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ANTI-AVOIDANCE PROVISIONS IN THE EC DIRECTIVES

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Introduction

On 23rd July 1990 the EC Commission approved several measures in the area of direct company taxation: the Council Directive on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (90/434/EEC), hereafter the 'Merger Directive' and the Council Directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (90/435/EEC), hereafter the 'Parent-Subsidiary Directive'. The objective of the Merger Directive is to remove the direct tax obstacles to cross-border restructuring operations within the European Union and the objective of the Parent-Subsidiary Directive is to remove the double taxation of certain dividend flows within the European Union. Both Directives have the force of law in all Member States. The overall aims of the Directives are clear from their preambles and from the gist of their provisions, but, taken strictly as legal texts meant to achieve these aims, they contain a number of omissions. This is perhaps the most fundamental problem of the Directives.[2] In interpreting the Directives, the Court of Justice, which prefers a teleological method of interpretation, relies heavily on the preamble and the general intent of legislation. This means that in some cases the Directives have to be treated as political statements. In addition, the Directives themselves have their limitations. The legitimate concern of the Member States to protect their tax base is, for example, reflected in a provision in both Directives that relieves the Member States of the obligation of applying them in cases of avoidance or evasion. In this article special attention is paid to the interpretation, scope and effects of these provisions.

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2 Survey of the implementation of the EC Corporate Tax Directives, IBFD, IBFD-Publications BV, Amsterdam, 1995.

General Anti-avoidance Provisions

The Parent-Subsidiary Directive contains an anti-avoidance provision that is phrased in general terms and which reads as follows:

> "This Directive should not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse".[3]

The anti-avoidance provision in the Merger Directive is more detailed and reads:

> "(1) A Member State may refuse to apply or withdraw the benefit of all or any part of the provisions of Titles II, III and IV where it appears that the merger, division, transfer of assets or exchange of shares:
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> (a) has as its principle objective or as one of its principle objectives tax evasion or tax avoidance; the fact that one of the operations referred to in article 1 is not carried out for valid commercial reasons such as the restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives."[4]

These provisions raise certain questions. What is meant by 'fraud' and 'abuse'?[5] Are these provisions necessary, given that the jurisprudence of the Court of Justice allows the Member States scope to prevent the abuse of EC legislation?[6] Can these provisions be used to remove all the substance from the Directives?[7]

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3 Article 1(2) of the Parent-Subsidiary Directive.

4 Article 11 of the Merger Directive.

5 Professor Dr Albert J Rädler, *"Do National Anti-Abuse Clauses Distort the Internal Market"*, in: European Taxation, September 1994, at 311-313.

6 Professor Dr Peter J Wattel, *"Misbruik van Europees Recht"* (Abuse of European Law), inaugural lecture of 22nd April 1993 on the occasion of his appointment as Professor of European Tax Law at the University of Amsterdam, published by FED.

7 Dennis Weber, "A closer look at the general anti-abuse clause in the Parent-Subsidairy Directive and the Merger Directive", in: EC Tax Review, 1996/2, at 63-69.

Common Definition of Abuse of Law

In order to discuss the issue of abuse of law properly, it is necessary to start with a clear definition of the term 'abuse' and particularly to make some delimitations with respect to other terms such as 'tax evasion', 'tax avoidance' and 'tax planning'. This is all the more so because differences exist in Member States as to the translation of these terms.

While the term 'fraud' seems to be quite clear and explicit in every language, 'tax evasion' is not; in the Netherlands this term can be translated as 'ontgaan van belastingen' and in Germany as 'Steuerhinterziehung', which ranges from 'fraud' to 'abuse'. A more appropriate translation is 'belastingvlucht' or 'Steuerflucht'. These are, however, just as ambiguous as 'tax evasion', and include both the intentional non-declaration of tax and the sophisticated use of loopholes which the tax administration might regard as immoral or even illegal.

'Tax avoidance' and 'abuse of law' are terms to describe strategies pursued by the taxpayer to reduce his tax liability by carefully structuring the factual situation or the legal or contractual basis of transactions. In the strategies covered by the two terms the taxpayer stays within the law as far as his legal obligations in the strict sense of the word are concerned. The taxpayer arranges the facts and the legal aspects of the transactions in such a way as to minimize his tax burden. Normally the taxpayer and the tax administration disagree as to whether a case is one of disallowed tax abuse or one of acceptable (clever) tax planning. The borderline between disallowed tax abuse and acceptable tax planning is sometimes narrow and is always very difficult to ascertain. The approach to tax avoidance varies from one Member State to the other (see below).

'Fraud' will not be discussed here since it is commonly interpreted as any illegal action of the taxpayer. The borderline between disallowed 'abuse' and acceptable 'tax planning' is the subject of this article.

Domestic Anti-avoidance Provisions

Without giving an exhaustive comparison of general anti-avoidance provisions in the domestic legislation of the Member States, a distinction can be made between the Civil Law countries and the Common Law countries.[8]

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[8] See for a comparison of anti-avoidance approaches: Prof Dr Cyrille David, *"L'abus de droit en Allemagne, en France, en Italie, aux Pays-Bas et au Royaume-Uni"*, in: Rivista di diritto finanziario e scienza delle finanze, LII, 2, I, 1993, at 220-256.

In the United Kingdom a general anti-abuse provision has not been enacted in the statutes. This is largely because the legal system of the United Kingdom is a Common Law system. However, the House of Lords has decided that the tax administration may combat certain transactions or structures which can be regarded as abusive from a tax point of view.[9] The abuse of law doctrine has been further developed in case law,[10] based on the facts in specific cases, and is therefore strongly influenced by the rules of common law. *Ramsay v IRC* developed the principle that the Commissioner may consider whether, on the facts, what is at issue is a composite transaction or a number of independent transactions. In *Craven v White* it was held that, in order for the *Ramsay* principle to apply, the intermediate steps had to serve no purpose other than that of saving tax; all stages of the composite transaction had to be preordained, with a degree of certainty that the taxpayer had control over the end result at the time when the intermediate steps were taken; in addition, there should be no interruption between the intermediate transaction and the disposal to the ultimate purchaser.

In some Member States a general anti-avoidance provision can be found in the legislation.[11] In France the general anti-avoidance provision is included in article L 64 du LPF (Livre des procédures fiscales):

> "Ne peuvent être opposés à l'administration des impôts les actes qui dissimulent la portée véritable d'un contrat ou d'une convention à l'aide de clauses:
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> (a) Qui donnent ouverture à des droits d'enregistrement ou à une taxe de publicité foncière moins élevés;
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> (b) Ou qui déguisent soit une réalisation, soit un transfert de bénéfices ou de revenus;
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> (c) Ou qui permettent d'éviter, en totalité ou en partie, le paiement des taxes sur le chiffre d'affaires correspondant aux opérations effectuées en exécution d'un contrat ou d'une convention."

The anti-avoidance provision applies only if the sole purpose of the legal transaction is the reduction of tax liability. This is one of the reasons that the French tax administration has never been very successful. Another reason could

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9 *Ramsay v IRC* [1982] STC 174.

10 *Furniss v Dawson* [1982] STC 267, *Craven v White* [1988] STC 476 and *Ensign Tankers (Leasing) Ltd v Stokes* [1992] STC 226.

11 E.g. in France, Germany, Spain and recently also in Belgium and Sweden.

be the special procedure under which a 'Comité consultatif' is set up in order to divide the burden of proof between the tax administration and the taxpayer.

In Germany the general anti-avoidance provision gives the tax administration more room to combat anti-avoidance schemes. Paragraph 42 AO (Abgabenordnung) states:

> "Durch Mißbrauch von Gestaltungsmöglichkeiten des Rechts kann das Steuergesetz nicht umgangen werden. Liegt ein Mißbrauch vor, so entsteht der Steueranspruch so, wie er bei einer den wirtschaftlichen Vorgängen angemessenen rechtlichen Gestaltung entsteht."

The question arises as to what kind of combinations of legal transactions constitute 'Mißbrauch'? In the second part of the section, 'Mißbrauch' is defined as "... eine zivielrechtliche Gestaltung, die den wirtschaftlichen Vorgängen (oder Zuständen) gegenüber unangemessen ist. Unangemessen ist eine zivielrechtliche Gestaltung, die verständige Parteien zur Erreichung des erstrebten wirtschaftlichen Ziels unter den gegebenen Umständen nicht gewählt haben würden." Reference is made both to economic reality and to the sound business decision of the entrepreneur. The result of the combined legal transactions is decisive rather than the taxpayer's motive in entering into these transactions. 'Mißbrauch' should be seen as a final transaction which only occurs if the taxpayer is conscious of the fact that his reason for entering into these legal transactions is to avoid tax liability.[12]

On 22nd July 1993 Belgium introduced a general anti-avoidance provision in article 344 § 1 WIB (Wetboek van de inkomstenbelasting):

> "Aan de administratie der directe belastingen kan niet worden tegengeworpen, de juridische kwalificatie door de partijen gegeven aan een akte alsook aan afzonderlijke akten die een zelfde verrichting tot stand brengen, wanneer de administratie door vermoedens of door andere in artikel 340 vermelde bewijsmiddelen vaststelt dat die kwalificatie tot doel heeft de belasting te ontwijken, tenzij de belastingplichtige bewijst dat die kwalificatie aan rechtmatige financiële of economische behoeften beantwoordt;"

This provision refers to economic reality and seems to represent a major step away from the existing approach. This approach, the 'Breepols-doctrine', was developed in jurisprudence[13] and states that the tax administration must permit any combination of legal transactions as long as the taxpayer has accepted all the legal

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12 Professor Dr Klaus Tipke/Professor Dr Joachim Lang, *'Steuerrecht - Ein systematischer Grundriß'*, verlag Dr Otto Schmidt KG, Köln, 13th edition, 1991, at 102.

13 Hof van Cassatie, 6th June 1961.

consequences of these transactions. Whether both concepts can apply to tax avoidance schemes in Belgium at the moment is very unclear.

In Sweden a general anti-abuse provision is included in the *"lagen mot skatteflykt"* (SFS 1980:865), the Tax Avoidance Law which was reinstated on 1st July 1995 after having been abolished for more than two years. According to this Law, a transaction may be deemed a method of tax avoidance, and the transaction may be disregarded for tax purposes, if all of the following requirements are met: (a) the transaction results in a significant tax benefit for the taxpayer; (b) tax considerations are deemed the main motive for the transaction; and (c) the transaction is contrary to the spirit of the law.

A similar approach can be found in the Netherlands. The general anti-avoidance provision is included in Article 31 AWR (Algemene wet inzake rijksbelastingen):

> "Voor de heffing van de directe belastingen wordt geen rekening gehouden met rechtshandelingen waarvan op grond van de omstandigheden dat zij geen wezenlijke verandering van feitelijke verhoudingen hebben ten doel gehad, of op grond van andere bepaalde feiten en omstandigheden moet worden aangenomen dat zij zouden achterwege gebleven zijn indien daarmede niet de heffing van de belasting voor het vervolg geheel of ten dele zou worden onmogelijk gemaakt".

Since 1st August 1987 this provision has been set aside because the *fraus legis* doctrine developed in civil case law[14] has also been applied in tax cases. The *fraus legis* doctrine has developed along similar lines as the above statutory provision but is more flexible. This doctrine gives the tax administration the possibility to ignore or replace a legal transaction or a scheme of legal transactions if the following conditions are met: (1) the principal motive for entering into the transaction(s) is the avoidance of taxation and (2) by entering into these transactions, the taxpayer violates the purpose and objective of the tax law.

From this comparison one may conclude that there is no common interpretation of disallowed 'tax avoidance' in the domestic legislation or in the jurisprudence of the Member States. In addition, it is uncertain whether the domestic approaches to combatting such 'tax avoidance' apply in international situations. Since the 'Monaco-Fall'[15] in which the German tax on the sales of shares in a German subsidiary was avoided by interposing a Swiss company between the German company and its shareholder who was resident in Monaco, this is doubtful for

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14 Hoge Raad (HR) 26th May 1926, ("driedagen-arrest")NJ 1926, 723.

15 Bundesfinanzhof (BFH) 29th October 1981, IR 89/80, Bundessteuerblatt (BStBl) II 1982, at 150.

Germany. In this case the application of Paragraph 42 AO was accepted by the German Supreme Court (Bundesfinanzhof). However, in a similar case[16] the Court refused to apply this provision. In the Netherlands the Supreme Court (Hoge Raad) decided that the *fraus legis* doctrine cannot be applied in international situations.[17] The preliminary conclusion is that domestic interpretations of 'tax avoidance' will not be very helpful in interpreting the Directives.

Case Law of the European Court of Justice

Fiscal Jurisprudence

As mentioned above, the Court of Justice favours a teleological interpretation. This means that the Court will try to develop a 'European' interpretation of 'tax avoidance'. A start has been made in the decisions of the Court in several cases regarding direct taxation. These cases mainly concern the general non-discrimination clause[18] and the 'four freedoms'.[19]

In the *Avoir fiscal* case[20] the French administration rejected application of the tax credit ('avoir fiscal') on French dividends received by a permanent establishment of a company resident in another Member State. The Court of Justice did not accept the French argument, amongst others, that this provision was introduced to reduce the risk of 'tax avoidance': "Dans cet ordre il n'a pas fait appel au risque d'évasion fiscale. Article 52 du traité de Rome ne permet pas une infraction de la liberté d'établissement pour des raisons identiques". This decision might have inspired the tax lawyers of Daily Mail and General Trust PLC when presenting their case to the Court of Justice.[21] According to Section 482(1)(a) of the Income and Corporation Taxes Act 1970 companies resident in the United Kingdom for tax purposes are prohibited from ceasing to be so resident without the consent of the Treasury. It was commonly accepted that the principal reason for the proposed

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16 BFH 10th November 1983, IV R 62/82.

17 HR 15th December 1993, BNB 1994/259.

18 Article 6 of the EC Treaty:

> "Within the scope of application of this Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited".

19 Articles 48, 52, 67 and 73b of the EC Treaty.

20 ECJ 28th January 1986, C-270/83.

21 ECJ 27th September 1988, C-81/87.

transfer of central management and control in this case was to enable the applicant, after establishing its residence for tax purposes in the Netherlands, to sell a significant part of its non-permanent assets and to use the proceeds of that sale to repurchase its own shares, without having to pay the tax to which such transactions would make it liable under UK tax law. The Court of Justice did not refer to 'tax avoidance', even though PLC was very clear in its motives, but to the absence of harmonized company law. The freedom of establishment principle was not created to make this kind of tax planning structure possible. As a consequence, the Court of Justice rejected the Daily Mail's 'tax planning' via the application of company law. The argument of 'anti-avoidance' was also used by the Luxembourg administration in order to defend the domestic provision that the deduction of tax from salaries and wages of taxpayers resident during only part of the year shall not be refunded.[22] The purpose of this provision was to protect the system of progressive taxation. The Court of Justice did not accept this justification and decided that Article 48 of the EC Treaty precludes a Member State from having such a provision in its tax legislation. The main consideration of the Court of Justice was that the provision violated the rule of proportionality.

In other cases[23] the Court of Justice accepted the fiscal coherence of the domestic tax system (including tax treaties concluded by a Member State) as a justification for different treatment. In the *Halliburton* case[24] the Netherlands administration justified its different treatment regarding a charge on the transfer of immovable property in an internal reorganisation by arguing, among other things, that the exemption for domestic companies could not apply to foreign entities because the administration is unable to check whether the legal forms of entities set up in other Member States are equivalent to those of public and private limited companies within the meaning of the national legislation. This argument was not accepted by the Court of Justice because since such information could be obtained under a Council Directive[25] concerning mutual assistance. In the recent *Asscher* case[26] the Court of Justice did not accept the 'anti-avoidance' argument of the Netherlands administration. Mr. Asscher, a Netherlands national who worked but did not reside in the Netherlands, received a salary which was taxed at a rate higher than that applicable to taxpayers engaged in the same activity who were

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22 ECJ 8th May 1990, C-175/88.

23 ECJ 28th January 1992, C-204/90 (Bachmann) and ECJ 11th August 1995, C-80/94 (Wielockx).

24 ECJ 12th April 1994, C-1/93.

25 Council Directive on mutual assistance by the competent authorities of the Member States in the field of direct taxation, 77/799/EEC of 19th December 1977.

26 ECJ 27th June 1996, C-107/94 (Asscher).

resident in the Netherlands or treated as such. The Netherlands government submitted that a difference in tax rates between non-resident, non-contributing taxpayers, on the one hand, and those who are resident or treated as such, on the other, is justified by the need to prevent the tax burden on the former from being appreciably lighter than on the latter. This advantage, which such non-residents are presumed to enjoy, resulted from the decision of the Netherlands legislature to abolish the right to deduct social security contributions. Such a circumstance may not be offset by tax differences affecting this category, since that would amount to penalizing them for not paying social security contributions in the Netherlands.

To summarize the above jurisprudence, the Court of Justice firmly rejected the 'abuse' argument as a justification for tax differences. However, after being confronted with the 'tax planning' in the *Daily Mail* case, they refined this firm rejection by calling on company law, proportionality, fiscal coherence, the Directive on mutual assistance, social security law, etc.

Non-fiscal Jurisprudence

The Court of Justice has also decided on non-fiscal issues regarding the abuse of European Law. The Court has dealt with three kinds of unacceptable 'abuse'.

The first category of abuse of European Law occurs if a resident of a Member State uses European Law in order to enjoy a domestic provision which does not apply to him.[27] A second category of 'abuse' occurs if a European rule is applied to escape domestic provisions.[28] In such cases a person resident in a Member State organizes his activities via another Member State in order to frustrate the domestic legislation in the first Member State by applying European Law. The third and last category of 'abuse' recognized by the Court of Justice is that in which European Law is used to frustrate a domestic provision.[29] The Court of Justice combats the 'abuse' of European Law either by the interpretation of the provision in European Law, or by not accepting the application of European Law because such an application is in itself abusive.

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27 E.g. ECJ 21st June 1988, C-39/86 (Lair) and ECJ 25th July 1991, C-221/89 (Factorame II).

28 E.g. ECJ 7th February 1979, C-115/78 (Knoors) and ECJ 19th January 1988, C-292/86 (Gullung).

29 See e.g. ECJ 27th September 1988, C-81/87 (*Daily Mail*).

European Anti-abuse Doctrine?

The jurisprudence of the Court of Justice illustrates, in my opinion, the development of a European 'anti-avoidance' approach. The case law clearly shows that the Court of Justice is willing to make a marginal test of whether a Member State can reasonably consider a situation to be abusive. The application of 'abuse' provisions by a Member State should serve an ultimate public interest which justifies an infraction of European Law, provided the application meets the requirement of proportionality. The Court of Justice does not accept the application of 'abuse' concepts which does not meet this requirement. In addition, 'abuse' concepts as a justification for differentiation will not be very successful if the issue is already covered by European Law. In other situations, however, 'abuse' is a valid justification to protect a specified public interest, such as, for example, the coherence of a domestic tax system.

Scope of the General Anti-abuse Provisions in the EC Directives

The remaining question is whether the 'anti-avoidance' provisions in the EC Directives are superfluous. As a result of the jurisprudence of the Court of Justice, Member States can combat 'abuse' on the basis of their national legislation, provided that the results are proportional and provided European rules have not yet been developed. Member States, however, prefer having as much freedom as possible to protect their tax revenues. As a result, the introduction of special provisions in the Directives limits the application of domestic 'anti-avoidance' approaches. Article 1(2) of the Parent-Subsidiary Directive refers to the domestic approaches. Article 11 of the Merger Directive contains its own concept of 'abuse', but also refers to domestic approaches. The question arises whether these European 'anti-avoidance' provisions give the Court of Justice the possibility of interpreting vague terms or whether they give the Member States room to manoeuvre in implementing the Directives. In my opinion, the room to manoeuvre is quite limited. The freedom of the Member States is limited by the purpose and spirit of the Directives, European Law and by the principle of proportionality. When interpreting vague terms, the Court of Justice will explicate the term and, by introducing certain conditions, will define a margin to the Member States within which they may implement their 'anti-avoidance' provisions. The national courts can then judge whether these conditions are being met by the Member States.

The Court of Justice requires a national implementation of the Directives without restrictions but with sufficient legal security. The implementation of the legal norm must contain all the rights and obligations provided by the Directives as well as adequate provisions to execute these rights and obligations. In this respect it is not sufficient that an implementation by ruling practice be introduced, because the policy of the tax administration can vary and taxpayers are not always aware of that policy. Another issue is the requirement of proportionality; this means, that

a general 'anti-avoidance' approach should contain the possibility of providing proof to the contrary.[30]

Conclusion

If certain conditions are fulfilled (e.g. proportionality), the European Court of Justice accepts the application of domestic 'anti-avoidance' approaches. Considering the European jurisprudence, in my opinion, the general 'anti-avoidance' provisions in the Directives somewhat enlarge the room to manoeuvre in applying domestic 'anti-avoidance' approaches, but limit the possibilities for Member States to refuse application of the Directives. In this respect, the general 'anti-avoidance' provisions in the Directives are superfluous.

30 See also: Dennis Weber, id.