TAX AVOIDANCE AND ABUSE OF EU LAW [1] [*]

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"In order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory" (*Thin Cap GLO*)

"taxpayers may choose to structure their business so as to limit their tax liability" (*Halifax*)

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* Before articles have been accepted for publication in EC Tax Journal's peer-reviewed section, they have been subject to double-blind peer-review; that is, two academic reviewers who shall remain anonymous to the author and to each other and neither of whom are from the same country as the author have evaluated the article's academic merit. Only articles confirmed by the reviewers to show the highest standards of scholarship are accepted for publication in this section.

1 In English, the concepts of "tax avoidance" and "tax evasion" have two separate meanings. The terms EU and Community are used interchangeably throughout this article to reflect the changes brought about by the Treaty of Lisbon. References to the Treaty on the Functioning of the European Union (TFEU) are used whenever possible.
"Tax evasion" is illegal. A taxpayer found to have committed tax evasion may be prosecuted under the criminal law. "Tax avoidance" on the other hand is legal and may occur where the taxpayer reduces his liability to tax by taking advantage of a fiscally attractive option afforded to him by legislation. Some forms of "tax avoidance" are acceptable to the Courts (sometimes called "tax mitigation"), whilst other forms of "tax avoidance" are unacceptable. This is how the concepts will be used in this article. Note: the ECJ sometimes uses the concept of "tax avoidance" when it means "tax evasion". Wherever this occurs in the text it will be noted by an appropriate footnote. For an interesting discussion of these concepts see: Philip Baker, *"Tax Avoidance, Tax Mitigation and Tax Evasion",* available online at http://www.taxbar.com/documents/Tax_Avoidance_Tax_MitigationPhilip_Baker.pdf (last visited 10/03/2011).

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Introduction

Understanding the notions of "abuse" and of "tax avoidance" is of utmost importance because what constitutes "abuse" of a fundamental freedom or "tax avoidance" can have an impact on the national tax regimes of the Member States and on taxpayers exercising the fundamental freedoms. In the absence of harmonised rules, the ECJ plays a key role in balancing the interests of the Member States in the regulation of direct tax matters (an area in which they retain considerable competence) with the interests of natural and legal persons whose EU fundamental freedom rights may be restricted only in limited situations. This interaction with the national tax regimes of the Member States permeates into their anti—tax avoidance rules contained in their CFC and thin capitalisation regimes, cross-border loss relief rules, DTC limitation on benefit (LoB) clauses and withholding tax provisions. This article sets out the results of an investigation of the ECJ's interpretation of the concepts of "abuse" and "tax avoidance". It is divided into three parts. Part I examines two particular types of "abusive" situation encountered in the Court's jurisprudence which have relevance for direct tax matters: where a company is incorporated in a Member State even though it does not conduct any business activity there, preferring to conduct its activities in other Member States; and where there is an alleged "abuse" of EU freedoms. Part II examines the concept of "tax avoidance" in the jurisprudence of the ECJ relating to the internal market and Part III provides some conclusions.

Part I "Abuse" of the Fundamental Freedoms

A. Companies formed in a Member State but which do not trade there.

The Court's jurisprudence plays a crucial role in the interpretation of the concepts of "tax avoidance", "circumvention" of national rules and regulations, and "abuse" of EU freedoms.[3] Whenever EU law is involved, the ECJ defines the broad parameters of these concepts from the perspective of EU law, leaving it up to national courts to apply this guidance to determine whether the national rules have breached these limits in a particular situation. This section focuses on the Court's jurisprudence, starting with *Segers,* concerning companies which were established in Member State A for the purpose of circumventing certain national rules of Member State B and which traded in Member State B through a subsidiary or a branch.

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3 *Segers.* This starts a line of case law followed by *Centros*, and culminates with *Inspire Art Ltd.* ECJ, 10 Jul. 1986, Case 79/85, *D. H. M. Segers v Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen ("Segers"),* [1986] ECR 2375; ECJ, 9 Mar. 1999, Case C-212/97, *Centros Ltd v Erhvervs- og Selskabsstyrelsen ("Centros"),* [1999] ECR I-1459 and ECJ, 30 Sep. 2003, Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd ("Inspire Art"),* [2003] ECR I-10155.

Segers

In *Segers*, the Court determined that a company, formed under the laws of Member State A and having its registered office there, which conducts its business entirely through a branch or subsidiary in Member State B is entitled to national treatment in Member State B. The fact that the company conducts no business in Member State A is of no relevance. EU law simply requires that the company was formed under the law of Member State A and is linked to that Member State by one of the three alternative connecting factors set out in Article 48 EC (Article 54 TFEU) (registered office, central administration, or principal place of business within the EU).[4] The Court said -

> "Provided that those requirements are satisfied, the fact that the company conducts its business through an agency, branch or subsidiary solely in another member-State is immaterial".[5]

The ECJ examined the argument that the need to combat "abuse" on public interest grounds was a possible justification for the different treatment imposed by the Dutch tax rules and the Court affirmed that the need to combat fraud might justify different treatment in some situations,[6] but that this justification did not apply in *Segers*.

The Dutch authorities argued that the scheme of forming a company in the United Kingdom, which in turn opened a subsidiary in the Netherlands, allowed certain Dutch nationals to circumvent Dutch social security rules through an abuse of the freedom of establishment. The Court rejected this argument saying that

> "the refusal to accord a sickness benefit to a director of a company formed in accordance with the law of another Member State cannot constitute an appropriate measure in that respect".[7]

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4 See Point 5 of the Advocate General's Opinion in *Segers*.

5 *Segers* paragraph 16 of the judgment.

6 On public interest, public health and public security grounds as specified in Article 46 EC (now Article 52(1) TFEU).

7 *Segers* paragraph 17. Advocate General Darmon noted in his Opinion in *Segers* that "…the possibility cannot be excluded that an operation of the same type as that carried out by him could have a fraudulent purpose. Nevertheless, the mere possibility of that happening cannot justify a general restriction on the right of establishment of natural and legal persons. On the other hand, the national authorities must be permitted to verify in individual cases that the companies thus formed have been, as is expressly provided in Article 58 of the EEC Treaty, formed in accordance with the legal provisions laid down to that effect. Similarly, they may control the activities of such companies with regard to the requirements of public policy. In that respect Article 56 EEC provides that the rules of the Treaty shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health".

Centros

The Court re-visited this "abuse" area in *Centros*, where two Danish nationals incorporated a company in the United Kingdom, Centros Limited, which did not trade there. Instead, it opened a branch in Denmark and conducted all its economic activities through its Danish branch. The Danish authorities refused registration of the branch because they felt that the right of establishment had been exercised in order to avoid Danish rules on minimum paid-up share capital for corporations.

The ECJ, following *Segers*, found that the incorporation of the United Kingdom company was covered by the freedom of establishment provisions of the Treaty, entitling such a company to establish a branch, agency or subsidiary in another Member State.[8] Centros had chosen to establish a branch in Denmark but the Danish authorities refused to register the branch. The Court held that this constituted a restriction on the freedom of establishment.[9]

The Danish authorities argued that refusal to register the branch was justified because the sole reason for the incorporation of Centros in the United Kingdom was to circumvent Danish company law rules concerning minimum paid-up share capital[10] and, thus, constituted an abuse of the right of establishment that Denmark was entitled to prevent.[11] The Danish authorities also argued that their rules were justified by the general interest of protecting company creditors.

Carefully examining each of these arguments, the Court delivered some extremely important conclusions. First, it followed its previous case law and affirmed that Member States can take measures to prevent their nationals from

> "attempting, undercover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law".[12]

However, the Court placed considerable limits on Member State action by insisting that in order to deny persons the benefit of EU law provisions, national courts had to (a) take account of abuse or fraudulent conduct on a case by case basis; (b) act on

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8 *Centros* paragraph 20

9 *Centros* paragraph 22.

10 Apparently, it was considerably cheaper to establish Centros Limited in England and trade in Denmark via a branch of Centros Limited.

11 *Centros* paragraph 23.

12 *Centros paragraph 24.*

the basis of objective evidence; and (c) assess such conduct in the light of objectives pursued by the EU law provisions.[13]

These limits place a significant burden on Member States and the way in which they design their national tax rules and LoB clauses in their DTCs because Member States that maintain anti-avoidance rules that are general in nature, which deny the national courts the power to assess fraudulent or abusive conduct on a case-by-case basis, may be incompatible with EU law if such general rules restrict the fundamental freedoms.

In *Centros*, the Court decided that Danish legislation relating to the formation of companies interacted with the freedom of establishment rules contained in the EC Treaty. As such, when a national of Member State A chose to set up a company in Member State B which had less restrictive company law rules, exercise of that choice, in itself, could not

> "constitute an abuse of the right of establishment. The right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty".[14]

The Court reiterated its earlier finding in *Segers*,[15] that the fact that the company is incorporated and has its registered office in Member State A, but conducted no economic activities there is immaterial. According to the Court this fact

> "is not sufficient to prove the existence of abuse or fraudulent conduct which would entitle the latter Member State [Member State A] to deny that company the benefit of the provisions of Community law relating to establishment".[16]

Consequently, the Court allowed the Danish nationals to circumvent the Danish rules on minimum paid-up share capital because there was no proven fraudulent conduct or abuse of the freedom of establishment. Indeed, it is often overlooked that the branch of the United Kingdom company established in Denmark conducted a real economic activity, meaning that the United Kingdom company conducted these

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13 *Centros paragraph 25.*

14 *Centros paragraph 27.*

15 *Segers paragraph 16.*

16 *Centros* paragraph 29.

real economic activities in Denmark given that the Danish branch is just a part of the United Kingdom company.[17]

Moreover, the Court rejected the Danish government's justifications advanced under Article 56 (Article 52 TFEU) of the Treaty.[18] However, the Court emphasised, that even though a Member State could not refuse to register a branch of a company fulfilling the Article 54 TFEU conditions, it could adopt

> "any appropriate measure for preventing or penalising fraud, either in relation to the company itself, if need be in cooperation with the Member State in which it was formed, or in relation to its members, where it has been established that they are attempting, by means of the formation of the company, to evade their obligations towards private or public creditors established on the territory of a Member State concerned. In any event, combating fraud cannot justify a practice of refusing to register a branch of a company which has its registered office in another Member State".[19]

The Court considered similar arguments and applied a similar line of reasoning in *Inspire Art Ltd.*

Inspire Art Limited

A Dutch national incorporated a United Kingdom company, Inspire Art Ltd, which did not trade in the United Kingdom, but traded in the Netherlands through a Dutch branch. Incorporation of the company in the United Kingdom allowed the Dutch national to circumvent Dutch rules on the formation of companies and minimum share capital requirements of Dutch law. Dutch rules subjected the registration of the branch to certain onerous conditions, which the company objected to on the ground that they restricted its right of establishment.

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17 See the discussion of *Centros* in Tom O'Shea, *"The United Kingdom's CFC Rules and the freedom of establishment: Cadbury Schweppes plc and its IFSC subsidiaries – tax avoidance or tax mitigation?* EC Tax Rev.2007, 1, 13-33 at 30. See also, Paul J. Omar, *"Centros, Uberseering and beyond: a European recipe for corporate migration: Part 2*", I.C.C.L.R. 2005, 16(1), 18-27 and Paul J. Omar, *"Centros, Uberseering and beyond: a European recipe for corporate migration: Part 1",* I.C.C.L.R. 2004, 15(12), 398-407; Vanessa Edwards, *"Case law of the European Court of Justice on freedom of establishment after Centros",* E.B.O.R. 2000, 1(1), 147-155; Anne Looijestijn-Clearie, *"Centros Ltd - a complete U-turn in the right of establishment for companies?"* I.C.L.Q. 2000, 49(3), 621-642. For a recent discussion see, Jesper Lau Hansen, *"A new look at Centros - from a Danish point of view",* E.B.L. Rev. 2002, 13(1), 85-95.

18 See paragraphs 35-38 of the *Centros* judgment. The Court decided that the Danish rules did not protect creditors because the branch would have been registered even if it had conducted only some business in the United Kingdom, even though Danish creditors would have been equally exposed to risks and less restrictive measures could have been put in place.

19 *Centros paragraph 38*.

The Dutch authorities argued that their rules were non-discriminatory because they applied to all companies incorporated in the Netherlands and that the objective behind such rules was the protection of creditors and consumers. A second argument, relating to "brass plate" companies, contended that the purpose of the provisions on freedom of establishment was to

> "enable undertakings carrying on activities in one Member State to achieve growth in another Member State, which is not the case of brass-plate companies".[20]
>
> A third argument related to the circumvention of national laws on the formation of companies. The Netherlands argued that to allow such companies the right of the freedom of establishment "would be an unacceptable evasion of national law".[21]

Following its previous case law, the ECJ dismissed all the Dutch government's arguments and made some interesting comments relating to "avoidance" and "evasion". The Court confirmed that the reasons why a company chose to incorporate in a particular Member State are "save in the case of fraud", irrelevant in a freedom of establishment context.[22] The mere fact that the company was incorporated in a Member State

> "for the sole purpose of enjoying the benefit of more favourable legislation does not constitute abuse even if that company conducts its activities entirely or mainly in that second State".[23]
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> Further, the Court noted that even though the establishment of the branch in this situation was covered by the freedom of establishment, a Member State was still entitled to adopt measures
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> "to prevent attempts by certain of its nationals improperly to evade domestic legislation by having recourse to the possibilities offered by the Treaty".[24]

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20 *Inspire Art Ltd* paragraph 84. For analysis see, Markus Rehberg, *"Inspire Art - freedom of establishment for companies in Europe between "abuse" and national regulatory concerns",* Eu. L.F. 2004, 1, 1-8.

21 *Inspire Art Ltd* paragraph 89.

22 *Inspire Art Ltd. paragraph 95.*

23 *Inspire Art Ltd. paragraph 96.*

24 *Inspire Art Ltd. paragraph 98.*

In analysing the justifications offered by the Netherlands for its restriction of the freedom of establishment, the ECJ affirmed[25] that the mere fact that a company does not carry-on business activities in the Member State of incorporation cannot constitute abuse of law, but the Court left it up to the national authorities

"to establish in every case whether the conditions on which such a restriction might be justified have been satisfied".[26]

Therefore, the Member States can take action in specific situations where the proof of fraud or abuse is available on an objective basis. However, in this particular case, the Dutch rules were too general to allow that examination to happen.[27]

Supremacy of EU law

To sum up, it is important to bear in mind that in an EU internal market context, the fundamental freedom provisions[28] may interact with national tax rules and rules contained in DTCs. When this happens, the freedoms must prevail unless the Member State's rules, if directly discriminatory, can be justified on grounds allowed by the TFEU;[29] and if indirectly discriminatory or non-discriminatory, it can be justified on general interest grounds which comply with the principle of proportionality.[30]

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25 Following *Centros*.

26 *Inspire Art Ltd.* p*aragraph 120*.

27 In relation to the other Dutch arguments concerning the protection of creditors, combating improper use of the right of establishment, protecting effective tax inspections and fairness in business dealings, the Court held that none of these justifications fell within Article 46 EC. As such they had to be evaluated according to its case law on overriding reasons related to the public interest. The Court found that even though Inspire Art Ltd. had been incorporated in the United Kingdom to circumvent Dutch rules on company formation, the Dutch national was, in an internal market context, entitled to make use of the freedom of establishment27 and, therefore, entitled to set up the company in the United Kingdom and use it to establish a branch in the Netherlands. The mere fact that the company never traded in the United Kingdom was "not sufficient to prove the existence of abuse or fraudulent conduct which would entitle the latter Member State to deny the company the benefit of Community law relating to the right of establishment".

28 The derogations relating to freedom of establishment are contained in Articles 45 EC and 46 EC. Article 45 EC carves out activities concerned with "the exercise of official authority". Article 46 EC provides for 'special treatment for foreign nationals on grounds of public policy, public security and public health'. See Article 51 TFEU and 52 TFEU respectively.

29 See ECJ, 6 Oct. 2009, Case C-153/08, *Commission v Spain ("Lotteries"),* [2009] ECR I-9735, paragraph 37.

30 See, for instance, *Kraus paragraph 32* and *Gebhard paragraph 37*. ECJ, 31 Mar. 1993, Case C-19/92, *Dieter Kraus v Land Baden-Württemberg ("Kraus"),* [1993] ECR I-1663 and ECJ, 30 Nov. 1995, Case C-55/94, *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano, ("Gebhard"),* [1995] ECR I-4165.

Interestingly, the rules of the EU internal market may alter a national court's perception of a given set of facts because conduct falling within an EU dimension has to be assessed in the light of the objectives of the TEU and TFEU. An example may be seen in a non-EU context where a company, established by an EU national in a third country, does not carry-on economic activities in that country and merely acts as a conduit or base company. This may suggest to some that tax avoidance is taking place. However, in an EU internal market environment, national courts of EU Member States must treat such a company formation as a mere exercise of the right of establishment and not draw any conclusion of "abuse" from the formation, location, and lack of business activity[31] of the company in that particular Member State.

The ECJ's case law in this area shows that in an EU context, the fact that a company conducts no business in a Member State is of little relevance to the concept of establishment. This fact, in itself, is not sufficient to prove abuse or fraud, which must be established in each specific case. However, the Court accepts that the need to combat fraud is a possible justification for restricting EU freedoms. It also accepts that the Member States can take measures to prevent their nationals from circumventing national rules and from "improperly"[32] using EU law to their advantage. In doing so, national systems must (a) consider each case on its merits and Member States; (b) not implement general rules which go beyond what is necessary to achieve the general interest objective at stake; (c) act on the basis of objective evidence; and (d) assess the conduct in the context of the objectives pursued by the EU law provisions. Any fraud or improper conduct must be proved on a case-by-case basis.

In relation to a company formed in an EU Member State by third country nationals, the Court has indicated that such an establishment must demonstrate an effective and continuous link[33] with the economy of a Member State. Finally, it should be

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31 On a deeper examination of the facts, perhaps the Court should have concluded that the Danish branch of activity was also the activity of the United Kingdom company. Under international tax law practice, the Danish branch and its activities still form part of the United Kingdom company.

32 Clearly, EU law and the fundamental freedoms can be used "properly" in a way which stills look like an apparent "abuse" situation. The example which comes to mind is *Chen* where a Chinese national used the free movement of persons and the rights granted to EU citizens to usurp the United Kingdom's immigration rules through an elaborate "visa planning" scheme involving what can only be described as a pre-planned series of steps to acquire the right to live and reside in the United Kingdom by having a child and making sure that child was born on the island of Ireland thus acquiring Irish citizenship for the child at birth and the subsequent right to move to the United Kingdom as that child's primary carer. See ECJ, 19 Oct. 2004, Case C-200/02, *Kunqian Catherine Zhu and Man Lavette Chen v Secretary of State for the Home Department,* [2004] ECR I-9925.

33 See *Uberseering* for a discussion on "continuous link". ECJ, 5 Nov. 2002, Case C-208/00, *Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC),* [2002] ECR I-9919, paragraph 74.

noted that it is a matter for the national courts to determine whether the criteria allowed by EU law for restricting EU freedoms have been fulfilled by the Member States.

The next section considers the concept of "abuse" of the freedoms in the Court's jurisprudence.

B. "Abuse" of the freedoms

An analysis of the Court's case law on "abuse" of the EU's fundamental freedoms indicates that the Member States retain considerable competence to deal with such abuse and to take proportionate action in the general interest.[34] This is because of the lack of EU harmonised rules in this area. However, a Member State's exercise of its direct taxing competence to deal with abuse and tax avoidance may result in the restriction of a fundamental freedom. Consequently, the Court must perform a delicate balancing function: it has to weigh the EU's interests alongside the interests of the Member State and apply the principle of proportionality in coming to its decision. Examples from across the various freedoms demonstrate the difficult balancing act conducted by the ECJ in this area. It is worthwhile examining this jurisprudence to understand the background to the Court's approach in the area of "abuse".

Freedom to provide services

Van Binsbergen

In *Van Binsbergen*, a Dutch rule provided that only persons established in the Netherlands were entitled to act as legal representatives before certain courts or tribunals. Van Binsbergen, a legal representative had, during the course of proceedings, transferred his residence from the Netherlands to another Member State. He argued that he did not have to be established in the Netherlands and cited the freedom to provide services provisions.

The Court noted that a requirement to habitually reside in the Member State where the service was provided would deprive the freedom to provide services of all meaning.[35] However, the Court decided that Member States could take certain action restricting the freedom to provide services if it could be justified by the

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34 See ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle v État belge* ("*SGI*"), [2010] ECR I-0000, paras. 65-66 (not yet reported).

35 ECJ, 3 Dec. 1974, Case 33/74 *Johannes Henricus Maria van Binsbergen v Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid ("Van Binsbergen"),* [1974] ECR 1299, paragraph 11.

general good.[36] Moreover, Member States could also take action to prevent a service provider, "whose activity is entirely or principally directed towards its territory", from using the freedom to provide services "for the purpose of avoiding professional rules of conduct, which would be applicable to him if he were established within that" Member State.[37] In this instance, the Court was not satisfied that a restriction on the freedom to provide services was actually necessary to ensure the proper administration of the justice system as less restrictive means could achieve the same objective.

One key point arising from *Van Binsbergen*, is that Member States, in the absence of harmonised rules, can take certain measures which restrict the freedoms if (a) they can justify them in the general interest; (b) the measures are indistinctly applicable; and (c) they meet the requirements of the proportionality principle; in other words, if the national rules comply with the *Gebhard* formula.[38]

"Broadcasting Cases"

The Court followed its *Van Binsbergen* reasoning in the "*Broadcasting cases"*.[39] Here, Dutch broadcasters tried to use the freedom to provide services to evade Dutch rules relating to broadcasters established on its territory. The Court said that

> "A Member State cannot be denied the right to take measures to prevent the exercise by a person providing services whose activity is wholly or principally directed towards its territory of the freedoms guaranteed for the purpose of avoiding the rules which would be applicable to him if he were established within that State".[40]

It was argued that the Dutch rules were justified in the public interest because of the cultural-policy objectives they tried to achieve. Member States could legitimately pursue such objectives and apply such rules to their own broadcasting organisations.[41] The rules prevented such broadcasters from improperly evading

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36 *Van Binsbergen* paragraph 12. In this instance, the Court was referring to professional rules, ethics, supervision and liability relating to legal representatives where the service-provider would evade those rules by establishing in another Member State.

37 *Van Binsbergen* paragraph 13.

38 ECJ, 30 Nov. 1995, Case C-55/94, *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano ("Gebhard"),* [1995] ECR I-4165, para. 37.

39 See ECJ, 3 Feb. 1993, Case C-148/91, *Vereniging Veronica Omroep Organisatie v Commissariaat voor de Media ('Veronica'),* [1993] ECR I-487 and ECJ, 5 Oct. 1994, Case C-23/93, *TV10 SA v Commissariaat voor de Media ("TV10"),* [1994] ECR I-4795.

40 *TV10* paragraph 20. See *Van Binsbergen* paragraph 13 and *Veronica* paragraph 12.

41 *Veronica* paragraph 11. See also *TV10* paragraph 19.

"the obligations deriving from national legislation concerning the pluralistic and non-commercial content of programmes".[42]

Veronica and TV10

In *Veronica*, the ECJ indicated that Member States can apply national rules to broadcasting organisations established on their territory, but in its *TV10* decision the Court apparently went somewhat further, determining that Member State A may treat as a "domestic broadcaster" those organisations that use the Treaty freedoms to establish themselves in another Member State in order to provide services in Member State A.[43]

> "a Member State may regard as a domestic broadcaster a radio and television organization which establishes itself in another Member State in order to provide services there which are intended for the first State' s territory, since the aim of that measure is to prevent organizations which establish themselves in another Member State from being able, by exercising the freedoms guaranteed by the Treaty, wrongfully to avoid obligations under national law, in this case those designed to ensure the pluralist and non-commercial content of programmes".
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> Thus, enterprises that use the Treaty freedoms to evade national rules may be treated in the same way as national organisations in certain circumstances, even though they are established in another Member State and are nationals of that Member State through the formation of a company in that Member State. In such cases, they are treated more or less as "virtual residents" of Member State A. This is an analogous situation to that found in *Schumacker,*[44] but, in this instance, it is the regulatory authority of the host State benefits from being able to treat a non-resident as if it were a resident entity.

"Virtual resident"

It will be recalled that in *Schumacker*, the taxpayer benefited from the right of free

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42 *Veronica* paragraph 13.

43 *TV10 paragraph 21*.

44 ECJ, 14 Feb. 1995, Case C-279/93, *Finanzamt Köln-Altstadt v Roland Schumacker ("Schumacker"),* [1995] ECR I-225. For an analysis of the *Schumacker* case see, John F. Avery Jones, "*What is the difference between Schumacker and Gschwind?*" B.T.R. 2000, 4, 195-197; John F. Avery Jones*, "What is the difference between Schumacker and Gilly?"* B.T.R. 1999, 1, 11-14; Elizabeth Keeling, *"Some observations on Finanzamt Koln-Altstadt v Roland Schumacker",* EC T.J. 1995/96, 1(2), 135-144.

movement of workers because the host State was obliged to grant national treatment to a non-resident, making such a non-resident a "virtual resident" entitled to national treatment in the host Member State because he was in a comparable situation to that of a resident. The host State was obliged to grant a personal tax allowance which was normally restricted to its residents. In the *Broadcasting cases*, the converse situation occurs, in an internal market context, allowing the regulatory authority of Member State B to regulate certain non-residents who are treated as "virtual residents" because there was no objective difference between a broadcaster who is established in Member State B and a broadcaster who is established in another Member State A by nationals of Member State B and which offered broadcasting services in Member State B, thus evading the regulatory rules of Member State B.

This jurisprudence of the Court demonstrates that the Member States retain considerable powers to deal with fraud and the circumvention of their national legal rules by their nationals in areas which have not been harmonised. Within the EU framework, utilisation of the freedom to provide services may be curtailed in limited circumstances by a Member State taking action when the EU freedoms have been improperly exercised. From the Court's *TV10* decision, it seems clear that legal persons of Member State A who are controlled by nationals of Member State B and, thus, which are objectively in the same situation as nationals of Member State B, may be regulated by Member State B where it is demonstrated that the fundamental freedoms have been used improperly to circumvent the national rules of Member State B.

Knoors

The Court looked at possible abuse of the freedom of establishment in *Knoors*, where a national of Member State A[45] had obtained a trade qualification in another Member State that was recognised under EU law rules. Knoors then returned to Member State A for the purposes of establishment. The Court decided that in respect of Member State A, even though Knoors was a national of that Member State, he was also in the same situation as any other EU national exercising the right of establishment in Member State A. The Court said -

> "these liberties, which are fundamental in the Community system, could not be fully realized if the Member States were in a position to refuse to grant the benefit of the provisions to those of their nationals who have taken advantage of the facilities existing in the matter of freedom of movement and establishment".[46]

45 In this case, the Netherlands.

46 ECJ, 7 Feb. 1979, Case 115/78, *J. Knoors v Staatssecretaris van Economische Zaken,* ("*Knoors"),* [1979] ECR 399, paragraph 20. See David Ratcliffe, *"Abuse of law/Abuse of Right",* VAT Int. 2003, 21(7), 2006-2008.

The Netherlands had argued that this created a risk that national rules would be evaded by its nationals in the area of training for a trade. The Court accepted that Member States had a “legitimate interest” in preventing

> “certain of its nationals, by means of facilities created under the Treaty, from attempting wrongly to evade the application of their national legislation….”[47]
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> The Court’s findings in *Knoors* should be contrasted with *Bouchoucha*, where France[48] had restricted access to the practice of osteopathy to persons holding the qualification of doctor of medicine.

Bouchoucha

Bouchoucha obtained a diploma in osteopathy in another Member State and returned to France to practice. However, the ECJ decided that France had a legitimate interest in preventing certain of its nationals from attempting to evade French rules regarding vocational qualifications by using the Treaty freedoms.[49] This has implications for taxation because direct tax matters are generally still within the competence of the Member States.

Thus, the ECJ in *Bouchoucha* recognised that in areas where harmonisation of rules has not taken place at the EU level, the Member States retain significant powers relating to regulating their own nationals. In this instance, the French rules defined the profession of “doctor” as including the practice of osteopathy. As long as France treated all its nationals in a similar way, then, in the absence of EU legislation, it could treat nationals from other Member States in an equivalent way if they established themselves in its territory. This was despite the fact that persons such as Bouchoucha could practice osteopathy in the United Kingdom without being a “doctor”, and possibly in other Member States, and could even provide osteopathy services to French nationals visiting the United Kingdom or other Member States.

The decision is significant from an “abuse” perspective because it demonstrates that Member States may retain certain proportionate domestic rules, which prevent their nationals from evading domestic rules by taking advantage of the EU freedoms. In the absence of EU harmonisation rules, interpretation of these national rules and

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47 *Knoors paragraph 25.* However, the Court felt that the risk of abuse did not exist in this case because of the length of periods during which the activity in question had to be pursued to obtain the trade qualification.

48 In this case, France.

49 See ECJ, 3 Oct. 1990, Case C-61/89, *Criminal proceedings against Marc Gaston Bouchoucha, (“Bouchoucha”),* [1990] ECR I-3551, paragraph 14, following *Knoors*. For analysis see, Julian Lonbay, *“Picking over the bones: rights of establishment reviewed”,* E.L. Rev. 1991, 16(6), 507-520.

interpretation of the concepts of "tax avoidance" and "tax evasion" lie within the competence of the Member States. In situations where there is no objective difference between a national of Member State A and a national of another Member State, it is the national courts of Member State A which will determine whether or not their regulatory rules have been infringed. In such circumstances, whilst nationals of other Member States may complain to the ECJ about breach of their fundamental freedom rights under the TFEU, Member State A may be able to demonstrate sufficient justification for its domestic rules to enable the restriction on the fundamental freedom to remain in place.

Free Movement of Goods

Leclerc

The ECJ's case law on free movement of goods has also touched upon "abuse" matters. In *Leclerc*,[50] for example, the Court noted that provisions, requiring the retail price of books (set by a publisher in Member State A) to be applied to the same books which were first exported from Member State A to Member State B and then re-imported into Member State A from Member State B, constituted a restriction on the free movement of goods

> "unless it is established that those books were exported for the sole purpose of re-importation in order to circumvent the legislation in question".[51]

Thus, exercise of the free movement of goods in order to acquire an advantage when the goods were re-imported can be regulated by the Member States when the free movement of goods was used to circumvent national rules.

Another example is seen in *General Milk Products*, where the Court dealt with a situation involving the re-exportation[52] of cheese to other Member States which

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50 In *Leclerc*, an attempt was made to evade national rules on retail prices for books. See ECJ, 10 Jan. 1985, Case 229/83, *Association des Centres distributeurs Édouard Leclerc and others v SARL "Au blé vert" and others, ("Leclerc"),* [1985] ECR 229.

51 In paragraph 26 of the judgment, the Court held that the national rules discouraged the marketing of re-imported books by preventing the importer of the books from passing on any price advantage obtained in the exporting Member State. This constituted a restriction on the freedom. In paragraph 27, the Court went on to say that this did not apply "where it is established that the books in question were exported for the sole purpose of re-importation" in order to circumvent national legislation.

52 In *Deutscher Apothekerverband*, the Court declared that since the trader which exported the pharmaceutical products in question was not involved with their re-importation, such re-importation could not be an abuse of the free movement of goods. ECJ, 11 Dec. 2003, case C-322/01, *Deutscher Apothekerverband eV v 0800 DocMorris NV and Jacques Waterval, ("Deutscher Apothekerverband"),* [2003] ECR I-4887.

generated the payment of special compensation grants. The ECJ held that the payment of such grants were legitimate

> "unless it can be shown that the import and export transactions were effected for the sole purpose of wrongfully securing an advantage under the above regulations".[53]

Interestingly, the Court used the expression "bona fide commercial transactions" in relation to the import and export transactions.[54] It noted that the bona fide nature of those transactions is a question of fact for the national courts.[55] This implies that the Court distinguishes between transactions carried out for normal commercial reasons (so-called "bona fide" commercial transactions) from those, which are carried out solely to gain an improper advantage from the fundamental freedoms or EU law rules. The Court does not accept that the latter transactions are legitimate in the absence of something more, such as commercial reasons for the particular transaction in question.

Tax avoidance

Applying this type of reasoning in a "tax avoidance" context, it seems likely that the Court would look for something more in the structuring of the transaction than simply an improper advantage gained from exercising the fundamental freedoms or utilising EU law rules. If "something more" is shown, then, it is unlikely that the Court will find that "abuse" of EU law has occurred. The notion of "sole purpose", therefore, takes on some importance as it becomes incumbent upon taxpayers to demonstrate business reasons for a transaction transgressing EU rules, over and above the obtaining of a tax advantage. This also suggests a transfer in the burden of proof in cases where the national authorities have demonstrated on the balance of probabilities that a transaction has improperly taken advantage of EU rules.

Free movement of workers

Lair

Abuse of EU law questions have also arisen in the context of the free movement of workers. In *Lair*, a French national resident in Germany was denied a vocational

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53 *General Milk Products paragraph 22*. ECJ, 3 mar. 1993, Case C-8/92, *General Milk Products GmbH v Hauptzollamt Hamburg-Jonas, ("General Milk"),* [1993] ECR I-779.

54 In *Leur-Bloem*, the Court, when speaking about Article 11 of Directive 90/434/EEC (Merger Directive), indicated that the reference to "valid commercial reasons" in Article 11 'is a concept involving more than the attainment of a purely fiscal advantage'. See ECJ, 17 Jul. 1997, Case C-28/95, *A. Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2, ("Leur-Bloem"),* [1997] ECR I-4161, paragraph 47.

55 *General Milk Products* paragraph 21.

training grant under domestic rules because she had not been involved in an occupational activity in Germany for a five-year period. The Court found that, whilst imposing such a minimum period was a restriction on the free movement of workers,

> "where it may be established on the basis of objective evidence that a worker has entered a Member State for the sole purpose of enjoying, after a very short period of occupational activity, the benefit of the student assistance system in that State, it should be observed that such abuses are not covered by the Community provisions in question".[56]

Therefore, the Court made it clear that EU law benefits may be denied if "abuse" can be proved on the basis of objective evidence. It expanded on this topic in *Paletta II*,[57] where it declared that a person cannot rely on EU law for the purposes of abuse or fraud.

Paletta II

In *Paletta II*, the ECJ said that even though national courts may take into account abuse or fraud on the part of the worker, on the basis of objective evidence,

> "to deny him the benefit of the provisions of Community law on which he seeks to rely, they must nevertheless assess such conduct in the light of the objectives pursued by those provisions".[58]

Thus, in *Paletta II*, when an employer doubted the veracity of a worker's medical certificate showing incapacity for work, which had been issued in another Member State, the Court accepted that employers could adduce evidence before the national court to support a finding of abuse or fraud on the part of the worker concerned.[59] However, the ECJ declared that national rules could not place the burden of proof on the worker to produce additional evidence that "the medically certified incapacity for work is genuine",[60] as this would add a further obstacle to the worker's right of free movement.

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56 ECJ, 21 Jun. 1988, Case 39/86, *Sylvie Lair v Universität Hannover* ("*Lair"), paragraph 43.*

57 ECJ, 2 May 1996, Case C-206/94, *Brennet AG v Vittorio Paletta, ("Paletta II"),* [1996] ECR I-2357.

58 *Paletta II paragraph 25*

59 *Paletta II* paragraph 27.

60 *Paletta II* paragraph 26.

Akrich

A further example that the Court remains intolerant to abuse of the EU's freedoms is seen in *Akrich*, where the Court demonstrated that abuse of EU law through "marriages of convenience" if they assist persons to evade national legislation will not be tolerated.[61] However, and this is quite significant for direct taxation matters in an EU framework, the Court noted that the motives which may have prompted a worker of Member State A to seek employment in another Member State are not relevant in relation to the right to enter and reside in the latter Member State provided that an effective and genuine activity is pursued.[62] Nor are the motives relevant if and when, such persons return to Member State A.

Walcher

The Court has also rejected circumstantial evidence of "abuse". In *Walcher*, for example, the Court dealt with an employment relationship involving a shareholder-employee who claimed unpaid salary after the company ran into financial difficulties. The Court found that the fact that the shareholder-employee remained in an employment relationship with the company for a longer period than a non-shareholder employee, was purely circumstantial evidence of abuse. The Court noted that this "does not automatically mean that there was an abuse".[63]

Free movement of capital

Kefalas

The Court's case law on free movement of capital reiterates that EU law cannot be relied upon for abusive or fraudulent ends. In *Kefalas*, the question before the ECJ

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61 The Court sees marriages of convenience as an abuse if they are entered into to facilitate the entry and residence of non-EU nationals into the Community. See paragraph 57 of the judgment in *Akrich*. See also ECJ, 25 Jul. 2008, Case C-127/08, *Blaise Baheten Metock and Others v Minister for Justice, Equality and Law Reform ("Metock"),* [2008] ECR I-6241. ECJ, 23 Sep. 2003, Case C-109/01, *Secretary of State for the Home Department v Hacene Akrich ("Akrich"),* [2003] ECR I-9607. For a discussion of the *Metock* case see, Elaine Fahey, *"Going back to basics: re-embracing the fundamentals of the free movement of persons in Metock",* Legal I.E.I. 2009, 36(1), 83-89.

62 *Akrich* paragraph 55 and see *Levin* paragraph 23. In *Ninni-Orasche*, the abuse was allegedly constituted by the national working in the Member State for only a few months. The Advocate General pointed out that the period of time that the activity is pursued does not matter as long as an effective and genuine activity was pursued. See point 41 of the Opinion *Ninni-Orasche*. ECJ, 6 Nov. 2003, Case C-413/01, *Franca Ninni-Orasche v Bundesminister für Wissenschaft, Verkehr und Kunst ("Ninni-Orasche"),* [2003] ECR I-13187 and ECJ, 23 Mar. 1982, Case 53/81, *D.M. Levin v Staatssecretaris van Justitie ("Levin"),* [1982] ECR 1035.

63 ECJ, 11 Sep. 2003, Case C-201/01, *Maria Walcher v Bundesamt für Soziales und Behindertenwesen Steiermark ("Walcher"),* [2003] ECR I-8827, paragraph 49.

asked "whether a national court may apply a provision of domestic law in order to assess whether the exercise of a right arising from a provision of EU law is abusive".[64] The Court answered this question positively, pointing out that

> "the application of such a national rule must not prejudice the full effect and uniform application of Community law in the Member States. (…) In particular, it is not open to the national courts, when assessing the exercise of a right arising from a provision of Community law, to alter the scope of that provision or to compromise the objectives pursued by it".[65]

However, the Court went on to say that EU law does not preclude a national court, "on the basis of sufficient telling evidence",[66] from examining whether a provision of EU law was exercised in an abusive manner.[67]

Some concluding remarks

The ECJ's case law on abuse of the free movement of workers shows that Member States can take action to prevent abuse of the freedom in situations where actual fraud or improper conduct utilising the right of free movement can be proved. Circumstantial evidence alone is not sufficient, nor are the motives for exercising EU law rights. National courts are allowed to investigate fraudulent or improper use of the freedom of movement on a case-by-case basis and evidence of abuse or fraud may be adduced at that time.

Proof of fraud or improper conduct transfers the burden of proof onto the person trying to obtain the benefit of the freedom to show that there are proper reasons for his actions. Whilst "the motive" behind a person's use of the right of free movement has been recognised by the Court as immaterial, once fraudulent conduct or improper use of the EU rights has been demonstrated on the balance of probabilities, motive may play an important role in rebutting the presumption of fraudulent or abusive conduct. As such, it is the national court that will weigh the reasons for the conduct together with the evidence of fraud or abuse adduced by the

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64 ECJ, 12 May 1998, Case C-367/96, *Alexandros Kefalas and Others v Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE), ("Kefalas"),* [1998] ECR I-2843.

65 *Kefalas paragraph 22*.

66 *Kefalas* paragraph 22

67 Similarly, in *X&Y*, the Court declared that tax evasion or fraud may be taken into account by the national court on a case-by-case basis, on the basis of objective evidence, to deny the persons concerned the benefit of the provisions of Community law, but they must assess such conduct in the light of the objectives pursued by the provisions". This means that the national court must examine the transaction in the light of EU objectives of the free movement of capital. ECJ, 21 Nov. 2002, Case C-436/00, *X and Y v Riksskatteverket, ("X and Y"),* [2002] ECR I-10829.

national authorities. The national court will then assess the conduct in the light of the objectives pursued by EU law and apply the proportionality principle to determine whether the national rules meet their objective and do not go beyond that objective.[68]

The jurisprudence of the ECJ in the area of "abuse" lays the foundations for its thinking in the area of "tax-planning" through the use of the fundamental freedoms. The Court makes it clear that EU law cannot be relied upon for abusive or fraudulent purposes; that "motive" is mostly irrelevant when it comes to determining whether the freedoms have been exercised in an abusive way; and that the Member States can take action to prevent abuse of their national laws through an inappropriate use of the freedoms.

Moreover, the ECJ has determined that it is the national court, operating within the parameters set by EU law (and, in particular, the ECJ's jurisprudence) that will decide whether the Member State is justified in having rules which restrict a fundamental freedom and that EU law advantages can be denied if "abuse" is proved on the basis of objective evidence.

This analysis of the Court's jurisprudence in relation to abuse of the fundamental freedoms lays the foundations for the Court's "tax" jurisprudence discussed in the next Part.

Part II The concept of "tax avoidance" in the EU

ICI

In analysing the Court's attitude to "tax avoidance" in an EU setting, a useful starting point is the Court's *ICI* judgment[69] where the United Kingdom's consortium relief rules were scrutinised. The United Kingdom had argued that "the risk of tax avoidance" was a justification for its tax rules, which provided for different treatment of groups based on the location of the seat of a parent company. The Court noted that the United Kingdom rules did not

> "have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits". [70]

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68 *See Centros paragraph 25.*

69 ECJ, 16 Jul. 1998, Case C-264/96, *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes), ("ICI"),* [1998] ECR I-4695. For analysis of the *ICI* judgment see, Jonathan Levy and Andrew Watters, *"Group/consortium relief, UK tax law and the European Union Treaty*", Tax J. 2002, 637, 19-21.

70 *ICI* paragraph 26.

Consequently, it held that the United Kingdom's rules were precluded by the freedom of establishment because they applied generally to all situations in which the majority of a group's subsidiaries were established, "for whatever reason, outside the United Kingdom".[71] According to the ECJ, the mere establishment of a company outside the United Kingdom

> "does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment."[72]

The ECJ, therefore, provides some parameters for the concept of "tax avoidance" when used in an EU context and sees "tax avoidance" as that which includes wholly artificial arrangements designed to obtain a tax advantage which circumvent national tax rules.

This view is confirmed in d*e Lasteyrie*,[73] where the Court encountered a French exit tax rule which was seen as an obstacle to the freedom of establishment. The French government argued that its tax rule was justified on the basis that the aim of the rule was the prevention of tax avoidance.[74] Echoing *ICI*, the Court said that the French tax rule was not

> "specifically designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French tax law". [75]

The Court went on to indicate that

> "the transfer of a physical person's tax residence outside the territory of a Member State does not, in itself, imply tax avoidance[76] (…). Tax evasion or tax fraud cannot be inferred generally from the fact that the tax residence of a physical person has been transferred to another Member State and cannot

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71 *ICI* paragraph 26.

72 *ICI* paragraph 26.

73 ECJ, 11 Mar. 2004, Case C-9/02*, Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie, ("de Lasteyrie"),* [2004] ECR I-2409. See Robert Anthony, *"France: exit tax sentenced under European law",* I.T. Rep. 2004, May, 6-9.

74 The objective of the French tax rule was to prevent a taxpayer from temporarily transferring his tax residence before selling securities with the sole aim of avoiding/evading French taxes on capital gains.

75 *de Lasteyrie paragraph 50.*

76 *de Lasteyrie paragraph 51.*

> justify a fiscal measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty".[77]

The Court, therefore, equates the concept of "tax avoidance" with the concepts of "tax evasion" or "tax fraud", and unacceptable "tax planning" through artificial arrangements designed to acquire a tax advantage. However, it is clear that the Court is not classifying about all forms of "tax avoidance" as "wholly artificial arrangements". There are lesser forms of tax avoidance which are perfectly acceptable to the Court.

Support for this conclusion is found in cases like *Barbier*, where the Court accepted that certain forms of tax planning ("tax avoidance" in the "tax mitigation" sense) were acceptable when they interacted with the use of the EU's freedoms.

Barbier

In *Barbier*,[78] a Dutch national and company director, moved to Belgium from where he continued to exercise his business activities. While resident in Belgium, he acquired some Dutch rental properties, which were mortgaged. Dutch rules allowed the legal title of immovable property to be separated from its financial ownership. Taking advantage of these rules, Barbier carried out a series of transactions, which transferred the financial ownership in the properties to Dutch companies which he controlled. These transactions resulted in certain tax advantages. After Barbier's death, a dispute arose with the Dutch authorities regarding the value of his estate. Dutch tax rules generated a higher taxable value for his estate because he had been resident outside the Netherlands at the time of his death. If he had resided in the Netherlands at the time of his death, the method of valuing his estate for tax purposes would have allowed the mortgages to be deducted, thus reducing the value of his estate for tax purposes. The ECJ said

> "a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence".[79]

Thus, the ECJ draws a distinction between different forms of "tax avoidance". "Tax avoidance", involving artificial arrangements designed to gain a tax advantage and

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77 *de Lasteyrie paragraph 51.*

78 ECJ, 11 Dec. 2003, Case C-364/01, *The heirs of H. Barbier v Inspecteur van de Belastingdienst Particulieren/Ondernemingen buitenland te Heerlen, ("Barbier"),* [2003] ECR I-15013. For analysis see, Timothy Lyons, *"The heirs of H.Barbier: taxing estates in the EU",* B.T.R. 2004, 3, 185-188 and Frans Sonneveldt, "*The Barbier Case",* Euro. Tax. 2004, 44(6), 284-287.

79 *Barbier paragraph 71.*

to circumvent national tax rules, is unacceptable and prohibited in the same way as tax evasion and tax fraud. This type of "tax avoidance" may justify a restriction of the EU freedoms on general interest grounds in certain circumstances. However, if the tax planning involves the use of EU freedoms to obtain tax benefits, which are legally provided by the rules of another Member State, then the Court accepts such situations in an internal market context and refuses to accept Member States' rules limiting such "tax avoidance" (or "tax mitigation") opportunities as possible justifications for restricting the fundamental freedoms. In other words, the ECJ accepts "tax mitigation" and divides the concept of "tax avoidance" into "tax avoidance" which is unacceptable and "tax avoidance" which comprises acceptable tax planning, or "tax mitigation".[80] However, there is another form of "tax avoidance" that is unacceptable to the Court. This can be seen from cases like *Marks and Spencer*[81] and *SGI,*[82] where the Court demonstrated that there was another form of tax avoidance which did not amount to "wholly artificial arrangements" but which, "taken together" with the need to ensure a balance in the allocation of taxing rights between the Member States, could be sufficient justification for national tax rules that restrict the fundamental freedoms.

"Tax avoidance" which is unacceptable to the ECJ

Marks and Spencer

In *Marks and Spencer*, the Court identified two different types of tax avoidance. The Court noted that the Member States

> "are free to adopt or to maintain in force rules having the specific purpose of precluding from a tax benefit wholly artificial arrangements whose purpose is to circumvent or escape national tax law".[83]

But the Court also identified another form of tax avoidance which did not amount to "wholly artificial arrangements" designed to circumvent the national tax system.

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80 This is also made clear in its later case law such as *Halifax* where the Court stated in relation to a VAT scheme that "taxpayers may choose to structure their business so as to limit their tax liability".

81 ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes), ("Marks and Spencer"),* [2005] ECR I-10837. For analysis see Tom O'Shea, *"Marks and Spencer v Halsey (HM Inspector of Taxes): restriction, justification and proportionality",* EC T.R. 2006, 15(2), 66-82; Peter Elliot, *"Marks and Spencer Plc v David Halsey (HM Inspector of Taxes)",* EC T.R. 2006, 15(3), 184-185 and Melchior Wathalet, *"Marks & Spencers Plc v Halsey: lessons to be drawn",* B.T.R. 2006, 2, 128-134.

82 ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle (SGI) v Belgian State ("SGI"),* [2010] ECR I-0000 (not yet reported). For a detailed analysis of the case, see Tom O'Shea, *"ECJ Upholds Belgian Transfer Pricing Regime",* Tax Notes International, Feb. 8, 2010, 491-494.

83 *Marks and Spencer* paragraph 57.

The Court accepted that this form of tax avoidance “taken together” with the need to ensure that the balance in the allocation of taxing rights between the Member States was preserved.

Thus, the Court found that the Member States could (i) deny companies the option of having their losses from being “taken into account in the Member State in which they are established or in another Member State”;[84] (ii) have rules which prevented “double-dipping”;[85] and (iii) prevent “loss-trafficking” whereby losses could be transferred within groups to Member States “in which the tax value of the losses is therefore the highest”.[86] However, retention of such tax rules was subject to the requirement that the principle of proportionality was respected. Thus, in relation to the United Kingdom’s group relief rules that were the subject-matter of the case, the Court found that

> “In the light of those three justifications, taken together, it must be observed that restrictive provisions such as those at issue in the main proceedings pursue legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest and that they are apt to ensure the attainment of those objectives”.[87]

But, the Court went on to assess whether the rules went beyond what was necessary to attain the objectives pursued and held that in certain limited circumstances the United Kingdom’s rules were disproportionate where a United Kingdom parent company could demonstrate that two conditions were fulfilled, namely, that

> “the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party or by offsetting the losses against the profits made by the subsidiary in previous periods, and
>
> there is no possibility for the foreign subsidiary’s losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party”.[88]

84 *Marks and Spencer* paragraph 46.

85 *Marks and Spencer* paragraph 47.

86 *Marks and Spencer* paragraph 49.

87 *Marks and Spencer* paragraph 51.

88 *Marks and Spencer* paragraph 55.

The Court's decision was significant for cross-border loss relief rules of the Member States. In certain situations, Member States who offered such group loss-relief advantages to their own resident companies would have to extend those loss-reliefs cross-border whenever the conditions specified in the so-called "no possibilities" test were satisfied.

The notion that "profits and losses were two sides of the same coin" (rejected as a justification in its own right in paragraph 40 of the *Marks and Spencer* judgment) could only be accepted as a justification when some jeopardy or threat to the symmetry or balance in the allocation of taxing rights was shown to exist, such as conduct on the part of the group amounting to tax avoidance (like double dipping or loss trafficking).[89]

The decision in *Marks and Spencer*, therefore, provided the Member States with a new tool to fight certain types of "tax avoidance". However, the principle of proportionality still has to be respected when designing national or DTC rules which have the aim of defeating "tax avoidance". It should not be overlooked that *Marks and Spencer* won their case on proportionality grounds.

SGI

The *Marks and Spencer* judgment was subsequently clarified by the ECJ decision in *SGI*, where the Court made it clear that there were two types of tax avoidance to be considered – tax avoidance involving wholly artificial arrangements, devoid of economic reality, designed to circumvent the national tax system and tax avoidance not involving purely artificial arrangements but which taken together with the need to preserve the balance in the allocation of taxing powers between the Member States. The former type of avoidance is a stand-alone justification for the national anti-avoidance rules; the latter type of avoidance is not sufficient in itself to constitute a justification in the general interest, however, when taken together with the need to safeguard the balance in the allocation of taxing rights it constitutes the jeopardy (or the conduct on the part of the taxpayer that the national rules are designed to deter) to that balance sufficient for that Member State to argue that its rules are necessary to protect that balance in the allocation of taxing rights. Simply arguing that the national rules are justified by the need to protect the balance in the

89 In other words, just because the United Kingdom did not tax the non-resident subsidiaries on their profits that did not automatically mean that group relief could be limited to United Kingdom resident companies and branches of non- resident companies situated in the United Kingdom. In order to justify the restriction on freedom of establishment of M&S `it is necessary to consider what the consequences would be if an advantage such as that at issue (…) were to be extended unconditionally'. The Court was therefore conducting a similar investigation in relation to the United Kingdom's group relief rules that it used in its cross-border dividend cases. See *Marks and Spencer* paragraph 41.

allocation of taxing rights is not enough.[90] This explains why the Court accepted the justification of balance in the allocation of taxing rights only when the tax avoidance element was present. There was no tax avoidance possible in relation to the "final losses" incurred in Germany and Belgium because they could only be relieved (if anywhere) in the UK. Therefore, no double-dipping and no "loss-trafficking" was possible.

Halifax

In the indirect tax field, the Court's decision in *Halifax*[91] demonstrates that the Member States can maintain tax rules designed to defeat unacceptable "tax planning". However, the rights of Member States have to be balanced with the rights of EU nationals to structure their tax affairs in the most tax-efficient way (in this instance, in the VAT field).

In *Halifax*, the Court explained that tax was "evaded" where "untruthful tax returns" or "improper invoices" were used but the question whether a transaction was carried out "for the sole purpose of obtaining a tax advantage" was "entirely irrelevant in determining whether" from a VAT perspective the transaction constituted "a supply of goods or services and an economic activity".[92] In other words, there was an "objective" element at stake, and if the VAT transactions satisfied certain objective criteria, they constituted supplies of goods or services etc., even if they were "carried out with the sole aim of obtaining a tax advantage, without any other economic objective". However, the Court noted that

> "The application of Community legislation cannot be extended to cover abusive practices by economic operators, that is to say transactions carried out not in the context of normal commercial operations, but solely for the

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90 That is clear from *Marks and Spencer* paragraph 40, where the "two sides of the same coin argument" was rejected by the Court. Something more had to be shown to make the justification work. This is where the "tax avoidance" element enters the picture. The tax avoidance conduct on the part of the taxpayer shows the actual or potential threat to the balance.

91 ECJ, 21 Feb. 2006, Case C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd and County Wide Property Investments Ltd v Commissioners of Customs & Excise, ("Halifax"),* [2006] ECR I-1609. For discussion of the *Halifax* judgment see, Mark Delaney, *"To be or not to be? Definition of "abuse" under Halifax examined",* T.P.I.I.T. 2007, 5(12), 11-12; Sjoerd Douma and Frank Engelen, *"Halifax Plc v Customs and Excise Commissioners: the ECJ applies the abuse of rights doctrine in VAT cases",* B.T.R. 2006, 4, 429-440; Lorraine Parkin, *"VAT anti-avoidance following Halifax",* Tax J. 2007, 876, 13-14; Dennis Dixon and Patrick Cannon, *"Halifax and Ramsay",* Tax J. 2007, 876, 11-12; Melanie Hall, *"Direct Tax Cases and Halifax",* Tax J. 2007, 886, 15-16 and Frank Carr, *"The Halifax Doctrine Re-visited",* Ir. T.R. 2008, 21(4), 24.

92 *Halifax* paragraph 59.

> purpose of wrongfully obtaining advantages provided for by Community law".[93]

Thus, the Court confirmed that the principle of preventing "abusive practices" also applied in the VAT area.

The Court went on to provide some guidance on what constituted "abuse" and on the concept of "acceptable tax-planning" against a backdrop of the principle of legal certainty. It highlighted (a) that "Community legislation must be certain and its application foreseeable by those subject to it" and that this requirement must be "observed all the more strictly" when the rules "entail financial consequences" so that the "extent of the obligations imposed" are clear to the persons concerned;[94] and (b) that "tax considerations" could influence a taxpayer's decision in terms of structuring or planning a VAT transaction: "taxpayers may choose to structure their business so as to limit their tax liability".[95]

The Court then formulated its two-pronged test for "abuse" in the VAT area (and said that this was a matter for the national court to verify): [96]

> "the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions (…) it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. (…) the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages".[97]

The two elements of the test involve (a) that the transactions result in the accrual of a tax advantage which is contrary to an EU law rule and (b) that it must also be apparent based on objective factors that obtaining a tax advantage was the "essential aim of the transactions". The Court went on to explain what should happen in the event of a finding of "abuse", namely, that the

93 *Halifax* paragraph 69.

94 *Halifax* paragraph 72.

95 *Halifax* paragraph 73.

96 *Halifax* paragraph 76. The Court indicated that "it was the responsibility of the national court to determine the real substance and significance of the transactions concerned. In doing so it may take account of the purely artificial nature of those transactions and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden" (*Halifax* paragraph 81).

97 *Halifax* paragraphs 74 and 75.

> "transactions involved in an abusive practice must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice".[98]

The Court therefore propounded a two-prong test for abuse in the VAT sphere with a subjective and an objective element. This test was expanded into the direct tax area in *Cadbury Schweppes* where the United Kingdom's CFC rules were challenged on grounds of incompatibility with EU law.[99]

Cadbury Schweppes

In *Cadbury Schweppes*,[100] the Court developed its thinking on "abusive practices" when the United Kingdom's CFC rules were challenged on grounds of incompatibility with Community law and, in particular, with the freedom of establishment. The Court noted that even though Cadbury Schweppes plc, a United Kingdom resident company, had decided to establish subsidiaries in the International Financial Services Centre (IFSC) in Ireland to take advantage of the favourable 10% tax regime, that fact did not "in itself constitute abuse".[101]

The United Kingdom argued that its CFC legislation was aimed at countering a particular type of "tax avoidance" involving the artificial transfer by a United Kingdom resident company of its profits to a low-tax State (Ireland) through the establishment of a subsidiary there. The Court, in response, noted that

> "any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable treatment of the parent company".[102]

98 *Halifax* paragraph 94.

99 The Court clarified the *Halifax* test in *Part Service*. See Tom O'Shea, *"Some ECJ Guidance on Abusive Tax Practices in the European Union*, Tax Notes International, 21 April 2008, 241-245. ECJ, 21 Feb. 2008, Case C-425/06, *Ministero dell'Economia e delle Finanze v Part Service Srl, ("Part Service"),* [2008] ECR I-897.

100 ECJ, 12 Sep. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, ("Cadbury Schweppes"),* [2006] ECR I-7995. For a detailed analysis of the case see, Tom O'Shea, "*The UK's CFC rules and the freedom of establishment: Cadbury Schweppes plc and its IFSC subsidiaries – tax avoidance or tax mitigation?"* EC Tax Review, 2007, 1, 13-33. For a recent analysis see Richard Wellens, "*Cadbury Schweppes and Beyond: the Future of the UK CFC Rules: Part 1",* I.T. Rep. 2009, Oct, 1-9 and Richard Wellens, "*Cadbury Schweppes and Beyond: the Future of the UK CFC Rules: Part 2",* I.T. Rep. 2009, Nov, 1-6.

101 *Cadbury Schweppes* paragraph 38.

102 *Cadbury Schweppes* paragraph 49.

Furthermore, the establishment of the subsidiary in Ireland could not "set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom".[103] However, such CFC rules might be justified where they related

> "to wholly artificial arrangements aimed at circumventing the application of the legislation of the" United Kingdom.[104]

The Court advised that, in these circumstances, it was necessary to consider the objective of the freedom of establishment[105] when assessing the conduct of a person opening a secondary establishment in another Member State. That objective was "to allow a national of a Member State to carry on his activities there (…) [and] to participate, on a stable and continuing basis, in the economic life (…) and to profit therefrom".[106]

The Court explained that this involved the "actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period (…) it presupposes actual establishment (…) in the host Member State and the pursuit of genuine economic activity there". [107] Therefore, for the United Kingdom rules to be justified on the ground of preventing "abusive practices"

> "the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory".[108]

Such "artificial arrangements" jeopardised the right of Member States to exercise their tax jurisdiction and undermined the "balanced allocation between Member States of the power to impose taxes".[109] Consequently, the Court was satisfied that the United Kingdom's CFC rules were suitable to achieve their objective because they could

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103 *Cadbury Schweppes* paragraph 50.

104 *Cadbury Schweppes* paragraph 51.

105 *Cadbury Schweppes* paragraph 52.

106 *Cadbury Schweppes* paragraph 53.

107 *Cadbury Schweppes* paragraph 54.

108 *Cadbury Schweppes* paragraph 55.

109 *Cadbury Schweppes* paragraph 56.

> "thwart practices which have no purpose other than to escape the tax normally due on the profits generated by activities carried on in national territory".[110]

The Court next had to ascertain whether the United Kingdom's CFC rules went beyond what was necessary to prevent artificial arrangements intended to solely escape tax and commented that two elements were needed to show that an "artificial arrangement" existed: a subjective and an objective element. The subjective element comprised the "intention to obtain a tax advantage". The objective aspect required the existence of

> "objective circumstances showing that, despite the formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment (…) has not been achieved".[111]

Thus, the United Kingdom's CFC rules complied with EU law if taxation was excluded in circumstances where, "despite the existence of tax motives, the incorporation of the CFC reflects economic reality".[112] In other words, there must be "an actual establishment intended to carry on genuine economic activities in the host Member State"[113] and this must be based on

> "objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment".[114]

Should these objective factors lead to the conclusion that the CFC was a "fictitious establishment" (like a "letterbox" or brass-plate company) "not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement".[115] However, the fact that the activities of the CFC could have been carried out in the United Kingdom "does not warrant the conclusion that there is a wholly artificial arrangement".[116] Moreover, if the CFC is treated as a wholly

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110 *Cadbury Schweppes* paragraph 59.

111 *Cadbury Schweppes* paragraph 64. This echoes *Halifax* paragraphs 74 and 75, discussed above.

112 *Cadbury Schweppes* paragraph 65.

113 *Cadbury Schweppes* paragraph 66.

114 *Cadbury Schweppes* paragraph 67.

115 *Cadbury Schweppes* paragraph 68.

116 *Cadbury Schweppes* paragraph 69.

artificial arrangement by the United Kingdom tax authorities, the United Kingdom parent company must be given an opportunity

> "to produce evidence that the CFC is actually established and that its activities are genuine".[117]

The Court concluded that it was for the national court to determine whether the United Kingdom's CFC rules, in particular, the "motive test", restricted taxation to wholly artificial arrangements or whether they taxed United Kingdom resident companies intending to obtain a reduction in United Kingdom taxation through the establishment of the CFC "despite the absence of objective evidence"[118] to indicate the existence of a wholly artificial arrangement. In this latter situation, the Court indicated that the CFC rules were "contrary to Articles 43 and 48 EC".[119]

The Court applied a similar test in *Thin Cap GLO* where the Court encountered arguments justifying the United Kingdom's "thin capitalisation" rules on grounds based on the fight against "abusive practices".

Thin Cap GLO

In *Thin Cap GLO*,[120] the United Kingdom argued that its "thin cap" rules were targeted at a particular form of tax avoidance, namely, the adoption of artificial arrangements designed to circumvent United Kingdom taxation rules. In other words, the United Kingdom's rules targeted "thin capitalisation" under which a group of companies attempted to reduce the taxation of one of its subsidiaries by funding that subsidiary through loan capital, rather than by equity capital, thereby allowing that subsidiary to transfer profits to its parent company in the form of interest which was deductible in the calculation of its taxable profits.[121] The United Kingdom argued that its "thin cap" rules achieved, and went no further than, that objective because its rules were based on the "arm's length principle" and treated "as a distribution only that proportion of the interest which exceeds what would

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117 *Cadbury Schweppes* paragraph 70.

118 *Cadbury Schweppes* paragraph 72.

119 *Cadbury Schweppes* paragraph 74.

120 ECJ, 13 Mar.2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, ("Thin Cap GLO")*, [2007] ECR I-2107. For some recent comments see, Bill Dodwell, "Thin Cap GLO: the EU and national direct taxation", Tax J. 2011, 1069, 10; Mark Persoff, *"Test Claimants in the Thin Cap Group Litigation v Commissioners of Her Majesty's Revenue and Customs",* EC T.R. 2010, 19(2), 100-105 and Michael Anderson and Philippe Freund, *"Thin Cap GLO judgment",* Tax J. 2009, 1006, 5-7.

121 *Thin Cap GLO* paragraph 75.

have been paid under a transaction entered into on an arm's length basis".[122] The Court indicated that

> "The mere fact that a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices".[123]

The Court went on to repeat its test for restricting a fundamental freedom on the grounds of preventing abusive practices found in *Cadbury Schweppes*,[124] namely, that the specific objective of the United Kingdom rules must be

> "to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory".[125]

The Court was satisfied that the United Kingdom's rules prevented such artificial tax planning, however, the remaining issue was whether the United Kingdom's rules went beyond what was necessary to achieve that objective. Recalling *Lankhorst-Hohorst*, the Court found that this requirement was not met in situations where the legislation did

> "not have the specific purpose of preventing wholly artificial arrangements designed to circumvent that legislation, but applies generally to any situation in which the parent company has its seat, for whatever reason, in another Member State".[126]

Thus, to comply with the principle of proportionality, a two-pronged test had to be met by the United Kingdom's rules. On any occasion when a wholly artificial arrangement was found to exist, the taxpayer, first, had to be given an opportunity to provide evidence of any commercial justification for the arrangements (without being subject to undue administrative constraints)[127] and second, the re-characterisation of the interest payments had to be limited to the excess over and above the arm's length amount. Consequently, the Court noted that it was for the

122 *Thin Cap GLO* paragraph 71.

123 *Thin Cap GLO* paragraph 73.

124 *Cadbury Schweppes* paragraph 55.

125 *Thin Cap GLO* paragraph 74.

126 *Thin Cap GLO* paragraph 79.

127 *Thin Cap GLO* paragraph 82.

national court to determine whether the United Kingdom's rules met these tests and whether taxpayers were given the opportunity under the United Kingdom's rules to provide evidence of commercial justification in those instances where their transactions failed the arm's length criterion (without being subject to undue administrative constraints).[128]

Part III Conclusions

The Court's attitude to "abuse of law" is consistent across the fundamental freedoms. As harmonised rules have not been put in place in all areas of the internal market (including direct taxation/DTC matters), the Member States retain significant regulatory powers in relation to their own territory. The Member States are therefore competent to maintain tax rules which aim at preventing "tax avoidance" and "tax evasion", subject to compliance with EU law.

Sometimes, the Member States may have rules which treat non-residents in the same way as residents, and benefits secured through the use of EU law rules may be denied if abuse can be proved on the basis of objective evidence. Once fraudulent conduct or improper use of the EU law rights has been demonstrated on the balance of probabilities, motive may play an important role in rebutting the presumption of fraudulent or abusive conduct. However, the Member States cannot claim "abuse" when advantages that are freely available in another Member State are availed of by its nationals through the use of the freedoms. Therefore, when a transaction appears to abuse EU law, business or other commercial reasons may need to be demonstrated for conducting the transaction, over and above the obtaining of the tax advantage because the burden of proof has shifted to the person exercising the fundamental freedom to demonstrate that the exercise of the freedom was proper.
The Court's application of a simple two-prong test for abuse of EU law, involving subjective and objective elements (the "*Halifax* test"), is an important development because it has been shown above to apply across the freedoms and in both direct and indirect taxation situations. The Court's use of the *Halifax* test in two recent VAT cases[129] concerning abusive practices demonstrates that the test has now become settled case law.

Finally, *Marks and Spencer* and the recent *SGI* judgment of the Court, demonstrate that tax avoidance involving wholly artificial arrangements is just one form of tax

128 *Thin Cap GLO* paragraphs 84-87.

129 See ECJ, 22 Dec. 2010, Case C-277/09, *The Commissioners for Her Majesty's Revenue & Customs v RBS Deutschland Holdings GmbH ("RBSD"),* [2010] ECR I-0000 (not yet reported) and ECJ, 22 Dec. 2010, Case C-103/09, *The Commissioners for Her Majesty's Revenue and Customs v Weald Leasing Ltd. ("Weald Leasing"),* [2010] ECR I-0000 (not yet reported). For an analysis see Tom O'Shea, *"ECJ Takes a Stand on 'Abusive Practices' in UK VAT Cases",* Tax Notes International, Feb. 7, 2011, 417-421.

avoidance that may constitute a justification in the general interest for national rules that restrict one of the fundamental freedoms.[130] Lesser forms of tax avoidance, not involving wholly artificial arrangements, may constitute a justification when *taken together* with the need to ensure the balance in the allocation of taxing rights between the Member States. This expands the scope for the Member States to justify their anti-avoidance rules beyond the realm of wholly artificial arrangements designed to usurp the national tax system.[131]

130 See the recent discussion on *SGI* and the three different types of "tax avoidance" in the Court's case law in Tom O'Shea, *"EU Views on Tax Avoidance",* Tax Notes International, Feb. 14, 2011, 480-482.

131 See the recent judgment of the UK's Court of Appeal in *Test Claimants in the Thin Cap Group Litigation v Commissioners for Her Majesty's Revenue and Customs* [2011] EWCA Civ 127, where the two judges in the majority declared that the judgment in *SGI* had given greater clarity to this area of EU law.