THE *THIN CAP GLO* AND *LASERTEC* DECISIONS

Martin Schuh[1]

Facts

In 2007, five years after ruling that the German thin capitalisation rules were incompatible with EC law, the ECJ delivered a judgment on the UK's thin capitalisation rules in *Thin Cap GLO*. This case concerned the British thin capitalisation rules which were in place until April 2004 and then replaced by transfer pricing provisions that were extended to cover debt financing.[2] A group of MNEs[3] challenged the UK thin capitalisation rules (through their UK subsidiaries) in the High Court which then referred the case to the ECJ.[4] Although these companies did not all have identical group structures, what they all had in common was that the UK provisions affected them. Different fact patterns could be categorized, the biggest difference being the residence of the parent company, i.e. EU or non-EU residence.[5] The test cases included situations where the UK subsidiary received a loan from a group member resident in another Member State and the parent company also being resident there and where the UK subsidiary received a loan from either a group member resident in a Member State, a third country, or in a Member State with a branch in a third country (the parent company

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2 See Morgan/Bridges in Tax Journal, Issue 877 p. 7.

3 Among the members were companies such as Volvo, Caterpillar and PepsiCo.

4 See *Thin Cap GLO* at para. 16.

5 A detailed illustration of the different fact patterns can be found in Morgan/Bridges, Tax Journal, Issue 877, 7; see also C-524/04 at para. 18f.

in these situations was a US resident).[6] In all cases, the UK-resident subsidiary received a loan from a non-UK group member.

The main question brought forward in this GLO was whether the UK thin capitalisation rules were compatible with EC law, since they applied only to loans made by a group member resident in another country than the UK to a UK subsidiary.

Which freedom applies?

One of the main issues of the case was which freedom applied, since some of the test cases involved situations involving third countries (such as Switzerland and the US).[7] If art. 56 ECT applied, all affected claimants were protected under the treaty whereas if art. 43 ECT applied, those groups with parent companies or branches outside the EU might not be protected from less favourable treatment. The ECJ stated that in cases where one company had definite influence over another company, art. 43 ECT applied.[8] Here, the UK's thin capitalisation rules applied only to group members since it covered cases where the parent company had a holding of at least 75 percent or the companies involved are under common control.[9] Therefore, legislation such as the UK thin capitalisation rules targets only relations within group companies and thus falls under art. 43 ECT.[10] Those claimants who relied on the application of art. 56 ECT, i.e. the ones where the parent company or the branch providing the loan were third country residents, were not covered since art. 43 applies only to Member State – Member State situations.

Restriction

Next, the court established whether there was a restriction of the freedom of establishment.[11] By deeming interest payments to be dividends, the subsidiary was subjected to higher tax, not only because expenses could not be deducted, but also because dividends were subject to advance corporation tax ("ACT").[12] The ECJ concluded that UK subsidiaries receiving loans from non-resident group members were in a less advantageous tax position than those receiving loans from related UK

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6 See *Thin Cap GLO* at para. 18f.

7 The claimants brought forward art. 39 (freedom to provide services), 43 (establishment) and 56 ECT (capital).

8 See *Thin Cap GLO* at para. 27, citing – among others – *Baars* and *Cadbury Schweppes*.

9 See *Thin Cap GLO* at para. 28ff..

10 See *Thin Cap GLO* at para. 33.

11 See *Thin Cap GLO* at para. 36ff..

12 See *Thin Cap GLO* at para. 39.

residents.[13] Interestingly, the ECJ held that, from a tax perspective, MNEs and group companies with members in only one Member State are not comparable and that MNEs might structure their group in order to transfer profits to low tax jurisdictions, but this does not mean that rules adopted by the Member States dealing with these issues might not pose a restriction to their freedom of establishment.[14] The court thus held that UK rules posed a restriction on art. 43 ECT, since a UK subsidiary is treated less favourably depending on where the affiliated lender is resident. This poses a disincentive to foreign companies since they might '…refrain from acquiring, creating or maintaining a subsidiary in the…' UK.[15]

Justification

On the issue of justification of that restriction, the ECJ examined the cohesion of the tax system and combating tax avoidance.[16] On the former, the court stated that no direct link between a tax advantage and a tax levy could be established here.[17] The latter, however, was seen differently by the court. Tax avoidance was valid justification in previous cases, but only where the legislation targeted wholly artificial arrangements.[18] Where a group company grants a loan to a related company established in another Member State this fact itself cannot constitute abuse.[19] Transferring this to the legislation here, the ECJ states that cross-border loans may be used to transfer profits abroad.[20] The UK legislation, by way of re-qualification as a dividend, '…is able to prevent practices the sole purpose of which is to avoid the tax…' and can thus be used as a justification.[21]

Proportionality

The question is then whether the legislation is proportional. The court reiterates that the German legislation considered in *Lankhorst-Hohorst* did not specifically target

13 See *Thin Cap GLO* at para. 46.

14 See *Thin Cap GLO* at para. 59f..

15 See *Thin Cap GLO* at para. 62f., citing *Lankhorst-Hohorst* at para. 32.

16 See *Thin Cap GLO* at para. 66ff..

17 See *Thin Cap GLO* at para. 66.

18 Such as *Cadbury Schweppes, ICI, Marks and Spencer* and *Lankhorst-Hohorst*, see *Thin Cap GLO* at para. 72 and 74.

19 See *Thin Cap GLO* at para. 73.

20 See *Thin Cap GLO* at para. 76.

21 See *Thin Cap GLO* at para. 77.

wholly artificial arrangements.[22] However, an arm's length comparison is an objective element that may be used to determine if the conditions agreed between two related companies constitute wholly artificial arrangements.[23] AG Geelhoed stated in his opinion on *Thin Cap* that in situations where doubts exist about a loan agreement between two group companies, if the taxpayer is given the opportunity to provide evidence that his arrangement is at arm's length, i.e. under fair market conditions, this should be regarded as not going beyond what is necessary and thus as proportional.[24] A second requirement is that where such evidence cannot be produced and the loan is regarded not at arm's length, only the exceeding amount should be re-qualified as a dividend.[25] If these two conditions are met, i.e. first if the legislation includes an objective element to determine if there is a wholly artificial arrangement and if it allows the taxpayer to provide evidence that his loan can in fact be commercially justified and secondly if it only proportionally re-qualifies the interest payments as dividends, then is does not go beyond what is necessary. Further, the taxpayer must not be subject to undue administrative constraints.[26] Therefore, the restriction of art. 43 ECT can be justified by the need to combat tax avoidance, without being disproportionate.

Unlike in *Lankhorst-Hohorst*, the thin capitalisation rules could be compatible with EC law if they were specific enough only to only target abusive structures and if they gave the taxpayer the opportunity to produce evidence that, although he does not meet fixed debt/equity ratios, his loan agreement was at arm's length.

The non-application of art. 56 ECT in this case resulted in several claimants in this test-case facing severe tax liabilities, since their parent company or a branch was resident in a third country. However, this judgment shows that it is possible to have thin capitalisation legislation compatible with EC law as long as it is narrow enough and does not generalise without offering the chance to produce evidence that shows that individual loan agreements are in order although they do not meet the general requirements such as debt/equity ratios.

Since the case also dealt with different fact patterns including those with a third country connection, *Thin Cap GLO* is also seen by many to have significant importance regarding the ECJ's agenda on art. 56 ECT and third countries.[27] One

22 See *Thin Cap GLO* at para. 79.

23 See *Thin Cap GLO* at para. 80f.

24 See *Thin Cap GLO* at para. 82, citing AG Geelhoed at para. 67 of his opinion.

25 See *Thin Cap GLO* at para. 83.

26 See *Thin Cap GLO* at para. 82 and 92.

27 See for instance *Panayi* in IntertaxVol. 35 Issue 5 (2007), p. 298ff. and *O'Shea* in TNI 2007, p. 371.

argument is that the ECJ seems to curb third countries' rights by not engaging article 56 ECT.[28] In situations where art. 56 ECT could actually be applied, the ECJ seemed to show reluctance to grant free movement of capital to third countries.[29] Others see the non-application of art. 56 ECT as a mandatory result of the court's jurisprudence and not as a scheme to provide less protection to third countries.[30] *Thin Cap GLO* does not limit third countries' rights under art. 56 ECT, they still enjoy the free movement of capital. However, the ECJ practically applies protection under the ECT only to Member State residents since it states that thin capitalisation rules – such as the UK ones –apply only where one company has control over another. This element of control triggers the application or art. 43 ECT and thus leaves no room for the application of art. 56 ECT. Regardless of the ECJ's motives behind its judgments, in practice third countries seem to lose out in thin capitalisation cases since art. 56 ECT does not apply. A good example in this regard is *Lasertec*.

Lasertec

Facts

Following the *Thin Cap GLO* decision the ECJ ruled on the *Lasertec* case in May 2007. The case involved a third country constellation and is thus worth mentioning. A Swiss company with a holding of 66.66 percent in a German company granted a loan to the latter in 1995. The then-applicable thin capitalisation rules included a debt-equity ratio of 3:1, which was exceeded by this loan arrangement. Therefore the interest payments made by the subsidiary were re-qualified as dividends (covert distributions) and thus non-deductible at the level of the German company. The question was which freedom applied – art. 43 ECT or art 56 ECT. The Swiss parent relied on art. 56 ECT since it applies to both Member State – Member State and Member State – third country situations. However, even art. 56 ECT might not have led to the deductibility of the payments because of the standstill provision under art. 57 (1) ECT, which states that domestic rules that already were in place before 1994 may continue to be used by the Member States without restricting the free movement of capital to or from third countries in direct investment (and other) situations. The referring court thought the thin capitalisation rules might be protected by this standstill provision.

Reasoned order

Instead of issuing a judgment, the ECJ decided the case by reasoned order and without a hearing or written opinion of the AG, stating that where the answer to a

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28 *Panayi* in IntertaxVol. 35 Issue 5 (2007), p. 298 (298).

29 Panayi in IntertaxVol. 35 Issue 5 (2007), p. 298 (301).

30 *O'Shea* in TNI 2007, p. 371 (371, 374).

referred question '…may be clearly deduced from existing case-law…', the court is allowed to do so.[31] Therefore, after *Lankhorst-Hohorst* and particularly *Thin Cap GLO*, the answer seemed clear to the court. The ECJ did not elaborate on whether art. 57 (1) ECT applied or not but – by reference to the previous thin capitalisation cases – stated that here, the German rules applied only where there was a minimum holding of 25 percent and thus an element of control was needed. The applicable freedom was art. 43 ECT, not art. 56 ECT. Thus, the court did not have to decide on the standstill provision. But since the owner was a Swiss company, the freedom of establishment did not apply here since it is granted only in Member State – Member State situations. This result seemed obvious after *Lankhorst-Hohorst* and *Thin Cap GLO* and thus the ECJ issued a reasoned order instead of a formal judgment.

NV Lammers & Van Cleeff

Facts

In *NV Lammers & Van Cleeff*, the ECJ decided on Belgian thin capitalisation rules. NV Lammers & Van Cleeff ("Van Cleeff") was the Belgian subsidiary of a Dutch parent company (BV Lammers & Van Cleeff). Van Cleeff had three directors, two were shareholders and the third was the Dutch parent company. Van Cleeff paid interest for a loan that was granted by the parent company. These interest payments were re-qualified by the Belgian tax authorities as dividends under a Belgian law provision[32] which allowed only interest payments made to non-Belgian directors to be re-qualified as dividends when certain limits were exceeded. The provision did not re-qualify similar payments made to Belgian directors.

Which freedom applies?

In this case, the Belgian court referred to several freedoms that might prohibit such treatment under the ECT, namely art. 12 ECT (discrimination on grounds of nationality), art. 43 ECT (the freedom of establishment) and art. 56 ECT (free movement of capital). Regarding discrimination on grounds of nationality the ECJ states that art. 12 ECT '…applies independently only to situations governed by Community law for which the EC Treaty lays down no specific rules of non-discrimination…'.[33] Since art. 43 ECT and art. 56 ECT are more specific when it comes to establishment and movement of capital, art. 12 ECT did not apply in this

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31 See *Lasertec* at para 15, where the ECJ refers to art. 104 (3) of the Rules of Procedure of the ECJ.

32 Art. 18 (2), point 3, of the Income Tax Code 1992, see *NV Lammers & Van Cleeff* at para. 10.

33 See *NV Lammers & Van Cleeff* at para. 14.

case.[34] The ECJ examines the fact pattern under art. 43 ECT first and states that there is a difference in treatment of resident companies depending on whether its director has its seat in Belgium or not.[35] If the director company is a Belgian resident, no re-qualification of interest payments occurs, no matter whether the limits set out by Belgian tax law are exceeded or not, whereas if the director has its seat outside Belgium, the payments are re-qualified, with the result that the payments are taxable.[36] The ECJ makes the point that this is also true for parent companies which perform management tasks for its Belgian subsidiary, resulting in less favourable treatment compared to a resident parent company.[37] This less favourable treatment results in an obstacle of the freedom of establishment because it will make it less attractive for non-resident companies to establish in Belgium through a subsidiary.[38] This obstacle is a restriction of art. 43 ECT.[39]

Justification

Without mentioning whether or not art. 56 ECT applies in this case, the court then went on to the issue of justification. This is important since in the whole *NV Lammers & Van Cleeff* judgment, the ECJ does not say that the free movement of capital does not apply, it just does not address the issue after finding a restriction of art. 43 ECT. The main justification brought forward was the prevention of tax avoidance. The court quotes *Thin Cap GLO* in this respect and points out that in order to justify a restriction the provision must target wholly artificial arrangements specifically.[40] As in *Thin Cap GLO*, a general presumption of tax abuse cannot be made solely because a non-resident parent company grants a loan to a resident company and thus cannot be used as a justifying argument.[41]

Further, if a payment of interest made by a subsidiary to its parent company is not at arm's length, a re-qualification might be justified since this constitutes an objective

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34 See *NV Lammers & Van Cleeff* at para. 14; see also *O'Shea* in TNI 2008, p. 837.

35 See *NV Lammers & Van Cleeff* at para. 20.

36 See *NV Lammers & Van Cleeff* at para. 21.

37 See *NV Lammers & Van Cleeff* at para. 22.

38 See *NV Lammers & Van Cleeff* at para. 23; see also *O'Shea* in TNI 2008, p. 837 (838).

39 See *NV Lammers & Van Cleeff* at para. 24; see also *O'Shea* in TNI 2008, p. 837 (838).

40 See *NV Lammers & Van Cleeff* at para. 26, quoting *Thin Cap GLO* at para. 72 and the case law cited there, i.e. *ICI*, *Lankhorst-Hohorst*, *Marks and Spencer* and *Cadbury Schweppes* in particular.

41 See *NV Lammers & Van Cleeff* at para. 27, quoting *Thin Cap GLO* at para. 73 and the case law there.

element which can be used to determine whether or not a wholly artificial arrangement is in place.[42]

Regarding the case at hand, the ECJ states that the interest payments were re-qualified as dividends under the Belgian rules because they exceeded a fixed limit.[43] This might target wholly artificial arrangements and could therefore be a justification of the restriction of art. 43 ECT.[44]

Proportionality

However, this justification would then have to be proportional, i.e. not go beyond what is necessary. Here, since the limit set out in Art. 18 (1), point 3, Income Tax Code 1992 is not tailored to target wholly artificial arrangements only, but might also affect solid businesses operating at arm's length, the ECJ states that this Belgian re-qualification clause does not meet the requirements set out in *Thin Cap GLO* and other cases (e.g. *Cadbury Schweppes*).[45] Thus, it does not meet the proportionality requirements.

In *NV Lammers & Van Cleeff*, the ECJ seems reluctant to confirm that the Belgian ratio approach targets wholly artificial arrangements. While the court did not confirm the objective to target wholly artificial arrangements in *Lankhorst-Hohorst*, it states here that even if the rules did, they were not proportional. However, this fact pattern was slightly different because the Belgian rule targeted mainly director payments. All in all, *NV Lammers & Van Cleeff* is in line with the previous judgments on thin capitalisation, particularly *Lankhorst-Hohorst* and *Thin Cap GLO*.

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42 See *NV Lammers & Van Cleeff* at para. 29f., quoting *Thin Cap GLO* at para. 80f.

43 See *NV Lammers & Van Cleeff* at para. 31; under Article 18 (1) point 3 of the Income Tax Code 1992, at the beginning of the taxable period the total of a subsidiary's interest-bearing loans are compared to its paid-up capital plus taxed reserves. If the former exceeds the amount of the latter, interest payments are deemed dividends.

44 See *NV Lammers & Van Cleeff* at para. 32.

45 See *NV Lammers & Van Cleeff* at para. 32f.; see also *O'Shea* in TNI 2008, p. 837 (838).