Anti-avoidance rules in new CIT Act (2/46/17)

Under the new CIT Act, an entity’s taxable income does not include dividends received from other entities and income arising on the sale of shares held for at least 36 months. In either case, however, this exemption is not available if the entity or its related party was formed or a particular transaction carried out for the main purpose of claiming any of the exemptions under the CIT Act or the PIT Act. Applying these rules is crucial in a structure that involves two or more entities. This article explores how the State Revenue Service (SRS) could evaluate such cases in the light of the Cabinet of Ministers’ new draft Regulation, and what criteria the OECD suggests for assessment internationally.

What transactional aspects could be assessed by the SRS?

The SRS has the power to deny these exemptions if any of the entities involved is considered to have been created artificially. The formation and activities of any entity involved or even a separate transaction will be assessed in terms of both group and ownership. It will be established whether the transaction involves a tax-haven entity, and the economic substance of the transaction will be evaluated.

When analysing an example in Annex 5 to the draft Cabinet Regulation, *Application of Provisions of the CIT Act*, the SRS will consider the following questions:

- What function is the entity performing? Is it limited to, for example, holding shares or intellectual property, i.e. passive functions that do not require involvement of substantial resources?
- Who is supplying a foreign entity’s operational needs? Are only external service providers involved?
- Does the country in which a foreign entity is operating provide for some particularly generous rules, for example, exempting special types of income?
- Do the group structure and transactions have a valid business purpose?

These questions do not, however, cover a lot of ground given the European Commission’s recommendations of December 2012 offering the following criteria:

- The legal characterisation of the individual steps making up an arrangement is inconsistent with the legal substance of that arrangement as a whole;
- The arrangement or series of arrangements is carried out in a manner that would not ordinarily be employed in what is expected to be a reasonable business conduct;
- The arrangement or series of arrangements includes elements that have the effect of offsetting or cancelling each other;
- Transactions concluded are circular in nature;
- The arrangement or series of arrangements results in a significant tax benefit but this is not reflected in the business risks undertaken by the taxpayer or its cash flows; and
- The expected pre-tax profit is insignificant in comparison to the amount of the expected tax benefit.

The European Commission’s study

The European Commission has continued work on studying aggressive tax behaviour strategies and indicators, and published its *Study on Structures of Aggressive Tax Planning and Indicators in 2015*. The study lists 32 indicators of aggressive tax behaviour and includes active indicators (such as the option of deducting deemed interest on shareholders’ equity) and passive indicators (e.g. an exemption on capital gains where intellectual property is transferred), and a lack of certain anti-avoidance rules (such as restrictions on interest deductions).

Since the application of general anti-avoidance rules is improving continuously, any existing structure should be assessed regularly. When setting up a new structure, significance should be attached to a valid business purpose and a balance between commercial benefits and tax benefits.