Chartered Institute of Taxation
Excellence in Taxation

# THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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# PAPER 3.01 – EU DIRECT TAX OPTION

## ADVANCED INTERNATIONAL TAXATION (THEMATIC)

Suggested solutions

<u>Question 1</u>

In Article 1, the following new provisions were introduced:

2. *Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances.*

   *An arrangement may comprise more than one step or part.*

3. *For the purposes of paragraph 2, an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.*

4. *This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse.*

By contrast with other anti-abuse provisions, under this anti-abuse provisions the Member States are obliged to deny the benefits of the Directive in case of abuse. Normally Member States are merely allowed to deny such benefits in case of abuse.

This brings about that Member States must adopt national legislative measures – if necessary – which allow them to deny the benefits of the Directive in case of abuse.

In the second place, Member States must apply a harmonized definition of abuse as laid down in Article 1. Abuse applies if the following conditions are met:

- An arrangement or series of arrangements was put into place;
- One of its main objectives is obtaining a tax advantage;
- The tax advantage defeats the objects or purpose of the Directive;
- The arrangement is not genuine, for example are not based on valid commercial reasons which reflect economic reality.

In the third place, Member States are obliged to actively enforce the anti-abuse provision, meaning that they are obliged to actively identify situations which are abusive and levy tax applying the anti-abuse arrangements.

Finally, also in their ruling practice, Member States must examine whether the rulings issued might facilitate tax avoidance and if so reject the benefits of the Directive.

The new provisions might for example affect structures in which letterbox-companies are interposed as intermediate holdings in order to enjoy the benefits of the Directive when dividends are distributed by an EU subsidiary company through an EU letterbox company to the parent company in a third state. In case of abuse, the State of the subsidiary company will be allowed (and obliged) to levy dividend withholding tax according its general tax laws.

The European business community should be so wise to reconsider its tax structures and assess whether they are in line with the new anti-abuse provisions. If not, the European business community might have to consider the option of bringing their corporate structures in line with the new provisions.

<u>Question 2</u>

The main issue of course is whether the bank, acting as a non-resident in Benitia, is confronted with a higher tax burden in Benitia, compared to the situation that the bank were a resident in Benitia.

The fact therefore is whether there is a discrimination at stake.

The issue at hand is to be seen from the perspective of the host state, or otherwise called source state.

The dividend withholding tax on the dividend in Benitia is €350. Would the bank be taxed in Benitia on its net profit, the tax burden would be €25. There is therefore a difference in tax burden of €325 that could be seen is a discriminatory treatment.

Striking in this respect is a difference in tax rates, 15% dividend withholding tax and 25% corporate income tax and a difference in tax base, €2,000 (dividend) versus €100 (net profit).

First of all it has to be established which treaty freedom is applicable here. As the transactions concern portfolio investments that do no give a decisive influence in the company, this issue does not relate to the freedom of establishment (Article 49 TFEU) but to the free movement of capital (Article 63 TFEU).

In CJEU 19 January 2006, C-265/04, Bouanich, the Court dealt with a more or less comparable case with regards to personal income tax. A resident of France had some shares in a Swedish company, and these were bought back by the company. Also in these situation a difference in tax rate and a difference in taxable base applied in the comparison of the taxation of a non-resident versus the taxation of a resident. The Court ruled that on an individual basis, the actual tax burden had to be compared between a resident and a non-resident. If, at the calculating level, the tax burden of the non-resident taxpayer is higher than that of resident taxpayer, this constitutes a discriminatory treatment, and the difference in tax has to be refunded by the source state to the non-resident taxpayer.

The main question of course is what should be taken in consideration at the comparison level. The bank does not carry out its business in Benitia by means of a permanent establishment. It engages in derivatives share transactions in Alania in shares from companies established in Benitia. As this case concerns the taxation of dividends in a cross-border setting, one could argue that the purchase and sale prize as well as the interest costs are not part of the comparison mode, and in that case there is no discriminatory tax treatment at stake. This however is subject to a ruling of the CJEU that is at present pending before the Court.

Question 3

Part 1

This issue was dealt with by the CJEU in the Prunus-case, CJEU 5 May 2011, case C-384/09.
This case deals with France, Luxembourg and the British Virgin Island, and is there to be seen as an external situation as mentioned under 1.

The CJEU firstly reports that the British Virgin Islands are included in the list of Overseas Countries and Territories (OCTs) in the Annex II to the TFEU Treaty.

The Court already previously held that the OCTs are subject to the special association arrangement set out in Part Four of the TFEU, with the result that, failing express reference, the general provision of the Treaty, whose territorial scope is in principle confined to the Member States, do not apply to them.

OCTs therefore benefit from the provisions of European Union law in a similar manner tot the Member States only when European Union law expressly provides that OCTs and Member States are to be treated in such a manner.

According to the CJEU the EU Treaty and the TFEU do not contain any express reference to movements of capital between Member States and OCT's.

According to the CJEU, OCTs benefit from the liberalization of the movement of capital provided for in Article 63 TFEU in their capacity as non-Member States. Prunus-ruling, paragraph 31.

According to the CJEU that interpretation is supported by the provision of the Seventh OCT Decision, adopted at a time when the movement of capital in relation to non-Member States was liberalised. Article 47(2) of that decision states that Article 64 TFEU is applicable mutatis mutandis to OCTs. Prunus-ruling, paragraph 32.

Part 2

On the internal situation, concerning a tax relation between an OCT and its own Member State, there has been a more or less explicit ruling of the CJEU, on 5 June 2014, in the cases C-24/12 and C-27/12 (X BV and TBG Ltd).

The CJEU referred to Article 55, a special curve-out clause in the OCT Decision to combat tax evasion.

Under Article 55(2) 'nothing in [the OCT Decision] may be construed to prevent the adoption or enforcement of any measure aimed at preventing the avoidance... of taxes pursuant to the tax provisions of... domestic fiscal legislation in force'.

The case ad hand in the cases C-24/12 and C-27/12 concerned the Netherlands versus a Netherlands OCT namely the Dutch Antilles.

The contested tax measure in the cases C-24/12 and C-27/12 concerned targeted measures to combat an outflow of money to tax haven countries. This measure was allowed, according to the Court, on the basis of the aforementioned Article 55(2).

The CJEU in the aforementioned ruling did not clearly state that in an internal situation an OCT can be regarded as a third state, but implicitly it looks that way.

## Question 4

According to Article 107, paragraph 1 of the TFEU any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market. State aid rules apply regardless of the form the aid is given in, i.e. any kind of tax relief can constitute State aid if the other criteria are fulfilled.

A specific kind of tax relief can be a special tax rate for certain companies, an exemption, special deductions, accelerated depreciation, special tax-free reserves, etc.

In 1998, the Commission presented a 'Notice on the application of the State-aid rules to measures relating to direct business taxation', explaining how Article 87 of the EC Treaty (State Aid) should be understood in company taxation matters.

According to that Notice, Article 107 sets out the following four tests to identify (fiscal) State aid contained in national (tax) measures:

1. favourable (tax) treatment;
2. at the cost of State resources: the advantage must be granted by the State or through State resources (including regional or local public bodies);
3. affecting competition and trade between Member States;
4. selectivity: the measure must be non-general, it must be specific or selective in a way that it favours 'certain undertakings or the production of certain goods'.

Tax rulings are concluded between an individual company and a tax administration of a certain Member State. They often address issues like transfer pricing. Of course such a ruling should be based on norms accepted in the international tax arena and furthermore such a ruling should abide the at arm's length principle.

If such a ruling however contains a specific tax advantage for the company as such that leads to a lower tax burden, this can be seen as providing state aid by the Member State involved in a hidden manner that is forbidden.

Question 5

A measure that hampers one of the four freedoms can only be justified if it pursues an objective that as such can be justified. The measure must also be adequate to achieve that objective and not go beyond what is necessary.

The reason for this requirement is that any exceptions to the fundamental freedoms must be interpreted strictly. Such measures are only acceptable if they are really necessary. If a measure does not actually contribute to the achievement of its objectives or if it has a broader scope than necessary, it cannot be said that the measure in that form is indispensable.

In several cases, the ECJ has, implicitly or explicitly, ruled that a measure is not justified because it is not adequate to achieve the objectives aimed at. For example the ICI case, C-264/96.

It is not justified either if it goes beyond what is necessary (e.g. Lasteyrie). This means, for example:

- A measure is not proportionate if less restrictive measures are available;
- Its scope is too broad and also affects taxpayers or situations that do not need to be addressed (Lasteyrie);
- Losses cannot be deducted anywhere any more (M&S);
- or personal allowances cannot be deducted anywhere (Schumacker).

The UK Group Relief regime, which allowed to consolidate profits and losses of resident UK companies, did not apply to UK companies of a group of which the majority consisted of non-resident companies. The UK government relied on the ant-abuse aim of the measure: ‘First, the legislation at issue is designed to reduce the risk of tax avoidance arising, in the present case, from the possibility for members of a consortium to channel the charges of non-resident subsidiaries to a subsidiary resident in the United Kingdom and to have profits accrue to non-resident subsidiaries’ (par. 25).

The ECJ, however, rejected the justification based on the risk of tax avoidance, noting that the legislation at issue does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, but applies generally to all situations in which the majority of a group's subsidiaries are established outside the United Kingdom’ (par. 26). The measure therefore went beyond what was necessary.

And then the ECJ tests whether the measure is adequate to achieve the objective: ’27 Furthermore, the risk of charges being transferred, which the legislation at issue is designed to prevent, is entirely independent of whether or not the majority of subsidiaries are resident in the United Kingdom. The existence of only one non-resident subsidiary is enough to create the risk invoked by the United Kingdom Government.’

Consequently, the ECJ considers the measure inadequate and therefore disproportionate. Even if there is just one foreign subsidiary, there is the same risk of tax avoidance. From that point of view, it does not make sense to distinguish groups with a minority of foreign subsidiaries from groups with a majority of foreign subsidiaries. One might also wonder, although the ECJ does not address this issue, how the existing legislation could reduce the risk of tax avoidance: whether the UK companies may consolidate their profits and losses has no influence on this type of tax avoidance. Anyhow, the UK legislation does not solve the problem of tax avoidance mentioned by the UK in the case at hand. Therefore, the measure is not proportionate. The exclusion of groups with many foreign subsidiaries from the Group relief regime cannot be justified and infringes the freedom of establishment.

Students may also present other ECJ cases in which the measure went beyond what is necessary or in which the measure was inadequate to achieve its aim.

## Question 6

In the famous Halifax judgment (ECJ 21 February 2006, case C-255/02) the Court provided the following guidelines with regard to abuse of European law and VAT:

> *The Sixth Directive must be interpreted as precluding any right of a taxable person to deduct input VAT where the transactions from which that right derives constitute an abusive practice.*
>
> *For it to be found that an abusive practice exists, it is necessary, first, that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and of 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. Second, 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.*
>
> *Where an abusive practice has been found to exist, the transactions involved must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice.*

The Halifax case concerned a legal structure set up by a UK bank aimed at artificially avoiding non-deductibility of input-VAT on the cost of constructions of call centres. The Court firmly curbed abuse practices, but also underpinned the importance of legal certainty for economic operators and the fact that they are free to structure their business so as to reduce their tax liability.

As general lines of the ECJ's jurisprudence can be determined:

1. Abuse consists of 'wholly artificial arrangements';
2. Abuse must be established on a case by case basis;
3. The Court does not easily consider abuse present where taxpayers seek to avail themselves to tax benefits by using other jurisdictions or by using a tax level the most favourable way.

In Part Service (CJEU 21 February 2008, C-425/06) the Court judged that the 6th VAT Directive must be interpreted as meaning that there can be a finding of an abusive practice when the accrual of a tax advantage constitutes the principal aim of the transaction or transactions at issue.

It is for the national court to determine, in light of the ruling on the interpretation of Community law provided by the present judgment, whether, for the purposes of the application of VAT, transactions such as those at issue in the dispute in the main proceedings can be considered to constitute an abusive practice under the Sixth Directive.

In CJEU 22 May 2008, C-162/07, Ampliscientifica) the Court ruled that the principle prohibiting the abuse of rights is therefore to prohibit wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage (see, to that effect, Case C 196/04 Cadbury Schweppes and Cadbury Schweppes Overseas [2006] ECR I 7995, paragraph 55).

And in the case Weald Leasing (CJEU 22 December 2010, C-103/09) concerning an abusive lease transaction, the Court ruled:

> *The tax advantage accruing from an undertaking's recourse to asset leasing transactions, such as those at issue in the main proceedings, instead of the outright purchase of those assets, does not constitute a tax advantage the grant of which would be contrary to the purpose of the relevant provisions of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, as amended by Council Directive 95/7/EC of 10 April 1995, and of the national legislation transposing it, provided that the contractual terms of those transactions, particularly those concerned with setting the level of rentals, correspond to arm's length terms and that the involvement of an intermediate third party company in those transactions is not such as to preclude the application of those provisions, a matter which it is for the national court to determine. The fact that the undertaking does not engage in leasing transactions in the context of its normal commercial operations is irrelevant in that regard.*

*If certain contractual terms of the leasing transactions at issue in the main proceedings, and/or the intervention of an intermediate third party company in those transactions, constituted an abusive practice, those transactions must be redefined so as to re-establish the situation that would have prevailed in the absence of the elements of those contractual terms which were abusive and/or in the absence of the intervention of that company.*

## Question 7

The present case involves the free movement of capital. According to former Directive 88/361, investments in immovable property are subject to the free movement of capital, as confirmed by the ECJ in various occasions (see e.g. the K case; Walther Stauffer C- 386/04; Commission/Greece C-155/09).

The impossibility to deduct interest payments related to foreign holiday houses, whereas similar costs in respect of domestic houses may be deducted, discourage taxpayers and make it less attractive to invest in foreign immovable property. This constitutes a restriction of the free movement of capital, art. 63 TFEU. See e.g. the K case.

Article 65, par. 1, sub a, of the TFEU provides that the free movement of capital 'shall be without prejudice to the right of Member States (a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation (…) with regard to the place where their capital is invested.

This might seem to justify the tax provision at stake. However, Article 65, par. 1, sub a, of the TFEU provides that 'The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital' Verkooyen C-35/98, Holböck, C-157/05.

Under the case law of the ECJ, in practice, in order to be justified under Article 65, par. 1, a national measure must meet the same requirements as under the rule of reason.

The cohesion justification (Bachmann C-204/90) might be invoked, and Member State Domus could argue that there is a direct link between a tax advantage – i.e. the fact that income from the immovable property is allocated to Member State Vacare under the tax treaty – and a tax disadvantage – i.e. the fact that interest payments are not tax deductible in Member State Domus.

In Renneberg, the ECJ however seems to reject this ground of justification. The ECJ, paras 49-58, ruled that a tax treaty with the exemption with progression system does not preclude the state of residence to allow the deduction of losses from foreign immovable property. The allocation of taxing rights by the treaty does therefore not preclude the deduction in Member State Domus of the interest payments.

In Renneberg, paras. 62-64, the ECJ considers the deductibility of interest payments connected to houses that are held for private use as deductions that regard the 'personal and family circumstances' of taxpayers (cfr. Schumacker).. From that point of view, there is no justification to distinguish between domestic and foreign holiday houses.

The simple risk that the interest payments are deducted both in Member State Domus and Member State Vacare constitutes as such not a justification.