

Artificial structures in Slovak tax law



Anti-avoidance regulation under Slovakia's Tax Procedure Act has gained some muscle recently. Under the amendment, which introduces a "business substance" clause, tax authorities can scrutinize the economic substance underlying reported transactions to determine whether those transactions genuinely accomplish any purpose beyond avoiding legally imposed taxes. What latitude do authorities have in interpreting its provisions?

In light of recent trends in the EU and in OECD member countries, Slovakia has begun directing more regulatory emphasis toward curbing tax avoidance arrangements in the area of direct taxes. From a regulator's perspective, the simple "substance over form" clause, which has always been present in Slovak law, cannot be entirely relied upon. Generally speaking, the regulator tries to be at the heels of tax planners, tracking their creative ideas and counteracting schemes deemed to be tax abusive.

The new "business substance" clause, effective as of January 1, 2014, represents an innovative regulatory concept complementing the general principle, "substance over form". In academic terms, "substance over form" serves to test authenticity. It allows authorities to look past the stated legal character of a transaction and either to ignore that characterization or to recast it to identify its underlying intent more accurately. In contrast, the "business substance" approach serves as a kind of motive test to confirm a transaction's commercial purpose apart from achieving potentially abusive tax advantages.

The "business substance" clause is not clear-cut in nature; no clearly delineated borders exist to separate suspected tax abuse

from tax planning strategies acceptable to tax authorities. Such borders are generally defined by case law. Since there is no established tax practice in the Slovak Republic, there is also no body of precedents to suggest how tax authorities and the Slovak courts may apply new rules. Slovak tax authorities appear to favor stringency in dealing with cases of suspected avoidance. Nevertheless, many cases before the Slovak Supreme Court, while based on sound economic arguments, have resulted in rulings favorable to taxpayers.

It is likely that interpretation of the "business substance" clause will evolve within the greater context of three guiding considerations: recent tax practice as it relates to the not insubstantial requirements of the Slovak Republic; rulings of the Court of Justice of the European Union (ECJ); and, above all, pertinent constitutional principles.

To some degree, the case law of foreign European courts may also come into play. In the UK, where similar regulations have existed for years, courts have already expanded the concept of the motive test. Based on UK rulings, motive is a decisive factor. A transaction may lead to certain tax benefits, but it must also include a demonstrable, justifiable business purpose of a financial nature (e.g.,

quicker distribution of profits among group members when using a structure involving tax-transparent entities). The concept of the absence of a "business substance" may apply in cases where a tax advantage appears to be the underlying reason for undertaking a transaction or implementing a legal construction. In order to sidestep running afoul of this clause, parties to such transactions should develop ready arguments to show that the transaction has been driven by economic needs and not by tax advantages only.

Further, the ECJ has adjudicated cases, contributing case law relating to the freedom of establishment. According to this established case law, anti-avoidance measures cannot be applied where it is demonstrated – on the basis of objective factors which are ascertainable by third parties – that, despite the existence of tax motives, there is at least one genuine economic activity. In essence, formal arrangements cannot be challenged solely on the basis that they give tax benefits to the involved parties; authorities must demonstrate further that no genuine economic activity is present.

Thus, a national measure restricting freedom of establishment can be applied only to wholly artificial arrangements aimed at

circumventing the law. As regards structures utilizing a third country, a similar rule should apply with respect to free movement of capital.

As there is no discernible safe harbor, the risk remains that Slovak tax authorities will attempt to challenge arrangements and structures providing significant tax benefits. Thus, taxpayers should develop proper documentation throughout the course of structuring and conducting transactions. Pre-emptive, detailed analysis is crucial for demonstrating legitimate economic purposes. Professional legal and tax advice providing cogent arguments for potential proceedings helps mitigate or eliminate the risk of administrative sanctions. So far, courts appear open to such arguments.

Challenges by the tax authorities of taxpayers' transaction structures and forms without apparent legal basis are likely to remain unsupported by the courts because of the fact that, among other things stated above, they would constitute a material interference in the rights of taxpayers, which are strongly protected by the Slovak Constitution. Summarizing the above, the taxpayers should be free to choose the structure and the form of transactions which they consider to be the most appropriate for their economic activities and also for the purposes of mitigating their tax burdens as long as such mitigation of tax is not the sole reason of the transaction structure and form.



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