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Editorial

Halifax and *Cadbury Schweppes*: one single European theory of abuse in tax law?

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Until now abuse in tax law in the European Single Market has been a matter that was dealt with in many different ways. In income tax the two Directives on cross-border dividends and interests refer the matter to national and treaty anti-abuse provisions. The Merger Directive contains a specific anti-abuse provision with a wording that is different from some national and treaty anti-abuse provisions. In the Sixth VAT Directive there is no single anti-abuse provision. Finally outside taxation there is a flourishing theory of abuse of Community law, but apparently tax lawyers prefer to spend their time in their own garden instead of visiting the garden of Community law and learning something from the flowers that are growing there.

Particularly regarding income tax abuse, Community law has not been used as a serious concept that might be useful in protecting national income tax systems. In some cases national tax administrations tried to use the argument of abuse as a justification for national tax measures infringing upon one of the four fundamental freedoms. However in doing so the national tax administrations were always making the argument from the point of view of abuse of national tax law, never from the point of view of abuse of European Community law. As a consequence, in most cases, the national anti-abuse arguments have been overshooting their targets from the point of view of European Community law and therefore have been struck down by the ECJ. This state of affairs may now have changed because of two recent ECJ decisions: *Halifax plc v Commissioners of Customs and Excises* (C-255/02, 21 February 2006) and *Cadbury Schweppes plc v Commissioners* (C-196/04, 12 September 2006).

Halifax is a VAT decision and *Cadbury Schweppes* is a corporate income tax decision, involving litigation in two totally different fields of taxation. Therefore the facts in these cases, interesting as they may be, are less relevant than the concept of abuse developed by the ECJ. Both cases deal with the concept of abuse of law not from a national law point of view, but applied from a point of view of European Community law: the Sixth VAT Directive in *Halifax* and the Treaty freedoms in *Cadbury Schweppes*. Therefore these decisions open the interesting perspective that the ECJ may finally come around to a coherent general theory of abuse of law that extends in a consistent way the notion of abuse of Community law to all tax matters. At the same time these theories may provide an instrument to protect the integrity of national tax systems, something which the Member States have been desperately and, so far, rather unsuccessfully trying to do, by using the argument of the cohesion of the national tax system.

1. Halifax

In *Halifax* the first question before the ECJ was: what is a supply for VAT purposes? The Court held that the scope of the VAT Directive is very wide and that the term supply is an objective one and encompasses all transactions which objectively fit within this definition, regardless of the purpose or result of the transaction, i.e. even when the intention of tax avoidance is the sole purpose of a transaction such intention is not relevant in judging whether a transaction constitutes a supply of goods or services and part of an economic activity within the framework of VAT.

The next question then was: whether a person performing such a transaction has the right to deduct the input VAT, where such a transaction on which that right is based has been concluded with the sole purpose of tax avoidance? The position of the taxpayer was that there is no general abuse of rights theory in the VAT Directive that can be used to deny the taxpayer the deduction for input tax.

To find an answer to this question the ECJ refers to the 'settled case law, (that) Community law cannot be relied upon for abusive or fraudulent ends' (at no. 68).

'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 purpose of wrongfully obtaining advantages provided for by Community law' (at no. 69).

This has been a general principle developed by long standing ECJ case law. The ECJ goes on to state: 'That principle of prohibiting abusive practices also applies to the sphere of VAT' (at no. 70).

The fact that Community law prohibits abusive practices does not mean however that a taxpayer may not prefer tax-exempt transactions over taxable transactions on the basis of tax considerations. The free choice of '*la voie la moins imposée*' is guaranteed

under Community law: 'taxpayers may choose to structure their business so as to limit their tax liability' (at no. 73).

In order for an abusive practice to exist the transactions must meet two conditions:

(a) notwithstanding formal application of the conditions laid down in the relevant statutory provisions the transactions result in the accrual of a tax advantage the grant of which *would be contrary to the purpose of the statutory provisions*; and
(b) it must be apparent from a number of objective factors that the *essential aim* of the transactions is to obtain a tax advantage. 'There is no abuse where the economic activity carried out may have *some other explanation*, other than the mere attainment of tax advantages' (at no. 75).

The question whether transactions are abusive is for the national courts to verify. In order to assess whether transactions seek essentially to obtain a tax advantage it is the responsibility of the national court to determine:

> 'the real substance and significance of the transactions concerned. In so doing 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' (at no. 81).

In the *Halifax* decision the ECJ has clarified substantially the role and the concept of abusive practices in the area of VAT. However there remains one cloud of ambiguity: the distinction between the sole purpose and the essential purpose. At one point the ECJ seems to imply that the existence of 'some other explanation' is sufficient to justify the transactions for tax purposes, which points to the sole purpose standard. At another point the ECJ lists several criteria of economic, legal or personal nature to assess the substance of the transaction, which points to the essential purpose and implies a balancing judgment between several purposes against one another. A sole purpose standard is simpler to apply than an essential purpose standard. The latter is more complex and less certain, but gives more room to national tax administration to fight what they consider as abusive practices.

2. Cadbury Scwheppes

In *Cadbury Schweppes* there were three main questions: first whether in establishing a company in another Member State solely to take advantage of a tax regime more favourable than in the home state constitutes an abuse of the freedoms of establishment, secondly whether the way the British CFC rules are formulated amounts to a restriction in the exercise of this right of establishment or a discrimination, when Cadbury Schweppes was exercising this right in a genuine manner, and thirdly if the British CFC legislation would be viewed as constituting a prohibited restriction or discrimination, whether it could be justified on grounds of prevention of tax avoidance and if so whether the legislation was proportionate in relation to its goal. The questions of abuse in *Cadbury Schweppes* were raised in quite a different way from *Halifax*. The question was not one of an artificial construction within the tax system of a single Member State, but rather a straightforward construction to take advantage of a tax benefit provided in the national legislation of another Member State, the question whether the establishment in the other Member State was genuine and effective and whether the home state was entitled to defend itself by imposing CFC legislation.

As to the first question the ECJ was very clear. It refers to prior (tax and non-tax) case law deciding that the purpose of benefiting from more favourable legislation in another Member State does not in itself constitute an abuse of the freedom of establishment (at no. 37). It also reiterates its earlier case law according to which the Member State of origin has no right to restrict the establishment of a company incorporated under its legislation in another Member State (at no. 42).

Then the ECJ establishes that CFC legislation creates a disadvantage for a resident company subject to it, even though the profit of the foreign CFC will not be subject to a higher tax burden than the profits of a domestic subsidiary, because of the rules against double taxation of dividends. The fact that the profits of the foreign subsidiary are subject to tax on behalf of the parent company, while this is not the case for domestic subsidiaries is held by the ECJ to constitute enough distinction to create a disadvantage. Such restriction can only be justified by overriding reasons of public interest.

The overriding reason of public interest advanced by half a dozen Member States was the fight against a specific form of tax avoidance involving the artificial transfer by a resident company of profits from the home state in which they are realized to a low tax state by means of the establishment of a subsidiary in that state and the effectuation of transactions primarily intended to make such transfer of profits to the subsidiary.

Citing earlier tax cases the ECJ firmly holds that the advantage resulting form the establishment of a subsidiary in a low tax jurisdiction, other than the one in which the parent company has been incorporated cannot by itself authorize that Member State to offset that advantage by less favourable tax treatment of the parent company. Reduction of tax revenue is not a ground of overriding public interest justifying any restriction or discrimination in the right of establishment (at no. 49). The ECJ then goes on to repeat its well settled case law that 'a national measure restricting the freedom of establishment may be justified *where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned*' (at no. 51). So far this is all well-known and traditional doctrine of the ECJ.

3. Abuse of Community law in taxation

However, the ECJ goes on to break new ground in applying the concept of abuse of Community law in

the area of taxation. In assessing whether the conduct of a taxpayer constitutes such wholly artificial arrangement one must take account of the objectives pursued by the freedom of establishment. The objective of this freedom is promoting and facilitating economic and social interpenetration within the Community. This involves 'the actual pursuit of an economic activity through a fixed establishment in (the other) State for an indefinite period … and the pursuit of genuine economic activity …' (at no. 54). Therefore the objective of the restriction must be to prevent 'abusive practices 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 the national territory' (at no. 55). The ECJ comes to the conclusion that CFC legislation is a suitable instrument to achieve the objective of preventing the abusive practices and therefore accepts the prevention of tax avoidance as a legitimate ground for restrictions (at no. 59).

4. Proportionality of anti-abuse provisions

As in the *Marks & Spencer* case, we are left with the question of proportionality. This question obliges the ECJ to perform an in-depth analysis of the CFC provisions in the UK legislation, which can be divided in two parts: a set of safe haven rules and a motive test. The ECJ leaves out the safe haven rules, because it is obvious that in those cases there is a genuine activity satisfying all the conditions for an effective establishment in the other Member State. Therefore the Court concentrates on the motive test. For the motive test to meet the concept of abuse two conditions must be fulfilled:

(a) there must be a subjective intention to obtain a tax advantage, and
(b) in addition there must be 'objective circumstances showing that, despite the formal observance of the conditions laid down in Community law, the objective pursued by freedom of establishment …. has not been achieved. In those circumstances, in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, *despite the existence of tax motives, the incorporation of a CFC reflects economic reality*' (at nos. 64 and 65).

The test of economic reality must be based on objective factors which are ascertainable by third parties permitting them to assess whether the CFC physically exists in terms of premises, staff and equipment.

The second condition to evaluate the existence of abuse is most crucial. When the objective factors are indeed indicating that there is no genuine economic activity in the territory of the host Member State, the CFC must be considered as a wholly artificial arrangement tantamount to an abuse against which the home state is justified to take action. However, neither the fact that the intention of the tax motive was paramount in setting up the establishment in the host state, nor the fact that the activities carried out by the CFC could just as well have been established in the home state 'warrant the conclusion that there is a wholly artificial arrangement' (at no. 69).

Finally the ECJ leaves it to the national courts:

> 'to determine whether …. the motive test, as defined by the legislation on CFCs lends itself to an interpretation which enables the taxation provided for by that legislation *to be restricted to wholly artificial arrangements or whether, on the contrary, the criteria on which the test is based mean that, where none of the exceptions laid down in that legislation applies and the intention to obtain a reduction in … tax is central …, the resident company comes within the scope of application of that legislation, despite the absence of objective evidence such as to indicate the existence of an arrangement of that nature*' (at no. 72)

i.e. when the CFC rules apply despite objective evidence that there is a genuine economic activity in the host state.

5. Impact of *Cadbury Schweppes*

The importance of this decision cannot be overestimated. It defines for income tax purposes what should be considered as an 'abuse of Community law', whereby in this case Community law stands for the basic freedoms. There is abuse only when the objectives of the basic freedoms are not attained. The objectives are not attained when there is no effective economic integration, which can be ascertained on the basis of objective economic standards such as physical presence, employees and equipment.

In defining the concept of abusive practices the decision also focuses on abuse of European Community law and not specifically on the abuse of national tax law. Abuse of national tax law is typically the focus of the national tax administration, while the focus of the ECJ is on the abuse of Community law. In CS the ECJ has 'denationalized' the concept of abuse and 'Europeanized' this concept by putting the focus on its effectiveness in the Internal Market, not in the national market. Something similar happened to the concept of cohesion, when the ECJ applied this concept on cross-border dividends in the *Manninen* decision (C-319/02), when the ECJ stated that cohesion also required elimination of double taxation on cross-border dividends and not only on domestic dividends. To put it briefly the ECJ has decided that in the field of income taxation national anti-avoidance or anti-abuse provisions can only be accepted in a cross-border context when they fight or prevent abuse of Community law, which is not necessarily the same as abuse of national law. There is abuse of Community law when transactions are wholly artificial constructions which do not reflect economic reality in the Internal Market context.

6. Comparison of anti-abuse doctrines

The two decisions leave us with two tempting questions.

(1) What is the impact of the *Cadbury Schweppes*

decision on references to avoidance and abuse in the directives on direct taxation?

(2) Are the anti-abuse doctrines in *Halifax* and *Cadbury Schweppes* identical or at least similar, so that it would be possible to speak of one single European anti-abuse doctrine for tax purposes?

On the first question the answer seems clear, at least in theory. Since the ECJ has set clear standards for anti-abuse provisions to be effective for tax purposes in Community law and because Community law has in general priority over national law, national and treaty anti-abuse provisions must meet the standards for abuse under Community law set by the ECJ in *Cadbury Schweppes*. The same rule applies of course to the anti-abuse provisions solely formulated in a European context, like the anti-abuse provision in the Merger Directive. These basic principles will contribute substantially to clarify the operation of national and treaty anti-abuse provisions in the cross-border context of the Internal Market.

The second question is more difficult to answer. The starting principle for the reasoning of the ECJ is in both cases identical: nationals of a Member State cannot attempt improperly or fraudulently to take advantage of provisions of Community law (*Halifax* at nos. 68 and 69 and *Cadbury Schweppes* at no. 35, each citing different precedent). But then each decision goes its own way, because the tax questions subject to the litigation are quite different.

6.1. Where is the difference?

In *Halifax* the question is very much akin to an interpretation of anti-abuse provisions of a national statute. In spite of VAT being a largely harmonized European tax, its concrete implementation is very similar to any other national tax. Therefore the conditions for an abuse to exist could very well be the same conditions as for a national law. In the words of *Halifax*: the grant of the tax advantage would be against *the purpose of the statute* and it must be ascertained on the basis of a series of objective factors that *essential aim* of the transactions is to obtain a tax advantage. However *Halifax* also refers to 'the purely artificial nature of those transactions' and 'the links of a legal, economic and/or personal nature' (at no. 81) to ascertain the reality of the transaction.

In *Cadbury Schweppes*, on the other hand, the question is not answered in the way a question of national tax law would be answered because the essence of the problem is a cross-border problem involving two national tax legislations. The ECJ does not use the words 'purpose of the national statute' or 'the sole or essential aim' to obtain a tax advantage, but rather wholly artificial arrangements aimed at circumventing the application of the national statute. In *Halifax* tax avoidance is established:

(a) when the tax advantage obtained is contrary to the purpose (or the spirit?) of the national VAT statute implementing the Sixth Directive, and

(b) when the tax advantage is the sole or essential aim of the transaction.

When there is some other explanation for the economic activity than the mere attainment of tax advantages the transaction stands for tax purposes.

In *Cadbury Schweppes* the objective of achieving the tax advantage in another Member State is considered not to be relevant in establishing the abusive practice. However when transactions are wholly artificial the objective to reduce tax burdens becomes relevant. A transaction is deemed to be wholly artificial for Community law purposes when the objectives of the fundamental freedoms are not fulfilled i.e. when the transaction does not result into effective integration or interpenetration of economic or social activities. When the latter objectives are fulfilled there can be no tax avoidance from a Community point of view, even when the reduction of tax burdens would be the 'only' purpose of the transaction. However when one looks closely at this formulation it is almost the same as the one in *Halifax*, because if effective economic integration and interpenetration is required between the home and the host state, it is clear that the tax advantage is not the sole objective, because effective economic goals are also present. In *Halifax* 'some other explanation' than the mere attainment of tax advantages needs also to be established and apparently this other explanation needs to be proven by indicators showing its economic reality.

The conclusion is that both decisions have used a reasoning to refute tax avoidance that is very similar if not identical: the economic reality of the transaction. There are two differences of which only one is significant. The first difference is that the economic reality in *Halifax* is the economic reality of domestic VAT transactions, while the economic reality in *Cadbury Schweppes* is the economic reality of exercising the fundamental freedoms through cross-border transactions. These are only differences in viewpoint, not in substance. In VAT one could also take the point of view of cross-border economic reality for example for intra-Community transactions. The second difference is more important: in *Halifax* the ECJ still leaves some leeway to the national courts in VAT to decide whether the tax motive is 'essential' compared to some other non-tax explanations. In *Cadbury Schweppes* the ECJ states categorically that when the cross-border economic reality of the transactions are established there can be no tax avoidance and the goal of achieving the tax advantage has no importance. When the ECJ, as it should, were to decide that the effective economic existence of the transactions would preclude the application of anti-avoidance provisions, the ECJ would in fact use only one single rule: if there is an effective economic transaction on the basis of objective criteria which third parties can ascertain, the tax motive becomes irrelevant, even if it is significantly more important than the economic content of the transactions. Such a rule would also come very close to existing general anti-avoidance doctrine applicable in many Member States.