Opinion of the European Economic and Social Committee on the ‘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’

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On 10 December 2007 the Commission decided to consult the European Economic and Social Committee, under Article 262 of the Treaty establishing the European Community, on the 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.

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee’s work on the subject, adopted its opinion on 14 July 2008. The rapporteur was Mr Burani.

At its 447th plenary session, held on 17 and 18 September 2008 (meeting of 17 September), the European Economic and Social Committee unanimously adopted the following opinion.

1. Conclusions and recommendations

1.1 The Commission document lays the foundations for a discussion between Member States on direct taxation in cross-border transactions. In particular, it proposes 'coordinated' solutions for the implementation of anti-abuse measures, an area in which cooperation between the different administrations is poor, with wholly national approaches.

1.2 The EESC welcomes the initiative — which is envisaged as long-term — particularly because it would result in the creation virtually of a Community body of laws (or at least that is the intention), based on the numerous judgments of the European Court of Justice. ECJ case law is extensive enough to be a good point of reference for national tax authorities, although the latter are not always willing to use it.

1.3 The starting point is the agreement between Member States on what is deemed 'abuse' — i.e. on the distinction between 'tax evasion' and 'tax avoidance'. The EESC stresses the importance of the ECJ judgments, which have established that, while there is no doubt that the former is an offence, a distinction needs to be made as regards the latter: avoidance is only an offence if 'wholly artificial arrangements' are set up, i.e. if fictitious situations are created. The setting-up of establishments with the intention of taking advantage of state aid granted in other countries does not count as an offence either: if the aid were not in line with the Treaty the distortion would be addressed at source by other means without involving individual parties.

1.4 A particularly important aspect is 'thin capitalisation', i.e. providing foreign subsidiaries with funds instead of increasing capital. The approach taken by administrations is somewhat subjective, and it is particularly difficult to judge when it comes to financial institutions.

1.5 Case law (see below) aside, the EESC draws attention to a number of fundamental principles on which Member States should agree, maybe introducing them as of now. Firstly, a balance needs to be struck between the interests of the state and those of the taxpayer, with the proportionality principle always applied when deciding on cases of 'wholly artificial arrangements'. This means that rules are needed for fair distribution of the burden of proof and, in particular, establishing the procedures to be followed by tax authorities when collecting proof, with due regard for the law.

1.6 In conclusion, the EESC feels that on such a multi-faceted, varying matter Member States’ goodwill and willing cooperation is needed: they have to strike a balance between protecting their finances and focusing on the public and respect for their rights. At the same time, it feels that it is its duty to highlight the role that tax administrations should play in combating both abuse and, most importantly, artificial (or even genuine) arrangements serving as a front for criminal activities.

2. Introduction

2.1 As promised in 2006 (1), the Commission has started work on coordinating Member States’ direct tax systems. The issue is quite clear: when implementing tax measures involving taxpayers’ cross-border activities each national authority is required to ensure that its country receives the appropriate revenue, but the diversity of systems could lead to differences in interpretation or application by other authorities. Taxpayers could take advantage of these differences and abuse them to avoid some or all of their obligations. On the other hand, double taxation also needs to be prevented.

2.2 To this end, most Member States have adopted a number of ‘anti-abuse rules’ — specific or general rules which differ from country to country. This situation can — and does — give rise to disputes in respect of taxpayers and sometimes between Member States themselves. The European Court of Justice (ECJ), called on to decide on various individual cases, has returned judgments which, in the absence of Community legislation on the matter, provide useful case law as a guide. The Commission has referred to this in drawing up the Communication in question.

2.3 The Communication is ‘intended to provide a framework for further discussion with Member States and stakeholders with a view to exploring the scope for coordinated solutions’. The Commission believes that 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; moreover, it will be necessary to coordinate application of anti-abuse measures in relations with third countries.

2.4 The Commission intends to launch a discussion between the Member States on these issues involving stakeholders, so as to reach conclusions on which all agree. This should lead to voluntary coordination of rules and procedures. There is no question of “harmonisation” — which would be too difficult to achieve in the short term — or of legislative measures, which would be practically impossible to prescribe.

3. Gist of the Communication

3.1 The Commission document takes particular care to define the relevant terminology and background to the issue, taking as basis ECJ judgments which have laid down a number of basic principles. Firstly, an abuse is defined: it ‘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 (1)’. A distinction must be made between an abuse and tax avoidance, which is defined as ‘wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned’.

3.2 Another basic principle is 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 freedoms’. However, the legitimacy of restrictive rules is dependent on their compliance with proportionality principles; the rules must, in addition, ‘serve the specific purpose of preventing wholly artificial arrangements’.

3.3 The ECJ has used specific criteria to define what does not constitute a ‘wholly artificial arrangement’: the fact that a subsidiary is established in another Member State cannot, of itself, be said to be covered by this definition, even where activities carried out by a secondary establishment in another Member State could just as well be pursued by the parent company. The argument that decisions to set up secondary establishments are based on tax considerations is not sufficient alone: provided that there is no abuse, it is perfectly legitimate to take advantage of a more favourable tax regime in another Member State. Lastly, the fact that a secondary establishment is set up in order to take advantage of state aid granted by another Member State does not constitute such an arrangement either: the distortion brought about by state aid which is not in line with the Treaty should be resolved at source by other means, but this does not warrant unilateral measures to counter its harmful effects.

3.4 However, the ECJ did place limits on broader interpretation of these principles: they do not hold where a further element of abuse is present such as the establishment of a ‘letterbox’ or ‘front’ subsidiary, or where terms and conditions of financial transactions between related companies resident in different Member States deviate from those that would have been agreed upon between unrelated parties. A substance-overform rule is therefore applied.

3.5 The Commission points out that the above criteria apply to specific cases but that it would be worth exploring the practical application of those principles to different types of business activities and structures.

3.6 As regards proportionality, the ECJ allows Member States to adopt ‘sale harbour’ criteria to target situations in which the probability of abuse is high; the setting-out of reasonable presumptive criteria is in the interest of both legal certainty for taxpayers and workability for authorities.

3.7 The Commission points out the need for criteria ensuring fairness: the burden of proof should not lie solely on the side of the taxpayer, who should be able to defend himself without excessive administrative burdens and with the guarantee that tax authorities’ assessments are subject to 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. In addition, intra-group transactions should be assessed using the arm’s length principle. Ultimately, however, these criteria should not prevent Member States from imposing penalties on taxpayers guilty of making use of abusive schemes to avoid tax.

3.8 After establishing general principles, the Commission document moves on to the practical application of the rules: this part of the document will be discussed on a case-by-case basis in the Specific comments section (see below).
4. General comments

4.1 The EESC views the Commission’s initiative very favourably: firstly, it aims to coordinate rules and procedures without giving way to the temptation of imposing constraints from above, adopting a realistic approach which takes into account the provisions of the Treaty but also Member States’ concerns; secondly, it aims to strike a balance between the ‘public interest’ (in each Member State) and the ‘need to avoid disproportionate restrictions’ on the internal market.

4.1.1 The EESC for its part recommends that the focus be on the individual/taxpayer. If and when coordination is attempted, it must first and foremost be based on fairness in respect of the taxpayer; while this principle seems to underpin the ECJ’s judgments it does not always seem to be observed in practice.

4.2 Moreover, the EESC’s concern seems to be shared by the ECJ and the Commission: when the proportionality principle (see point 3.2 above), to be adopted to prevent excessively restrictive rules applying in cases of ‘wholly artificial arrangements’ (see point 3.3), is mentioned, this is clearly not a reference to hypothetical situations. There are numerous breaches of the rules and some may well never come to light, but there are just as many subsidiaries established abroad whose legitimacy is called into question or disputed. If tax authorities were to take on board the principles set forth in ECJ judgments then businesses would be able to operate in an environment of legal certainty, without unnecessary red tape and without running the risk of double taxation.

4.3 The EESC endorses the Commission’s comment (see point 3.5) that the catalogue of lawful and unlawful cases is too varied to form the basis of general principles and that it is therefore necessary to explore the practical application of those principles to different types of business activities and structures. However, looking at individual cases in the light of ECJ judgments would as a first step enable businesses themselves to make an initial assessment of the likelihood of their decisions to set up subsidiaries abroad not being opposed — provided, of course, that the authorities decide to act in line with ECJ case law, albeit adapting it to each individual case. Taking a case-by-case approach would allow individual situations to be assessed fairly, avoiding standardised solutions based on form over substance.

4.4 If both businesses and authorities act in this way, it will be easier to isolate ‘letterbox’ or ‘front’ subsidiaries (see point 3.4), which constitute explicit fraud. Looking at case law in this area could help Member States when they establish ‘safe harbour’ criteria (see point 3.6) restricting fundamental rights.

4.5 The point raised by the Commission relating to criteria ensuring fairness (see point 3.7) warrants particular attention. One principle of common law relating to criminal justice is the presumption of innocence, which places the burden of proof on the prosecution. Although tax law is not always based on these rules, there is no doubt that any oppressive measures taken by authorities would be a burden for both businesses and private individuals.

4.5.1 The EESC endorses the recommendation to establish rules for fair distribution of the burden of proof: respect for fundamental freedoms and the presumption of innocence must underpin tax administrations’ relations with taxpayers. Rules are needed which establish the procedures to be followed by tax authorities when collecting proof and which determine where their autonomy ends when it comes to offences subject to criminal sanction, as in the case of tax avoidance achieved by unlawful means, which is tantamount to tax evasion.

5. Specific comments: application of rules within the EU/EEA

5.1 The Commission refers to the principle that ‘anti-abuse measures must […] be accurately targeted at wholly artificial arrangements designed to circumvent national legislation (or Community rules as transposed into national legislation)’. Although it would be difficult to disagree with this principle, it is still very much open to interpretation. The same can be said of the recommendation that rules should not be disproportionate to the aim of curbing abuses.

5.2 The EESC believes that the only way of coordinating measures adopted — assuming there is a sincere desire so to do — is for the Member States to work with the Commission and examine these measures together. The purpose of the rules in each administration, though the underlying philosophies derive from different traditions and situations, is to safeguard the common good. One may hope for these differences to be mitigated, but it will be some time before the practical results are visible.

5.2.1 The EESC entirely agrees with the Commission document that anti-abuse measures designed to curb cross-border tax avoidance must not be applied to purely domestic situations where there is no possible risk of abuse. The ECJ also finds such measures unnecessary, as well as counterproductive in terms of competitiveness.

5.3 One important point is the interpretation of the terms debt and equity financing. One Member State may view a transaction as an equity injection and another merely as a loan on which interest is tax deductible. The same holds for hybrid entities, regarded as corporate bodies by one Member State and as transparent entities by another. This may lead to double exemptions or double taxation. These are familiar instances that benefit, or suffer, not only from differences in the rules applied in different Member States, but also from the different approach of administrations, prone to either favour or discourage cross-border investments.

5.3.1 The EESC finds this one of the more sensitive issues and one which should be the basis of future discussion.
5.4 Also germane to this are the rules on Controlled Foreign Corporations (CFC). Customarily, the profits of a CFC are attributed to the parent company and taxed — albeit under a special regime — in the country where the latter is established. In the Commission’s view, this difference in treatment constitutes discrimination unless there is an objective, relevant difference of situation such as to justify it. These rules also constitute ‘an obstacle to the ability of the latter to establish itself in other MSs by way of subsidiaries’.

5.4.1 The EESC calls for the rules on CFCs to be scrutinised and, if necessary, revised. Important for all companies, they are particularly so for those in the financial sector. As the Commission says: ‘[I]t is crucial that taxpayers are given the opportunity to demonstrate […] that their transactions served bona fide business purposes’. While this can sometimes be a difficult requirement for commercial businesses to meet, for the financial sector it could become a crucial problem. The rules that apply in this sector on both judicial review and prudential control actually serve as a guarantee for companies that are properly controlled. At the same time, their complexity and the differences from country to country could provide easy loopholes for a range of improper dealings. Prime among these is the establishment of — sometimes fictitious or even seemingly normal — companies for speculative or downright criminal ends which use sophisticated techniques to avoid tax and prudential controls. Targeted fiscal rules can be more useful than prudential controls in bringing these activities to light.

5.5 The rules on thin capitalisation (capitalisation through debt financing, a surreptitious form of equity financing) mentioned in point 4.3 are another central concern. They often diverge radically between different Member States as a result of different views and legal traditions. The advantage or otherwise of financing subsidiaries by means of equity rather than debt lies in the different treatment of dividends and interest, and businesses make this decision based on the tax regime operating in the country of the controlled company. It is not unusual for the same parent company to choose between the two systems when financing controlled companies in different Member States.

5.5.1 The Commission would like to see thin cap rules abolished or at least changed to exclude agreements with lenders in other Member States. This would eliminate the difference in treatment between resident subsidiaries according to the seat of their parent company. The Commission also adds that ‘MSs should […] be able to protect their tax bases from artificial erosion through structured debt financing, also within the EU/EEA’. The EESC warns against making generalisations: there could be cases where it really is necessary, or at least preferable, to use debt financing, quite apart from tax considerations.

5.5.2 The EESC’s reservations would appear to be echoed in the European Court of Justice’s Thin Cap ruling, which recognises that ‘measures to prevent thin capitalisation are not per se impermissible. Their application must however be confined to purely artificial arrangements’. This form of capitalisation should not, therefore, be excluded: all that is needed is to make controls to forestall abuse more effective and to set tighter rules to ensure the transparency of transactions.

5.6 In the light of all the preceding remarks, the EESC concludes that the various arguments put forward employ concepts that are vague or interpreted in different ways — either strictly or loosely — in the various Member States. Before the discussions that the Commission would like to see can begin, there must therefore be agreement on the terminology to be used and on the scope of every term.

5.6.1 The same can be said of tax avoidance. In the view of the ECJ — though not of some taxation authorities — this is not per se an offence and only becomes one if ‘a wholly artificial arrangement’ is involved, in which case it constitutes a fraud subject to administrative and/or criminal sanction. On this principle, too, a preliminary agreement is needed on not only the scope but also the interpretation of the term ‘wholly artificial arrangement’.

6. Specific comments: application of anti-abuse rules in relation to third countries

6.1 Generally speaking, rules on CFCs also apply to subsidiaries of third-country companies established in the EU and to subsidiaries in third countries of companies established in the EU, except in the many cases where there are bilateral agreements. Moreover, discriminatory treatment is compatible with Community law where the establishment of Member States’ citizens or companies in third countries, and vice versa, is concerned. This should also be the case for provisions to ban or regulate the injection of thin capital, for corporation tax and especially for specific anti-avoidance rules.

6.2 The Committee has no particular comments to make on this aspect, but would like to stress the need to pay great attention to the application of anti-avoidance rules to new or recently established companies from certain third countries and subsidiaries of EU companies in those countries. There is a disturbing proliferation of crime — not only financial — throughout the world. Committed and effective collaboration on this front would be even better and quicker than coordination between administrations. The problem is far less about taxation than about security: the tax authorities can make a huge contribution here.


The President
of the European Economic and Social Committee

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