What Does Economic Substance Mean from an Economic Point of View?

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Abstract. *Every democratic country must ensure a level of living as balanced and efficient as possible, both with regard to the needs and resources of the citizens who are part of this environment, as well as with regard to relations with internal or external partners. Without a harmonization of the economy from a legislative point of view, especially in the field of taxation, domestically and internationally, states allow the possibility of abusive interpretation of economic and fiscal legislation. It is normal for every manager, as well as each state to want a rapid development of managerial decisions, with economic and fiscal indicators over the competition. Practice has shown us that the economy is not held by territorial boundaries and that ways of interpretation will always be sought that are beneficial from the point of view of a strategy, of a business plan. The economic substance of a transaction is, in theory, the same, regardless of the boundaries and legal framework in different jurisdictional systems. It is essential for the legislature to ensure the optimal conditions for economic development with normal and fair competition. This presentation seeks to find correct solutions, collective interpretations of anti-abuse clauses, economic substance in order to efficiently collect taxes and duties owed to the state budget.*

Keywords: abuse of rights, GAAR, legal framework, accounting documents, tax code.

JEL Classification: M41, H26

1. Introduction

At the state level, legislative measures are needed to reduce the abuse of rights and the unlimited ways in which it can founded. The General Anti-Avoidance Rule (GAAR) can be defined as a concept by which the tax authorities of a state can decrease or stop the tax benefits from economic transactions that the legislation in several fields or even in a single field of activity allows under certain conditions and that do not have economic substance. The main purpose for which these transactions take place is that of the tax benefit, apparently legal, that the state-specific legislation provides under certain legal conditions. The appearance of legality is the essence of the financial-accounting documents submitted to obtain these benefits. The GAAR aims to ensure rules of tax integrity, of protection of the tax system.

Not all developed economies, economies such as Canada, Austria, Germany or France have agreed and legislated the introduction of a GAAR taking into account the assessment of the financial-accounting operations specific to each case that is under investigation or dispute, starting from the premise that not all ways of avoiding the payment of taxes and duties due to the state budget are predictable. (https://www.pwc.com/cz/cs/danove-sluzby/danova-politika/assets/gaar-general-anti-avoidance-rule-en.pdf). Starting from this premise, in the Romanian tax law and not only, there are specific anti-abuse rules (SAAR) that aim to draw some norms of economic

conduct in a known financial-accounting way, which can be used to identify cases of income avoidance collected by the budgets of the states, the interpretation of the economic substance can be abusive.

We consider that the GAAR rules are not always beneficial for the tax system, taking into account that an overly restrictive system of rules corresponding to GAAR may represent or offer the possibility of misinterpreting the object of the economic transaction between the contracting parties, with the risk that the beneficiaries of tax deductions can be prejudiced due to the comparative interpretation of the economic substance. Article 11 paragraph 1 of the Romanian Tax Code provides the general anti-abuse rule: *"When determining the amount of a tax, a tax or a mandatory social contribution, the tax authorities may disregard a transaction that does not have an economic purpose, adjusting its tax effects, or may reclassification the form of a transaction / activity to reflect the economic content of the transaction / activity".* The general rule must be interpreted in conjunction with article 14 paragraph 2 of the Fiscal Procedure Code which orders that: *"The factual situations relevant from the tax point of view shall be assessed by the authorities in accordance with their economic reality, determined on the basis of the evidence administered under the terms of this Code. Where there are differences between the substance or economic nature of a transaction or transaction and its legal form, the tax authority shall assess such transactions or transactions, in compliance with their economic substance".* The adjustment of taxes must start from the principle of the taxpayer's good faith in determining the taxes related to the commercial operations carried out. The economic substance must be checked via GAAR and SAAR before any adverse effects occur.

Not always GAAR or SAAR rules should be used. Taxpayers are free to make managerial decisions based on the legislative framework, without the state intervening. Such an example of tax practice can be exemplified by the taxpayer's decision to close or continue an economic transaction in his own name or in participation with other economic operators, including state institutions. Another example of the non-activating of these rules is the agreement of the taxpayer's will to pay dividends from the profit or to increase the salaries in relation to the additional profit made or to reinvest the profit in economic activities. Such cases ensure the freedom of decision in the way of conducting the operations carried out and cannot be interpreted as abusive by the tax authorities.

By the Government Emergency Ordinance nr. 79 of 2017, a provision against abuse of rights with regard to the *activities "undertaken with the main purpose or with one of the main purposes of obtaining a tax advantage that contravenes the object or purpose pursued by the applicable tax provisions"* was introduced in art. 40 ind. 4 of the Romanian Tax Code. This legislative amendment is in agree with the European Union Directive no. 2016/1164 as a result of activities within the OECD, inspired by the BEPS (*Base Erosion and Profit Shifting*) program, developed within the Organization for Economic Co-operation and Development (OECD), to which Romania is not yet a member through BEPS (Base Erosion and Profit Shifting). Base Erosion and Profit Shifting is identifying the tax policies used by multinationals through which they transfer the profit made in countries where taxation is higher in jurisdictions where taxation is low. This method avoids the payment of the increased tax from the jurisdiction in which the multinational company operates. The Organization for Economic Co-operation and Development (OECD) aims to identify and reduce these legislative discrepancies between member states, which benefit large multinationals through their major resources. According to a press release from the Organization for Economic Co-operation and Development (OECD), the practices that multinationals use and that are target by the Base Erosion and Profit Shifting program, have caused damage to

countries with a higher taxation rate, between 100-240 trillion USD annually. For this reason, the Organization for Economic Co-operation and Development (OECD) currently includes 141 countries that have harmonized their jurisdiction to combat this phenomenon and are working together to implement 15 measures to avoid the payment of taxes with different international legal effects. The transparency of tax legislation and commercial operations carried out by multinational companies and the digitization of tax information ensure balanced legislative framework for combating this phenomenon.

2. Research methodology

The scientific approach of the research is represented mainly by the comparison between the judicial theory and practice regarding the ways of interpretation, apparently legal, and which the legislation allows with transactions that include economic operations that can be classified as having abusive economic substances.

For the purpose of the investigation, it was taken into account the judicial practice and the specialized literature, finding methods and presumptions regarding the economic substance from the fiscal and economic point of view, interpretation of the anti-abuse clauses and the good faith of the taxpayers subjected to the analysis.

It was proceeded to the study of the jurisprudence at national and international level, to the use of public databases (Web of Science) from the online environment, being applied qualitative and quantitative methods in correlation with SWOT analyses in order to be able to transcribe the result in this field.

3. Abuse of rights

The theory of abuse of rights is not legislated in law no. 227/2015 on the Romanian Tax Code or in law no. 207/2015 on the Romanian Procedure Tax Code. Abuse of rights is legislated only in art. 15 of law no. 289/2009, the Romanian Civil Code: *"No right may be exercised for the purpose of harming another or in an excessive and unreasonable way, contrary to good faith."*

Given that, the abuse of rights is an illegal act, the liability of the guilty person is made according to the legal norm violated and civil tort or even criminal measures can be applied. The Romanian Tax Code, through article 11 paragraphs 1, 3 and 3 establishes the legal framework for determine the norms against abuses in economic operations at national or international level.

Art. 14 paragraph 1 of the Romanian Tax Code stipulates that *"Incomes, other benefits and patrimonial elements are subject to tax legislation, regardless of whether they are obtained from acts or facts that meet or not the requirements of other legal provisions".*

With regard to the art. 11 paragraph 1 of the Romanian Tax Code, the tax authorities have the possibility to apply several measures to correct the erroneous calculation of the taxable base:

- Cancellation of the transaction subject to tax treatment and which has no economic purpose.
- Conversion or legal reclassification of an economic transaction in order to show the reality of the subject-matter of the documents.

The legislator, in the same article 11 paragraph 2 of the Romanian Tax Code, offered to the tax authorities' adequate methods to ensure a correct and conclusive analysis regarding the real market price set by taxpayers in the commercial transactions and on which there is a presumption of abuse of rights, such as the following methods:

- Comparing the amount price set between taxpayers with the price set by other persons who have the same commercial object in progress, independently of the taxpayer subject of verification.
- The plus-cost method is based on the establishment of a price by calculating each economic indicator that ensures the total cost of the market price, including the profit applied to the traded good or service.
- The method of establishing a resale price show the 'transposition' of the controlled transaction by 'changing' the contracting parts with objective ones, independent person, without the expenses relating to the sale, any expenses that objectively influence the taxpayer and the determination of the percentage of the taxpayer's objective economic profit.
- "Another method recognized in the transfer pricing guidelines issued by the Organization for Economic Co-operation and Development". With regard to this last aspect, we can see that Romania has a wide scope of interpretation with foreign elements, related to an external factor. We consider this method to have many issues, if the national legislation is not harmonized with special laws according to the collaboration with the Organization for Economic Co-operation and Development. We consider appropriate to have such a method, but in which does not leave the possibility of different national or international legal interpretation.

In both cases, the abuse of rights has an exclusive fiscal purpose and there can be no discussion of changing the legal effects that the contracting part's or taxpayers had for the commercial operations. The Romanian Tax Code explicitly provides this anti-abuse rule in art. 14 paragraph 3*: "The authorities determines the tax treatment of an operation taking into account only the tax legislation, the tax treatment not being influenced by the fact that the transaction meets or does not meet the requirements of other legal text ".*

4. The subjective side and the objective side of the economic substance. Causation and the effects of the economic substance.

The subjective side of the economic substance must be analyzed in the light of the taxpayer's manifestation of will regarding the economic transaction and its legal possible consequences.

At the time of application of article 11 paragraph 1 of the Second Sentence of Law nr. 227/2015 on the Romanian Tax Code we consider that the taxpayer's guilt from a fiscal point of view, as well as the mobile and purpose of the transactions carried out, should be analyzed. The guilt must be analyzed in terms of the taxpayer's intention to unfairly benefit from a better tax treatment or to evade the payment of taxes owed to the State, as well as in terms of the taxpayer's culpability regarding the economic substance of a transaction. Equally important in the assessment of the economic substance and the application of the provisions of art. 11 of the Romanian Tax Code are the mobile, purpose and reasons used by the taxpayer in economic transaction.

With regard to the objective side, we consider that it is necessary to take into account also the action or non-action that led to the analysis of the economic substance of the transaction, the immediate consequence produced by the fake financial-accounting documents used or the legal reconsideration from the real purpose of the transaction as well as the link between the transaction carried out and the purpose pursued by the taxpayer.

✓ **Example 1:**

By decision No. 187/2021 of 28 June 2021 of the Romanian High Court of Cassation and Justice is also settled a case related to the limits of the prevalence of the fund over the form, analyzing aspects that make the difference between the penal-crime of tax evasion and the fiscal facts for which taxes have been additionally established. Although initially the prosecution requested by indictment the criminal liability of the defendants under for committing the crime of tax evasion, provided for by art. 9 paragraph 1 lit. c and paragraph 3 of law no. 241/2005, applying art. 5 of Penal Code, the court found that acquittal is required, based on art. 396 paragraph 5 in relation to article 16 paragraph 1 lit. b. sentence I of the Romanian Procedural Code whereas the act is not provided by the criminal law.

The analyzed case has a special importance regarding aspects related to the economic substance of the transactions carried out through several companies in Romania and Bulgaria, being in the situation of an abuse of rights, by subjectively interpreting the tax rules on VAT, regarding the same transactions.

In fact, during 2 years, 2012-2014, B SRL, authorized dealer, purchases from Germany, Netherlands and France, agricultural equipment for resale purposes on the territory of Romania, but through a chain of companies, including the company founded on the territory of Bulgaria, with the name E, belonging to deputy C. Company E, formally received the goods (the machines being of Germany origin, Netherlands and France) and latter, delivers them to the Romanian clients of E, in Romania. The machines were transported to Romania through Bulgaria, to the headquarters of Company B and representing intra-Community transactions, they were not VAT- transactions.

By this method, it was considered that an unreal commercial circuit was created in order to evade the payment of VAT and indirectly to create a competitive economic advantage over other economic operators with the same object of activity.

After judging the case, the Romanian High Court holds that we are not in the presence of the crime of tax evasion for the following reasons:

- According to Council of Europe Directive 2006/112/EC, the detailed aspects represent legal intra-community transactions.
- The artificial nature of the transactions is given by the interposition of E from Bulgaria with the purpose of evading the payment of VAT to the general consolidated budget of the state in the amount of a damage of 1,245,164 euros.
- Proof of commercial purpose in the case of E Bulgaria is missing.

The 132 transactions carried out by B- supplier to E Bulgaria-client are fictitious.

They are fictitious not in that they did not take place from a material point of view but in the fact that *"although it has a material existence, it does not exist in relation to the facts".* The transactions between firms B and E are real and have proven an economic purpose, with profit margin.

In Halifax- case C-255/02, the European Union Court of Justice decides that in order to be in the presence of law-abuse, two conditions are required: commercial transactions must meet all the legal conditions relating to form and aim to obtain tax advantages, advantages that would be contrary to the very purpose set by the legislator in those provisions.

Thus, the Court also rules on the principle of the prevalence of substance over form and shows that it" constitutes *a fundamental principle of the common system of VAT established by Community law, which applies in accordance with the other principles recognized by Community legislation and case-law, including the principle of the fight against fraud, tax evasion and possible abuses. For this reason, the tax*

legislation conditional the VAT deductibility of acquisitions to cumulative, in addition to the conditions of the form (including the condition that the taxable person has the invoice containing the information requested by law), to the essential substantive condition, that the acquisitions for which the deduction is requested must be effective and intended for the benefit of the own taxable transactions, regarding the taxable person."

The Court also shows that the difference between the abuse of law and tax fraud is represented by the existence in the criminal circuit in the chain of companies of a *"ghost"* company that will not pay the VAT related to the transaction, otherwise there is the possibility of carrying out a procedure of fiscal optimization / reclassification, an aspect that is not of a criminal nature and which has the legal framework necessary to establish the tax damage caused by abusive practices.

The legality of economic transactions is also given by the case-law of the European Union Court of Justice, that shows us that the economic operator has the possibility to carry out its legal economic activity supposed appropriate, including in the field of nonpaying VAT, the negative condition imposed being related to the purpose of the economic transaction carried out, that is not to carry out the activity in order to obtain an illegal tax advantage.

- ✓ **Example 2:**

Decision no. 6386/2020 of 26 November 2020 of Romania High Court of Cassation and Justice also rules on consumer prices, with implications for the economic substance, of the commercial transactions carried out, with fiscal effect. The object of the decision is represented by the acts issued by Cluj County Public Finance Agency, the amounts additionally imposed as a result of the corrections made regarding the tax loss, during the years 2007 – 2010, in the total amount of 1,074,878 RON, considering that the tax adjustment measures were taken by the authorities legally, the affiliated companies trying to avoid legal terms with unjustified transfer prices.

In fact, companies B, respectively company B., invoiced services, representing the rental of machinery, following the tax audit on transfer prices, establishing that the commercial mark-up and capital interest, practiced as a result of these commercial relations, being in total 11.5%.

The state authorities considered that the reality of the economic relations, the economic substance, is different, the total mark-up margin practiced being between 21.15% and 184%, the rental of the machines being carried out at prices much higher than those normally practiced on the market. For this reason, the measure was taken to adjust these operations in line with the reality of the relevant market. The High Court specifies that the transfer pricing file must be completed and motivated (according to art. 3 paragraph 2 of Order no. 222/2008): *"the comparability study must be argued so that it can provide certainty that all the conditions for comparing transactions from affiliated entities with similar transactions from independent companies are met."*

With regard to transfer pricing, we make the following clarifications:

- They are to be found in transactions between companies within the same group, related companies;
- Transactions between related parts have a real market price in comparison with other similar transactions between independent parts;
- The parts are obligated to hold and complete the transfer pricing file.

If there are suspicions about the rule above, the transfer prices may be adjusted on the basis of article 11 (1) (a) and (b) 2 of Romanian Tax Code and the Order of the Romanian Ministry of Public Finance no. 222/2008. The adjustment can also be made

by the *"cost plus method",* being necessary to analyze the types and composition of the expenses, especially the operating and non-operational ones.

✓ **Example 3:**

Decision No. 2614/2018 of 18 June 2018 of Romanian High Court of Cassation and Justice has as object the cancellation of the authorities acts issued by the County Administration of Public Finances of Caras-Severin - The tax inspection activity regarding the VAT refund in the amount of 1,611,315 RON. In fact, it was noted that A SRL *"engaged costs related to a project for the development of a wind farm in Mehadica, Caras-Severin County, with a capacity of approximately 48MW: costs for legal assistance services invoiced by SC C. and Associates; costs for wind project development services invoiced by D. SRL; costs for consultancy and representation services of the beneficiary in the relationship with the network operator in order to obtain the technical approval for the connection of the wind farm, invoiced by C E. SRL; costs for the pillar/ pillar measuring services and for the headquarters security invoiced by F. SRL Bucharest and for G. SRL Bucharest, costs for the rental of the building invoiced by H. SRL; costs for assistance and consultancy services for the implementation of energy projects, invoiced by I. SRL; costs for project management and administration services, development and operation of a wind farm invoiced by J. SRL; costs for the services invoiced by K. SRL and by L. SRL."* Because it was not possible to prove the real intention to develop the wind farm, A SRL's request was rejected, the services provided not being beneficial to the firm, not being able to lead to the development of the company.

With regard to the assistance services, it was also found that two of the lawyers are administrators of A SRL, one of the majority shareholders of A SRL is one of the two lawyers, the headquarters of A SRL is also the headquarters of the law firm and the amount of legal services is high (more than 1,000,000 euros and includes also services invoiced by hourly payment) and these raise suspicions about the economic substance of the transactions carried out. The court does not agree with the tax expertise in the case, arguing that the existence or registration in the accounts of the financial accounting supporting documents is not debated, the taxpayer's intention regarding the reality and necessity of the operations carried out is being debated, the economic substance of the commercial transactions being challenged*, "the way in which the tax authorities have applied the principle of economic prevalence over the legal entity, regarding article 11 paragraph 1 of Tax Code and point 46 paragraph 1 of Order no. 3055/2009, which allows them not to take into account a transaction that does not have an economic purpose or to reframe the form of a transaction in order to reflect the economic content of the transaction, is an operation in which the exercise of the right of appreciation and the correlation of certain provisions of tax law takes place, operations in which the tax expert cannot substitute himself either for the tax control authorities or for the court of law."*

Romanian High Court of Cassation and Justice considers that A SRL could not prove the economic substance, the intention for which these expenses were made for future economic and obtaining profit from this activity.

5. Conclusions

Abuse of tax law is an issue that has been debated in all states that apply real tax policies based on the fairness of transactions and the legitimate interest of taxpayers. In this context, we can discuss the theory of the prevalence of economics over the legal or

"substance over form" in tax law. The economic substance directly influences the abuse of rights effects, the legal provisions can often be interpreted by the taxpayer or by the tax authorities differently. For the correct economic relations or for correct interpretation of the legal transaction's effects, common rules must be established with regard to financial transactions and their registration, from the accounting point of view, and special rules, which can be understood, interpreted taking into account the free will expressed agreement of the contracting parts, of the tax authorities, of persons governed by public or private law or natural or legal persons.

The economic substance directly influences the theory of the prevalence of economics over the legal in tax law. As the foundation of the tax system, all states are concerned to collect and supply the general consolidated budget with taxes provided be the specific legislation. It is normal that in external com relationships, states want to keep the amounts of money resulting from taxes and duties in the state and thus ensuring a stable and sustainable development, according to the internships and governance policies adopted. The State, through the competent authorities, is able to take measure in certain activities, transactions or facts and to contribute to the growth and development of the area of competence.

The economic substance has a close connection with the theory of the prevalence of the fund over the form, a theory legislated be the art. 14 paragraph of the Tax Procedure Code: *"The factual situations relevant from the fiscal point of view shall be assessed by the tax authorities in accordance with their economic reality, determined on the basis of the evidence administered under the terms of this Code. Where there are differences between the substance or economic nature of a transaction and its legal form, the tax authority shall assess such transactions, in compliance with their economic substance".* Starting from the multitude of practical cases in which the economic substance of a transaction is requalified / reconsidered by the tax authorities differently, both internally and externally, we can appreciate that a set of rules is needed, a guide that includes aspects of good practice in the field of analyzing the abuse of the right of the fund's collection on the form. This set of rules will be the subject of a further study.

We consider that excessive taxation, the establishment of taxes and duties without taking into account factors that influence the economic, social, and political or any other behavior of the taxpayer or of any other kind of the taxpayer or of the tax authorities will lead to the misinterpretation of socially anti-abusive terms.

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