

ANTI-TAX AVOIDANCE MEASURES IN LITHUANIAN CASE-LAW¹

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I. INTRODUCTION

A. Importance of tax avoidance

A day hardly passes without some kind of news or comments being posted in each major newspaper or web portal concerning tax avoidance. This is true for Lithuanian, EU, American or any other news sources.

Tax avoidance issues have become of central importance in the politics as well. The notice about the upcoming meeting of the European Council stated that:

When EU leaders meet on 22 May 2013, they will discuss tax policy, with a particular focus on how to improve the efficiency of tax collection and best tackle tax evasion and fraud with the aim of strengthening member states' fiscal stance and deepening the internal market.³

The discussion is not limited to general policy issues. Particular multinational corporations are under fire as well. On the 16 May 2013, Google executives were called to the UK Parliament for questioning by the public accounts committee

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3 <http://www.european-council.europa.eu/council-meetings?meeting=4aa156c3-db37-4231-9b32-a90114a48bce&lang=en&type=EuropeanCouncil>

about their tax practices.⁴ Apparently, Google paid £10m in UK corporate taxes on revenues of £11.9bn - less than 0.1% - between 2006 and 2011.⁵ Apple CEO was called in front of the US Senate on 21 May 2013 to face similar questions.⁶ Amazon and Starbucks were also questioned in the UK Parliament in November 2012.⁷ According to various estimates from \$8 trillion to even \$123 trillion could be held offshore by various taxpayers worldwide.⁸ President of the European Commission, called for EU countries to exchange income tax data automatically, saying tax evasion and illegal fraud in the EU cost \$1.2 trillion a year, “nearly double the 2012 combined annual budget deficit of all member states”.⁹

Those enormous amounts of money indicate the importance of tax avoidance both for the States and equally for the taxpayers.

B. Difference between avoidance, evasion, abuse and circumvention of law

There is a variety of concepts, which tend to describe similar activities: tax avoidance, evasion, fraud, abuse, mitigation, circumvention of law.¹⁰ All those concepts could be divided into 3 groups: [a] criminal activities (fraud, evasion); [b] grey area where the most uncertainty lies (avoidance, abuse, and circumvention of law); [c] acceptable behaviour (mitigation, tax indifference).

The OECD defines tax **evasion** as a term that is difficult to define but which is generally used to mean illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax Authority.¹¹

The OECD also defines tax **avoidance** as a term that is difficult to define but which is generally used to describe the arrangement of a taxpayer’s affairs that is intended to reduce his tax liability and that although the arrangement could be

4 <http://www.bbc.co.uk/news/business-22551401>

5 <http://www.bbc.co.uk/news/business-22676080>

6 <http://www.usatoday.com/story/money/business/2013/05/21/apple-tax-stakes/2347745/>

7 <http://www.bbc.co.uk/news/business-20288077>

8 <http://taxjustice.blogspot.co.uk/2013/02/new-tax-haven-cover-story-in-economist.html>

9 <http://www.bbc.co.uk/news/business-22600984>

10 Philip Baker, “*Tax Avoidance, Tax Mitigation and Tax Evasion*”, available online at http://www.taxbar.com/documents/Tax_Avoidance_Tax_MitigationPhilip_Baker.pdf

11 <http://www.oecd.org/ctp/glossaryoftaxterms.htm>

strictly legal it is usually in contradiction with the intent of the law it purports to follow. Cf. Evasion.¹²

Philip Baker¹³ draws a spectrum of conduct where on the one side tax evasion or fraud stand as actions, which must involve intentional behaviour or actual knowledge of the wrongdoing, such as intentional non-reporting of income or deliberately claiming a deduction to which a person knows he is not entitled.

It is rightly suggested that we should use the word tax fraud for this type of conduct to avoid any confusion especially when in French *evasion fiscale* means avoidance. This point was nicely illustrated by the European Council President Mr. Herman Van Rompuy, who was describing the meeting of the European Council where tax avoidance was discussed, he said:

Our second focus at this European Council meeting was on tax evasion and tax fraud. This was not a new topic, and certainly a sensitive one, where progress is difficult. Yet, this European Council was different. Why? Well, there was unusual momentum, partly due to a series of scandals in different countries. In times of budgetary consolidation, when governments have to take hard decisions that directly affect the life of citizens, **tax fraud and tax evasion become more unacceptable than ever.**¹⁴

He was clearly referring to recently publicized issues of a tiny tax burden of huge multinational corporations in the UK and the US such as Google, Starbucks, Amazon and Apple. All those cases are related to tax mitigation or avoidance at most. Clearly, neither tax fraud nor evasion has ever been acceptable in Europe and it has nothing to do with a fairness of tax systems. Therefore, it is obvious that even at the highest political levels there is a significant confusion about proper terminology in this area.

At the opposite side of the spectrum stand tax indifference and mitigation – conducts which are perfectly legal and acceptable. Tax mitigation has been described as a conduct when a taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.

What lies between tax fraud and tax mitigation is tax avoidance. Many statutory provisions say that it is avoidance if a taxpayer's dominant purpose - or his sole

12 <http://www.oecd.org/ctp/glossaryoftaxterms.htm>

13 Philip Baker, *"Tax Avoidance, Tax Mitigation and Tax Evasion"*, available online at http://www.taxbar.com/documents/Tax_Avoidance_Tax_MitigationPhilip_Baker.pdf

14 Speech by President of the European Council Herman Van Rompuy at the European Parliament, Brussels, 28 May 2013, Tax Analysts, 2013 WTD 103-17

purpose - was to reduce or eliminate tax liability. One significant difference between avoidance and fraud is that in case of avoidance all information is disclosed to the Tax Authority as required by law.¹⁵

Tax abuse and circumvention of tax law are closely linked to tax avoidance. Both of those concepts refer to situations when certain actions of the taxpayer literally comply with the tax laws but achieve financial and legal consequences different from those intended by the legislator.¹⁶ Tax abuse and circumvention of law describe the same activity by referring to subjective and substantive rights respectively. Tax avoidance is focused on the result of saving tax.¹⁷

In this article the author will use terms tax fraud, avoidance and mitigation to refer to those three groups of conduct described above.

C. The concept of anti-avoidance measures

The tax system is being made up of a set of specific laws that govern how various items are taxed. Anti-avoidance doctrines are applied in addition to these laws. They usually weigh tax and non-tax elements in a transaction and disallow tax benefits for transactions that have insufficient non-tax elements.¹⁸ The overall effect of strengthened anti-avoidance measures will depend on the cost of their implementation, level of decreased economic activity, due to the broadened tax base, and other factors.¹⁹

Anti-avoidance measures could be broadly categorized as [a] statute based and [b] court-based general anti-avoidance measures.²⁰ The US courts have been the first to develop five main anti-avoidance doctrines: (1) economic substance; (2) substance over form; (3) step transaction; (4) business purpose; (5) sham transaction.²¹ The EU tax directives also contain anti-abuse provisions and the

15 Dr Adam Zalasinski, *Some Basic Aspects of the Concept of Abuse in the Tax Case Law of the European Court of Justice*, INTERTAX, Volume 36, Issue 4, Kluwer Law International 2008, p. 159

16 Ibid, p. 159-160

17 Ibid, p. 160

18 D.A. Weisbach, *An Economic Analysis of Anti-Tax Avoidance Doctrines*, Am. L. Econ. Rev., Working Paper No. 99 (17 May 2002), available at <http://ssrn.com/abstract=228536>

19 Ibid.

20 S. Goradia 'General anti avoidance rule - ready or not, here I come' http://www.bmr advisors.com/upload/documents/General%20Anti%20avoidance%20rule-ready%20or%20not,%20here%20i%20come_Shefali_13%20Aug,%20101281939599.pdf.

21 Dr. Patricia Lampreave, *An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union*, Bulletin for International Taxation, March 2012, IBFD, p. 154

CJEU has developed a wholly artificial arrangement doctrine when dealing with aggressive tax avoidance.

In this article the author will analyse application of those anti-avoidance measures in Lithuanian tax case-law. There are several courts dealing with tax cases however, only the rulings of the Supreme Administrative Court have an official power of a legal precedent. Therefore, the author will analyse only this Court's rulings.

II. VARIETY OF ANTI-AVOIDANCE MEASURES IN LITHUANIA

A. Lithuanian legal provisions

The General Lithuanian anti-avoidance rule is contained in Art. 69 (1) of Law on Tax Administration (hereinafter – LTA). Art. 10 of the same law explicitly states that in respect of taxes, the content of the activities carried on by the participants of legal relations shall take precedence over their form. General economic substance principal is stated in Art. 40 (1) of the Law on Corporate Income Tax. Art. 40 (2) of the Law on Corporate Income Tax contains a provision, which is a legal basis for transfer pricing rules. The Thin capitalization provisions are defined by the resolution of the Lithuanian Government.²²

The CFC legislation provides that income, received by a controlled entity, shall be included in the income of a controlling entity of Lithuania.²³ The controlled entities, for the purpose of CFC regime, are registered in the jurisdiction of the “black” list. Entities shall also be regarded as CFCs if registered in any other (not the “white” list) jurisdiction and their actual payable tax rate is 75% or less of Lithuanian corporate income tax rate.²⁴ The same CFC rules apply for private individuals.²⁵

The OECD influence on Lithuanian legislation is significant – the main document defining the transfer pricing rules of Lithuania²⁶ provides that guidance can be sought from the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The Supreme Court also confirmed that where

22 Rules for the requalification of income or payments, approved by Resolution No 1575 of the Government of the Republic of Lithuania of 9 December 2003

23 Article 2 (29) of Law on Corporate income tax, 20 December 2001, No IX-675

24 30 August 2010 explanation No. KD-5231 of Lithuanian State Tax Inspectorate.

25 Article 13 of Law on personal income tax

26 09 April 2004 resolution of the Finance Minister of Lithuania No. 1K-123

Lithuanian domestic case law is not sufficient foreign court decisions may be used for the interpretation of international agreements.²⁷

B. Mitigating taxes is lawful

i. Lithuanian case law

The Lithuanian courts have confirmed that taxpayers have a right to look for the best economic result of their transactions and mitigating taxes is lawful. This has been established by the Supreme Administrative Court, which stated that:

There is no law obliging a taxpayer to choose such model of behaviour, which would cause the highest tax burden when there is an opportunity to choose among several lawful models. There is also no obligation to transfer property (conclude transactions) in such a way which is most beneficial to the state's budget. It is obvious that a person acting honestly (legal subject, taxpayer) has a right and an opportunity to predict consequences of his behaviour and to choose such lawful model of activities which would allow conduct his activities with lowest expenses but only if the principle prohibiting abuse of law is followed. <...> **The fact that a taxpayer obtained a certain tax benefit while concluding a transaction or by participating in it does not in itself provide a basis to consider such transaction as abusive.**²⁸

ii. CJEU case law

In *Halifax* the CJEU ruled that where the taxable person chooses one of two transactions, the sixth directive does not require him to choose the one that involves paying the highest amount of VAT. Taxpayers may choose to structure their business so as to limit their tax liability.²⁹ The same rule was reiterated in *Part Service*.³⁰

In *RBS Deutschland* the Court stated that taxable persons are generally free to choose the organisational structures and the form of transactions which they

27 17 May 2010 decision of the Supreme Court of Lithuania in a civil case No. 3K-3-216/2010

28 18 November 2011 decision of the Supreme Administrative Court of Lithuania in the administrative case No. A-575-3448-11

29 Case C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v Commissioners of Customs & Excise*, Para 73

30 C-425/06, *Ministero dell'Economia e delle Finanze, v Part Service Srl*, para 47

consider to be most appropriate for their economic activities and for the purposes of limiting their tax burdens.³¹

C. Abuse of law principle

In an EU internal market context, the fundamental freedom provisions may interact with national tax rules and rules contained in DTCs. When this happens, the freedoms must prevail unless the Member State's rules, if directly discriminatory, can be justified on grounds allowed by the TFEU; and if indirectly discriminatory or non-discriminatory, it can be justified on general interest grounds, which comply with the principle of proportionality.³²

In *Cadbury Schweppes* the CJEU stated that nationals of a Member State cannot attempt, under cover of the rights created by the Treaty, improperly to circumvent their national legislation. They must not improperly or fraudulently take advantage of provisions of Community law.³³ The Court also stated that the fact that a Community national sought to profit from tax advantages in force in a Member State other than his State of residence cannot in itself deprive him of the right to rely on the provisions of the Treaty.³⁴ The fact that the company was established in a Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse of that freedom.³⁵

The Court repeated same comments in *Thin Cap GLO*, where it stated that the mere fact that a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty.³⁶

A test for abusive tax practices in VAT sphere has been set out by the Court in *Halifax*: a practice is abusive if, first, the transactions were contrary to the purpose of the VAT directive and the national legislation transposing it and second, that it must be apparent from a number of objective factors that the essential aim of the

31 Case C-277/09, *The Commissioners for Her Majesty's Revenue and Customs v RBS Deutschland Holdings GmbH*, Para 53

32 Tom O'Shea, *TAX AVOIDANCE AND ABUSE OF EU LAW*, The EC Tax Journal, Volume 11, 2010-11

33 Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, para 35

34 *Ibid*, para 36

35 *Ibid*, para 37

36 Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*, Para 73

transactions concerned is to obtain a tax advantage. The Court went on to stress that the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages.³⁷

In Lithuanian, in *K.U.* case³⁸ the Supreme Administrative Court stated that an honest taxpayer has a right to choose such mode of behaviour which demands least expenses as long as the law is not abused. The Court stated that for the abuse to be identified firstly, the advantage obtained must contradict the purpose of the law and secondly, the entirety of objective factors must indicate that the main purpose of the transaction was to obtain a tax advantage. The court relied on the CJEU case law in *Weald Leasing Ltd*³⁹ when identifying this test.

The Court has also ruled that the law should not defend a person who is abusing tax laws and in such case the tax administrator has a right to re-characterize non disclosed circumstances and assess the tax base accordingly.

III. CFC, THIN CAPITALIZATION AND TRANSFER PRICING RULES

A. CFC rules

The term CFC refers to Controlled foreign company. Under CFC rules income of the CFC is typically either deemed to be realized directly by the shareholders or deemed to be distributed to them by way of dividend. Often only part of the CFC's income is dealt with in this way, typically passive income such as dividends, interest and royalties ("tainted income").⁴⁰

CJEU has dealt with national CFC rules on various occasions. In *Cadbury Schweppes* the Court confirmed that the taxpayers must not abuse EU law, but profiting from tax advantages in force in another Member State cannot in itself deprive them of the right to rely on the provisions of the Treaty.⁴¹ Taking advantage of more favourable company formation rules had also been accepted by the Court in *Centros* and in *Inspire Art*.⁴² UK CFC rules provided that the profits

37 Tom O'Shea, *CFC REFORMS IN THE UK – SOME EU LAW COMMENTS*, The EC Tax Journal Volume 13, 2012-13

38 Decision of 04 February 2011 case No. A-438-201/2011 SAC

39 Case C-103/09 *Commissioners v Weald Leasing Ltd.*, paras 27-30

40 IBFD Glossary, *Controlled foreign company (e.g. UK)*

41 Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, paras 35 and 36

42 Tom O'Shea, *The UK's CFC rules and the freedom of establishment: Cadbury Schweppes plc and its IFSC subsidiaries – tax avoidance or tax mitigation?*, EC TAX REVIEW 2007/1

of a foreign subsidiary are attributed to the UK parent company if the subsidiary paid less than $\frac{3}{4}$ of taxes compared to what it would pay in the UK. On the other hand CFC rules were not triggered when the subsidiary was established in the UK or in another country with not so low taxation. The Court found this different treatment restrictive. Dealing with justifications the Court stated that lower taxation of subsidiary could not in itself authorize a Member State to offset that advantage by less favourable treatment of the parent company.⁴³ The Court ruled that national measures could be justified on the ground of prevention of abusive practices if the specific objective of such a restriction is to prevent conduct involving the creation of wholly artificial arrangements, which do not reflect economic reality, with a view to escaping tax.⁴⁴ The Court cited *Halifax* and *Emsland-Starke* cases and listed the requirements for the arrangement to be considered as wholly artificial. [a] It must have a subjective element consisting of the intention to obtain a tax advantage, and [b] objective circumstances must show that, despite formal observance of the conditions laid down by the EU law, [c] the objective pursued by freedom of establishment, i.e. the actual establishment of the company and the pursuit of genuine economic activity there, has not been achieved.⁴⁵

In *CFC GLO*⁴⁶ the Court noted that national CFC rules could be justified if they specifically target wholly artificial arrangements designed to circumvent the legislation of the Member State concerned, but that such tax measures must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives, that CFC is actually established in the host Member State and carries on genuine economic activities there. The Court also noted that the resident company must be given an opportunity, without being subject to undue administrative constraints, to produce evidence that the CFC is actually established and that its activities are genuine.⁴⁷ Lithuanian CFC provisions are in the Law on Corporate Income Tax⁴⁸ as well as in the decree of the Government.⁴⁹ There are also two orders of the Minister of

43 *Cadbury Schweppes*, para 49

44 *Ibid*, para 55

45 *Ibid*, para 64

46 Case C-201/05, *Test Claimants in the CFC and Dividend Group Litigation v Commissioners of Inland Revenue*

47 Tom O'Shea 'ECJ Clarifies Issues Raised in Connection with U.K. Dividend Tax, CFC Rules' Tax Analysts 2008 WTD 98-1

48 Article 39 of Law on Corporate Income Tax No. IX-675

49 Decree No. 517 of the Government of the Republic of Lithuania of 12 April 2002

Finance, which established “black” and “white” lists of jurisdictions for the purposes of identifying CFCs.⁵⁰

The CFC rules generally apply when the following three conditions are satisfied:

- [a] on the **last day** of the tax period,
- [b] a Lithuanian entity or a person (“controlling person”) **alone** holds, directly or indirectly, more than **50%** of the shares in the controlled entity; or
- [c] **together** with related persons holds more than **50%** shares in the controlled entity, and his **own part** amounts to at least **10%** of those shares or rights to profit.

Companies registered or otherwise organized in the white listed jurisdictions will not fall under the CFC regulations. If the entity is registered or otherwise organized in the black listed jurisdiction, it will be subject to CFC rules notwithstanding its legal form. Also, the entity will be considered a CFC if [a] it is registered in the white listed jurisdiction but obtains special tax benefits under the domestic legislation; or [b] it is registered in neither white nor black listed jurisdiction but it pays corporate income tax at a rate less than $\frac{3}{4}$ of Lithuanian standard rate, i.e. its tax rate is lower than 11.25%.

Unfortunately, there are no significant Lithuanian cases dealing with CFC rules. There is only one case from 2007, which dealt with a provision in the Law on personal income tax⁵¹, which has been repealed several years ago. The mentioned provision stated that dividends received by the Lithuanian resident (individual) were taxed at a higher rate if the distributing company was a CFC. The Supreme Administrative Court has ruled⁵² that even though Estonia was not in the white list of jurisdictions, after Lithuania and Estonia were accepted into the EU, the EU law should prevail. The court cited *Verkooijen*⁵³ and stated that rules implementing different treatment for domestic and intra EU dividends are incompatible with the EU law. However, it must be noted that the Court was not entirely right. The CJEU has accepted that the obligations of a member state acting in a source member state capacity may differ from those in which it is acting in a residence member state capacity. Thus, in *ACT IV GLO (C-374/04)*, the CJEU accepted that a member state could have different obligations under EU law.⁵⁴

50 The white list is provided in the Order No. 24 of 24 January 2002 and the black one in the Order No. 344 of 22 December 2001

51 Article 6(2) of the Law on Personal Income Tax

52 Decision of 26 February 2007 case No. A8 – 207/2007 SAC

53 Case C-35/98 *Verkooijen* [2000] ECR I-4071

54 Tom O’Shea ‘*Taxpayer Wins First Round in Consortium Relief Case*’ Tax Analysts 2012 WTD 98-22

Lithuanian CFC legislation is quite straightforward and that may be the reason why there is virtually no case-law on any of the issues related to CFCs. For CFC rules to be triggered one has to formally own a significant stock in the foreign law taxed subsidiary. However, Lithuanian CFC legislation does not have a provision, which would allow escaping CFC rules in relation to the income of foreign subsidiaries, which have substance in their existence and activities. Therefore, Lithuanian CFC legislation may be found incompatible with the EU law since it targets companies, which are actually established in the host Member State and carry on genuine economic activities there.

B. Thin Capitalization rules

Thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Tax laws typically allow a deduction for interest paid or payable. The higher the level of debt in a company, the lower will be its taxable profit. For this reason, debt is often a more tax efficient method of finance than equity.⁵⁵

Thin capitalization rules usually take one of the two forms: [a] limiting a maximum amount of debt on which deductible interest payments are available; or [b] limiting a maximum amount of interest that may be deducted by reference to the ratio of interest (paid or payable) to another variable.⁵⁶ Lithuania has chosen a second type of thin capitalization legislation. The rules are provided in the decree of the Government and are actually called The Rules of Income or Payment Characterization.⁵⁷

Thin capitalisation Rules apply in respect to borrowings from related parties, as well as borrowings guaranteed by related parties. The debt to equity ratio is 4:1 in such cases. The above regulations are not applicable in cases when Lithuanian entity has sufficient proof that the same loan under the same conditions would have been granted by non-related entity.

Foreign-registered entities are excluded from the scope of the thin capitalization rules as a result of condition of having to be registered in accordance with the Lithuanian law. It should also be noted that the Lithuanian permanent establishments of foreign entities are not affected by thin capitalization rules. The

55 OECD - Thin capitalization legislation, a background paper for country tax administrations, August 2012

56 Ibid

57 Decree of the Government of the Republic of Lithuania No. 1575 of 09 December 2003.

definition of interest is very wide. Interest-free loans are not included in debt capital in measuring the debt to equity ratio.⁵⁸

There were various CJEU cases dealing with thin capitalization rules. German rules were analysed in *Lankhorst-Hohorst*⁵⁹ where the Dutch company provided a loan to a German subsidiary, which was in a dire financial situation. German law provided that consideration in respect of loan capital, which a corporation had obtained from a substantial shareholder was regarded as a hidden profit distribution where: [a] a consideration calculated as a fraction of the capital was agreed and [b] the loan capital was more than three times the shareholder's proportional equity capital, save where the corporation could have obtained the loan capital from a third party under otherwise similar circumstances.⁶⁰ The Court did not accept a prevention of tax avoidance argument and stated that the provision in question did not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent tax legislation, but applied generally to any situation in which a parent company was not resident in Germany. In that case none of the companies were found to be abusing the law.

Following *Lankhorst-Hohorst* case, *Thin Cap GLO*⁶¹ ruling was issued. Four issues were raised in this case: [a] whether the UK rules, which limited the ability of a resident borrower company to deduct from its taxable income interest paid to a non-resident lender in the same company group, whereas such limitation did not apply when the lender was a domestic group company, were precluded by the EU law; [b] whether there is any consequence as to the applicability of the freedoms because of the fact that either the parent company or the lender or both were resident outside the EU (third country); [c] whether it made a difference in the determination of whether or not a restriction exists on these freedoms if the borrowing constituted an abuse of rights or was part of an artificial arrangement, and [d] how the claims brought in order to remedy the incompatibility of UK law with EU law must be classified from a procedural law perspective.⁶² The Court ruled that thin capitalization legislation, which is only applied to interest payments to non-resident lenders, constitutes, in principle, a restriction on the freedom of establishment. Such restriction may be justified by the prevention of tax avoidance provided that it is proportionate to that aim, i.e., the legislation [a] provides for the

58 Robertas Degešys 'A comparative study of the thin capitalization rules in the member states of the European Union and certain other states : Lithuania' European Taxation, September/October 2005

59 Case C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*

60 Ibid

61 Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*

62 Ibid

consideration of objective and verifiable elements to identify purely artificial arrangements, [b] allows taxpayers to produce, without being subject to undue administrative burden, evidence as to the commercial justification for the transaction, and [c] applies only to that part of the interest that exceeds the arm's length standard.⁶³

In *NV Lammers & Van Cleeff*⁶⁴ the CJEU held that the Belgian provision that reclassified as dividends interest payments to a foreign director company if the interest-bearing loan was higher than the paid-up capital plus taxed reserves, but not if the interest was paid to a resident director company, was incompatible with the freedom of establishment.⁶⁵ The taxpayer won the case on the principle of proportionality. The Court found that interest payments were reclassified as dividends because one of the limits specified in the Belgian legislation had been exceeded. However, such rules went beyond what was necessary to prevent abusive practices because such rules also affected situations that did not involve purely artificial arrangements. The Court commented that reclassifying interest payments in the circumstances of this case when they exceeded the specified limit could also apply to interest paid on loans granted on an arm's-length basis. The Belgian rules, therefore, went too far in combating abusive practices because non-abusive loans could also be reclassified by the thin cap rules at issue.⁶⁶

Unfortunately, there are no Lithuanian cases dealing with thin capitalization rules therefore, there is no domestic case law to compare to that of the CJEU. There could be several explanations for such situation but the most probable one is that the State Tax Inspectorate is not being active enough in applying thin capitalization provisions.

C. Transfer pricing rules

Art. 40(1) of the Law on Corporate Income Tax contains a general provision that all transactions concluded between any persons must be based on a fair market value. Art. 40(2) of the same law provides a more specific provision that the Tax Authority has a right to characterise transactions concluded between associated persons if they do not correspond to the arm's length principle. This is the basis for transfer pricing adjustments. There are more specific transfer pricing rules adopted by the Minister of Finance.⁶⁷ The rules are quite short but they make an

63 Ibid

64 Case C-105/07 *NV Lammers & Van Cleeff v Belgische Staat*

65 Ibid

66 Tom O'Shea 'ECJ Overturns Belgian Thin Cap Rules' Tax Notes Int'l, March 10, 2008, p. 837

67 Decree of the Minister of Finance of the Republic of Lithuania No. 1K-123 of 09-04-2004

explicit reference to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as a legal source for interpretation of issues not directly addressed by domestic rules.

There was only one case at the Supreme Administrative Court which relied on transfer pricing provisions but nothing significant was analysed there. One explanation for a lack of transfer pricing case law is the lack of any objective data about transaction prices between Lithuanian entities. There are also no Lithuanian transfer pricing databases similar to Amadeus or ONESOURCE. The only publicly available database is the statistics of the Central Bank of Lithuania where taxpayers can find average interest rates for the loans issued by the commercial banks. There are no similar sources for other financial information. The other reason could be the complexity of economic analysis involved in a proper calculation of transfer prices. The lack of experts in this field encourages both parties to the dispute to settle at an early stage.

IV. APPLICATION OF SUBSTANCE OVER FORM PRINCIPLE

A. International origin of Substance over form principle

Substance over form principle was firstly applied by the US Supreme Court in *Gregory v. Helvering*.⁶⁸ The US Court ruled that:

the whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

In the UK the doctrine was introduced in *Ramsay*⁶⁹ case where the House of Lords denied the taxpayer's deduction of an alleged capital loss resulting from a series of circular and self-cancelling transactions. The Court had to deal with previously established precedent in *Duke of Westminster*⁷⁰ where the House of Lords refused to look at the substance of the transaction and allowed the Duke of Westminster to convert wages paid to his employees into annuity payments that could be deducted

68 *Gregory v Helvering* 293 U.S. 465 (1935)

69 *Ramsay Ltd. v Inland Revenue Commissioners* [1982] A.C. 300

70 *IRS v Duke of Westminster* [1936] A.C. 1; 19 TC 490

from the Duke's income. In *Ramsay* Lord Wilberforce affirmed that the principle established in *Duke of Westminster* could not "compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs".⁷¹

The OECD Model Tax Treaty and its Commentary also regularly pay attention to the substance over form doctrine.⁷²

B. Substance over form in Lithuanian legislation

The principle of substance over form is provided in the Art. 10 and 69 of the LTA. Art.10 states a general rules that in tax environment substance takes priority over the formal expression. Art. 69 is much more detailed and provides a mechanism for calculating taxes using this principle. It states that when the transaction of a taxpayer has been concluded with a purpose of obtaining a tax benefit, the tax administrator has a right to apply substance over form principle while assessing taxes. In such case a tax administrator has a right to ignore the formal expression of the taxpayer's activities and to restore hidden or distorted circumstances related to taxation and asses taxes accordingly. Article 69(2) states that when the taxpayer makes a mistake or when the taxpayer's activities do not match formal requirements of the law but the substance of the transaction corresponds to the circumstances provided in tax laws, the tax must be assessed using mentioned provisions of tax laws.

C. Substance over form in case law of CJEU

In *Halifax* the CJEU ruled that in VAT context the term supply of services is objective in nature and applies without regard to the purpose or results of the transactions concerned and without its being necessary for the tax Authority to carry out inquiries to determine the intention of the taxable person.⁷³

In *Ocean Finance*⁷⁴ the CJEU further analysed the notion of the "supply of services" for VAT purposes. It found that given that the contractual position

71 Christine Alves Alvarrenga 'Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?' Bulletin for International Taxation, 2013 (Volume 67), No. 7

72 Bart Kusters 'Substance over Form under Tax Treaties' Asia-Pacific Tax Bulletin, 2013 (Volume 19), No. 1, IBFD

73 Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd and County Wide Property Investments Ltd v Commissioners of Customs & Excise*, paras 56 and 57

74 Case C-653/11, *Her Majesty's Commissioners of Revenue and Customs v Paul Newey, trading under the business name Ocean Finance*

normally reflects the economic and commercial reality of the transactions and in order to satisfy the requirements of legal certainty, the relevant contractual terms constitute a factor to be taken into consideration when the supplier and the recipient in a 'supply of services' transaction have to be identified. Sometimes, certain contractual terms do not wholly reflect the economic and commercial reality of the transactions. That is the case in particular if it becomes apparent that those contractual terms constitute a purely artificial arrangement, which does not correspond with the economic and commercial reality of the transactions. Preventing possible tax evasion, avoidance and abuse is an objective recognised and encouraged by the Sixth Directive and the effect of the principle that the abuse of rights is prohibited is to bar wholly artificial arrangements, which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage. In the main proceedings, it is not disputed that, formally, in accordance with the contractual terms, the company supplied loan broking services and that it was the recipient of the supplies of advertising services. However, taking into account the economic reality of the business relationships between them, it is conceivable that the effective use and enjoyment of the services at issue in the main proceedings took place in the United Kingdom.⁷⁵

D. Substance over form in Lithuanian VAT case-law

Tauja case as the main precedent in VAT cases

The LTA containing substance over form principles laid out in Art. 10 and 69 was enacted on 13 April 2004 and entered into force on the day Lithuania was accepted to the EU, i.e. on 01 May 2004. The very first ruling of the Supreme Administrative Court citing Article 10 of the LTA was issued on 27 October 2004 in *Tauja* case⁷⁶. Even though the transactions in question took place before the LTA entered into force, its provisions were applicable to the dispute.

The significance of *Tauja* ruling is indicated by the fact that the rulings was issued by all the 14 judges of the Court. The fact that it was issued by all the judges of the Court and that it was the first ruling on the subject after the enactment of the new LTA made it the primary source of law for the later judgments.

In *Tauja* a taxpayer - legal entity purchased wood from various other Lithuanian entities and claimed VAT deduction on those purchases. Tax Authority established that the sellers did not have licenses to cut wood, they did not have documents proving they purchased wood anywhere else, they did not declare any sales and some of the invoices were allegedly falsified. Tax Authority denied VAT

⁷⁵ Ibid, paras 43-48

⁷⁶ Decision of 27 October 2004 in case No. A1-355/2004 SAC

deduction for Tauja arguing that invoices issued by the sellers were not valid since there was no object of those transactions. There was no evidence that the sellers could have obtained wood in any legal way.

The Supreme Administrative Court ruled that substance over form principle enshrined in Art. 10 of the new LTA must be applied. The Court noted that the legislator's position to give priority to the substance of the transaction is very clear. It also stated that if the taxpayer has invoices issued in accordance to all formal requirements it still does not give the right for a VAT deduction if the transaction did not take place or its substance differed from the one indicated in the invoices. On the other hand if the invoices lack some data the taxpayer may still retain its right to deduct input VAT if other evidence shows that the transaction actually took place as indicated in those invoices. The Court cited CJEU's ruling in *Goodwin and Unstead*⁷⁷ and found that for VAT purposes there is no difference whether the goods were firstly obtained in a legal manner as long as such type of goods can be placed in civil circulation, e.g. counterfeit perfumes are illegally produced but still subject to VAT if sold. It also stated that honesty of the taxpayer claiming VAT refund is very important. The taxpayer, which knew or should have known that VAT has not been paid or will not be paid by the seller and still claims VAT deduction is acting dishonestly and loses a right to deduction. The Court annulled previous decisions of Tax Authority and ruled that they have been investigating and arguing wrong issues and ordered them to renew investigation and find out whether the substance of the transactions correspond to the form (invoices), i.e. whether the transactions actually took place and whether the taxpayer was acting honestly.

ii. Recent developments in VAT field – *Cleanex* saga

Interesting issues were analysed in a series of recent cases related to UAB Lichemus and UAB Cleanex. UAB Lichemus was a Lithuanian company engaged in providing cleaning services. The company became insolvent. Before the bankruptcy proceedings were initiated business of the company was actually transferred to a sister company – UAB Cleanex. Lichemus was left with significant debts to the Tax Authority and not sufficient assets.

The State Tax Inspectorate decided to apply substance over form and concluded that the new company must have acquired not only the business but also tax liabilities of Lichemus. Commission on Tax Disputes affirmed taxpayer's complaint and annulled the decision of the Tax Authority. Taxman filed an appeal to Vilnius Regional Administrative Court, which ruled to the contrary.⁷⁸ The Court

77 Case C-3/97 *Goodwin v Unstead*

78 Decision of 04-04-2011 in case No. I-2014-189/2011 VRAC

stated that Lichemus' managers were acting dishonestly because they knew that the company was in a dire financial status but failed to initiate bankruptcy, did not inform the creditors and right before the company went bankrupt, have transferred most valuable assets of the company away in exchange of covering debts of associated creditors.

The decision was appealed and the Supreme Administrative Court upheld the decision of the lower court.⁷⁹ It stated that Art. 69 of the LTA can be applied only when the sole purpose of the transaction of the taxpayer was to obtain a tax advantage. In this case there was no such purpose in the activities of Cleanex, there even was no transaction as such. Only a series of actions by Lichemus and its shareholders took place and transferred activities of Lichemus to Cleanex. Therefore, Art. 69 of the LTA cannot be applied in this case. However, the Court made another important conclusion that dishonest behaviour of the taxpayer alone is sufficient to assess additional taxes. The Court concluded that there was sufficient evidence to find that Cleanex took over rights and obligations of Lichemus and tax liabilities should be taken over as well.

Even though the decisions of the Supreme Administrative Court are final and not subject to appeal, the taxpayer did not give up. It used another available action – it asked the Supreme Administrative Court to renew the process because significant errors were made in the previous decision of the Court. The arguments of Cleanex were affirmed and the process was renewed.⁸⁰ At the same time the Court noted that Lichemus and Cleanex are two separate legal entities and two separate taxpayers. There are no explicit legal provisions in Lithuanian tax laws allowing transfer of tax burden from one taxpayer to another in such circumstances. Therefore, the Court concluded that substance over form principle (Art. 10 of the LTA) should not be used in transferring tax burden from one taxpayer to another. Substance over form principle is applicable to the participant of the transaction. Since Cleanex did not participate in the transactions, for which Lichemus was not able to pay taxes, Art. 10 of the LTA could not be applied to Cleanex. Besides the LTA requires taxes, their calculation and other aspects to be very clearly defined. Since transfer of tax burden in such circumstances is not prescribed in the tax laws, it cannot be construed from the general principle of substance over form. Since the process was renewed a new decision was issued by the Court, constituted of the extended 5 judge panel.⁸¹ The Court stated that Art. 10 of the LTA can be applied separately from Art. 69 of the same law. However, Art. 10 of the LTA in itself does not create additional tax obligations to taxpayers. It can only be applied in order to reassess factual circumstances of a transaction and then apply different

79 Decision of 12-03-2012 in case No. A556 - 141/2012 SAC

80 Decision of 03-12-2012 in case No. P602-163/2012 SAC

81 Decision of 11-04-2013 in case No. A442-724/2013 SAC

provision of tax laws which impose taxes and which otherwise would not be applicable to the same transaction if the form as opposed to substance was affirmed. Besides, principle of substance over form must be applied reasonably and honestly.

In relation to the argument of dishonest behaviour the Court ruled that the breach of the obligation to not abuse tax laws and to act honestly in itself does not impose additional taxation. Even if creation of Cleanex and transfer of the business was conducted with an attempt to abuse the law it does not mean that Cleanex was acting dishonestly. The company is not liable for the obligations of its shareholders, it is a separate entity. Tax Authority being a creditor of Lichemus in bankruptcy could have employed available remedies provided by civil law, i.e. challenging transactions made by Lichemus if they caused damage to the creditors of insolvent company, or could have initiated criminal investigation against persons responsible for the transfer of business. The Court finally ruled in favour of the taxpayer.

iii. Wrong interpretation of CJEU case-law in Lithuanian VAT jurisprudence

In *Tauja* case, discussed above, the Court stated that the taxpayer is acting dishonestly if he enters into transaction knowing that the seller will not pay VAT on that transaction. However, the non-payment of VAT must be caused by unlawful actions of the seller. If VAT was not paid, the seller has breached the law. Therefore, a two-limb test has been created for the taxpayer to lose his right into the recovery of input VAT. Firstly, the seller must not pay the VAT and secondly, the buyer must have knowledge about the fact that the seller is not going to pay VAT. The Court is not making any clear distinction between the reasons of the non-payment of VAT. One might consider that the reason for the non-payment is irrelevant and only the fact itself is important. However, in *Tauja* the Court was dealing with a non-payment of VAT due to fraudulent activities. It is reasonable to presume that the Court had in mind only situations when the VAT is not paid by the sellers engaged in fraudulent activities, not all other imaginable situations.

Three years later the Court had to consider similar issues in *Alsva* case.⁸² The taxpayer bought a land plot with a building on it. Sale of such property was not subject to VAT and the seller had no obligation to indicate VAT separately in the invoice as well as to pay it. However, the seller chose to do it and then automatically acquired an obligation to pay indicated VAT. The buyer claimed VAT deduction on the same transaction. Tax Authority denied the claim arguing that the seller did not pay VAT and *Alsva* accordingly cannot claim the deduction since it must have known that the seller will not pay VAT. The Court ruled to the

82 Decision of 02-04-2007 in case No. A8 – 345/2007 SAC

contrary. It cited CJEU in *Axel Kittel*⁸³ and ruled that the buyer loses a right to a VAT deduction not in every case of non-payment by the seller, but only when the VAT is not paid due to fraudulent activities. Consequently, when the seller does not pay VAT due to its dire financial situation without any fraud on its part, the buyer maintains its right to claim a deduction of input VAT.

In several later cases the Court again ruled that the buyers lose a right to claim input VAT deduction if they knew that the sellers will not pay it to the budget.⁸⁴ The Court did not distinguish between the reasons of the non-payment. In several other cases the Court made references to the fraudulent activities of the seller and buyer's knowledge about it as a reason for the denial of VAT refund.⁸⁵ Decisions in both types of cases were issued side by side in the years after *Tauja* ruling. Therefore, it is clear the Court is maintaining both lines of reasoning in its jurisprudence.

The Court is often citing the case law of CJEU while issuing its decisions and while explaining reasons for the denial of VAT deduction. However, case law of the CJEU, which is cited by Lithuanian courts, is quite consistent on this point.

In *Sanofi*⁸⁶ the Court stated that:

National legislation which excludes from the right to deduct VAT expenditure [...] without making any provision for the taxable person to demonstrate the absence of tax evasion or avoidance in order to take advantage of the right of deduction is not a means proportionate to the objective of combating tax evasion and avoidance and has a disproportionate effect on the objectives and principles of the Sixth Directive.

In *Federation of Technological industries*⁸⁷ the CJEU stated that:

Traders who take every precaution which could reasonably be required of them to ensure that their transactions do not form part of a chain which

83 Joined Cases C-439/04 and C-440/04 *Axel Kittel v État belge and État belge v Recolta Recycling SPRL*

84 Decision of 15-06-2007 in case No. A-606/07 SAC, decision of 11-09-2008 in case No. 438-1559/2008 SAC, decision of 29-10-2008 in case No. A(556)-1659/2008 SAC, decision of 18-02-2010 in case No. A-442-230/2010 SAC, decision of 30-06-2011 in case No. A(442)-2393/2011 SAC

85 Decision of 19-10-2009 in case No. A438-1097/2009 SAC, decision of 06-04-2010 No. A(556)-610/2010, decision of 02-07-2010 No. A438-550/2010, decision of 23-08-2010 No. A438-721/2010, decision of 14-02-2011 No. A(556)-2496/2011, 10-03-2011 No. A-442-2464-11 SAC, decision of 23-04-2012 No. A575-1686/2012 SAC.

86 Case C-177/99 *Ampafrance v Sanofi*, para 62

87 Case C-384/04 *Federation of Technological Industries and Others*, para 33

includes a transaction vitiated by VAT fraud must be able to rely on the legality of those transactions without the risk of being made jointly and severally liable to pay the VAT due from another taxable person.

In *Axel Kittel*⁸⁸ the Court ruled that:

Where a recipient of a supply of goods is a taxable person who did not and could not know that the transaction concerned was connected with a fraud committed by the seller, Article 17 of the Sixth Directive must be interpreted as meaning that it precludes a rule of national law under which the fact that the contract of sale is void – by reason of a civil law provision which renders that contract incurably void as contrary to public policy for unlawful basis of the contract attributable to the seller – causes that taxable person to lose the right to deduct the VAT he has paid. It is irrelevant in this respect whether the fact that the contract is void is due to fraudulent evasion of VAT or to other fraud. By contrast, where it is ascertained, having regard to objective factors, that the supply is to a taxable person who knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT, it is for the national court to refuse that taxable person entitlement to the right to deduct.

In *Halifax*⁸⁹ the CJEU stated that:

The right of deduction is an integral part of the VAT scheme and in principle may not be limited. It must be exercised immediately in respect of all the taxes charged on transactions relating to inputs. However, it is only in the absence of fraud or abuse that the right to deduct, once it has arisen, is retained. Accordingly, the Sixth Directive must be interpreted as precluding any right of a taxable person to deduct input VAT where the transactions from which that right derives constitute an abusive practice.

As seen from the case law of the CJEU, only fraudulent or abusive non-payment of VAT by the seller is relevant when considering the buyer's right to deduct input VAT. Consequently, when the seller fails to pay VAT due to some objective reasons the buyer should retain its right of deduction.

Hence, one could accuse Lithuanian courts unlawfully expanding the scope of the mentioned rule in domestic litigation and wrongly interpreting the case law of the

88 Joined Cases C-439/04 and C-440/04 *Axel Kittel v État belge and État belge v Recolta Recycling SPRL*, paras 60 and 61

89 Case C-255/02 *Halifax and Others*, paras 81-83

CJEU in situations when there is no consideration given to the reasons of the seller's failure to pay VAT.

E. Substance over form in Lithuanian direct taxation cases

iv. Application of Art.10 of the LTA

In *Pajurio mediena*⁹⁰ the tax Authority found that the company bought goods from other companies, which could not have sold them. The Court applied substance over form principle and ruled that since the company actually paid for the goods and actually bought the wood, even though from unidentified sources, it still can deduct those expenses for Corporate Income Tax purposes. This conclusion was made notwithstanding the fact that the taxpayer was not allowed to recover input VAT since the sellers were empty companies, which never paid any VAT on those sales.

In *Automobiliu laguna*⁹¹ case the main issue was whether the shares owned by the private individual were issued by the company while forming a new increased share capital or was it a last phase of previously started reorganization of the company. Since reorganization was done before 1999, shares obtained in reorganization were not subject to Personal Income Tax if sold at any profit. On the other hand profit from the sale of shares obtained after 1999 was taxable. He argued that when starting reorganization before 1999 he already intended to not only change the legal form of his company but also to increase its share capital. He provided an early shareholder's resolution and additionally requirements of his main supplier to have a share capital bigger than a certain threshold. The Court ruled that the taxpayer did not prove that his purpose in reorganization was to also increase a share capital at some point in the future. The Court did not explain why it did not take into consideration contractual requirements of certain size of share capital raised by the main supplier. The Court took a formal approach and stated that the reorganization according to the Law on Companies is finished when a new entity is registered and the Court did not see the reason why should this concept be extended to cover later increases of share capital.

v. Application of Art. 10 of the LTA in relation to the source of funds

In *E. Š.*⁹² the taxpayer, private individual, declared that he was able to lend a significant amount of money to a Lithuanian company because he obtained those funds as a loan from the US company. Tax Authority decided that the taxpayer

90 Decision of 25-11-2004 in case No. A15 - 957/2004 SAC

91 Decision of 07-01-2013 in case No. A-602-2280-12 SAC

92 Decision of 24-05-2005 in case No. A15 - 614 / 2005 SAC

actually earned those funds from unidentified sources and never paid taxes. Consequently, the whole amount was taxed. The Court upheld the position of the Tax Authority and applied substance over form principle (Art. 10 of the LTA) while stating that there is enough evidence to conclude that the US company never lent anything to the taxpayer. Firstly, the company was registered only a month after the loan agreement with the taxpayer was concluded. Secondly, the taxpayer claimed that he has received a loan in cash in Lithuania from a representative of the US company, not by a bank transfer. The Court found that the records of Lithuanian Customs Authority show that the named person did not enter Lithuania at relevant time periods and hence could not have given cash to the taxpayer.

Very similar issue was analysed in *M. V.*⁹³ case. A taxpayer, private individual, argued that the sources of his funds were the loans received from five other individuals. The taxpayer provided copies of loan agreements with those lenders. The Court stated that in those types of cases substance over form must prevail. The Court also stated that the loan agreements should be considered only as formal evidence. The definite substantial evidence could be the proof that the funds were actually transferred to the taxpayer, such as bank wire transfer confirmations, witness statements, financial capabilities of the lenders, etc. In present case, the Court did not have much difficulty to reach a verdict against the taxpayer. There was no direct evidence proving that funds were transferred to the taxpayer in any form. It also appeared that most of those five lenders were either unemployed or quite small social allowances where their only source of income. They could not have accumulated enough funds to provide loans indicated in the loan agreements. Almost identical situation was in *N. V.* case.⁹⁴ There again the court applied Art. 10 of the LTA while disregarding loan agreements provided by the taxpayer as an evidence of his sources of funds. The lenders were young individuals, who were still being supported by their parents and had no declared income to be able to provide significant loans. Interestingly enough the Court changed the legal basis of the decision of the State Tax Inspectorate and stated that when the loan agreements are valid and enforceable under the civil law the Tax Authority must apply Art. 69 of the LTA if it wants to disregard otherwise valid contract. Such advocacy of the Court is questionable since it deprives the taxpayer of the possibility to defend himself in the process if such arguments were never raised in the proceedings at any earlier stage.

vi. Interest free loans

In *Meskenas*⁹⁵ case private individual received substantial amounts from the wholly

93 Decision of 15-03-2007 in case No. A17 – 301/2007 SAC

94 Decision of 01-04-2011 in case No. A438-953/2011 SAC

95 Decision of 18-11-2011 in case No. A575–3448/2011 SAC

owned company. She argued that parts of the funds were loans and remaining were funds transferred in order for her to make certain purchases on behalf of the company. Tax Authority applied Art. 10 of the LTA in finding that it must have been disguised profit distribution, which should be taxed accordingly. In relation to the loans the Court found that those were interest free loans issued for a long period without any security at the time when the company itself was in debt to various creditors. The taxpayer also did not start repaying the alleged loan until criminal investigation against the taxpayer was initiated. After the taxpayer lost the case she asked the Court to renew the process but the Court declined.⁹⁶

vii. Application of Art. 69 of the LTA

In *Imortalis*⁹⁷ case the Court, while dealing with the procedural issues, noted that Art. 69 of the LTA can be applied when the taxpayer's transaction is entered into with a purpose of obtaining a tax advantage. Unfortunately, the Court did not further elaborate on whether that should be the only purpose, or the main, or just one of several equally important purposes. This case was cited and relied on in another case⁹⁸ last year. Dealing with step transactions the Court again applied substance over form principle without investigating whether there were any other motives besides obtaining a tax advantage. This does not seem to be a correct application of the principle because it clearly contradicts well established Lithuanian and international case-law stating that the fact that a taxpayer obtained a certain tax benefit while entering into a transaction or by participating in it does not in itself provide a basis to consider such transaction as abusive.⁹⁹

In *Finjura*¹⁰⁰ the Court dealt with the situation where the taxpayer, a company, has purchased shares from its employee and later on sold them at a huge loss. The Tax Authority applied substance over form principle and concluded that the transaction was an attempt to pay salary to the employee while presenting it as a purchase of securities. Hired experts concluded that purchased securities indeed were worth zero. The Court did not agree with the Tax Authority. It stated that Tax Authority did not provide any evidence that the taxpayer (the company, the employer) obtained any tax benefit from this transaction. The employee received an advantage, but not the employer. Since tax benefit is an essential element for the application of Art. 69 of the LTA, it could not be applied in this case.

96 Decision of 20-07-2012 in case No. P438-101/2012 SAC

97 Decision of 18-07-2008 in case No. A502-1305/2008 SAC

98 Decision of 27-09-2012 in case No. A438-1715/2012 SAC

99 Decision of 18-11-2011 in case No. A-575-3448-11 SAC

100 Decision of 16-09-2008 in case No. A-756-1591/2008 SAC

In *Nauduva*¹⁰¹ case the Court dealt with the obligations of the tax agent. Under Lithuanian legislation the legal entity paying out funds to the private individual (type A income) has an obligation to withhold personal income tax. In such situation, a company paying out the funds is considered a taxpayer and has all the obligations of the taxpayer related to paying taxes in time. In *Nauduva* the Court ruled that when substance over form principle is applied to a certain transaction the exception to the obligations of the tax agent can be applied as well. If it is established that the only purpose of the transaction was to obtain a tax advantage the tax may be sought from the real recipient of the benefit – the actual taxpayer, not only from the tax agent. That way the Court dealt with the situation of artificially shifting tax burden to the insolvent company where the Tax Authority has no way to recover unpaid taxes from the tax agent.

In *Karaliskas vezejas*¹⁰² the taxpayer, a passenger transportation company, has entered into several agreements with its current employees and rented vehicles from them. The taxpayer claimed Corporate Income Tax deductions for the rent expenses. The Tax Authority established that in fact the taxpayer never paid any rent payments to those people and denied deductions. The Court applied Art. 10 and 69 of the LTA and stated that evidence shows that substance of the transactions differs significantly from their form. First of all the company did not pay any rent payments for several years and started making small payments only when the tax investigation was initiated. When questioned in court, the employees stated that they are not aware of any debts of the company to them. The Court also applied business purpose doctrine in finding that the taxpayer has decided to unilaterally (without any initiative from the employees) increase rent payments on several occasions and amended rent agreements accordingly. That clearly contradicts any economic logic of a profit seeking entity.

viii. Covert salary payments

In *Jubana*¹⁰³ the taxpayer allegedly purchased market research and other studies from its employees. The Court ruled that substance over form principle (Art. 69 of the LTA) must be applied. There was no independence element in the activities of those service providers. They were and continued to be employees of the taxpayer at all relevant times. The taxpayer had difficulty in providing evidence of the purchased studies. The Tax Authority discovered that major part of the research materials allegedly purchased by the taxpayer were plain copies of information available on the internet free of charge. The studies allegedly prepared by different persons were also identical in certain parts. Some information transferred from the

101 Decision of 12-04-2010 in case No. A-438-359/2010 SAC

102 Decision of 10-12-2012 in case No. A602-2698/2012 SAC

103 Decision of 08-03-2012 in case No. A442-179/2012 SAC

internet into those studies appeared online later than the date the studies were allegedly prepared. The Court concluded that the true purpose of payments was to pay salary for the employees of the taxpayer and copyright agreements together with the provided studies should be disregarded.

In *Saurida*¹⁰⁴ the taxpayer paid various amounts of funds to its employees disguised as payment for the rent of their personal vehicles. The Court found that the company had 28 own vehicles and most of them were not fully used during relevant periods, so renting additional ones was not economically rational. According to the agreements with the vehicle owners, they were supposed to provide driving services as well. However, it was established that the company paid for the use of vehicles and driving services even during those periods when the employees were actually sick or on vacation. The Court concluded that the payments were actually salaries paid to the employees of the taxpayer. Very similar situation and the same conclusion was in *MV Trading*¹⁰⁵ case, where the taxpayer allegedly rented vehicles from its employees. Once the Court established that several witnesses confirmed that the cars were actually never used for the business of the taxpayer, it was an easy decision to make.

In *Saerimner*¹⁰⁶ the taxpayer also concluded service providing agreements with its employees and tried paying out part of their salaries in such way. The Court ruled against the taxpayer and found that service agreements should be disregarded since the service providers were indeed not independent, they were providing services to the taxpayer only or its subsidiaries. The Court also noted that services provided under the contracts were analogous to the job functions of the same persons as employees. It was also established that payments for the services were paid on monthly basis at the same intervals as the salaries and the services were being provided on a long term basis. The analogous nature of services provided by the services agreements and labour contracts was the most important aspect in reaching the Court's decision. The Court was careful enough to note that lack of independence was not a decisive factor and should not be the basis for disregarding the services agreements in itself.

ix. Application of Art. 69 of the LTA in relation to the tax agents

The principle of *Nauduva*¹⁰⁷ was later applied in *J.A.P.*¹⁰⁸ case but in a rather strange way. The taxpayer – private individual – had a preliminary agreement with

104 Decision of 05-03-2013 in case No. A556-404/2013 SAC

105 Decision of 05-12-2012 in case No. A438-2830/2012 SAC

106 Decision of 28-06-2012 in case No. A602-164/2012 SAC

107 Decision of 12-04-2010 in case No. A-438-359/2010 SAC

108 Decision of 22-09-2010 in case No. A442 - 965/2010 SAC

a seller of the newly built house. The price of the house was LTL 240'000. However, later on upon completion of the construction of the house the parties concluded the main sale-purchase agreement and lowered the price to LTL 150'000 citing certain additional construction works as not being made by the seller. The Tax Authority concluded that the real value of the house was still LTL 240'000 and the buyer has received income in kind, amounting to the price difference. The State Tax Inspectorate assessed additional payable Personal Income Tax from the taxpayer. The taxpayer argued that since the income in kind is considered type A income and it was received from the seller (legal entity) it is the tax agent who has an obligation to pay the additionally assessed taxes on behalf of the taxpayer. The Case ruled that even though the Tax Authority has not relied on Art. 69 of the LTA in the current tax dispute it has nevertheless actually applied it. Citing *Nauduva*¹⁰⁹ the Court concluded that since Art. 69 of the LTA was applied the Tax Authority obtained a right to demand unpaid tax from the recipient of income - J.A.P. The author can see at least two flaws in the argumentation of the Court. Firstly, the Tax Authority has not raised any arguments in relation to Art. 69 of the LTA during the proceedings. The Court (whose ruling is not subject to the appeal) cannot use this argument by itself. Using the argument the Court effectively deprived the taxpayer from the right to the defence¹¹⁰ and due process since the taxpayer could not have prepared a defence against the argument, which was not raised in the proceedings. Secondly, the same Court has found on various occasions that Art. 69 of the LTA can be applied only when a tax motive is established in the actions of the taxpayer. This has been explicitly stated in *Nauduva*¹¹¹ ruling on which the Court relied here in *J.A.P.* However, the Court did not establish any tax motive in the actions of the taxpayer. There could not even be such a motive because the taxpayer as a seller only worsened his tax position by reducing the tax basis of the purchased property and will have to pay more tax upon the sale later on. Therefore, the author believes application of Art. 69 of the LTA in relation to the taxpayer (a buyer) was not well grounded.

F. Conclusions

Art. 10 of the LTA as a general provision of substance over form principle is being applied in various types of cases. Since it cannot create any tax obligations

109 Decision of 12-04-2010 in case No. A-438-359/2010 SAC

110 A right to defence is included in Article 5 of the Law on the Administrative Proceedings, which is applicable to all the disputes heard in the administrative courts. It is also a general constitutional principle, which has been recognized by the same Supreme Administrative Court on various occasions and even labelled as fundamental principle of human rights, enshrined in the Constitution and ECHR (e.g. Decision of 08-05-2013 in case No. AS-492-258-13 SAC).

111 Decision of 12-04-2010 in case No. A-438-359/2010 SAC

itself this provision must be accompanied by another article of specific tax law to impose taxes.

One very clear trend in this type of cases is that in the absolute majority of cases the Tax Authority wins. The Court unilaterally changed argumentation and legal basis relied by the Tax Authority on several occasions and therefore breached the taxpayers' rights to a due process and effective defence. There is no explanation in the Court's jurisprudence on whether the tax motive should be the main or the only one in order to apply Art. 69 of the LTA.

The fact that the taxpayer starts acting in a way corresponding to the form of his transactions but begins doing it only after the tax investigation is underway, will not be taken into consideration by the Court.

V. STEP TRANSACTIONS

A. Origin of step transactions doctrine

Step transactions doctrine is mostly used together with the substance over form. It is an anti-avoidance doctrine developed by the courts under which a transaction consisting of several "steps" is viewed in its entirety in determining the tax treatment. Economically meaningless steps are collapsed or ignored and the tax treatment is applied to the resulting transaction. In effect, the tax treatment follows the ultimate result of the steps rather than the results of each separate transaction.¹¹²

In the US the step transaction doctrine is generally used by the courts to disregard interconnected steps that have no significance for tax purposes by consolidating these into a single transaction.¹¹³ It was created in *McDonald's Restaurant*¹¹⁴ case as a direct consequence of the *Gregory v Helvering*¹¹⁵ ruling.

In the UK in *Furniss v Dawson*¹¹⁶ Lord Fraser of Tulleybelton, while explaining the meaning of the already mentioned *Ramsay*¹¹⁷ case, stated that the true principle

112 IBFD Glossary 'Step transaction (e.g. Canada; US)'

113 Christine Alves Alvarrenga 'Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?' Bulletin for International Taxation, 2013 (Volume 67), No. 7, IBFD

114 *McDonald's Restaurants of Illinois, Inc. v Commissioner* 688 F.2d 520 (7th Cir. 1982).

115 *Gregory v Helvering* 293 U.S. 465 (1935)

116 *Furniss v Dawson* [1984] A.C. 474, 512

117 *WT Ramsay Ltd. v Inland Revenue Commissioners* [1982] A.C. 300

of that decision was that the fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately.

Later on in *Craven v White*¹¹⁸ the Court dealt with a situation where separate transactions took place at significant time gaps and even involved a change of initial plans. Lord Jauncey suggested that the taxpayers could escape application of step transactions doctrine if they prepared better.¹¹⁹

B. Step transactions in Lithuanian case-law

Under the Law on Personal Income Tax, gifts between parents and children are not taxable. Also, a tax basis of a property received as a gift equals the value indicated in the gift agreement. Taxpayers often tried to take advantage of those provisions and the Tax Authority could only invoke step transactions doctrine to deal with such attempts.

In *G.M.*¹²⁰ case several transactions took place: [A] The taxpayer and her sister received a right to restore ownership rights into a land plot, which previously belonged to their parents and was nationalized during Soviet occupation. [B] The taxpayer refused to restore property rights into the land plot and allowed her sister to become a sole owner of the plot. [C] The taxpayer's sister sold a land plot to the taxpayer's son and his wife for LTL 5'000, which corresponded to actual expenses incurred during restoration of ownership rights. [D] The taxpayer's son and his wife concluded an agreement separating their property, obtained in marriage and the son became a sole owner of the land plot. [E] Several days later the taxpayer's son gave the land plot as a gift to his mother – the taxpayer and indicated the gift's value as a real market value of the land plot (LTL 250'000). Since gifts from children to their parent were not taxable, they realized a value appreciation tax-free. [F] A week later the taxpayer sold the land plot to the developer for the same LTL 250'000 without earning any profit on the sale since her tax basis was LTL 250'000. The Court concluded that the only purpose of the gift to the taxpayer was to obtain a tax advantage by artificially creating a high tax basis before selling the land plot to the developer. The timing of the transactions triggered application of the step transactions doctrine. The Court did not accept the taxpayer's argument that she had rights into this property at the very beginning, it stated that when the

118 *Craven (Inspector of Taxes) Appellant v White (Stephen) Respondent*, House of Lords [1989] A.C. 398

119 Victor Thuronyi 'Comparative Tax Law' 2003 Kluwer Law International, p. 177-178

120 Decision of 23-06-2005 in case No. A6-741-05 SAC

taxpayer forego the right to restore ownership for the benefit of her sister she lost any rights into it irrevocably.

In *G.O.*¹²¹ a taxpayer's daughter purchased a land plot for LTL 5'000 and almost a year later gave it as a gift to the taxpayer. The value of the land plot was indicated as LTL 490'000. Two days later the taxpayer sold the land to the real estate company for the same price. The Court ruled that the tax basis should be LTL 5'000 since the step transactions doctrine should be applied. The gift transaction was concluded with a sole purpose to obtain a tax advantage. Additional circumstances supported such findings. The money from the developer was actually transferred directly to the daughters account. On the same day the taxpayer received a gift she also issued a power of attorney allowing her daughter to take any actions whatsoever regarding the land plot including a right to sell it. The daughter has also been conducting negotiations with the final buyer even before the gift agreement was concluded.

In *Antarija*¹²² case the taxpayer's father bought a vehicle for LTL 27'000 and two months later gave it as a gift to the taxpayer with indicated value of LTL 57'000. The next day the taxpayer sold it for LTL 57'000 to an associated entity - UAB Antarija. The Court concluded that the timing of the transactions allows application of Art. 69 of the LTA. There was also no evidence that the value of the car could have been increased during those two months by any additional investments into it. It was declared that the sole purpose of the gift transaction was to artificially increase tax basis before selling it to the company. The taxpayer also helped Tax Authority when admitted that the sale of the car was being planned even before he received a gift.

Quite similar situations and reasoning of the Court appeared in *V.B.*,¹²³ *I.I.*,¹²⁴ *R.M. & V.M.*¹²⁵ and *S.K.*¹²⁶ cases.

In *R. A. P.*¹²⁷ case the taxpayer's son bought a land plot at a small price, gave it to the taxpayer as a gift with a value equal to a market price. On the same day the taxpayer concluded a preliminary agreement with a real estate developer and 12 days later sold it at a market price. The Court upheld the position of the Tax

121 Decision of 13-09-2005 in case No. A10 – 1019/2005 SAC

122 Decision of 28-02-2006 in case No. A10-846-06 SAC

123 Decision of 17-07-2007 in case No. A11 – 719/2007 SAC

124 Decision of 20-02-2008 in case No. A556 - 250/2008 SAC

125 Decision of 30-04-2009 in case No. A442 - 499/2009 SAC

126 Decision of 11-10-2010 in case No. A-438-1126/2010 SAC

127 Decision of 20-04-2009 in case No. A-438-493/2009 SAC

Authority that Art. 69 of the LTA should be applied, timing of the transactions was crucial. No other purpose of the gift could be established. The taxpayer also argued that the tax benefit and the tax motive could be established only in the actions of the taxpayer's son, not the taxpayer. Unfortunately, the Court completely ignored this argument.

In *R.S.*¹²⁸ the taxpayer again gave away land plots as gifts to his close relatives who afterwards sold them to third parties rather quickly. As in previous cases the value of the gifts was close to the market value and tax basis was increased before the property was sold to the final buyers. The taxpayer tried arguing that he had previously lent some funds from his mother and that is why he gave her several plots as a gift afterwards and that should be construed as debt repayment. The Court did not accept this argument because the loan agreement was not provided to the Tax Authority upon initial stages of investigation and tax dispute. Later resurfacing of the agreement raised suspicions to the Court.

In *S.G.*¹²⁹ the taxpayer received a land plot as a gift from his parents and three days later sold it to a third person. The value of a gift again was same as the sale price. The Court applied step transaction doctrine. The decision was based on two circumstances, firstly, the buyer confirmed that he had known about the upcoming sale several months before the taxpayer got it as a gift, so the prearranged nature of the transaction was proven. Secondly, the taxpayer argued that the land plot was given to him as financial support from his parents. However, he could not provide sufficient evidence to show where did he spent the received sale proceeds. This indicates that the Court could have accepted this argument if it was supported by some objective evidence.

A certain breakthrough was reached in *R.U.*¹³⁰ case. There, as usual, the taxpayer gave several land plots as gifts to his parents, who sold them to the third parties 1-3 months later. The Court applied step transaction doctrine and did not accept the taxpayer's argument that the main purpose of the gift transactions was to support his elderly parents. Tax Authority also proved that the taxpayer himself was actively involved in selling those land plots on behalf of his parents. However, the important issue is that the Court ruled that the taxpayer, not his parents, received a tax benefit and all the income from the sale of those land plots should be attributed to the taxpayer while his parents have a right to request a refund of any taxes they paid on those sales. The same principle was approved in another later case – *Ipsa facto*.¹³¹

128 Decision of 17-03-2010 in case No. A556 – 735/2010 SAC

129 Decision of 15-04-2010 in case No. A442 - 611/2010 SAC

130 Decision of 19-04-2010 in case No. A438-481/2010 SAC

131 Decision of 23-01-2012 in case No. A438-89/2012 SAC

In *R.K.*¹³² the taxpayer received a farming land plot as a gift from his neighbour, then changed its purpose to residential and divided it into smaller plots. Two of the plots he sold himself while the remaining 11 plots gave away as gifts to his close relatives, who either sold them to third parties directly or gave away as gifts to their close relatives and then they sold the plots to final buyers. The land plots were sold in a period of 17 months. The Tax Authority applied step transaction doctrine and considered all sales as being made by the taxpayer. The taxpayer argued that the purpose of his gifts was to allow his closest relatives to live together in one neighbourhood. This was rebutted by the fact that those relatives transferred received land plots to other persons rather quickly. The Court also noted that the initial owner of the land plots (the taxpayer's neighbour and a close friend) began depositing significant amounts of cash into his bank accounts, buying new cars and real estate at the time the sales of those land plots took place. This indicated that the taxpayer might have been cooperating with his neighbour in the whole scheme.

In *Antiques*¹³³ the taxpayer's sister sold some high valued property and gave all the sale proceeds to her mother as a gift. Five days later the taxpayer's mother gave the same amount of money as a gift to the taxpayer. That way they tried to avoid a direct gift between siblings, which was taxable as opposed to non-taxable gifts between children and their parents. The Court reiterated previous case-law and stated that there is no prohibition to conclude such transactions unless their only purpose is to obtain a tax benefit of some kind. The taxpayer tried to argue that the purpose of a gift to his mother was to support her. The arguments was not accepted because the taxpayer's sister while giving her initial explanations to the Tax Authority has confirmed that she knew from the very beginning that the money will be given to the taxpayer later on. This was supported by the fact that the funds were actually transferred directly from the sister's bank account to the taxpayer. Interestingly enough the taxpayer's sister also explained to the Tax Authority that the idea to interpose another transaction was given by the notary public as a way of saving some taxes.

VI. CONCLUSIONS

This article is currently the most comprehensive review of Lithuanian case law dealing with anti-tax avoidance measures. Actually, there is hardly any academic work on this issue. This may be the reason why there is so much inconsistency in the case law of the Supreme Administrative Court of Lithuania when dealing with

132 Decision of 27-09-2012 in case No. A438-1715/2012 SAC

133 Decision of 04-02-2011 in case No. A-438-201/2011 SAC

tax issues. This problem has been admitted by the head of the mentioned court in a recent tax conference in Vilnius, Lithuania.¹³⁴

Even though there is a variety of anti avoidance provisions in Lithuanian legislation most of the case law deals with application of substance over form principle as well step transaction doctrine. There are some cases on transfer pricing provisions and almost none dealing with thin capitalization and CFC rules. The reasoning of the Court in step transaction cases could be criticized. The Court relies on Art. 69 of the LTA when applying substance over form principle as well as step transaction. The same Court has ruled on many occasions that the tax purpose needs to be established for Art. 69 of the LTA to apply. However, in many earlier cases there were no tax motives in the actions of the taxpayers under investigation. They were just participants in the middle transactions where they usually received gifts valued at a fair market value and sold them without any profit or tax benefit again at the market price. The Court nevertheless used to conclude that Art. 69 of the LTA is applicable for such taxpayers. This practice began to change in 2010 where the Court finally admitted that such intermediaries neither obtain any tax benefit nor earn any profit and Art. 69 of the LTA should not be applied in their assessments. It remains to be seen whether the Court will maintain this line of reasoning.

The Court will apply step transaction doctrine if the Tax Authority proves that the initial and the final owners of the property had some contacts before the middle transactions took place. If they negotiated a final result before undertaking the middle transactions the taxpayer's chances of winning the case become very small. A possible defence for taxpayers could be to provide evidence that the sale proceeds from the final sale were used by the person participating in the middle transactions. Consequently, if the Tax Authority prove that the money were transferred from the final buyer to the initial owner it will be considered an evidence of the pre-arranged artificial transactions.

There are no defined time periods, which would make step transaction doctrine not applicable. A gap of several months between the transactions will definitely be considered as short. In one case 17 months period for a more than a dozen transactions was considered as an evidence of pre-arranged result.

The step transaction approach of Lithuanian Court corresponds to the position of the CJEU regarding wholly artificial arrangements as described in *Cadbury Schweppes*¹³⁵. The CJEU stated that in order for a restriction to be justified on the

134 International scientific-practical conference 'Tax mitigation: pursuit of effectiveness or abuse of law' Vilnius 16-17 May 2013

135 Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, para 55.

ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.

The Court often applies business purpose and economic substance doctrines alongside substance over form without making explicit reference to any legal sources but interpreting them as general principles of law.

Analysis of the case law applying substance over form principle reveals other inconsistencies in the Court's analysis. Firstly, in dealing with VAT cases the Court relies on the principles established in the case law of the CJEU but expands its application with dire consequences for the taxpayers. In the case law of the CJEU, on which Lithuanian Court relies, only fraudulent or abusive non-payment of VAT by the seller is relevant when considering the buyer's right to deduct input VAT. Therefore, according to the CJEU when the seller fails to pay VAT due some objective reasons without any fraud or abuse the buyer should retain its right of deduction. Lithuanian Supreme Administrative Court however expanded this rule and applies it even in such cases when the seller could not pay it due to objective reasons, such as a dire financial situation. It is probably just a matter of time until some taxpayer will request the Court to refer the issue to the CJEU.

Secondly, in direct tax cases there is also a lack of consistency in the Court's reasoning on when Art. 69 of the LTA should be applied. Whether substance over form principle can be applied when it is established that the only purpose of the taxpayer's transaction was to obtain a tax benefit, or is it enough that a tax motive is the main but not the only one. So far there is still no answer to that question.

In all types of cases there is a clear and well established principle that the Court will ignore evidence, e.g. contracts, which are provided by the taxpayers at the final stages of the tax dispute. Unless taxpayers can prove that there was an objective reason why the evidence was not produced earlier it will not help their case. This approach could also be criticized because if the Court suspects that the documents were forged it should refer the matter to other institutions dealing with such issues. However, if the Court does not suspect forgery it should take the evidence into consideration.

Some cases involved serious breach of the taxpayers' right to a due process when the Court acted as an advocate of the State Tax Inspectorate by re-characterizing their arguments and applying new legal basis, which were not raised by the Tax Authority at any previous stage of the dispute. This prevents taxpayers from preparing a reasonable defence because they cannot and should not provide arguments against the accusations not raised by the other party. There is also a

universal right to the appeal which is breached if new arguments are raised at the court of last instance whose decision are not subject to any appeal.

In one case, acting on a bad advice of a state official – public notary did not help the taxpayer and did not influence the Court’s ruling in any way because tax advice is not the function of a notary and the taxpayers should be very careful in seeking advice from such officials.

The main advice for the taxpayers should be to ensure that all their transactions have substance otherwise winning a case becomes very complicated.