



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 10.12.2007
COM(2007) 785 final

**COMMUNICATION FROM THE COMMISSION
TO THE COUNCIL, THE EUROPEAN PARLIAMENT AND THE EUROPEAN
ECONOMIC AND SOCIAL COMMITTEE**

**The application of anti-abuse measures in the area of direct taxation – within the EU
and in relation to third countries**

1. INTRODUCTION

In its Communication on the co-ordination of the Member States' (MSs') direct tax systems in the Internal Market¹, the Commission outlined ways in which coordination and cooperation between the MSs could enable them to attain their tax policy goals and protect their tax bases while observing their EC Treaty obligations and ensuring the elimination of double taxation. In some areas such coordination is plainly essential. In others, unilateral remedies are possible but it may nevertheless be preferable to seek common solutions, even where at first sight the MSs' vested interests in those areas might not always appear to be concurring. The Commission has a legal obligation to ensure that MSs observe their EC Treaty obligations but also a political responsibility to seek and promote constructive solutions to that end. With regard to the application of anti-avoidance rules the Commission considers that, in particular in the light of some recent European Court of Justice (ECJ) decisions, there is an urgent need

- to strike a proper balance between the public interest of combating abuse and the need to avoid disproportionate restrictions on cross-border activity within the EU; and
- for better coordination of the application of anti-abuse measures in relation to third countries in order to protect MSs' tax bases.

With that in mind, the present Communication analyses the principles flowing from the relevant ECJ case law with a view to prompting a more general debate on appropriate responses to the challenges faced by MSs in this area. The Communication is therefore intended to provide a framework for further discussion with MSs and stakeholders with a view to exploring the scope for coordinated solutions in this area.

The notion of "anti-abuse rules" covers a broad range of rules, measures and practices. Some MSs apply a general concept of abuse based on legislation or developed in case law. Others apply more specific anti-abuse provisions, such as Controlled Foreign Corporation (CFC) and thin capitalisation rules which aim to protect the domestic tax base from particular types of erosion. Other types of specific anti-abuse provisions include switch-over from exemption to credit method in certain cross-border situations (where foreign source income has been subject to a low or preferential tax rate) and provisions explicitly targeted at passive investment in other countries. Many MSs apply a combination of general and specific anti-abuse rules. Anti-abuse rules are also envisaged in the EC corporate tax directives.

As regards the compatibility of national anti-abuse measures with EC law, a distinction has to be drawn between their application within the Community (where the four fundamental freedoms apply) and their application vis-à-vis third countries (where only the free movement of capital applies)². The application of anti-abuse rules in respect of third countries is therefore discussed separately in chapter 4.

¹ COM(2006)823, 19.12.2006.

² It may be noted that the application of certain anti-abuse provisions in tax treaties with third countries could indirectly also affect the freedom of establishment of companies resident in other MSs.

The present Communication focuses only on the area of direct taxation. It should of course be noted that the Commission pursues an active policy as regards anti-avoidance schemes in the field of indirect taxation, and particularly as concerns VAT. This policy is decisively influenced by the greater degree of harmonization in the indirect tax field and the fact that Directive 2006/112/EC³ includes specific rules and procedures allowing MSs to fight avoidance and to take measures against evasion. In this respect the Commission works closely with MSs and, through special working groups, has taken a proactive role in tackling abuses.

2. DEFINITIONS AND KEY PRINCIPLES FROM ECJ CASE LAW

Avoidance and abuse

The ECJ has held that a person who would otherwise be in a situation covered by Community law may forfeit his Community law rights where he seeks to abuse them. Such cases are exceptional: an abuse occurs only where, despite formal observance of the conditions laid down in the relevant Community rules, their purpose is not achieved and there is an intention to obtain an advantage by artificially creating the conditions for obtaining it.⁴ The ECJ has in particular applied the doctrine to the Community legislation on export refunds and VAT.

In its case law on direct taxation the ECJ has, in addition, held that the need to prevent tax avoidance or abuse can constitute an overriding reason in the public interest capable of justifying a restriction on fundamental freedoms⁵. The notion of tax avoidance is however limited to "wholly artificial arrangements aimed at circumventing the application of the legislation of the MS concerned". In order to be lawful national tax rules must be proportionate and serve the specific purpose of preventing *wholly artificial arrangements*.

Wholly artificial arrangements

Prompted by arguments raised by MSs the ECJ has identified several factors which do not *of themselves* suffice to constitute abusive, i.e. wholly artificial arrangements. It has held, for instance, that the mere fact that a subsidiary is established in another MS cannot, of itself, be treated as giving rise to tax avoidance⁶ and that the fact that the activities carried out by a secondary establishment in another MS could just as well be pursued by the taxpayer from within the territory of its home MS does not warrant the conclusion that there is a wholly artificial arrangement⁷. The ECJ has also expressly confirmed that it is quite legitimate for tax considerations to play a role in the decision on where to establish a subsidiary⁸. The objective of minimising one's tax burden is in itself a valid commercial consideration as long as the arrangements entered into with a view to achieving it do not amount to artificial transfers of profits. In so far as taxpayers have not entered into abusive practices, MSs cannot hinder the exercise of the rights of freedom of movement simply because of lower levels of taxation in other MSs⁹. This is the case even in respect of special favourable regimes in the other MSs' tax systems¹⁰. Distortions to the location of business activities due to state aid that is

³ OJ L 347, 11.12.2006, p. 1–118.

⁴ *Emsland-Stärke* C-110/99, #52-53; *Halifax* C-255/02, #74-75.

⁵ Eg. *Lankhorst*, C-324/00, #37.

⁶ *ICI*, C-264/96, #26.

⁷ C-196/04, #69.

⁸ *Cadbury*, #37.

⁹ *Eurowings*, C-294/97, #44.

¹⁰ *Cadbury*, #36-38.

incompatible with the EC Treaty and to harmful tax competition do not entitle MSs to take unilateral measures intended to counter their effects by limiting freedom of movement¹¹; rather they need to be resolved at source through the appropriate judicial or political procedures. Obviously, anti-abuse measures must themselves, too, comply with the EC treaty provisions on state aid¹². The Commission will continue to monitor the application of the EC Treaty state aid rules and to lend its support to the work undertaken in the Council by the Code of Conduct Group.

In order for anti-abuse rules to be justified, they must be confined to situations in which there is a further element of abuse. In its recent case law the ECJ has given more explicit guidance on the criteria for detecting abusive practices, i.e. wholly artificial arrangements. In *Cadbury*, the ECJ held that an establishment is to be regarded as genuine where, based on an evaluation of objective factors which are ascertainable by third parties, in particular evidence of physical existence in terms of premises, staff and equipment, it reflects economic reality, i.e. an actual establishment carrying on genuine economic activities and not a mere "letterbox" or "front" subsidiary¹³. In *Thin Cap*¹⁴ the issue was not whether the establishment of the taxpayers concerned was genuine but whether the MS concerned could impose tax restrictions on financing arrangements between related companies. The ECJ confirmed that the fact that the terms and conditions of financial transactions between related companies resident in different MSs deviate from those that would have been agreed upon between unrelated parties constitutes an objective and independently verifiable element for the purpose of determining whether the transaction in question represents, in whole or in part, a purely artificial arrangement. Legislation framed on that basis was proportionate on condition that the taxpayer was given the opportunity to provide evidence of any commercial justification for the arrangement.

The detection of a wholly artificial arrangement thus amounts in effect to a substance-over-form analysis. Application of the relevant tests in the context of EC Treaty freedoms and corporate tax directives necessitates an evaluation of their objectives and purposes against those underlying the arrangements entered into by their prospective beneficiaries (taxpayers). In the context of corporate establishment there are inevitably difficulties in determining the level of economic presence and commerciality of arrangements. Objective factors for determining whether there is adequate substance include such verifiable criteria as the effective place of management and tangible presence of the establishment as well as the real commercial risk assumed by it. However, it is not altogether certain how those criteria may apply in respect of, for example, intra-group financial services and holding companies, whose activities generally do not require significant physical presence.

The ECJ has clarified the permitted scope of certain types of anti-avoidance rules and set out a number of criteria to assess the genuineness of establishment and the commercial character of arrangements entered into by taxpayers. While the application of the principles flowing from the case law will ultimately depend on the facts of particular cases, the Commission nevertheless considers that it would be worthwhile exploring the practical application of those

¹¹ Eg. AG Léger in *Cadbury*, #55-60.

¹² See, Commission Notice of 11 November 1998, OJ C 384/98, in particular #13.

¹³ #67-68.

¹⁴ C-524/04.

principles to different types of business activities and structures¹⁵. It proposes to do so together with the MSs and would also welcome input from the business community.

Proportionality

It follows from *Cadbury* and *Thin Cap* that, for the purposes of determining whether a transaction represents a purely artificial arrangement, national anti-abuse rules may comprise 'safe harbour' criteria to target situations in which the probability of abuse is highest. Indeed, the Commission shares the view of Advocate General (AG) Geelhoed who, in *Thin Cap*, opined that the setting out of reasonable presumptive criteria contributes to a balanced application of national anti-abuse measures as it is in the interest of both legal certainty for the taxpayers, and workability for tax authorities¹⁶.

However, in order to ensure that genuine establishments and transactions are not unduly sanctioned it is imperative that where the existence of a purely artificial arrangement is presumed, the taxpayer is given the opportunity, without being subject to undue administrative constraints, to produce evidence of any commercial justification that there may be for that arrangement. The extent to which the onus to demonstrate that their transactions served *bona fide* business purposes can be placed on the taxpayer can only be determined on a case-by-case basis. In this regard the Commission considers that burden of proof should not lie solely on the side of the taxpayer and that account should be taken of the general compliance capacity of the taxpayer and of the type of arrangement in question. It is equally vital in the interest of proportionality that the result of the relevant assessment by the tax authority can be made subject to an independent judicial review. Moreover, the adjustments to the taxable income as a result of the application of the anti-abuse rules should be limited to the extent that is attributable to the purely artificial arrangement. With regard to intra-group transactions that means adherence to the arm's length principle, i.e. the commercial terms as would have been agreed upon between unrelated parties. However, this, in the Commission's view should not prevent MSs from imposing penalties on taxpayers who have made use of abusive schemes to avoid tax.

3. APPLICATION OF ANTI-ABUSE RULES WITHIN THE EU/EEA

General

MSs need to be able to operate effective tax systems and prevent their tax bases from being unduly eroded because of inadvertent non-taxation and abuse. At the same time, it is important to ensure that there are no undue obstacles to the exercise of the rights conferred upon individuals and economic operators by Community law provisions. Anti-abuse measures must therefore be accurately targeted at wholly artificial arrangements designed to circumvent national legislation (or Community rules as transposed into national legislation). This is also the case with regard to the application of anti-abuse rules in relation to EEA States (except for

¹⁵ In this respect it might also be worth exploring the scope for establishing a non-exhaustive inventory of fact patterns that generally indicate the presence of an artificial arrangement – by way of example, incorporation of a secondary establishment which purports to provide goods or services from another jurisdiction without any real substance or physical operation therein, or more generally, types of arrangements which serve no business purpose (or which might be even contrary to general business interests, if not entered into for the purpose of avoiding tax).

¹⁶ #66.

situations where there is no adequate information exchange relationship with the EEA State concerned). In order to ensure that such rules are not disproportionate to the objective of curbing abuse and to guarantee legal certainty, adequate safeguards must be provided so that taxpayers have the opportunity to provide evidence of any commercial justifications that there may be for their arrangements.

In the Commission's view it would be regrettable if, in order to avoid the charge of discrimination, MSs extended the application of anti-abuse measures designed to curb cross-border tax avoidance to purely domestic situations where no possible risk of abuse exists. Such unilateral solutions only undermine the competitiveness of the MSs' economies, and are not in the interest of the Internal Market. Indeed, as AG Geelhoed observed in *Thin Cap*¹⁷ such an extension "...is quite pointless and indeed counterproductive for economic efficiency." Moreover, it remains debatable whether such extensions can successfully bring all restrictive measures into line with MSs' EC Treaty obligations.

Lack of concerted interaction between MSs' tax systems may result in unintended non-taxation and provide scope for abuse, thus undermining their fairness and balance. *Mismatches* may arise, for example, in relation to the qualification of debt and equity. One MS may consider a transaction to be an equity injection and thereby exempt the income derived from it (as profit distribution), whereas another MS may consider the same transaction to be a loan and allow tax deductibility for the consequent payments (as interest). This may result in a deduction in one MS without corresponding taxation in another MS. The same is true of hybrid entities, i.e. entities which are regarded as corporate bodies by one MS and as transparent entities by another. This difference in qualification may lead to double exemptions or double deductions. Such problems are best tackled at source, by reducing the occurrence of mismatches. Failing that, it is desirable to improve administrative co-operation to detect situations in which such mismatches are exploited abusively. The Commission proposes to discuss these issues with MSs in more detail to examine what scope there is for possible coordinated solutions in this area.

Administrative co-operation on fraudulent tax schemes and specific cases of abuse can be of key importance in ensuring the effectiveness of anti-abuse measures. Tax avoidance schemes are often highly complex and can involve operations in many different MSs and third countries, which makes it increasingly difficult for MSs to detect and combat such schemes on their own. Moreover, targeted anti-abuse measures involve a high burden of proof for tax administrations, which makes co-operation between them all the more important. It would also appear useful for MSs to *share best practices* developed at national level.

Common types of anti-abuse rules in MSs' tax legislation

CFC rules. The main purpose of CFC rules is to prevent resident companies from avoiding domestic tax by diverting income to subsidiaries in low tax countries, and – as the ECJ has recognised – CFC rules are in general apt to achieve that purpose. The scope of CFC rules is generally defined by reference to criteria regarding control, effective level of taxation, activity and type of income of the CFC, and they typically provide that profits of a CFC may be attributed to its domestic parent company and subjected to current taxation in the hands of the latter. Under CFC rules, the profits of a subsidiary receive different tax treatment for the sole reason that the subsidiary is resident in another State. That difference in treatment constitutes

¹⁷ #68.

discrimination unless there is an objective, relevant difference of situation such as to justify it. Equally, the inclusion of the profits of a foreign subsidiary in the taxable profits of the resident parent company constitutes an obstacle to the ability of the latter to establish itself in other MSs by way of subsidiaries.

Short of abolishing CFC rules altogether or refraining from applying them within the EU/EEA, it is therefore necessary to ensure that the CFC rules are targeted at wholly artificial arrangements only. Their scope may be narrowed by way of various exceptions, such as acceptable distribution policy, exempt (genuine industrial or commercial) activities, public quotation, etc., but above all, it is crucial that taxpayers are given the opportunity to demonstrate, under judicial review, that their transactions served *bona fide* business purposes.

The limits on the permitted scope of CFC-type rules are without prejudice to the application of transfer pricing rules, which may be used more generally to target non-commercial pricing arrangements between associated companies. CFC rules may therefore continue to perform a useful function as an adjunct to rules on corporate residence and transfer pricing in so far as they provide a means of combating the more artificial types of tax planning, i.e. diversion of (paper) profits to controlled companies which are not genuinely established in other MSs or EEA States. MSs must however ensure that such measures are not applied in respect of secondary establishments in other MSs and EEA States engaged in genuine business activities and do not go beyond what is necessary to achieve their avowed purpose of tackling artificial profit shifting.

Thin capitalisation rules. There are many different approaches to the design of thin cap rules which reflect the different views and legal traditions of MSs. However, the background to these rules is similar. Debt and equity financing attract different tax consequences. Financing a company by means of equity will normally result in a distribution of profits to the shareholder in the form of dividends, but only after taxation of such profits at the level of the subsidiary. Debt financing will result in a payment of interest to the creditors (who can also be the shareholders), but such payments generally reduce the taxable profits of the subsidiary. Dividend and interest may also attract different withholding tax consequences. The difference in treatment between debt and equity financing under national tax law (and at bilateral level), as a result of which the source state's taxing rights on interest are generally more limited than those on dividends, make debt financing considerably more attractive in a cross-border context and can therefore lead to the erosion of the tax base in the state of the subsidiary.

By abolishing their thin cap rules altogether or by carving out dealings with lenders resident in other MSs and EEA States from their scope, the difference in treatment between resident subsidiaries according to the seat of their parent company within the EU/EEA would be removed. The Commission is of the opinion that MSs should, however, be able to protect their tax bases from artificial erosion through structured debt financing, also within the EU/EEA. Following *Lankhorst*, some MSs have tried to avoid the charge of discrimination by extending the application of their thin cap rules to cover also purely national relations. As discussed above, this is not desirable development.

In *Thin Cap* the ECJ acknowledged that measures to prevent thin capitalisation are not per se impermissible. Their application must however be confined to purely artificial arrangements. This may be achieved by ensuring that the terms of the debt financing arrangements between related companies remain within the limits of what would have been agreed upon between unrelated parties or that they are based on otherwise valid commercial reasons. The Commission considers that the principles laid down by the ECJ in relation to thin cap rules

also apply to transfer pricing rules, which are essential to the continued existence of individual national tax systems. MSs cannot operate effective tax systems unless they are able to ensure that their tax bases are not eroded through non-commercial arrangements between associated companies.

4. APPLICATION OF ANTI-ABUSE RULES IN RELATION TO THIRD COUNTRIES

CFC rules determine the tax treatment of the profits of a foreign company controlled by a resident. As such rules are directed at, and thus only affect resident shareholders with definite influence over a foreign company (usually a parent in a corporate group) their centre of gravity lies with the ability of companies (and as the case may be, individuals) to establish themselves, through subsidiaries, in other countries. Similarly, MSs' thin cap rules are directed exclusively at group debt financing arrangements, i.e. they are only applied in situations where a foreign shareholder holds a substantial participation in the resident subsidiary. Thus, the centre of gravity in respect of thin cap rules also lies clearly with the freedom of establishment and as in the case of CFC rules their application is therefore to be examined solely from the perspective of Article 43 of the EC Treaty¹⁸.

As Community law does not require MSs to avoid discrimination in relation to the establishment of their nationals outside the Community, or the establishment of third-country nationals in a MS¹⁹ the issue of discrimination does not arise in the cases of a controlled company or a creditor/shareholder resident in a third country. MSs should therefore not be precluded from applying CFC and thin cap rules in relation to third countries. Community law does not impose any particular requirements on the legitimacy of the application of such legislation to transactions outside the EU²⁰.

However, should the application of those rules not be confined to situations and transactions between companies in a corporate group (or otherwise related parties where one has definite influence over the other) and to the extent that this was the case, they would need to comply with Article 56 of the EC Treaty, and also in relation to third countries, be applied to wholly artificial arrangements only (with the exception of situations where there is no adequate information exchange relationship with the third country concerned).

The corporate tax directives only apply to companies incorporated in the MSs and their overall objective is to create *within the Community* conditions analogous to those of an internal market by removing tax obstacles to cross-border reorganisations and to payments of dividends, interest and royalties. It would therefore not appear to fall within their ambit to, for instance, facilitate arrangements intended to avoid withholding taxes on payments to non-European entities, if such structuring does not serve any commercial purpose. In this regard it may be noted that such avoidance constructions are best curbed by, if not uniform, at least well co-ordinated application of anti-avoidance measures.

The Commission considers that, in particular in respect of application of their anti-avoidance rules to international tax avoidance schemes, the MSs should, in order to protect their tax

¹⁸ *Lasertec*, C-492/04, #20.

¹⁹ As the ECJ noted in *ICI*: " (...), when deciding an issue concerning a situation which lies outside the scope of Community law, the national court is not required, under Community law, either to interpret its legislation in a way conforming with Community law or to disapply that legislation (...)" #34

²⁰ Their application may however be precluded by the relevant Double Tax Convention.

bases, seek to improve the coordination of anti-abuse measures in relation to third countries. Such co-ordination can usefully consist of administrative co-operation, (e.g. exchange of information and sharing of best practices). The Commission would also encourage MSs, where appropriate, to enhance administrative co-operation with their non-EU partners.

5. CONCLUSIONS

The ECJ has handed down a number of important judgments in this area in which it has clarified the limitations on the lawful use of anti-avoidance rules. The judgments will undoubtedly have a significant impact on the existing rules which have not been formulated with these constraints in mind. It is in particular clear that rules must not be framed too broadly but be targeted at situations where there is no genuine establishment or more generally where there is a lack of commercial underpinning.

There is therefore a need for a general review by MSs of their anti-avoidance rules. The Commission is willing to support and assist MSs in conducting such reviews. In the Commission's view, while the ECJ has laid down clear criteria which must be applied to individual facts, there remains scope for exploring the practical application of those principles more generally beyond the circumstances of the particular contexts in which they arose. The Commission therefore invites the MSs and other stakeholders to work with it to promote a better understanding of the implications for MSs' tax systems. The Commission is also keen to explore the scope for specific co-ordinated solutions in more detail in close co-operation with MSs with a view to:

- developing common definitions for abuse and wholly artificial arrangements (to provide guidance on the application of those concepts in the area of direct tax);
- improving administrative co-operation so as to more effectively detect and contain abuse and fraudulent tax schemes;
- sharing best practices that are compatible with EC law, in particular with a view to ensuring proportionality of anti-abuse measures;
- reducing potential mismatches resulting in inadvertent non-taxation; and
- ensuring better coordination of anti-abuse measures in relation to third countries.

The Commission invites the Council, the European Parliament and the Economic and Social Committee to give their opinion on this Communication.