

“THE LAW ENDS WHERE ABUSE BEGINS”

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In the recent appeals of *Halifax plc et al v Commissioners of Customs and Excise* (“*Halifax*”),² the VAT and Duties Tribunal in London was asked, for the first time in the UK Courts, to rule on the application of the “abuse of rights” principle to taxpayers who had sought, by means of a series of steps, to (putting it neutrally) procure a particular tax advantage.

The UK tax authorities, the Commissioners of Customs and Excise (“the Commissioners”), made two specific submissions to the Tribunal:

- (1) a transaction entered into solely for the purposes of (in that case) VAT avoidance is neither itself a “supply” nor a step taken in the course or furtherance of an “economic activity” as those terms in the 6th EC VAT Directive (“the 6th Directive”) and the equivalent terms in the Value Added Tax Act (“VATA”) 1994 are properly to be interpreted. This is a principle of *interpretation*.
- (2) In any event, such a transaction should, in accordance with the general principle of EC law preventing “abuse of rights”,³ be disregarded and, instead, the terms of the 6th Directive (and, here, the provisions of VATA 1994 which implement the Directive) applied to the true nature of the transaction(s) in issue. This is a principle of *substance*.

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² LON/00/0977, 1st March 2001.

³ In the words of Planiol, “Le droit cesse là où l’abus commence”.

Although the Tribunal did not find it necessary to rule on the second submission, it considered - and accepted - the first, thus marking a new departure for the Courts in the UK. This article considers, in the style of a rather long case note, the ambit of the "abuse of rights" principle in both of the guises identified in *Halifax*. In order to put the decision of the Tribunal in *Halifax* into context, the background facts in the case are briefly described.

It should however be said at this point that whilst the application of the "abuse of rights" doctrine in the tax field is a novel step for English lawyers, both the concept and its application in tax disputes will be very familiar to lawyers and advisers in other EC jurisdictions.⁴

1. The Facts in *Halifax*

Three companies in the Halifax plc group (referred to below as "H", "CWPI" and "LPDS" respectively) appealed against decisions made by the Commissioners to disallow input tax claims made by CWPI and LPDS. H, CWPI and LPDS are all separately registered for VAT purposes. The claims to input tax came about because H wished for the purposes of its business to construct "call centres" at four sites in the UK. Had it done so directly H would have suffered input tax on the construction costs which would have been largely irrecoverable given H's position as a predominantly exempt trader (H's recovery rate was less than 5% at the relevant dates). With this in mind H entered into a VAT avoidance scheme under which a number of steps were taken:

- (1) H loaned £59m to LPDS;
- (2) pursuant to an agreement ("the Agreement for Leases") H granted 20 year leases (extendable to 99 years) of the relevant sites of the call centres to LPDS for premiums totalling £7,388,981;
- (3) LPDS contracted with H to carry out initial construction works ("the initial work") on the sites for a sum of £104,085 plus VAT ("the Agreement for Works");
- (4) LPDS contracted with CWPI for CWPI to construct the call centres, including the initial work, and made an advance payment to CWPI of

⁴ The author seeks forgiveness in advance for any over-simplification, or inaccurate summary, of the position in other EC jurisdictions. Readers of a nervous disposition should look away now.

£44,815,000 (£38,140,425 plus VAT) ("the First CWPI Agreement");

- (5) CWPI contracted with arm's length builders ("the builders") for the provision of construction services under which periodic payments (plus VAT) have been, and will be, made;
- (6) CWPI contracted with H for the provision by H of the services of *its* personnel to assist in managing the construction works;
- (7) LPDS agreed to assign its leases of the sites to another company in the Halifax group (Halifax Property Investments Limited, "HPI") on completion of the call centres, in each case for a premium ("the Lease Assignments");
- (8) HPI agreed to sub-lease the completed call centres to H for use in its business, again for a premium in each case ("the Sub-leases"). In respect of one site H had *itself* already entered into a development agreement with an arm's length builder which, to make the scheme 'work', had to be novated to CWPI.

The VAT treatment which H sought to achieve was, broadly, as follows: the recovery of all of the input tax on the construction costs by CWPI because it was making "taxable supplies" in the course of its "business" to LPDS; the recovery by LPDS of all of its input tax because in the first partial exemption year it only made "taxable supplies" in the course of its "business" (the initial work) and the exempt supply by LPDS of the leases to HPI in the next partial exemption year. In this way, all of the input tax would be recovered by companies in the Halifax group and no irrecoverable tax suffered by H.

The Commissioners contended, broadly, that no "taxable supplies" were made to LPDS by CWPI in the course of its "business", no "taxable supplies" were made to H by LPDS in the course of its "business" and that the true "supply" for VAT purposes was that made by the arm's length builders to H. In this way H would recover input tax on the construction costs but only to the extent of its partial exemption position.

1.1 The Relevant Statutory Provisions in *Halifax*

A "taxable person" (that is, one carrying on an "economic activity") is required to charge VAT ("output tax") on supplies of goods or services for a consideration ("taxable supplies") and to account for that output tax to the Commissioners: Articles 2, 4-6 of the 6th Directive and ss.1, 3-5 VATA 1994. Such a person is

entitled, when accounting for output tax, to deduct VAT ("input tax") incurred by him on supplies made to him insofar as that input tax is attributable to taxable transactions made or to be made by him: Articles 17-20 of the 6th Directive and ss.24-26 VATA 1994.

2. The Principle of Interpretation

It is settled law that a broad purposive construction must be given to EC legislation and that UK legislation (here VATA 1994) which implements EC legislation (here the 6th Directive) must be construed in conformity with EC law⁵. It is therefore necessary to identify the purpose of the 6th Directive since this governs both the Directive and VATA 1994.

The purpose of the 6th Directive is to apply to goods and services a tax on consumption exactly proportional to the price of those goods and services, to be borne by the final consumer.⁶ Specifically, the purpose of the 'partial exemption' rules is to ensure that VAT is borne by a taxable person to the extent that he does not make taxable supplies and is thus to be regarded as a final consumer, thereby respecting the principle of fiscal neutrality.⁷

In stark contrast, the Commissioners contended - and the Tribunal found as a fact - that the sole purpose of H, LPDS and CWPI in entering into or procuring these transactions was to procure (in group terms) input tax recovery on the costs of constructing the call centres despite H being largely exempt. In effect H sought, contrary to the purpose of the 6th Directive, the recovery of input tax to which it would not otherwise be entitled. The relevant terms to which this purposive approach was to be applied in these appeals were "supply" and "economic activity" ("supply" and "business" in VATA 1994).

2.1 The Commissioners' Contentions on "Supply"

Whether there is a "supply" and to whom it is made are not to be determined

⁵ *Marleasing* [1990] ECR I-4135 at 4159 (para 8).

⁶ Article 2 of the 1st Directive and *Elida Gibbs* [1996] STC 1387 per AG Fennelly at 1393d-1394g (paras 18-21) and the ECJ at 1403e-1404f (paras 26-33).

⁷ *Becker* [1982] ECR 53 per the ECJ at 75 (para 44) and *Régie Dauphinoise* [1996] STC 1187 per AG Lenz at 1185a-1186g (paras 34-40) and the ECJ at 1191j-1192a (para 21).

solely by reference to any contracts entered into by the parties⁸. Instead, the true meaning of the term is to be determined by examining the "commercial reality" and identifying the result which is most consistent with the overall scheme of VAT⁹. This approach of concentrating on the underlying nature of the activity or transaction in question has been used by the European Court of Justice ("ECJ") in a number of different types of VAT dispute to determine whether if there is a single or a multiple supply¹⁰ or whether there has been a supply of goods or of services¹¹ and even where it means re-characterising the transaction in fact carried out by the parties and taxing that re-characterisation.¹²

The Commissioners contended that, necessarily, the approach is also to be used to determine the logically prior question of whether there is a "supply" at all. This is the right course, so the argument ran, for two reasons - first as a matter of principle and second in light of the decided cases. As a matter of principle, the purpose of the 6th Directive is to impose within the EC a uniform tax on consumption by means of a turnover tax borne by the final consumer. Such a tax can - and need - only regulate genuine economic transactions, i.e. those driven by proper economic considerations. It is for this reason that both fictitious transactions and those where there can be no competition in a lawful economic sector are outside the scope of the tax.¹³ Artificial transactions, particularly those motivated solely by *tax avoidance*, have, and should have, no greater standing. As a matter of authority, it is settled law that both artificial transactions and persons who have artificially acquired a particular status fall outside the

⁸ *Reed Personnel Services* [1995] STC 588 per Laws J at 591c-h and 595a-g and *Eastbourne Taxi Radio Cars* [1998] STC 669 per Simon Brown LJ at 676g-h.

⁹ *Elida Gibbs* [1996] STC 1387 per AG Fennelly at 1393d-1394g (paras 18-21) and the ECJ at 1403e-1404f (paras 26-33).

¹⁰ *Card Protection Plan* [1999] STC 270 per the ECJ at 293c-e (paras 28-29).

¹¹ *Faaborg-Gelting* [1996] STC 774 per AG Cosmos at 779a-e (paras 14-15) and the ECJ at 783a-d (paras 12-14).

¹² *Glawe* [1994] STC 543 per AG Jacobs at 547f-548b (paras 17-19) and the ECJ at 551h-552c (paras 8-13); *Fischer* [1998] STC 708 per AG Jacobs at 717b-719j (paras 41-58); *First National Bank of Chicago* [1998] STC 850 per AG Lenz at 863a-864a (paras 66-70) and the ECJ at 871b-872g (paras 36-49).

¹³ *Sandell*, 1992, Case No 9665 (UK VAT Tribunal) and *Fischer* [1998] STC 708 per the ECJ at 722e-j (paras 19-21).

scope of EC law.¹⁴ While there is no authority directly concerned with the meaning of the term "supply" for VAT purposes, by direct analogy with these decisions of the ECJ there is no such "supply" where the transaction in question is *solely* motivated by tax avoidance considerations.

2.2 The Commissioners' Contentions on "Economic Activity/Business"¹⁵

By Article 4.1 of the 6th Directive a person is only a "taxable person" if he carries on an "economic activity", whatever the purpose or result of that activity. That is, for example, whether or not the person intends to, or does, make a profit. "Economic activity" is defined in Article 4.2 in an objective manner. Although it is a wide term, it does not necessarily extend to activities which have non-commercial characteristics.¹⁶ Equally, it does not extend to artificial transactions entered into solely for the purposes of tax avoidance.¹⁷ Article 4.1 serves to define a taxable person by reference to his carrying out an "economic activity"; the provision gives no guidance as to the definition of "economic activity" itself which is, and should be, approached with the purpose of the person concerned in mind.

The Courts in the UK have traditionally adopted the same approach in direct tax cases. Thus if the sole object of a transaction was tax avoidance ('a raid on the Revenue') it is not a "trading" transaction for corporation tax/income tax purposes.¹⁸ In light of the above, the Commissioners contended that here the relevant persons (LPDS and CWPI) were neither "trading" nor "providing services" and thus were not carrying on an "economic activity" within the terms of Article 4.2.

¹⁴ *Levin* [1982] ECR 1035 per the ECJ at 1050 (para 17); *Leclerc* [1985] ECR 1 per AG Darmon at 13 (para 17) and the ECJ at 35 (para 27); *General Milk Products* [1993] ECR I 779 per the ECJ at 799 (para 21); *Leur-Bloem* [1997] STC 1205 per the ECJ at 1232a-b (para 47); *Fischer* [1998] STC 708 per AG Jacobs at 711j-713e (paras 13-20).

¹⁵ For present purposes the two terms must be regarded as synonymous. The term "economic activity" is used here since it is that term which is considered by the ECJ in the authorities.

¹⁶ *Wellcome Trust* [1996] STC 945 per the ECJ at 959d-e (para 31); *EC v France* [1988] ECR 4797 per the ECJ at 4818 (para 21).

¹⁷ See the authorities cited in footnote 14 above.

¹⁸ *FA & AB Ltd v Lupton* [1972] AC 634 per Viscount Dilhorne at 657 and Lord Donovan at 657. This is so even if there is a "profit" built into the scheme: *Thomson v Gurneville Securities* [1972] AC 661.

2.3 The Counter-Argument

Halifax contended, shortly and simply, that a supply which is not genuine is not a "supply" at all for the purposes of the tax. A genuine supply however is such a "supply" whatever the purpose of the person making the supply. In other words, what constitutes a "supply" for tax purposes is to be gauged objectively and not by reference to such subjective factors as the motives or intentions of the party concerned. To conclude otherwise in the present case would involve the 'globalisation' of the affairs of the taxpayers and breach the cardinal rule of VAT that each supply must be looked at singly and the tax treatment provided for in the legislation applied accordingly.

Reference was made to decisions of the House of Lords¹⁹ and, specifically, to a leading judgment of the ECJ²⁰ where that Court declares, in terms, that each supply in a 'chain of supplies' must be looked at singly and that "the ultimate aim pursued by the taxable person is irrelevant" (para 19 of the judgment). The bank also relied on the terms of the 6th Directive itself, where, in Article 4.1, a taxable person is defined as one who carries out an economic activity "whatever the purpose or results of that activity".

3. The Principle of Substance

3.1 General Principles of EC Law

EC law is based on a hierarchy of rules under which 'lower' rules derive their validity from, and are bound to respect, 'higher' rules. "General principles" are principles of law extrapolated by the ECJ from the laws of the Member States and elevated to the status of a source of EC law. Such principles have constitutional status and are equal (in terms of the hierarchy) to the Treaty on Economic Union ("the Treaty") itself. As such they are binding on the institutions of the EC and on the Member States. In consequence, the Courts of the UK are obliged to give effect to the general principles of EC law when construing EC law (e.g. a directive) and, by extension, any national implementing legislation (e.g. VATA 1994) unless it is impossible to do so.²¹

¹⁹ *Robert Gordon's College* [1995] STC 1093, *Thorn Materials* [1998] STC 725 and *ICAEW* [1999] STC 1155.

²⁰ *BLP Group plc* [1996] ECR I-983.

²¹ *Rauh* [1991] ECR I-1647 per the ECJ at 1672 (para 17) and *Marleasing* (see above).

3.2 "Abuse of Rights" - the Position in Other Member States

This concept - that a Court can, and should, prevent a person from 'abusing' rights by seeking to take advantage of them in circumstances in which they were not intended to be available to him - is both common to most Member States of the EC and now found in the jurisprudence of the EC itself.²² It may help an appreciation of the ambit of the principle to look at it first in a domestic context, drawing on examples from two Member States. At the domestic (national) level, the principle allows a national Court to disregard transactions entered into by the parties and, instead, to apply the domestic tax legislation to the true nature of the transactions in issue. This is particularly important in the context of VAT where distortion of competition must be avoided (see the tenth and seventeenth recitals to the 6th Directive).

In France the principle ("abus de droit") has been given statutory form in article L64 of the Livres des Procédures Fiscales²³ ("LPF"). Under this article the Courts can, where transactions have been entered into solely with a view to procuring a particular tax treatment under domestic tax laws, disregard the transactions entered into by the parties and tax the true nature of the transaction instead.²⁴ Although the principle was originally applied in cases of dissimulation (that is sham transactions, fictitious transactions or the artificial interposition of a 'dummy' person²⁵) it has been extended in recent years to cover 'pure' tax avoidance where there is no dissimulation.²⁶

Similarly in Germany the principle has been given statutory form in s.42 of the Abgabenordnung.²⁷ Under this section the Courts must, where a person has chosen particular legal arrangements solely for tax reasons, disregard the

²² It is a common feature, in one form or another, of virtually all legal systems. See, for example, (1) Double Tax Agreements where provision is made to prevent "treaty shopping" (e.g. the UK: NL Agreement, Art 10(6)); and (2) the European Convention on Human Rights, Art 17.

²³ The Tax Procedure Code.

²⁴ The historical position is usefully summarised in the submissions to the Conseil d'Etat of the Commissaire du Gouvernement (a person similar, in UK terms, to an amicus) in *Benjador and Lalande* 21/7/1989, D Fisc 1990, 28, pp.21-29.

²⁵ See *Benjador and Lalande* and, in the context of VAT, *La Bretagne* 25/3/1983, RJF 6/83, No 775.

²⁶ *SDMO* 4/8/1998, RJF 5/98, No 593.

²⁷ General Tax Code.

transactions entered into by the parties and tax the true nature of the transaction instead. Examples in the VAT field include the interposition of a company in letting transactions with a view to securing recovery of input tax.²⁸ In this latter area, German savings banks have attempted to secure the recovery of input tax on the acquisition of land or buildings for use in their exempt activities by the interposition of intermediate companies funded by the bank. In the absence of any non-tax purpose for such an arrangement it seems that it would be treated as an abuse of rights in German law.²⁹

Such a domestic rule allowing transactions which have been carried out in order to circumvent national law to be disregarded can be relied on by a national Court even if it means not applying EC law to the transactions concerned. The ECJ will not allow persons to abuse EC law in order to circumvent national law.³⁰ This aspect of the principle has also found expression in EC legislation.³¹

3.3 "Abuse of Rights" - an EC Principle

The principle has now become a "general principle" of EC law. It has been used by the ECJ in two main types of case. First, where a person carries out transactions 'under cover' of rights conferred by EC law with a view to circumventing national law the ECJ has approved the denial of the benefit of the relevant EC law rights to the person concerned. This is because the person is seeking to exercise the EC right "unreasonably to derive, to the detriment of others, an improper advantage, manifestly contrary to the objective pursued by the legislator in conferring that particular right on the individual".³²

Secondly, where a person carries out transactions not for an *economic* purpose but solely to obtain the benefit of provisions of *EC law* (e.g. those conferring a

²⁸ *The Bundesfinanzhof (the Federal Supreme Tax Court) decision*, 14/5/1992, BStBl. II 1992, p.931.

²⁹ *BFH decision*, 18/12/1996, BStBl. II 1997, p.374.

³⁰ *Diamantis* C-373/97, 23/3/2000 per the ECJ at paras 32-35 and *Kefalas* [1998] ECR I 2843 per the ECJ at 2869 (paras 19-22) (both cases concerning the Greek statutory abuse of rights principle).

³¹ Article 1(2) of Council Directive 90/435/EEC (the 'Parent/Subsidiary Directive').

³² See, most recently, *Centros* [1999] ECR I 1459 per AG La Pergola at 1476-1477 (para 20) and the ECJ at 1492-1493 (paras 24-25). Although the ECJ does not, in this line of cases, expressly describe the principle as one of *EC law*, it cannot be anything else since the ECJ sets down principles for the application of EC law and does not merely 'bless' domestic abuse of rights laws. This application of the principle mirrors, at the level of *EC law*, the respect for domestic abuse of rights rules considered above.

financial benefit) the ECJ has approved the denial of the benefit of the relevant EC law to that person. This is because the conditions for the grant of the benefit concerned have been created artificially.³³

3.4 The Commissioners' Contentions

Each of these cases demonstrates, the Commissioners' contended, the overriding rationale of the principle: EC law is designed (in this field) to ensure the operation of the Single Market within the Community. However, artificial transactions which have no true *economic* purpose play no part in the operation of the Single Market and are therefore not entitled to the protection of the rules regulating that Market. This second aspect of the principle has also found expression in EC legislation: see Council Regulation 2988/95 on the protection of the EC's own financial interests, Article 4(3).

The principle applies (see the submissions of the European Commission in *Emsland-Stärke*, adopted by the ECJ: paras 39-42 and 52-54) where there is evidence that:

- (1) Despite formal observance of the conditions in EC law for the grant of a particular benefit, the purpose of the EC rules in issue has not been achieved.
- (2) The person concerned intended to obtain the benefit of the EC rules by creating artificially the conditions laid down for the grant of the benefit.

Such evidence must be adduced - before the national Court - in accordance with the rules of national law and due respect must be paid to the principle of effectiveness of EC law.³⁴ Where such evidence is present the Court must deny the advantage which is sought to be obtained. In a VAT context the relevant abusive steps are ignored and (in the present case) the true nature of the transaction is taxed.

³³ *General Milk Products* [1993] ECR I 779 per the ECJ at 799 (para 21), *EMU Tabac* [1998] ECR I 1605 per AG Colomer at 1627-1628 (para 89) (entitlement to bring excise goods into the UK without payment of duty) [CAB, tab 38] and, most recently, *Emsland-Stärke v Hauptzollamt Hamburg Jonas*, C-110/99, 14/12/2000 per AG Alber at paras 28, 39-45, 62-68 and 78-83 and the ECJ at paras 36-45 and 50-58 [CAB, tab 47] (entitlement to export refunds under Commission Regulation 2730/79).

³⁴ Although the principle of legal certainty (or "lawfulness") must also be respected, there is no conflict between the two principles since the abuse of rights doctrine represents a clear and unambiguous basis upon which persons can order their affairs: *Emsland-Stärke* per AG Alber at paras 28, 84 and the ECJ at paras 24 and 56.

Applying these principles to the facts in *Halifax* the Commissioners contended that despite formal observance of the conditions in EC law for the grant of the benefit of the right to recover input tax (see Article 17, 6th Directive), the purpose of the Directive has not been achieved since H would (in group terms) be entitled to recover input tax notwithstanding its largely exempt status. Equally, H clearly intended to obtain the benefit of input tax recovery by creating artificially the conditions laid down for the grant of the benefit through transactions *solely* entered into for VAT avoidance purposes. Accordingly, the Tribunal, in applying the right to deduct input tax under Article 17, 6th Directive, as implemented in ss.24-26 VATA 1994, can (and should) deny the advantage which is sought to be obtained. Here this meant, the Commissioners said, denying recovery of input tax by disregarding the insertion of CWPI and LPDS into the legal and financial structure for the construction of the call centres. Instead, the true nature of the transactions to be taxed was a supply by the builders to H. It is this which permitted H to recover the input tax which it would otherwise have been able to recover in accordance with its partial exemption position, but no more.

3.5 The Counter-Argument

Halifax contended that, even if there were such a general principle of EC law, it could have no application to the present case since the Halifax was relying on the terms of UK legislation and not EC rights. Equally, such general principles were, like directives which had no "direct effect", not capable of being applied by Member States *against* individuals. Inevitably, the dispute ran, the "abuse of rights" argument could not help the Commissioners; Halifax was entitled under UK statute to the tax benefit it claimed and that was the end of the matter.

4. The Tribunal's Decision in *Halifax*

The Tribunal accepted the submissions of the Commissioners on the first main contention - the principle of interpretation - leaving the "principle of substance" argument for another day. In particular the Tribunal referred, by way of analogy, to the UK cases on whether a tax avoidance transaction was a "trading transaction" for UK direct tax purposes³⁵ and compared that approach favourably with the approach of the ECJ in VAT cases such as *Fischer*³⁶ in which the Court excludes from the protection of the 6th Directive transactions which are "wholly alien" to the objects of the Directive. In the mind of the tribunal, transactions

³⁵ *FA & AB Lupton et al.*

³⁶ [1998] STC 708.

entered into solely for the purposes of tax avoidance are as "alien" to the objects of the 6th Directive as the sale of illegal drugs; the inherent nature of the transactions - tax avoidance - necessarily excludes a business purpose. In arriving at this conclusion the Tribunal rejected the submission of the Halifax, relying on *BLP*, that the purpose (or "ultimate aim") of the taxpayer be irrelevant for the purposes of determining whether there be an "economic activity"; the Tribunal saw the *BLP* case as being more limited, concerned only with the attribution of input tax. Equally, the Tribunal did not regard itself as 'globalising' the affairs of the taxpayers, nor as disregarding valid supplies. Instead, the Tribunal believed itself to be applying the statutory terms ("supply and "economic activity" to transactions which have some economic or business character and not to those, tax avoidance, transactions which do not.

5. Summary

As many commentators have observed, this is perhaps just the first shot in what may well be a long battle in the Courts in the UK and, ultimately, in the EC over the application - and, indeed, scope - of the "abuse of rights principle"³⁷. Perhaps the only thing which can be said with any certainty at this early stage in this new campaign between tax gatherer and taxpayer is that sooner rather than later the ECJ will be faced, for the first time, with having to determine how far rights conferred by, or under the auspices of, EC law can be relied upon to avoid taxes otherwise payable to the Member States and ultimately (in the case of VAT) to the EC itself. How will the ECJ regard those who carry out transactions which have the effect of reducing the EC's "own resources"? Only time will tell.

³⁷ There are already a number of appeals before the VAT Tribunal where the operation of the "Halifax" principle or approach to other situations will be examined.