. Moreover, this part of the piece attempts to foresee the German Federal Finance Court's judgement in respect of the abusiveness of the German-Swiss structure X, Y, Z.

How the OECD's Commentary on Article 29(9) of the MC 2017 (PPT) can be helpful to decode PPT under EU abuse standard

There are some important interpretative materials produced by the OECD in respect of the PPT – the OECD's Commentary to the PPT in Article 29(9) of the OECD MC (2017) and the corresponding examples. I would say that such materials could be used, *mutatis mutandis*, to determine the abuse under the PPT standard for purposes of EU primary and secondary law since there is a scarcity of interpretative materials directly stemming from the CJEU's case law on abuse of tax law under EU treaties on that fresh topic. Moreover, the CJEU, despite the need for autonomous meaning of EU terms, has already many times acknowledged the relevance of OECD Commentary as interpretative source for the purposes of EU law in respects of the terms used in the OECD MC. This is the case of the PPT.[1]

An in depth analysis and systematisation of the examples of application of the PPT by the OECD has been done by me previously.[2] It shows, among the others, that the following factors could be used for determining an application of the PPT:

- **The purpose of creating and entering into an arrangement or transaction**: (i) essentially for treaty benefits, e.g. assigning to a foreign entity the right to the payment of dividends solely to benefit from low or no withholding tax under the treaty in force in the resident state of that foreign entity or splitting up a construction contract to avoid a PE status and thus the taxation of profits at the PE's state, or (ii) essentially for nontax business purposes/no treaty benefits, e.g. establishing a manufacturing plant or the regional investment platform;
- **The purpose of establishing entities**: (i) entities established essentially for active business or investing purposes (e.g. for purposes of manufacturing or investing in certain assets in order to maximize their value and realizing appreciation through the disposal of the investments), or (ii) entities established essentially for tax purposes (e.g. to avoid a PE status by concluding a part of the divided contract);
- **The nature of an arrangement or transaction**: (i) essentially on paper, for example, assignments of the rights to the payment of dividends, the acquisition of the usufruct of the preferred shares, or (ii) essentially with actual economic presence, such as manufacturing, real business performing substantive economic functions and active conduct of a business with highly qualified human resources;
- **The nature (i.e. the functionality and scope) of the activities which are carried out by the parties involved** (with emphasis on the newly established entity, if any): (i) essentially active business or investments, such as manufacturing, managing a diversified portfolio of investments or providing group services, or (ii) essentially passive business or investments, e.g. purely passive behaviours that rely on receiving income from holding a property (e.g. shares in companies) without an active engagement in the management of that property;
- **The purpose of choosing a jurisdiction in which the new entity is established**, e.g. the jurisdiction chosen mainly for its low or no taxation and its large network of tax treaties or the jurisdiction chosen mainly for non-tax reasons, such as: political stability; an efficient and transparent regulatory and legal system; the availability of skilled and experienced personnel and support services; the low manufacturing costs; and the large customers base;
- **The level of dependency or independency of the parties involved**, e.g. independent (unrelated) entities versus wholly or partly owned entities (parent and subsidiary);
- **The duration of existence or functioning of entities via which an arrangement or transaction was conducted**, e.g. entities established and existing for many years vs. newly established entities;
- **The appointment of the majority of the board of directors of the newly established entity from the residents of that entity's resident state** and the employment of an experienced local management team and other staff with qualification and expertise commensurate and relevant to the newly established entity's functions and scope of its business activities, or the reliance on the personnel and management of other companies established in countries other than the newly established entity's resident state;
- **The presence of circular cash flows**, e.g. the issuing and buying of preferred shares or the assigning of promissory notes; and – the impact of an arrangement or transaction on net cash flows of the parties, e.g. maintaining a centralized cash management accounting system and entering into interest rate and foreign exchange contracts.

Those factors imply that *the economic substance and business purpose of (i) an arrangement or*

(ii) transaction constitute features of "relevant facts and circumstances" of significance for determining whether one of their principal purposes was to obtain treaty benefit(s). This also shows, by analogy, that the active business test under the LOB clause (Article 7(8)-(13) of the MLI) seems to be one of the most important tests for appropriately dealing with abusive treaty shopping.[3] Most importantly, it appears that the factors/features of abuse under the PPT standard in respect abuse of EU law and tax treaties are similar and aim to scrutinize the degree of economic substance of the arrangement (in the CJEU's case law references are usually made to a company) or transaction. It is therefore not impossible that EU abuse and tax treaty abuse standards will largely converge.

Moreover, it is worth to reiterate that the CJEU in point 84 of its judgement in *X GmbH* (Case C-135/17) defined the concept of abuse, in the context of the free movement of capital, as any scheme which has as *its primary objective or one of its primary objectives the artificial transfer of the profits* made by way of activities carried out in the territory of a Member State to third countries with a low tax rate. Consequently, on the one hand, the CJEU seems to lower the threshold of the abuse by stepping down from the sole or essential tax avoidance purpose to primary or one of the primary purposes (the PPT standard). On the other, the CJEU requires the tax authorities to prove that income has been transferred via artificial activities, which could be understood as artificial transactions.

This, in my view, means that the analysed judgment has introduced a kind of two-fold economic substance test. First to determine the artificiality of the entity. Second to determine the artificiality of the transaction. If the first test fails, still the second test may lead to the conclusion that the case is abusive insofar as the transactions between non-artificial entities are artificial (see more at sections 18.6.3 and 18.6.4 of my PhD thesis).

Guideline form the US Tax Court in tax avoidance cases

The PPT standard is quite new and not well established under the CJEU case law regarding abuse of EU primary law. Indeed, the Court did not elaborate at all on the understanding on the phrases "principle purpose" and "one of the principal purposes" in *X GmbH* (Case C-135/17). It is therefore worthwhile to look at the case law of foreign courts which has more experience in that area. Since one can find under US Internal Revenue Code almost 30 provisions that use the phrase "principal purpose" in relation to provisions aiming against tax avoidance, US case law may be useful to determine the meaning of "principle purpose" and "one of the principal purposes" in context of discussed EU-standard of abuse.

The judgment of US Tax Court in *Dittler Bros, Inc. v. Commissioner*, 72, T.C. 896, 915 (1979), 27 August 1979, is considered to be a landmark judgment in which the term "principal purpose" was given a meaning in tax avoidance scenario. The US Tax Court stated that this term should be construed in accordance with its ordinary meaning, that is "first in rank, authority, importance, or degree".[4] Accordingly, the judgement in the *Dittler* case shows that *any standard using principal purpose is met only when the purpose to evade or avoid tax exceeds or outranks in importance any other purpose*.

In the judgement in *Furstenberg v. Commissioner of Internal Revenue* (83 T.C. No. 43, 83 T.C. 755, 26 November 1984), US Tax Court stated that although the phrase "one of its principal purposes" has never specifically been interpreted, the definition of "principal purpose" set forth in

Dittler Bros, Inc. v. Commissioner is instructive to it. Consequently, *the phrase "one of its principal purposes" and "principal purpose" in tax avoidance cases should be understood alike* and set the tax avoidance standard which is met only when the purpose to avoid tax exceeds or outranks in importance any other purpose.

Such understanding of the phrases "principal purpose" and "one of the principal purposes" is, in this author's opinion, relevant to the new PPT standard of abuse under the EU primary and secondary law (and by analogy under tax treaties). Only such interpretative approach may ensure a consistent and reasonable application of this standard.[5] Otherwise the EU abuse standard may be lowered too much with the result that, as the OECD under tax treaties in my view incorrectly suggests,[6] a refusal of tax benefit to a taxpayer would be possible if one of the principal purposes was to obtain that benefit. In other words, the OECD implies that under the PPT standard of abuse it need not be the dominant purpose; it need only have been one of the factors that weighed heavily in the taxpayer's thinking.[7] This is an unreasonable way of understanding the PPT standard of abuse which may trigger more uncertainty than foreseeability for taxpayers involved in international business and investment, and therefore must be rejected. Indeed, too much uncertainty and the lack of sufficient degree of foreseeability may negatively affect cross-border commerce, whilst EU law and tax treaties should facilitate them within the scope of their application.[8] Moreover, too low standard for applying the PPT will prevent the use of tax treaties for tax optimization purposes rather than the abuse of tax treaties for tax avoidance purposes.

Conclusions and the foresight of the German Federal Finance Court's judgement

The closer look at the CJEU's case law in tax avoidance cases, the OECD's Commentary to Article 29(9) of the 2017 MC, and US case law imply that:

1. To determine the abuse under the PPT standard it is of outmost importance to focus on economic substance and non-tax business purpose of (a) the entire arrangement and (b) the particular transaction or set of transactions (for more guideline on the interplay between (a) and (b) see section 18.6.4 of my PhD thesis);
2. The phrases "principal purpose" and "one of the principal purposes" refers to one and the same PPT standard of abuse in tax avoidance cases which is met only when the purpose to avoid tax exceeds or outranks in importance any other purpose;
3. "One of the principal purposes" should therefore not be understood literally but contextually and purposively as "the principal purpose".

Furthermore, currently it is possible to list the three main phrases as used by the CJEU in the context of abuse of EU law to determine the tax advantage intention of a taxpayer: (i) sole aim; (ii) essential aim; and (iii) principal aim or one of the principal aims. Quantitatively speaking, I think that it is not unwise to attribute them the following percentage of likeliness of tax avoidance's intention: (i) sole aim = 95-100%; (ii) essential aim = 80-90% and more; (iii) principal/one of the principal aims = 60-70% and more. So while balancing avoidance and non-avoidance intent, the tax authorities must establish whether the taxpayer's intention was solely/essentially/principally (i.e. not less than 60-70% likeliness) to avoid taxation, not simply probably (i.e. more than 50% likeliness, e.g. 50.01%). Accordingly, a borderline between avoidance and non-avoidance intention cannot be too thin, and can never be pushed below 50%, as the OECD's implies, because it would be inacceptable under the principle of legal certainty and foreseeability. It would also be damaging for Single Market, which is "Europe's best asset to generate growth and innovation, attract

investments and foster the competitiveness of its companies in globalised markets",[9] and significantly deviates from the CJEU's case law in direct tax cases regarding tax optimization.[10]

Had the German Federal Finance Court followed the above guideline, it would most likely decide that the principal purpose of X (German company) was to avoid taxation in Germany by the use of Y (Swiss CFC), because concluding a debt assignment contract by Y with Z seemingly had the principal purpose to transfer profits from Germany to Switzerland (low tax country) in order to avoid taxation on those profits in Germany. Concluding about the principal purpose is, however, not enough to determine the abuse of EU law under the PPT standard. An artificiality of transaction must be also proven and this is about the economic substance of Y. The facts of the case, as delivered by the German Federal Finance Court, did not carry enough factual information to conclude about the economic substance of Y and artificiality of the transactions between X, Y, and Z. Although a deeper investigation is needed, my intuition tells me that Y did not have enough economic substance and the transactions between X, Y and Z were artificial (again not enough substance) in the sense that they were essentially designed and realized to avoid taxation in Germany.

References[+]

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