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FEATURED PERSPECTIVES

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by Wolfgang Kessler and Rolf Eicke

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It is more than just a rule. A statutory general antiabuse rule is a statement — a statement of tax jurisdictions, whether the lawmaker or the judges are primarily in charge of targeting the cases that lack both substance and business reasons. Most countries in continental Europe incorporated a GAAR in their tax codes. Among common-law jurisdictions there is a tie. Canada and Australia have a GAAR; the United States and the United Kingdom do not. Just recently, John Cullinane explained in the *Financial Times* why the United Kingdom does not need such a rule.[1] Like the United States, the United Kingdom takes a ''the judges shall decide'' approach.

Previous GAAR

Historically, Germany has taken the middle road. The legislature codified a butter-soft and broad GAAR, and the courts breathed life into it. We described the case law history (see ''Closer to Haven? New German Tax Planning Opportunities,'' *Tax Notes Int'l,* May 8, 2006, p. 501) and showed that the German Federal Tax Court (Bundesfinanzhof, or BFH) has established an argument on how much substance is needed to accept a structure for tax purposes.

However, the legislature did not want to leave the BFH all by itself when it comes to defining the facts and circumstances of ''abuse.'' The former rule in section 42 AO (*Abgabenordnung,* or the general tax code) can be translated as: ''The tax code must not be circumvented by way of abuse of legal planning opportunities. In case of an abuse, the tax liability is created as if the tax planning followed sound business reasons.'' There's no word on the nature and content of abuse.

Freudian Slip

Obviously, the legislature was not too fond of how the courts filled in the gaps. Another reason for the modification of the GAAR is laid down in a very early draft of the Annual Tax Act 2008. The legislature made a Freudian slip by stating, ''Otherwise, an ingenious taxpayer would be better off than one who uses a normal legal measure, even though both have achieved the same from a business point of view.'' This passage was deleted in the following drafts; however, it says much about the lawmakers' intentions. Between the lines, it targets legal but ''ingenious'' tax planning. We strongly oppose this reasoning. Targeting per se legal tax planning is like riding on a razor blade, at least from a legal and constitutional point of view. The German Constitutional Court has continuously upheld the principle that taxpayers are entitled to structure their legal relations in a way to lower their tax liabilities. In fact, tax law is a ''consecution law'' that has to follow the legal consequences of other legal disciplines (in particular, the civil law). Tax law cannot per se render legal civil law planning meaningless for tax purposes. The rule is: Tax planning is legal. Only as an

[1]John Cullinane, ''Better ways for lawmakers to tackle tax avoidance,'' *Financial Times*, Jan. 25, 2007, p. 12.

exception can it be considered tax evasion or tax fraud. However, it is important that any further interpretation of the new rule complies with this ''rule-exception'' principle. Hopefully, the explanation on the early draft was no more than a Freudian slip and does not materialize in future conduct of the tax authorities.

Earlier Draft

As amended, the Freudian slip is from an early draft that proposed to severely tighten the GAAR. It provided that abuse has occurred if a tax benefit was received based on an ''uncommon legal structure'' and if no relevant nontax reasons were given. The nontax reasons were supposed to be demonstrated by the taxpayer. Nontax reasons were defined as either business or political reasons. In case of an abuse, the draft foresaw the opportunity to ''negotiate'' with the tax authorities on that matter. ''Negotiating'' tax liabilities is unknown to the German tax system. If this rule was implemented, it would have run counter to the principle of equal taxation. In other words, if the draft had materialized, we would be talking about an entirely new rule that would have shaped the German tax system and rendered decades of case law on section 42 AO meaningless.

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However, the legislature passed a new version of the GAAR in the Annual Tax Act 2008 that does not have such a massive impact on the German tax system.

Final Legal Framework

The new version provides that an abuse occurs only if the taxpayer chooses an ''inappropriate legal structure'' not complying with the law. Therefore, for the first time, abuse of law is outlined in the statute. Yet the statute does not define what inappropriate means. Therefore, resorting to case law is helpful. The BFH has established that the word ''inappropriate'' describes any legal structure that two unrelated and reasonable parties would not have chosen to achieve a specific business goal. In essence, inappropriate structures are, in the view of the BFH, ''complex, complicated, and artificial.''

The burden of proof of whether or not a structure is inappropriate rests with the tax authorities:

- The tax authorities must compare the tax consequences of an appropriate structure with the tax consequences of an inappropriate structure.
- If the latter results in a tax advantage for the taxpayer or a third party, the tax authorities must further examine whether or not this tax advantage is stipulated for in the particular applicable provision. Legislative history reveals that examples for such a stipulation within the provision are statutory election rights for tax purposes as well as tax incentives.

The new regime is applicable beginning January 1, 2008, for calendar years that begin after December 31, 2007.

Tax Advantages: Now and Then

For tax advantages that were formerly promoted by the legislature and later withdrawn, the German tax system features a very interesting turnaround.

The tax regime used to endorse and spark interest in the wide range of tax shelter schemes regarding loss allocation, movie, solar and wind energy, and shipping funds. To generate losses, millions of taxpayers invested in these funds to reduce their taxes payable. Because in Germany, and elsewhere, the drive to save taxes is stronger than most other forces, German taxpayers financed many Hollywood movies (for example, the *Lord of the Rings* trilogy) and South Korean shipping yards. Suddenly those effects were no longer desired by legislators, so they restricted those schemes in a way that drove many of those funds out of business. The lesson here is that a tax advantage stipulated for in the relevant statute might wither when policies change.

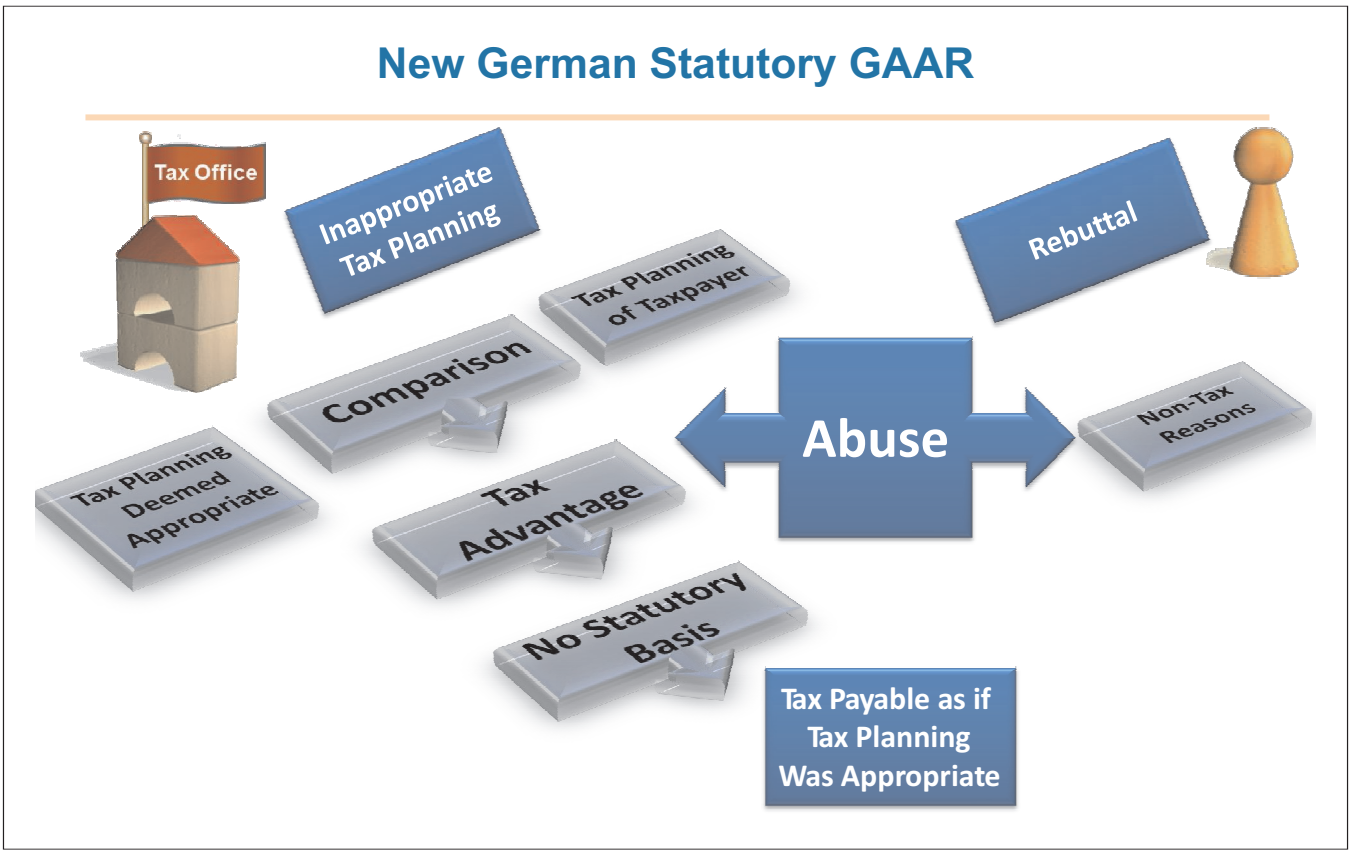
Room for Rebuttal

However, even in case of a presumption of abuse, the taxpayer has a right to rebut and demonstrate that the overall structure is based on relevant nontax reasons. ''Relevant'' describes reasons and facts that must be considered in light of all circumstances.

In case the rebuttal has not been attempted or fails, the tax payable is computed as if the particular structure was based on sound business reasons.

Priority Issue

The legislature ends a dispute that has been hovering over the German tax law for decades: the question of which antiabuse rule takes priority over the other. The position of the tax authorities has always been that even if a special antiabuse rule (for example, the anti-treaty-shopping rule) applies, the statutory GAAR can still apply as well. There has never been a sound argument why the general rule will not be superseded by a special rule as provided by the *lex specialis* principle.



After all, the legislature now follows the *lex specialis* principle and has declared that the application and legal consequences of the GAAR are superseded if a special antiabuse rule applies. Accordingly, the legislature takes the position of the latest BFH case law. Thus, before presuming an abuse has occurred, the tax authorities must analyze whether or not the applicable legal statute contains a provision that prevents tax avoidance.

In a nutshell, the new rule has three features to remember:

- inappropriate tax planning constitutes an abuse;
- the presumption of abuse can be rebutted by the taxpayer demonstrating sound business reasons for the particular structure; and
- the GAAR is superseded if a special antiabuse rule applies.

Conclusion

The German legislature has tightened the GAAR effective beginning January 1, 2008, thereby implicitly expressing its discontent with the rather taxpayer-friendly interpretation by the courts. The provision is still very broad, but for the first time, it attempts to define abuse. From now on, all inappropriate tax planning measures are under special scrutiny. Yet it could have been worse, as the first legislative draft suggested. Luckily, much of the case law on the old regime will continue to apply.

That is why the new GAAR can be considered as generally accepted — assuming the broad definition of abuse is not ''abused'' by the tax authorities and that the German Federal Tax Court continues to fill the gaps in the legal wording in a way that balances the interests of the tax authorities and the taxpayers. ◆