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General anti-avoidance rule – an economic approach

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The article includes an overview of the conclusions from economic analysis about the general anti-avoidance rule (GAAR). In particular it pinpoints issues such as: the sensibility of a standard-based approach compared to the rules-based approach, the role of the legal system in which the rule is used and the weaknesses associated with the application of the rule in practice. The article then proceeds to present the results of a limited number of quantitative studies with a special focus on: the court's choice of the premises in assessing the merits of the GAAR and the impact of such regulation on foreign investments and the formation of subsidiaries in other countries. The article concludes with an analysis of factors conducive to the introduction of the GAAR in a tax system.

Keywords: anti-avoidance rule, tax avoidance, economic analysis of law

1. Introduction

A *general anti-avoidance rule* (GAAR), has only a limited number of economic analyzes, despite a fairly wide and growing interest in its implementation in various tax systems, including as one of the basic elements of the draft EU Anti-Tax Avoidance Directive. This situation in itself seems to be interesting and can be explained primarily by the heterogeneity in the regulation of this rule in particular legal systems and the limited availability of empirical material. In general, the economic interest in the anti-tax avoidance rule focuses on the economic analysis of the law or on the empirical study of the potential consequences of this rule, the most important of which is the restriction of foreign investments.

An economic analysis of the law indicates that this rule belongs to the so-called approach based on standards (*standard-based approach*), unlike a regulatory approach (a *rule-based approach*), in which specific undesirable behavior of taxpayers is limited (Kaplow, 1992). Potentially, it allows proactive actions to be taken (it prevents future abuses) instead of being reactive (used in relation to abuses that occurred in the past). At the same time, such standards are considered to be more difficult to be circumvented by the taxpayers, although at the same time they increase the uncertainty of applying the law. For this reason, it is assumed that specific regulations should be applied to the typical activities, and standards (such as GAAR) to unusual situations, that are difficult to regulate directly by the legislator. This

approach is in line with procedural economy, as it saves time of judicial authorities (and indirectly also for law enforcement agencies such as tax authorities).

2. The role of the legal system

It is worth noting that the legal system in which the rule is applied in is also significant. In common law countries, this rule allows to identify new atypical cases on which further case-law is based, while in civil law states it complements the existing rules. Thus, in the latter countries, there is a temptation for the anti-avoidance rule to replace specific regulations. As a result, instead of atypical cases, the rule becomes a tool used for typical transactions, although those which are not described sufficiently by law. In contrast, in the system of customary law, subsequent judgments determine the jurisprudence line, and the rule is used only to create new categories of cases. This means that this rule was previously used in common law countries[1]. In civil law systems the GAAR does not play the same role, because judgments are not law-making, so the use of a rule must be frequent (in any doubtful case), which is done to the detriment of the taxpayers. On the other hand, even in the case of common law countries it is pointed out that the anti-avoidance rule allows for maintaining control over case law, which would otherwise be too lenient for tax evaders. The latter argument stems from the civil courts usually settling the cases, in which the judges usually do not have adequate competence to assess complicated transactions and tax structures. In civil law states, such cases are resolved by specialized (administrative) courts, which alleviates this problem, but at the same time may cause the solutions to be more often consistent with the position of tax authorities and not the taxpayers.

[1] For example, for 16 countries applying such a rule as indicated by the Ministry of Finance (Księgowość Infor..., 2017), half are common law states. Currently, there is an increase in the use of this form of regulation in civil law countries.

In order to counteract the abuse of the anti-avoidance rule, panels of experts are usually drafted to assess its use in specific cases (in Poland it is the Council for Counteracting Tax Avoidance). It is assumed that the use of a collegiate type body in the process should lead to a more balanced assessment of complicated facts that are on the verge of legal tax planning. Here, however, the problems are related to the appropriate composition of this type of bodies, so that they are not dominated by representatives of the tax authorities or the representatives of enterprises. The advantage of one party may mean excessive fiscalism or render the rule ineffective. Unfortunately, on the other hand, a large number of entities deciding on the application of the rule (organs, council, courts, etc.) may lead to an increase in the time of proceedings and formulation of different opinions at least at certain stages of the proceedings. Thus, a trade off arises between the effectiveness of the rule and the precision of its application.

3. Allegations regarding the use of the anti-avoidance rule

In literature numerous voices are raised indicating weaknesses in the use of an anti-avoidance rule, although at least some of them are only assumptions that have not yet been confirmed empirically. The basic allegations raised against GAAR include (Mittal, Kumar, Agarwal, Kumar 2013; Trade Union Congress, *The Deficiences...*, 2017):

- limiting foreign direct investments by harassing investors and limiting the possibility of avoiding tax on dividends. It should be noted, however, that there is no direct evidence for a reduction in capital flows or foreign direct investments caused by the rule. In literature, quotations of stock exchange turnover and reduced investments caused by the change of double taxation agreements (e.g. agreements between India and Mauritius) are cited. And these to some extent may operate similarly to the anti-avoidance rule (Mittal, Kumar, Agarw-

al, Kumar 2013) but, as the authors admit, these changes are temporary and relatively short-lived (several months). Similarly, assessments of investment sensitivity to taxation of multinational enterprises give ambiguous results (Sorbe, Johansson, 2017). Moreover, the study conducted on German subsidiaries showed that the existence of this rule has a positive, rather than a negative impact on the number of such companies located in a given country (Schanz, Dinkel, Keller 2017);

- practical difficulties in distinguishing artificial tax structures that only serve to avoid taxation or structures limiting taxes paid as part of the business activity (the concept of abuse of law is key here and it is difficult to use in most of the solutions provided by tax avoidance agreements (see: Kudła 2013)). In this case, the details of the design of GAAR and the possibility of using it in relation to traditional forms of tax planning are decisive;
- limited scope of application, because the rule helps to combat tax avoidance among the smallest taxpayers and very large taxpayers only to a small extent. In the case of the first group, this is due to administrative costs (or the existence of minimum benefit thresholds for the taxpayer to apply to the rule), while for the second group, due to the complexity of the operations, as well as treating such practices as acceptable and normal in business (the latter does not mean, however, that the actions of large international entities are actually in line with the purpose of tax regulations, in particular with the purpose of the regulation on avoiding double taxation). As a result, the overall effectiveness of the rule in combating the phenomenon of tax avoidance is low. For example, as estimated in the UK, this rule limits the amount of tax avoidance, estimated at 25 billion pounds per year by up to 1% (in reality, even less as by just 40–60 million GBP per year) (Trade Union Congress, New anti-tax abuse..., 2013);
- introducing long-term uncertainty as to the impact of transactions. Uncertainty which cannot be avoided or the cost of avoidance of which is high (e.g. in the form of a significant payment for issuing an tax decision) limits the utility of taxpayers with risk aversion. At the same time, for entities characterized by neutrality towards risk, this solution has no impact on their usability. The last case concerns mainly legal persons (large enterprises) in which there is no direct connection between the assets of a person making optimized tax decisions and the assets of a legal person. Thus, due to the attitude towards risk, the rule introduces differentiation among taxpayers (risk aversion entities avoid optimization activities that could expose them to the operation of the rule, although such actions might be legal, while entities that are neutral to risk use unauthorized optimization measures anyway) (see: Kudła, 2004). It is worth mentioning that this is a typical feature of legal regulations that are not specific and have the character of general rules;
- a small preventive impact, as the application of the rule does not require additional consequences exceeding the due tax liability (sometimes additional administrative sanctions are foreseen. They occur in countries such as: Australia, France, Ireland, New Zealand, the United States and Hungary, after: *Księgowość Infor...*, 2017). This means that tax evaders may be willing to risk the use of artificial structures, counting on the fact that as the consequence of applying the rule they will only have to pay higher tax, which would be paid anyway if the construction to avoid taxation was not applied. From the point of view of the economic analysis of law, the lack of penalties encourages tax avoidance, as tax avoidance does not reduce the taxpayer's utility (they will pay the tax in the correct amount determined by the tax authorities or a lower tax if the applied tax avoidance measures are not

questioned). Of course, the use of the rule does not exclude additional liability (e.g. fiscal penalties), but it is not a necessary element of its application. Only if we assume that the taxpayers follow the so-called *prospect theory*, that is, they consider losses from the point of view of a reference point (property held at a given moment), the payment of tax in due amount can be a sufficient punishment for the taxpayer, prompting him to abandon illegal optimization activities. However, this situation will only take place if a lower tax is paid at the reference point, and the use of the rule forces the taxpayer to incur an additional cost in the form of payment of an additional tax. However, such a situation seems doubtful for at least two reasons. First, tax avoidance usually refers to future benefits rather than current transactions, and therefore it is difficult to link the payment of additional tax to the current reference point (current taxpayer's assets). Secondly, the taxpayers covered by the rule are usually large enterprises (legal entities) who do not perceive their situation in accordance with psychological theories and do not consider financial loss as a phenomenon causing negative emotions they would like to avoid;

- difficulties of proof, because the burden of proof in the rule usually rests on the tax authority (the opposite solution operates in: Australia, Ireland, New Zealand, the United States and Hungary; moreover, in several other countries the burden of proof is shared between the tax authority and the taxpayer: France, Spain, India, Canada, South Africa) (*Księgowość Infor...*, 2017). The burden of proof means higher costs for a given party and on the one hand may hinder the use of regulations (if the burden of proof rests with the tax authority) or cause additional costs for the taxpayers (if they are obliged to prove that they did not breach the rule). Regardless of which side the burden of proof rests on, it is believed that such rules give excessive authority to tax authorities (Whait, Whittenburg, Horowitz, 2012).

As one can see, some of the allegations depend largely on the design of a particular GAAR. Individual structures differ in the degree of protection of the taxpayer's interests. For example: the requirement of simultaneous fulfillment of several criteria for the application of the rule, transferring the burden of proof on the tax authority using the active role of the bodies assessing the correct application of certain taxpayer activities, lead to a restricted use of this legal instrument.

4. Studies on the effects of the tax avoidance rule

As already mentioned, the analysis of the consequences of the application of the anti-avoidance rule is rarely found in the literature on economic law analysis. As can be assumed, this results from the heterogeneity of the rule itself, difficulties in excluding other factors that may affect the behavior of taxpayers and the ambiguity of the very concept of tax avoidance. Nevertheless, there are several studies on the effects of the use of the anti-avoidance rule and the ways in which the rule can be used by the courts. This last issue was the subject of a study in Australia (Whait, Whittenburg, Horowitz, 2012), concerning the determination of factors taken into account by the courts in assessing the validity of the use of GAAR. The conducted analysis showed that the main factor conducive to the application of the rule was the occurrence of a tax advantage for the taxpayer, which is the dominant cause of the application of a specific tax avoidance scheme. In addition, the following was taken into account: the existence of a dominant cause related to or unrelated to the tax scheme, not achieving the tax objective, the discrepancy between the time of introduction of the tax scheme and the benefit and duration of the scheme. These individual characteristics were also of decisive importance for the court s decisions, because without them, the taxpayers

should win ¾ cases, while in fact 2/3 of the cases were won by the tax authorities. According to the obtained results of the logit model, the taxpayer's chances of undermining the position of tax authorities increase significantly when it is impossible to show a clear relationship between the tax advantage and the tax avoidance schemes used.

In terms of investments, research has been carried out on the sensitivity of international companies to the so-called effective tax rate (Sorbe, Johansson, 2017). As it turns out, the existence of strong anti-taxation regulations (albeit not only in the form of GAAR) increases the tax sensitivity of investments of international enterprises, in industries in which there are strong incentives to shift revenues abroad. However, this result is not immune to the estimation method, which may be due to the differences between the legal provisions of the anti-avoidance rules in different countries (heterogeneity of legal regulation).

The impact of such a rule on the number of subsidiaries located in a given country was studied in the research on German enterprises (Schanz, Dinkel, Keller 2017). Contrary to expectations, the existence of GAAR had a positive impact on the number of German subsidiaries existing in a given country (although at the same time a negative impact on their relative number). It was expected that a rule discouraging aggressive tax optimization, would also discourage the creation of subsidiaries. There are at least a few possible explanations for this result. First of all, it cannot be ruled out that this instrument, as an advanced anti-avoidance tool, is more willingly used by investment-attractive countries, and the control variables used do not fully take into account this phenomenon. In other words, the anti-avoidance rule is applied by countries that are significant to German enterprises, regardless of the applicable anti-avoidance legislation. Secondly, large international enterprises create taxation schemes that cannot be easily undermined by tax authorities or undermining them, due to the investment benefits of a given country, it is pointless. This last hypothesis is supported by the use of data on subsidiaries from the largest German enterprises, whose investments are usually very desirable in other countries.

5. Determinants of the use of the rule in tax systems around the world

In the last study, one can also notice some interesting dependencies regarding the correlation of the use of the rule with other variables used in the study. The strongest correlations occur between the application of GAAR and the existence of regulations concerning: foreign controlled companies (0.4) and counteracting excessive debt financing (rules limiting "thin capitalization"). At the same time, negative correlations between the use of GAAR and gross domestic product can be observed (-0,4), the degree of development of double taxation conventions in a given country (-0,3), tax incentives for research and development (-0,3) and the index of the rule of law (-0,3). I means that the application of the anti-avoidance rule is often associated with other tax avoidance solutions, and the rule is also more readily introduced in the developed countries with an established legal system and not applying significant specific tax breaks for research and development investments. This is somewhat unexpected, as one could expect that such a rule would mostly apply to countries with low tax collectability. However, as can be seen, it is rather related to a high degree of development and the advancement of tax avoidance techniques. In less developed countries, the taxpayers do not have to apply complicated tax structures to reduce the value of taxes they pay. At the same time, their knowledge of tax avoidance measures may be limited, as there are few international companies that have adequate internationally diversified activities to avoid large-scale taxation. In this sense, the increase in the internationalization of economies and the growing importance of international enterprises enforce the introduction of general regulations preventing the avoidance of taxation (such as GAAR).

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