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The Doctrine of “ Substance over form “ in Economic Relations

Abstract. The article discusses issues of application of the doctrine of “ Substance over form” in the legislation and judicial practices of England, the USA, Asian and continental European states. Special attention is paid to the development of the mentioned doctrine in Georgia

Key words: “ Substance over form “ doctrine, doctrine of business purpose, doctrine of economic substance, conductor companies

The principle of freedom of contract/agreement (Article 319 of the Civil Code of Georgia) gives private law entities the opportunity to freely enter into contracts within the legal framework and determine the content of those contracts. They can enter into agreements that are not provided for by the law, but do not contradict it.

The form of an agreement has a significant impact on the tax obligations of the parties. The form of an agreement gives taxpayers almost unlimited opportunities to manipulate tax contributions. Entities of entrepreneurial activity strive to maximize profit, including - at the expense of tax reduction, which leads to serious losses of budget tax revenues.

In order to avoid the negative consequences of such manipulations, states create certain restrictions in the tax field in relation to the use of the civil legal form. One such limitation is based on the Anglo-American judicial doctrine of “substance over form”. Let us consider how it was formed in different legal systems, including in Georgia.

At the beginning of the 20th century, in the Anglo-American legal system, the principle of priority of form over content was utilized. According to this principle, tax consequences were determined by the form of relationship chosen by the taxpayer.

For example, *Duke Westminster v. IRS* (1936) case, the House of Lords held that the taxpayer had every right to choose the form of relationship and thereby influence the amount of tax liability.¹ The essence of the case was as follows: the Duke of Westminster had a hired gardener, to whom he paid £1 a week. In addition, he gave the gardener an additional £2 per week. At that particular time, the standard wage of a gardener was £3 a week. According to the current legislation, a person had to pay a special insurance tax on the income given in the form of a salary, while a gift was not subject to a special tax. The tax authority argued in court that the duke was actually paying the gardener a salary under the guise of regular gifts in order to avoid special taxes. The court did not take into account the arguments of the tax authority and the decision was made in favor of the taxpayer.

The mentioned approach, which is also called “textualism”, implies the interpretation of the tax law literally, with exact correspondence to the text.²

Later, the tax authorities and courts realized that the mentioned approach caused serious violations in the tax field, the principle was changed and the approach went beyond the scope of "textualism".

The attitude of English judges towards the doctrine of "substance over form" changed much later. *Furniss v. Dowson's* case (1982) points out that tax consequences are determined by the content of the relationship, not its form. In the United Kingdom, the doctrine of "substance over form" has also formed the basis for cases such as *IRC v. Burmah Oil Co* (1982) and *W.T. Ramsay Ltd. v. IRC* (1982) .

In the United States, the doctrine of "substance over form" has formed the basis of cases such as *US v. Oregon-Washington Railroad & Navigation Co.* (1918), *Gregory v. Helvering* (1935), *Helvering v. F & R Lazarus & Co.* (1939), *Comm'r v. Court Holding Co.* (1945) . The decisions of the US Supreme Court (Supreme Court of the United States) state that tax authorities are not obliged to take into account the officially concluded and documented agreements between the parties, and they have full right to evaluate the content and reality of the transaction/operation. The doctrine of "substance over form" was enunciated by the US Supreme Court in *Gregory v. In the Helvering Case* (1935)³. The case was as follows: the tax-paying individual (Mrs. Evelyn Gregor) purchased the company's shares through the formal reorganization of enterprises in order to avoid the tax imposed on the dividend. As a result, the taxpayer benefited from the current legislation on corporate reorganization and was exempted from taxation. The court found that the reorganization was legally valid, although it intended to exempt Mrs. Gregory from paying dividends. According to the court's decision, the form was so different from the content that it could not be used to determine tax obligations. The court reclassified the transaction carried out for tax purposes as the sale of shares without taking into account the reorganization process, as a result of which Ms. Evelyn Gregori's tax liability arose.

Although the doctrine of "substance over form" is an effective means of combating tax evasion in the US, according to American lawyers, it is a "deadly weapon in the hands of tax authorities". It is also worth noting that the doctrine of "substance over form" has not been the subject of discussion in the US Supreme Court since 1986, which may indicate the lack of unequivocal support of the doctrine in the judicial system.⁴

Despite the importance of the doctrine, its application to protect the rights of taxpayers has certain limitations. By virtue of the first limitation, the form of the transaction cannot be ignored if the operation changed the economic position of the parties and/or the transaction had a business purpose.⁵

In case the operation brought economic benefits to the taxpayer other than tax benefits, the form of the transaction cannot be ignored for tax purposes. Accordingly, it is permissible to ignore the form of the transaction for tax purposes, if the transaction did not change the economic situation of the parties (doctrine of economic essence). Ignoring the form of the transaction is not allowed even if the parties to the transaction were driven by the goal of obtaining non-tax profit (doctrine of business purpose).

Thus, if applying the doctrine of economic essence we determine the objective indicators of the

³ U.S. Supreme Court, *Gregory v. Helvering*, 293 U.S. 465 (1935). source: <https://supreme.justia.com/cases/federal/us/293/465/>

⁴ Allen D. Madison. *The Tension Between Textualism and Substance Over Form Doctrines in Tax Law*// Santa Clara Law Review. 2003. Vol. 43. P. 702.

⁵ see.: Yoram Keinan. *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, Akron Tax Journal. 2007. P. 53. source: <https://www.uakron.edu/law/lawreview/taxjournal/atj22/docs/keinant22.pdf>

transaction (usually the financial result), the doctrine of business purpose establishes the subjective indicator - the intention of the taxpayer.

Ignoring the form of the relationship is not allowed if any condition (objective or subjective) is met, although there are precedents that require both conditions to be met. In the event that none of the restrictions yielded a positive result, the tax authority has the right to change the tax liability depending on the content of the relationship, ignoring its form.

By virtue of the second limitation, content is used only if the form is demonstrably different from the content of the operation. This issue is an evaluative one. As a rule, the relationship must be so artificially disguised that the form loses all reasonable meaning(s). In the event that the chain of transactions consists of artificially created links, all links are focused on receiving tax benefits and individually they do not have independent value, the court usually considers the set of links as one transaction.

Finally, by virtue of the third limitation, the doctrine applies only if the form of the transaction provides an opportunity to receive a tax benefit that the person would not have received if the substance had been complied with. Thus, the doctrine can be applied only if the form of the transaction provides only or mainly the opportunity to receive tax benefits, which the person would not have received according to the actual content.

In the Gregory case cited above, the court held that the distribution of the dividend gave rise to a tax liability, although taxation was avoided through the use of reorganization procedures.

American courts do not apply the doctrine of “substance over form” to fictitious transactions. In similar situations, American courts use the sham transaction doctrine⁶.

In order to fight against the unjustified use of tax benefits provided by treaties on the avoidance of double taxation, a variety of the doctrine often discussed in the common law system - the beneficial owner, or, as it is called in the USA, anti-conduit rule (anti-conduit rule)⁷ is used.

According to the mentioned rules, the tax relief (lower tax rate for taxation at the source of income) provided for in the double taxation agreement is not applicable if the legal (formal) recipient of the income is not its actual recipient, that is, he/she does not have the right to dispose of the income at his own discretion, is devoid of substance and transfers the received income to another person (represents a transit ring - conductor).

The courts of the United States have repeatedly considered disputes of the mentioned category. In addition, the main issue was to determine the essence of the transit ring. American jurisprudence recognizes the essence of a transit company, if even an insignificant part of the income remains at its disposal. For example, in the Northern Industries case, the transit company kept 1% of the funds going to it at its disposal, which was enough for the court to recognize it as the actual recipient of the income. In cases where all the received income is transferred to another person, the courts share the position of the tax authorities (for example, the Aiken case)⁸.

In addition to receiving a share of the profits, the criterion for the existence of a transit company

⁶ Mahoney v. Commissioner, 808 F.2d 1219, 1220 (6th Cir. 1987). ინტერნეტ რესურსი: <https://casetext.com/case/mahoney-v-cir>

⁷ see. P.C. Фатхутдинов, Доктрина бенефициарного владельца в налоговых отношениях //Налоговед. 2011. № 2. С. 45–53. source: <https://nalogoved.ru/art/210.html>

⁸ see. А.В. Фокин, Каскадные роялти: понятие и проблемы налогообложения (на примере США) // Налоги. 2009. № 1 (Мудрый Экономист). source: <https://wiseeconomist.ru/poleznoe/56937-kaskadnye-royalti-ponyatie-problemy-nalogooblozheniya-primere-ssha>

is the existence of connections with other companies. This criterion of SDI or the so-called case of Cascading Royalties, license fees (royalties) were paid as income through the transit company. The tax authorities tried to recognize the mentioned company as a conduit and refuse to apply the minimum rate of tax at the source of payment provided by the agreement on avoidance of double taxation. The essence of the cascading royalty case was this: royalties from SDI USA, Inc. (the payer) were paid to SDI Netherlands B.V. (the transit company), and from SDI Netherlands B.V. to the ultimate recipient - SDI Bermuda Ltd (the actual beneficiary of the proceeds).

In the mentioned case, the US Tax Court found that SDI Netherlands B.V. had substance, as it received income not only from the US, but also from other jurisdictions (France, Germany, Great Britain). In addition, the terms of the license and sublicense agreements differed from each other, which allowed SDI Netherlands B.V. to make a profit from the activity (indicated the presence of substance).

The Indofood precedent has direct application in Australia (the Myer case) and other common law countries.

Therefore, the doctrine of "substance over form" is a key tool in the fight against tax evasion in the common law system, although it has serious limitations. The doctrine is applied only if the form lacks a business purpose or economic substance, the chain of transactions consists of artificially created, individually devoid links, or if the form of the transaction provides an opportunity to receive tax benefits, which a person would not receive if it were consistent with the content.

There is no unified position in European countries regarding the mentioned doctrine. In some European states, for example, in Latvia, this doctrine is reflected in the legislation.⁹ On the contrary, rather liberal standards of protection of the interests of taxpayers have been adopted in Belgium, and rules of priority of the form over the content are applied. However, the form implies a real legal component (and not an economic one). If the form is created to cover another transaction or without the intention of creating legal consequences, then the actual legal form is used.¹⁰

Following the common law system, in the continental legal system, including the European Union Court of Justice (hereinafter - ECJ), the tendency to use the doctrine in the cases of tax evasion (abuse of rights) is clearly visible. One of the most high-profile cases in which it has been used is the „Halifax plc“ case. On February 21, 2006, in case C-255/02 Halifax plc¹¹, the Court of Justice of the European Union ruled that the form was significantly different from the content and, therefore, it could not be used to determine tax obligations.

The circumstances of the case were as follows: Due to the limitations set by the UK tax law, the finance company (Halifax) could only deduct a small part of the VAT paid. The construction cost of the business center included a taxable amount of approximately \$10 million. The company handed over the business center construction project to its subsidiary (Co.A). In turn, the subsidiary company (Co.A) commissioned the construction works to another subsidiary company (Co.B) of the Halifax Co. Both Halifax subsidiaries (both Co.A and Co.B) reduced the amount of VAT payable by the amount of VAT directly attributable to the cost of various components of the construction of the business centre. The built

9 J. Bernatonis, *The Doctrine of Substance over Form in Lithuanian Tax Law // European Taxation*. 2007. April. P. 187.

10 D. Garabedian *Belgian Report in: Form and Substance in Tax Law, Cahier de Droit Fiscal International*. Vol. LXXX-VIIa. Kluwer Law International, 2002. P. 153–173.

11 ECJ, *Halifax plc and Others v Commissioners of Customs & Excise* <https://curia.europa.eu/juris/liste.jsf?language=en&num=C-255/02>

business center was transferred (without VAT) to a third subsidiary of Halifax (Co.C), which leased the building to Halifax. The transfer and subsequent leasing of the business center to Co.C was not subject to VAT. As a result, the entire amount of VAT directly attributable to the cost of various components of the construction of the business center was received/counted.

Applying the business purpose doctrine, the court concluded that the sole purpose of Co.B and Co.C in this case was to avoid VAT. The court also noted that Co.B did not in fact provide services to Halifax (as independent contractors did), giving rise to the application of the doctrine of priority of content over form (paragraphs 76, 77 of the judgment).

Thus, following in the footsteps of the common law system, the tendency of the doctrine in question to be widely used in the fight against tax evasion in the continental legal system is clearly visible.

The doctrine of “substance over form” is widely used in China as well. According to Circular No. 601 of 2009, a transit company is not the beneficial owner of the income if it has no substance. In addition, it is considered that a transit company has no essence if it transfers a part of its income (60% or more) to its shareholders, does not carry out any other activity except for the right to receive income (investment holding), and its effective tax rate is zero.¹²

The doctrine of “substance over form” is also actively used in Japanese judicial practice. If the Japanese tax authorities prove that the conductor company is insolvent, it is considered that the form of structuring of the financing does not correspond to the content of the operation. In addition, the essence implies the connection of the company with the state, in particular, it should be managed by local directors, the meetings of the board of directors should be held in Japan, the income should be deposited in local accounts and subsequently, the income should not be deposited in a third country.

In India, on the contrary, there are several precedents that recognize the priority of form over substance, including that the benefit of double taxation treaties is permissible for a transit company. In particular, in the *Azadi Bachao Andolan* case (2003), the court confirmed the legality of the transit company’s use of tax relief, since the said company was established in accordance with the national legislation of the transit state.¹³ The same position is confirmed in the cases of *e-Trade Mauritius Limited* (2010) and *Satellite Television Asia Region Advertising Sales* (2010).¹⁴ However, it is important to note that India’s national legislation is undergoing changes: changes are planned to combat tax evasion, and the company legislation is also changing, reflecting the concept of beneficial owner.

Thus, after the United States, England and European countries, the doctrine of “substance over form” is actively introduced into the legislations and practices of the Asian region, which reflects the general tendency of tax authorities to fight against tax violations.

The Organization for Economic Cooperation and Development (hereinafter OECD) generalized the established rules for combating tax violations. The OECD considers that the doctrine of “substance over form” applies to any relationship, regardless of their civil law characteristics. OECD considers the doctrine in question as an effective means of combating tax violations.

The Commentary on the OECD Model Convention states that the doctrine of “substance over form” can be used in conjunction with the doctrine of business purpose: a tax offense will occur if the

12 Based on www.pwccn.com. Materials.

13 *Azadi Bachao Andolan*, 263 ITR 706 (2003). source: <https://itatonline.org/digest/uo-i-v-azadi-bachao-andolan-2003-263-itr-706-132-taxman-373-184-ctr-450-sc/>

14 *e-Trade Mauritius Limited* case, 324 ITR 1 (2010), *Satellite Television Asia Region Advertising Sales*, ITA No. 1840/Mum/04 (2010).

civil law construction (form) by the taxpayer is solely or mainly provided for by treaties on the avoidance of double taxation in order to take advantage of tax benefits.¹⁵

The doctrine of "substance over form" is most often applied to structures in which transit companies participate and are not the beneficial owners of the revenue generated. Commentaries on the OECD Model Convention point out that the transit company's use of the tax advantages granted by the treaty on the avoidance of double taxation is contradicts the objectives of the treaty.¹⁶

According to the comments of the OECD model convention, a person who has the right to use and enjoy the received income is considered a beneficial owner. The recipient of the income is not the owner of the income, if he/she has the obligation to transfer the income to another person (for example, to shareholders). In addition, the mentioned obligation can be derived directly from the documents or can be defined on the basis of facts and circumstances.

Accordingly, if the recipient acts as an agent, nominee or transit company, in this case, it is clear that he/she is not the owner of the income. That is why it will not be right for him/her to take advantage of the benefits provided by the agreement on avoidance of double taxation.¹⁷

In Georgia, the form of relations has an essential meaning for legal and first of all, civil relations: in accordance with the general rule, civil legislation recognizes the form of relations that the parties have chosen. At the same time, the transaction is invalid, if it is concluded without the intention that it will have corresponding legal consequences (sham transaction) or if the parties with the concluded transaction want to cover another transaction (false transaction).

The discussed doctrine was gradually developed in Georgia. At the initial stage of the development of the national taxation system, the tax consequences were mainly defined in the form of relations. At the beginning of the 90s of the XX century, the principle of priority of form over the substance was used and the fight against tax offenses was limited to ineffective changes in the legislation. In order to reduce the tax burden, taxpayers mainly used artificial transactions and tax violations were massive in nature. It was necessary to develop universal means to prevent tax violations. As a result, the principle of priority of substance over form was reflected in the Tax Code of Georgia on December 22, 2004, which came into effect on January 1, 2005.

According to Article 73 of the Tax Code of Georgia, Part 9, subsection "b", for the purpose of determining the tax liability, the tax authority has the right to change the qualification of an economic operation, taking into account the form and substance, if the form of the operation does not correspond to its substance.

The mentioned norm is based on the doctrine of priority of substance over form. According to Article 73 of the Tax Code of Georgia, Part 9, subsection "B", the tax consequences of a transaction or operation are determined by the substance of the actual relations between the parties, and its form is not taken into account if it does not correspond to the actual relations between the parties.

By virtue of Article 73, Part 9, Sub-Clause "b" of the Tax Code of Georgia, the taxpayer is obliged to reflect the transaction or operation in the accounting and tax accounting documents based on its economic substance. In case of non-fulfillment of the said requirement, the tax authority has the right

¹⁵ see.: para 9.5 of the OECD Commentary on article 1 of the Model Tax Convention on Income and Capital (Condensed version) - OECD Publications, (23 2010 08 1 P) ISBN 978-92-64-08948-8 - No. 57501 2010.

¹⁶ об.: para 12.4 of the Discussion Draft «Clarification of the Meaning of «Beneficial Owner» in the OECD Model Tax Convention // www.oecd.org.

¹⁷ see also, April 12, 2011 report on amendments to the OECD Model Convention Commentary: www.oecd.org.

to use the real economic substance of the transaction or operation to determine the tax consequences, that is, the tax authority has the right to change the legal qualification of the transaction or operation carried out by the taxpayer for taxation purposes, if the form of the transaction or operation does not correspond to its substance.

If the court, based on the assessment of the evidence presented by the tax authority and the taxpayer, comes to the conclusion that the economic operation of the taxpayer for tax purposes is not reflected in the accounting and tax accounting documents in accordance with its real economic substance, it determines the scope of the tax liability of the taxpayer, the relevant transaction or considering the true economic substance of the operation.

By means of the norm in question, tax authorities can also effectively identify sham and false transactions, apply the real economic substance to the tax consequences of invalid transactions (sham and false transaction) and determine tax liabilities based on the real economic substance of the relevant transaction or operation.

In the practice of reducing the tax burden, there are still frequent cases when taxpayers do not sign labor contracts with employees and enter into civil law contracts for labor or service provision with individual entrepreneurs with the status of a small business. Taxpayers do not calculate income tax, withhold it and transfer it to the appropriate budget from the income of the mentioned persons. Regardless of the form of the contract, the content of these legal relations does not change, and in fact there are labor relations. Accordingly, tax authorities can successfully charge income tax to the taxpayer, even though the person was not formally charged with the function of tax agent at the time of the civil transaction.

Dividing a business to use special taxation regimes, paying in advance instead of a loan, signing tenants as sole proprietors, signing a lease instead of buying and selling, signing a rental agreement instead of a lease agreement - these are just a few examples when taxpayers hide the substance behind the form (of transactions). In all these cases, the doctrine of “substance over form” should be successfully applied.

An example of a taxpayer hiding his or her income behind a form can also be the conclusion of a joint activity (partnership) agreement to cover a lease agreement. One of the participants of the joint activity enters the building into the partnership under the cover of the contribution stipulated by the agreement, although in fact no joint activity is carried out and the other “partner” uses the building exclusively for his/her own business purposes. In this case, the tax authorities have the right to review the tax obligations of the parties based on the essence of the relationship, ignoring their form and be guided by the doctrine of “substance over form”.

The rule of application of Article 73, Part 9, subparagraph “b” of the Tax Code of Georgia is regulated by the methodical instructions approved by the order of the head of the Revenue Service No. 20231 of July 28, 2022, “On changes in the qualifications of economic operations”, which aims to change the qualifications of economic operations carried out by the taxpayer in the case of establishing a unified methodological approach.

According to methodological guidelines, no suspicious economic operation should remain outside the scope of tax audit. In addition, a suspicious economic operation means an economic operation, the

form of which may not correspond to its substance, due to its flawed will/purpose, including an economic operation that is exempted from taxation by the tax legislation of Georgia and/or to which a preferential taxation regime applies, as well as an economic operation , as a result of which tax liabilities did not arise and/or are reduced and/or arise after the expiration of the limitation period.

In order to change the qualification of a suspicious business operation, the tax auditor must go through six mandatory steps. Initially, he must search for a suspicious economic operation and carry out its initial study, in subsequent steps he must describe and analyze the operation, assess its substance, request the taxpayer to submit information and/or accounting documents related to the suspicious economic operation, request information related to the suspicious economic operation from third parties and finally, in the presence of sufficient grounds, carry out changes in the qualification of a suspicious economic operation and sign the results.

The essence of the discussed norm of the Tax Code of Georgia should not be understood as if all cases of inconsistency (deviation) of the form of economic operation with its substance inevitably give rise to the right of the tax authority to change its qualification.

It should be noted, that the mentioned right is not absolute, since the same relations can be presented in a different form. Accordingly, the review of the structure of any legal economic operation by the tax authorities by virtue of the free choice of the form of relationship is not allowed. For example, if a VAT-taxable person orders a foreign general contractor, who is also a VAT-taxable person, to perform certain works and the latter, in turn, assigns the execution of these works to a VAT-taxable Georgian subcontractor, the place of service provision is considered the place where the service recipient is established (Article 162¹ of the Tax Code of Georgia). Based on the content of the relationship, we can conclude that the subcontractor provides services to a person subject to VAT in Georgia, because ultimately it is the latter who is interested in receiving those services. Moreover, we can conclude that the services provided by the subcontractor are subject to VAT taxation in Georgia because the final recipient of the services is based in Georgia. In addition, the form of relations provides that the subcontractor provides services to a foreign general contractor, who is the recipient of those services and therefore, those services are not subject to VAT taxation in Georgia. In the case under consideration, unconditional application of the doctrine of priority of substance over form is unwarranted, since the parties may have non-tax motives for creating such relations, in particular, it is possible that the customer wants the general contractor to act as the organizer of those works and be responsible for the quality of their performance.

When applying the mentioned doctrine, it is advisable to consider and follow the limitations established in the American judicial practice: the doctrine can be used only in cases where the form does not have a business purpose or has not changed the economic situation of the taxpayer. However, in applying the doctrine, the form must be essentially different from the substance, which must be decided in each case, taking into account the specific circumstances.