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The Influence of the COVID-19 Pandemic on the Application of the OECD PPT, GAARs and (Some) SAARs: Lack of Substance for the Protection of Health

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Many States have incorporated General Anti-Avoidance Rules (GAARs) into their tax laws to prevent tax avoidance; within the EU, a GAAR is even mandatory for corporate taxation since 1 January 2019 (Article 6 of the EU Anti-Tax Avoidance Directive (EU ATAD)). States are recommended in the OECD Model Tax Convention on Income and Capital to include a Principal Purpose Test (OECD PPT) in their tax treaties[1] and in the UN Model Double Tax Convention for tax treaties between developed and developing countries. Finally, States also include Special Anti-Avoidance Rules (SAARs) in their national laws (such as CFC rules, thin cap rules, earning stripping rules, anti-hybrid rules, etc.) or tax treaties.

The COVID-19 pandemic may affect the application of GAARs, the OECD PPT and some SAARs:

GAARs and the OECD PPT have in common that the subjective intention a taxpayer has with an arrangement or transaction is taken into account for the question of whether there is tax avoidance. Under the EU GAAR, for example, tax avoidance occurs when an arrangement has been put into place "for the main purpose or one of the main purpose of obtaining a tax advantage". The OECD PPT requires that obtaining a treaty benefit "was one of the principal purposes of any arrangement or transaction". SAARs are often more general. For example, the aim of an earning stripping rule is to counter BEPS, but in general does not take into account the subjective intention of a taxpayer. However, there are also SAARs that do take into account the subjective intention. An example is the EU CFC rule embodied in the EU ATAD.

In practice, the subjective intention a taxpayer has with an arrangement or transaction is often derived from objective circumstances. In short, from the "substance" that a company (arrangement or transaction) has. The Court of Justice of the EU (the Court) also takes into account objective circumstances to answer the question whether a taxpayer has the subjective intention to avoid tax. We see this clearly in the groundbreaking *Danish beneficial ownership* cases [2] from 2019. As to whether a company acted as a conduit company that was used to avoid withholding tax on dividend or interest payments, the Court referred, in explaining the European principle of abuse of rights (in fact a GAAR), 'in particular' to 'the management of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has'. In the same direction, the Court already ruled in the *Cadbury*

Schweppes case[3] from 2006: in this case, for the answer to the question whether a company was a letterbox company under a UK CFC rule (i.e. a SAAR), it had to be taken into account whether the company had premises, staff and equipment. We now see similar conditions in the EU CFC rule.

In practice, we see that tax administrations, as well as the national legislator, prefer to rely on objective circumstances. The OECD Commentary on the OECD PPT also rightly suggests that this is relevant[4]. We are seeing more and more States assuming that there is no question of tax avoidance in case there is *sufficient* substance[5].

But what if there is not enough substance in a country because the COVID-19 pandemic does not allow persons to carry out economic activities in a certain State and/or cannot travel due to work/travel or quarantine restrictions. For example, holding a board meeting (but also other activities) in a particular State may not be possible because of such restrictions.

I want to distinguish three situations here:

- First: suppose that pre-COVID-19 a company did meet the substance requirements, but during the pandemic it lacks substance. The question to be asked is whether the substance requirements have not been met 'for the main purpose or one of the main purposes of obtaining a *tax advantage*'[6] *or* for the main purpose of the *protection of the health for the person involved and society*' (in short: the protection of the health). In my view, in such a case, in most situations the main purpose for the lack of substance will be the protection of health.
- Second: Suppose that a company did not have sufficient substance pre-COVID-19 and did also not have sufficient substance during the COVID-19 pandemic. Then the question must also be asked whether the lack of substance is the effect of the measures to protect of the health. Since no change has occurred here by the COVID-19 pandemic, it will be less likely to defend that the lack of substance is the result of this pandemic. However, this does not mean that the lack of substance automatically means that the main purpose of the arrangement is to obtain a tax advantage. There can always be other valid business reasons for the lack of substance.
- Third: The situation in which a company is currently being established, i.e. during the COVID-19 pandemic. Such a company might not be able to meet the substance requirements due to the current travel/work and quarantine restrictions. This situation is more difficult to judge because we have no pre-COVID-19 situation to compare with. One answer could be that the OECD Secretariat Analysis solution regarding the influence of COVID-19 on the application of tax treaties has to be followed[7]. In this analysis, any consequences of the COVID-19 pandemic for the creation of a PE, and a change in the residence of companies and individuals in general, are denied because it was assumed to be an *exceptional* and *temporary* situation. But what if it turns out that the situation is not as temporary as we would like. In particular, the legal requirements regarding quarantine may remain in force for some time in certain countries. When foreigners have to quarantine for two weeks after arriving in a certain country; taking a flight for one board meeting is not really an option.

An additional circumstance that has to be taken into account for the question whether the main purpose of the lack of substance is the protection of the health, is that restrictions created by the COVID-19 pandemic can be divided into public, private and own taxpayer restrictions:

- *Public measures*: First, restrictions imposed by *governments*. This refers in particular to work/travel and quarantine restrictions. It seems to me that non-compliance with the substance

requirements due to restrictions imposed by governments will not have a tax avoidance reason.

- *Private measures:* Second, restrictions caused by restrictions in *private sector services*, especially in aviation. Suppose there are no (or a limited number of) flights to a particular location. This can be a practical hurdle for working in a particular country. As a result, certain substance requirements may not be met. In my opinion, such practical problems arising from a restriction in the services of third parties are also important in determining whether the lack of substance is motivated by tax avoidance motives.
- *Own taxpayer measures*: Third, a *company's policy* itself could affect the substance in a particular State. For example, suppose a multinational company prohibits its employees from working in a particular State (this may be related to that state's COVID-19 policy or to a State's medical facilities, for example) or generally prohibits its personnel from traveling internationally. Although the government or a third-party service provider does not impose restrictions in such a case, the company's policy can have consequences for the substance of a company in a certain State. Here too it can be defended that this policy (and therefore also the consequences thereof: lack of substance) does not aim to avoid tax, but is related to the protection of the health. That the policy of the company is relevant as such, we also see in example E of the commentary on the OECD PPT, in which example company policy is taken into account when this is 'conforming to the standard commercial organization and behaviour of the group'[8].

The issues I raise in this post will become more relevant the longer the restrictions as a result of the COVID-19 pandemic last. At the time of writing this post (late April 2020), China has eased its lockdown and European countries are starting to gently loosen their lockdown rules. The USA might follow soon. If, afterwards, it appears that this was a first start back to normal life, the problems discussed above will turn out to be of a temporary nature. However, if it later turns out that various work/travel and quarantine restrictions still apply, the relevance will increase. In order to remove uncertainty on this point, it would be good if the OECD (with regard to the OECD PPT) and the European Commission (with regard to the EU GAAR) publish their views on this so that OECD and EU Member States and their taxpayers have something to hold on to.

[1] Article 29 (9) OECD Model Treaty.

[2] 26 February 2019, *N Luxembourg 1,* C?115/16, C?118/16, C?119/16 and C?299/16.

[3] 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C?196/04, EU:C:2006:544.

[4] See for instance example G in para. 182 of the commentary on art. 29 OECD Model Tax Convention on Income and Capital (2017), in which, inter alia, reference is made to "real business"; 'substantive economic functions'; 'own personnel located in State R'.

[5] In the EU you see this especially when implementing the EU CFC rule in the member states. For example, Italy and Portugal do not apply the CFC rule when there is substance in the foreign company. However, there is still no clarity when the Italian considers a Portuguese tax authority that there is *sufficient* substance. Other States are more concrete about this. For example, the Netherlands has specific substance requirements for the application of the GAAR in the case of withholding tax on dividend and in the case of the EU CFC rule.

[6] Under the EU GAAR. Under the PPT OECD the question is whether obtaining a 'treaty benefit' is 'one of the *principal purposes*'. It is essentially the same question.

[7] 3 April 2020, OECD Secretariat Analysis of tax treaties and the impact of the COVID-19 Crisis.

[8] See example E in para. 187 of the commentary on art. 29 OECD Model Tax Convention on Income and Capital (2017).

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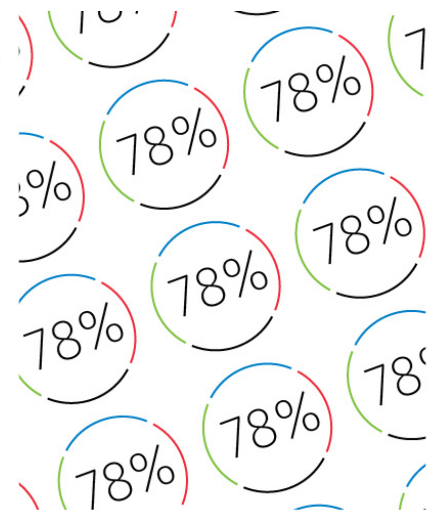

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