European Union

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Hybrid Financial Instruments and Primary EU Law – Part 2

This article analyses the influence of EU law on hybrid financial instruments (HFIs). Part 1, published in *European Taxation* 11 (2013), addressed the impact of primary EU law on HFIs, identified the applicable freedom, discussed the influence of the TFEU on the approach of Member States to classification and taxation of HFIs and addressed the conformity of coordination rules with EU law. Part 2 analyses potential justifications and the proportionality test.

6. Justifications – The Existence of Legitimate Grounds

6.1. In general

Under the third step of the test developed by the ECJ, whether or not the national provision in question can be justified must be examined. The recognized restriction may be in compliance with the Treaty on the Functioning of the European Union (TFEU) (2007)[113] if the discrimination concerns situations that are not objectively comparative or if the discrimination is justified by overriding reasons in the public interest. Once it is established that coordination rules may infringe the freedom of movement, possible justifications from the perspective of the Member States should be considered. The analysis herein does not purport to be exhaustive and the goal is not to present firm conclusions but rather to discuss the general principles of coordination rules in light of basic EU tax law principles.

Member States may initially argue that any anti-arbitrage measure is being put in place simply to ensure single taxation of income and to prevent white income (i.e. non-taxed income). Ensuring single taxation can thus be said to align the cross-border situation to the domestic situation or to a cross-border situation where no tax benefit can be obtained. However, to date, such a justification has not been seen in the case law. The closest existing justification to such an argument may be the prevention of double use of losses or the prevention of tax abuse, which are both analysed in section 6.

6.2. Loss of revenue

According to recognized ECJ principles, loss of tax revenue is not one of the justifications worth safeguarding and is not acknowledged as a reason for restricting the right of establishment or the free movement of capital.[114] The rejection of loss of tax revenue as a justification should, however, be viewed in context in that the ECJ has generally accepted other justifications that may prevent a loss of revenue of Member States. This includes fiscal cohesion, the effectiveness of fiscal supervision and the prevention of tax avoidance and abuse.

Further, in the context of coordination rules, it can even be stated that there is no loss of revenue in the Member State that has introduced the coordination rule in question. Such rules target benefits that arise as a consequence of a mismatch between the legislation of two or more Member States.

6.3. Level of taxation and prevention of harmful tax competition

Member States may argue that they are merely neutralizing the taxation of cross-border hybrid financial instruments (HFIs) within groups of companies by countering specific types of tax avoidance involving a transfer of profits from the Member State in which they were earned to a low-tax state.[115] It is settled case law, however, that any advantage resulting from the low taxation to which a subsidiary in a Member State is subject cannot, in itself, authorize the Member State of the parent company to offset that advantage by treating the parent company less favourably.[116] This principle should also be applicable to the opposite situation, where the restriction is imposed by the state of the receiving company (the subsidiary).

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113. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD.

114. *See*, for example, UK: ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries (ICI) v. Kenneth Hall Colmer,* para. 28, ECJ Case Law IBFD; DE: ECJ, 21 Sept. 1999, Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, para. 51, ECJ Case Law IBFD; UK: ECJ, Joined Cases C-397/98 and C-410/98, *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v. Commissioners of Inland Revenue and HM Attorney General*, para. 59, ECJ Case Law IBFD; SE: ECJ, 21 Nov. 2002, Case C-436/00, *X and Y v. Riksskatteverket*, para. 50, ECJ Case Law IBFD; LU: ECJ, 28 Apr. 1998, Case C-120/95, *Nicolas Decker v. Caisse de maladie des employés privés*, para. 39; LU: ECJ, 28 Apr. 1998, Case C-158/96, *Raymond Kohll v. Union des caisses de maladie*, para. 41; NL: ECJ, 6 June 2000, Case C-35/98, *Staatssecretaris van Financiën v. B.G.M. Verkooijen*, para. 48, ECJ Case Law IBFD; and FI: ECJ, 3 Oct. 2002, Case C-136/00, *Rolf Dieter Danner*, para. 56, ECJ Case Law IBFD.
115. *See*, for example, the argument in UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, para. 48, ECJ Case Law IBFD.
116. *See Cadbury Schweppes* (C-196/04), para. 49 with references.

In general, the low tax argument has not been successful before the ECJ. In *Lenz* (Case C-315/02), the Austrian and Danish governments presented the argument that it is relevant to include the level of taxation for companies registered in other Member States in evaluating whether or not discrimination can be justified. The ECJ replied in paragraph 41 that the level of taxation of companies resident in other Member States is not relevant to the question of whether or not national legislation constitutes a violation of the free movement of capital. Further, the ECJ stated in paragraph 43 that:

> Whilst one cannot exclude the possibility that extension of the tax legislation in question to revenue from capital originating in another Member State might make it advantageous for investors living in Austria to buy shares of companies established in other Member States, where corporation tax is lower than in Austria, that possibility is in no way capable of justifying legislation such as that at issue in the main proceedings. As regards an argument based on a possible tax advantage for taxpayers receiving in their country of residence dividends from companies established in another Member State, it is clear from settled case-law that unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages, even supposing that such advantages exist (Verkooijen, paragraph 61, and case-law there cited).

See, also to that effect, *Cadbury Schweppes* (Case C-196/04) and, moreover, *Eurowings Luftverkehrs AG* (Case C-294/97),[117] where the following was stated by the ECJ in paragraphs 43-45:

> 43. Contrary to what was argued by the Finanzamt, that difference of treatment can also not be justified by the fact that the lessor established in another Member State is there subject to lower taxation.
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> 44. Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State (see, as regards Article 52 of the EC Treaty (now, after amendment, Article 43 EC), Commission v France, paragraph 21, and Asscher, paragraph 53, both cited above).
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> 45. As the Commission rightly observed, such compensatory tax arrangements prejudice the very foundations of the single market.

Accordingly, it is not possible to justify a restriction by referring to the level of taxation in other Member States.

An argument presented by the German government in *Columbus Container Services* (Case C-298/05)[118] is that the German switch-over clause (from the exemption to credit method) regarding foreign branches in low-tax countries can be justified as a measure preventing harmful tax competition. In this respect Germany, in fact, reserves the right to offset a tax advantage in another country by a tax disadvantage in Germany. A similar argument could be presented in the context of HFIs and unilateral coordination rules. According to settled case law, such a purpose is not an argument that justifies a restriction of the fundamental freedoms.[119]

6.4. Ensuring the effectiveness of fiscal supervision

ECJ case law indicates that the need for "effective tax control" may be an imperative general justification for limiting the fundamental freedoms of the TFEU.[120] The domestic legislation in question was, however, tested under the proportionality principle.

In the context of coordination rules, there seems to be no real need for the Member State that introduced the coordination provision to exercise fiscal supervision. The ECJ, in this context, would assess the genuine connection between the provision at hand and the need for effectiveness of fiscal supervision and whether there are other means available, such as applying the Mutual Assistance Directive (2011/16/EU).[121] This justification was also invoked in *SIAT* (Case C-318/10). Here the ECJ stated in paragraph 44 that it is clear from the case law of the Court that, in order to ensure the effectiveness of fiscal supervision that is intended to combat tax evasion, a Member State may apply measures that enable the amount of expenditure deductible in that state as a business expense to be ascertained clearly and precisely.

This statement should also be seen in light of the fact that the Belgian provision at hand did not completely disallow a deduction, as a business expense, of payments made to providers who were not subject therein to tax on income or were subject therein, in respect of the relevant income, to a tax regime that was appreciably more advantageous than the applicable regime in Belgium; rather, it allowed the resident taxpayers to provide proof that the transactions carried out were genuine and proper and that the expenses incurred were normal. The situation with regard to coordination rules is quite different.

6.5. Coherence of the tax system

To a certain extent, the ECJ has accepted a justification based on the "coherence of the tax system". This argument was accepted in *Bachmann* (Case C-204/90)[122] but has not been successively applied by Member States in

117. DE: ECJ, 26 Oct. 1999, Case C-294/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna,* paras. 41-45, ECJ Case Law IBFD.
118. DE: ECJ, 6 Dec. 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt,* para. 43, ECJ Case Law IBFD.
119. *See* DE: Opinion of Advocate General Mengozzi, 29 Mar. 2007, Case C-298/05, *Columbus Container Services*, para. 165, ECJ Case Law IBFD. Moreover the Advocate General notes that fighting harmful tax competition is a matter of political means and cannot be resolved on the basis of Member State rights under the TFEU.
120. *See*, for example, DE: ECJ, Case 120/78, *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein*, para. 8, ECJ Case Law IBFD; LU: ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, para. 31, ECJ Case Law IBFD; and FR: ECJ, 8 July 1999, Case C-254/97, *Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA v. Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Economie et des Finances and Ministère de l'Agriculture, de la Pêche et de l'Alimentation*, para. 18, ECJ Case Law IBFD. These arguments were rejected in DE: ECJ, 12 Dec. 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt,* ECJ Case Law IBFD.
121. EU Mutual Assistance Directive (2011): Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L 64 (2011), EU Law IBFD.
122. BE: ECJ, 28 Jan. 1992, Case C-204/90, *Hanns-Martin Bachmann v. Belgian State,* ECJ Case Law IBFD.

recent cases.[123] The argument only applies to the same taxpayer and not for the purpose of establishing less favourable conditions for foreign subsidiaries.[124] Thus, whenever the argument was successfully applied, the taxpayer was one and the same person. There is no such cohesion when subsidiaries owned by parent companies resident in other Member States are treated less favourably than other companies and no other means are present to set off such a treatment. Recently, the cohesion argument was accepted in *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* (Case C-157/07).[125] Here, the ECJ found a German provision that recaptured utilized losses in permanent establishments (PEs) as justifiable on the basis of coherence.

Based on the above, the coordination rules at hand should not be justified on the basis of coherence of the tax system. A deduction in the hands of a subsidiary (debtor) is not generally granted on the basis of anticipated taxation of the same company or any other company. The outcome of *Bosal Holding BV* (C-168/01)[126] and *Keller Holding GmbH* (C-471/04)[127] favours an argument that an interest deduction cannot be denied on the basis that the costs are indirectly instrumental to earning taxable profits that are taxable in the Member State in which the parent company is established.

Similarly, a tax exemption in the hands of a parent company is not granted on the basis of corresponding taxation, i.e. requiring taxation at the exact same level as that of the state of origin. Both types of coordination rules in question do not relate to the taxation of the same taxpayer that would otherwise be granted the domestic tax benefit.

Dörfler, Heurung and Adrian (2007) have also expressed concern as to whether the German law principle of correspondence might constitute a violation of EU law.[128]

6.6. Balanced allocation of the power to impose taxes

Since the *Marks & Spencer* (Case C-446/03)[129] decision in 2005, the balanced allocation of the right to tax has been an important justification under EU tax law. The ECJ has stated, with respect to the balanced allocation between Member States of the power to tax, that such a justification is acceptable, in particular, where the system in question is designed to prevent conduct capable of jeopardizing the right of a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory.[130] It was in *Marks & Spencer* that the ECJ, for the first time, accepted a justification that was based on three separate arguments:
- that profits and losses are two sides of the same coin and should be treated symmetrically in order to ensure a balanced allocation of the right to impose tax;
- that the prevention of double utilization of the same loss is a justifiable reason; and
- that there is a risk of tax avoidance if the loss was not taken into consideration in the state of residence of the subsidiary.[131]

In *Oy AA* (Case C-231/05) the justification was based on the balanced right to tax in combination with the prevention of abuse, whereas in *Lidl* (Case C-414/06) the justification included double utilization of losses and the balanced allocation of the right to tax.[132]

According to established ECJ case law, the balanced allocation of the right to tax cannot, as a standalone argument, justify any restriction on the fundamental freedoms of movement.[133] It seems that the balanced allocation of the right to tax should only be seen as a protection for Member States to ensure taxation of the activities carried out in the territory of that Member State.[134]

With respect to coordination rules, the intention is not to ensure the right to tax the activities carried out in the territory of the Member State but instead to neutralize potential benefits from a mismatch of the legal systems and classification practices of different Member States.

6.7. Prevention of double use of losses

The justification regarding double dips, as accepted in *Marks & Spencer*, involves possible deductions of losses at the parent, as well as the subsidiary, level. Accordingly, the justification does not require that the loss in question

123. *See* NL: ECJ, 11 Aug. 1995, Case C-80/94, *G.H.E.J. Wielockx v. Inspecteur der Directe Belastingen,* ECJ Case Law IBFD; DK: ECJ, 30 Jan. 2007, Case C-150/04, *Commission of the European Communities v. Denmark,* ECJ Case Law IBFD; and *Danner* (C-136/00).
124. *See Lankhorst-Hohorst* (C-324/00), para. 41; *Wielockx* (C-80/94), para. 24; LU: ECJ, 14 Nov. 1995, Case C-484/93, *Peter Svensson and Lena Gustavsson v. Ministre du Logement et de l'Urbanisme*, para. 18, ECJ Case Law IBFD; NL: ECJ, 6 June 2000, Case C-35/98, *Staatssecretaris van Financiën v. B.G.M. Verkooijen*, paras. 56-58, ECJ Case Law IBFD; *Eurowings Luftverkehrs* (C-294/97), para. 42; NL: ECJ, 13 Apr. 2000, Case C-251/98, *C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, para. 40, ECJ Case Law IBFD; AT: ECJ, 15 July 2004, Case C-315/02, *Anneliese Lenz v. Finanzlandesdirektion für Tirol*, para. 36, ECJ Case Law IBFD; and FI: ECJ, 7 Sept. 2004, Case C-319/02, *Petri Manninen*, para. 48, ECJ Case Law IBFD.
125. *See* DE: ECJ, 23 Oct. 2008, Case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v. Finanzamt für Körperschaften III in Berlin,* ECJ Case Law IBFD.
126. NL: ECJ, 18 Sept. 2003, Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*, ECJ Case Law IBFD.
127. DE: ECJ, 23 Feb. 2006, Case C-471/04, *Keller Holding v. Finanzamt Offenbach am Main-land*, ECJ Case Law IBFD.
128. G. Dörfler, O. Heurung & R. Adrian, *Korrespondenzprinzip bei verdeckter Gewinnausschüttung und verdeckter Einlage*, DStR, p. 514 at p. 517 et seq. (2007) (footnotes omitted).
129. UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes),* ECJ Case Law IBFD.
130. *See* BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, para. 60, ECJ Case Law IBFD and BE: ECJ, 5 July 2010, Case C-318/10, *Société d'investissement pour l'agriculture tropicale SA (SIAT) v. État Belge*, para. 45, ECJ Case Law IBFD.
131. *See Marks & Spencer* (C-446/03).
132. *See* FI: ECJ, 18 July 2007, Case C-231/05, *Oy AA*, para. 60, ECJ Case Law IBFD and BE: ECJ, 15 May 2008, Case C-414/06, *Lidl Belgium GmbH & Co. KG v. Finanzamt Heilbronn*, para. 42, ECJ Case Law IBFD.
133. *See Rewe Zentralfinanz* (C-347/04), para. 42 et seq. and NL: ECJ, 8 Nov. 2007, Case C-379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam,* para. 56 et seq., ECJ Case Law IBFD.
134. *See Cadbury Schweppes* (C-196/04), para. 56 and AT: ECJ, 4 Dec. 2008, Case C-330/07, *Jobra Vermögensverwaltungs-Gesellschaft mbH v. Finanzamt Amstetten Melk Scheibbs*, para. 33, ECJ Case Law IBFD.

be utilized at the level of the same taxpayer. This conclusion may be relevant in the context of coordination rules targeting HFIs where double benefits may arise by way of simultaneous deduction and tax exemption in the hands of different taxpayers.

The justification regarding double deduction of losses was also present in the *Lidl* decision regarding losses in foreign PEs.[135] Moreover, in *Deutsche Shell GmbH* (Case C-293/06),[136] regarding the tax treatment of repatriation of the start-up capital of the PE of Deutsche Shell in another Member State, the ECJ made an interesting remark in paragraph 51:

> 51. As far as concerns the specific argument alleging that Deutsche Shell is likely to benefit from a double advantage from the currency loss, it must be observed that a Member State which has waived its tax powers by concluding a double taxation convention such as that applicable in the main proceedings cannot rely on the lack of tax powers with respect to the results of a permanent establishment which belongs to a company established in the territory of that State in order to justify the refusal to deduct expenditure incurred by that company which, by its nature, cannot be taken into account in the Member State where that establishment is situated.

In *Philips Electronics* (Case C-18/11)[137] the ECJ did not accept the risk of double utilization of losses. The case concerned the transfer of losses from PEs of non-resident companies in the United Kingdom to other group companies in the United Kingdom. The ECJ stated:

> 27. It follows that the host Member State, on whose territory the economic activity giving rise to the losses of the permanent establishment is carried out, cannot, in a situation such as that at issue in the main proceedings, use the objective of preserving the allocation of the power to impose taxes between the Member States as justification for the fact that, under its national legislation, the possibility of transferring, by means of group relief and to a resident company, losses sustained by the permanent establishment in that Member State of a non-resident company is subject to a condition that those losses cannot be used for the purposes of foreign taxation, while the transfer of losses sustained in that Member State by a resident company is not subject to any equivalent condition.
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> 28. As regards, secondly, the objective of preventing the double use of losses, it must be observed that even if such a ground, considered independently, could be relied on, it cannot in any event be relied on in circumstances such as those in the main proceedings to justify the national legislation of the host Member State.

As a parallel, this case may be used to argue that, in the context of HFIs and coordination rules, the tax treatment in the creditor state cannot justify the denial of deductibility in the state of residence of the debtor.[138]

Is should also be recalled that the risk of double use of losses is not parallel to the situation where a loss deduction is allowed in one Member State whereas another Member State allows for deductibility regarding a loss on shares.[139]

135. *See Lidl Belgium* (C-414/06), para. 36.
136. DE: ECJ, 28 Feb. 2008, Case C-293/06, *Deutsche Shell GmbH v. Finanzamt für Großunternehmen in Hamburg*, ECJ Case Law IBFD.
137. UK: ECJ, 6 Dec. 2012, Case C-18/11, *The Commissioners for Her Majesty's Revenue & Customs v. Philips Electronics UK Ltd*, ECJ Case Law IBFD.
138. *See* S. Dalby Madsen, *Analysis of the impact on Danish legislation following the* Philips Electronics *ruling by the ECJ (C-11/18)*, SR-Skat, p. 94 (2013) to this effect.
139. *See Rewe Zentralfinanz* (C-347/04), para. 47 et seq.

Based on the preceding paragraphs it can be concluded that the objective of preventing double use of losses cannot successfully be used to justify coordination rules disallowing interest deductibility in the host state or disallowing a participation exemption in the state of origin. The ECJ seems to allow this justification only where there is a direct link to the activities carried out in the territory of the Member State in question.

6.8. Prevention of tax abuse - Should tax arbitrage arrangements be considered abusive?

In recent years, in particular, the ECJ has decided a number of cases in the field of tax law on the question of abuse of EU law.[140] The prevention of tax avoidance/tax abuse has become a more effective justification for restrictions on the fundamental freedoms, provided that the domestic rules are proportionate in attaining the aim pursued.[141] In the following, the author reviews cross-border arbitrage in light of ECJ case law regarding tax abuse. Tax arbitrage constitutes a specific form of tax savings based on a difference in classification and legislation amongst the Member States.

In several cases, the ECJ has stated that it is acceptable to introduce domestic legislation aimed at preventing tax avoidance.[142] In its practice, the ECJ has held that domestic legislation that limits the freedom of establishment may be justified when it specifically targets "purely artificial arrangements with the objective of circumventing the relevant Member State's legislation".[143] The line between acceptable tax avoidance and unacceptable tax evasion was touched upon (but was far from clarified) in the ECJ's decision in *Cadbury Schweppes* (Case C-196/04).[144] The ECJ stated that:[145]

> It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive

140. *See* regarding the doctrine of abuse of the ECJ, for example, T. O'Shea, *EU Tax Law and Double tax Conventions*, p. 161 et seq. (Avoir Fiscal Limited 2008); A. Armenia & A. Zalasinski, EU Report, *The taxation of foreign passive income for groups of companies*, *IFA Cahiers de droit fiscal international*, vol. 98a, p. 62 (Sdu Fiscale & Financiële Uitgevers 2013), Online Books IBFD; D. Weber, *Tax Avoidance and the EC Treaty Freedoms: A Study of the Limitations under European Law to the Prevention of Tax Avoidance* (Kluwer 2005); K. Engsig Sørensen, *Abuse of rights in Community law: A principle of substance or merely rhetoric?*, 43 Common Market Law Rev. 2, p. 423 et seq. (2006); L. De Broe, *International Tax Planning and Prevention of Abuse*, p. 799 et seq. (IBFD 2008); and M. Dahlberg, *Direct Taxation in Relation to the Freedom of Establishment and the Free Movement of Capital*, p. 223 et seq. (Kluwer 2005).
141. *See* Armenia & Zalasinski, *supra* n. 140, at p. 63.
142. *See*, for example, *Lankhorst-Hohorst* (C-324/00).
143. *See*, for instance, *Cadbury Schweppes* (C-196/04), para. 51 with references.
144. *See*, for commentary, M. Lang, *Rechtsmissbrauch und Gemeinschaftsrecht im Lichte von* Halifax *und* Cadbury Schweppes *(Abuse of law and community law - in the light of* Halifax *and* Cadbury Schweppes), 16 SWI 6, p. 273 et seq. (2006), analysing the *Cadbury Schweppes* (C-196/04) case as well as UK: ECJ, 21 Feb. 2006, Case C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v. Commissioners of Customs & Excise, BUPA Hospitals Ltd, Goldsborough Developments Ltd v. Commissioners of Customs and Excise and University of Huddersfield Higher Education Corporation v. Commissioners of Customs and Excise*, ECJ Case Law IBFD and T. O'Shea, *The UK's CFC rules and the freedom of establishment : Cadbury Schweppes plc and its IFSC subsidiaries - tax avoidance or tax mitigation?*, 16 EC Tax Rev. 1, p. 13 et seq. (2007).
145. *See Cadbury Schweppes* (C-196/04), para. 55.

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

It is interesting to note the criteria that the ECJ applied to test the existence of a "wholly artificial arrangement which does not reflect economic reality". The ECJ has said that this assessment contains both objective and subjective elements. The subjective element requires that it be demonstrated that the taxpayer had an intention to obtain a tax saving. The objective factors are, "ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment".[146]

Further, the ECJ stated that:

> If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a 'letterbox' or 'front' subsidiary […].

As stated by the ECJ in *Cadbury Schweppes*, such national practices can only be upheld if they actually prevent tax abuse and tax abuse alone. Many HFIs used for tax arbitrage purposes should not face great difficulty in passing the objective test. Moreover, HFIs often serve the underlying purpose of providing financing needed in order to fulfill business purposes.

The decision in *Halifax*[147] concerned a VAT exempt bank (subject to a 5% VAT deduction), which let its relevant transactions pass through a fully taxable subsidiary to obtain a full VAT deduction. The ECJ concluded that a VAT refund could not be allowed under the Sixth VAT Directive (77/338),[148] as the underlying transaction constituted an abusive practice. The finding of an *abusive practice* firstly requires that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth VAT Directive and of national legislation transposing it, result in the accrual of a tax advantage, the granting of which would be contrary to the purpose of those provisions. Secondly, 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.[149] Tax authorities in several Member States have interpreted the *Halifax* decision widely, such that importance has also been attached to the decision in terms of direct taxes.[150]

In *Part Service Srl.* (Case C-425/06),[151] the Italian Court of Cassation (*Corte Suprema di Cassazione*) brought the following question to the ECJ with respect to the interpretation of the Sixth VAT Directive (77/338):

> Does the concept of abuse of rights defined in the judgment of the Court of Justice in [Halifax and Others] as *transactions, the essential aim of whichis to obtain a tax advantage*, correspond to the definition transactions carried out for no commercial reasons other than a tax advantage, or is it broader or more restrictive than that definition?

This ECJ's answer confirmed that the Sixth VAT Directive (77/338) should be interpreted as meaning that there can be a finding of an abusive practice where the accrual of a tax advantage constitutes the principal aim of the transaction or transactions at issue.

In the context of HFIs, this may affect some structures solely established for tax purposes. In many situations, however, HFIs would not fulfill that test since the underlying transaction would, in fact, take place irrespective of the tax treatment, perhaps in the form of a straightforward debt or equity. The same cannot be said with respect to the transactions in *Part Service*, which seem to have been carried out solely for VAT purposes. Therefore, in the author's opinion, tax arbitrage also should not, on this basis, be considered abusive in the context of interpretation of the TFEU.

In *Lankhorst-Hohorst*, the ECJ did not find any such tax avoidance/evasion (paragraph 38) due to the fact that the loan was advanced to offer support to Lankhorst-Hohorst in order to reduce the interest rate from bank financing and that the losses of the company clearly exceeded the intra-group interest payments. The ECJ provided further clarification regarding the tax avoidance test in *Test Claimants in the Thin Cap Group Litigation* (Case C-524/04).[152] The ECJ concluded that the TFEU precludes thin capitalization legislation resulting in an interest deduction restriction on loans from parent companies in other Member States, unless (1) the legislation provides for consideration of objective and verifiable elements that make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allows taxpayers to produce evidence as to the commercial justification for the transaction in question and (2) where it is established that such an arrangement exists, such legislation treats that

146. *See Cadbury Schweppes* (C-196/04), para. 67.
147. *Halifax* (C-255/02).
148. EU Sixth VAT Directive: Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, EU Law IBFD.
149. *See Halifax* (C-255/02), para. 85 et seq. The outcome of the case is in line with established case law, according to which EU law cannot be relied on with regard to abuse or fraud; *see*, for example, GR: ECJ, 12 May 1998, Case C-367/96, *Alexandros Kefalas and Others v. Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE)*, para. 20; GR: ECJ, 23 Mar. 2000, Case C-373/97, *Dionysios Diamantis v. Elliniko Dimosio (Greek State) and Organismos Ikonomikis Anasygkrotisis Epicheiriseon AE (OAE)*, para. 33, ECJ Case Law IBFD; and DK: ECJ, 3 Mar. 2005, Case C-32/03, *I/S Fini H v. Skatteministeriet*, para. 32, ECJ Case Law IBFD. In *Halifax* (C-255/02), para. 59, however, the Court found it completely irrelevant for the interpretation of the Sixth VAT Directive whether or not the main objective of the transaction was to obtain tax benefits.
150. *See* L. Sheppard, WTD 25-8, p. 5 (2007) and, for Italian law, M. Rossi, WTD 58-9, p. 20 (2007) referring to two rulings where Italian courts disregarded certain transactions arranged to avoid direct taxes with reference to the *Halifax* (C-255/02) decision and, for French law, L. Leclercq, *Interacting Principles: The French Abuse of Law Concept and the EU Notion of Abusive Practices*, 61 Bull. Intl. Taxn. 6, p. 235 et seq. (2007), Journals IBFD.
151. IT: ECJ, 21 Feb. 2008, Case C-425/06, *Part Service, Ministero dell'Economia e delle Finanze, formerly Ministero delle Finanze v. Part Service Srl, company in liquidation, formerly Italservice Srl,* ECJ Case Law IBFD.
152. *See* UK: ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD.

interest as a distribution only to the extent that it exceeds what would have been agreed upon at arm's length.[153] The ECJ has refined the notion of abuse to include loans that do not respect the arm's length principle. It is surprising to see that the arm's length test is now viewed as an objective test that is applicable in order to determine whether or not tax abuse is present. The reasoning of the ECJ seems to be that the arm's length principle can be used to conclude whether or not a loan would have been granted at all between independent parties. If a loan is granted in a non-arm's length environment the reasoning seems to be that the loan that is granted anyway is then considered a wholly artificial arrangement, which would not have be granted between independent parties. Even this test does not seem to cause problems for most HFIs, which presumably are carefully structured to take into account the limitations of the arm's length test under the domestic law of the Member States involved.

In the context of HFIs, and based on the above, any purpose for the transaction other than tax savings should be demonstrated. Where there is a need for financing, such a requirement can be fulfilled since the nature of the financing (equity, debt or hybrid) should not result in the transaction generally being considered abusive.

Armenia and Zalasinski (2013)[154] summarize ECJ case law to date regarding abuse as follows (footnotes omitted):

> […] The wholly/purely artificial arrangements concept seems to have an autonomous EU meaning and, so far, covers (a) the factors related to artificiality of establishment (no premises, staff and equipment), (b) artificiality of the transaction itself (no business purpose whatsoever), and (c) the terms under which the taxpayer engaged in these transactions (the arm's length principle).

In the context of HFIs and tax arbitrage, it is assumed that the use of such instruments does, in fact, reflect economic reality and that the tax advantage obtained is merely a consequence of differences in the legislation or classification principles applied in the Member States involved. If this is not the situation, treaty protection should not be granted.

The avoidance objective was also considered in *SIAT*, wherein the ECJ stated the following:[155]

> By providing that payments made to non-resident providers are not to be regarded as business expenses unless the taxpayer demonstrates that they relate to genuine and proper transactions and do not exceed the normal limits, the legislation at issue in the main proceedings facilitates attaining the objective of preventing tax evasion and avoidance, for which that legislation was adopted.

In this respect, it is evident that a documentation requirement may be said to fulfill the objective of combatting tax avoidance and evasion. However, the result of providing the needed documentation is that the taxpayer would benefit from a tax treatment that is similar to that applicable to domestic transactions. This is not the case with respect to coordination rules.

An important contribution to an understanding of the ECJ's view on tax arbitrage is *RBS Deutschland Holdings GmbH* (Case C-277/09).[156] This was a VAT case concerning the interpretation of article 17(3) of the Sixth VAT Directive (77/388). The UK authorities refused to allow a deduction for VAT on the purchase of motor vehicles used for leasing transactions. The facts were that a German subsidiary of RBS (UK) purchased cars in the United Kingdom with a view to leasing them, with a put option, to an unconnected company in the United Kingdom and paid VAT on those purchases. According to UK legislation, supplies consisting of the rental of cars were treated as supplies of services made in Germany and, accordingly, not subject to VAT in the United Kingdom. Under German law, these supplies were treated as supplies of goods in the United Kingdom and, accordingly, not subject to VAT in Germany. The consequence was that no output tax was charged on those supplies in either Member State. RBS selected its German subsidiary as lessor and determined the duration of the leasing arrangement with a view to obtaining the tax advantage (no VAT chargeable on the rental payments). The Court of Session (Scotland) referred four specific questions to the ECJ regarding the interpretation of article 17(3). The interesting question in this specific context relates to the determination of whether or not the described practice (arbitrage based on a difference in implementation of the Sixth VAT directive), constitutes an abusive prohibited practice. The ECJ answered this question by referring to the *Halifax* case and emphasized that the transactions concerned took place between unconnected parties and were not artificial in nature and moreover were not carried out in the context to obtain a tax advantage.[157] The ECJ found that nothing in the facts suggested an artificial arrangement that did not reflect economic reality, the sole aim of which was to obtain a tax advantage, since RBSD is a company established in Germany carrying out a business providing banking and leasing services.[158] Based on this, the ECJ stated the following:[159]

> In those circumstances, the fact that services were supplied to a company established in one Member State by a company established in another Member State, and that the terms of the transactions carried out were chosen on the basis of factors specific to the economic operators concerned, cannot be regarded as constituting an abuse of rights. RBSD in fact provided the services at issue in the course of a genuine economic activity.
>
> It is important to add that taxable persons are generally free to choose the organisational structures and the form of transactions which they consider to be most appropriate for their economic activities and for the purposes of limiting their tax burdens.

It is settled case law that the national tax legislation in the state of origin cannot contain requirements as regards the level of taxation in the host state in order to prevent tax jurisdiction shopping. Such practices do not, in themselves, constitute abuse as long as they do not involve the

153. *Test Claimants in the Thin Cap Group Litigation* (C-524/04), para. 92.
154. Armenia & Zalasinski, *supra* n. 140, at p. 66.
155. *SIAT* (C-318/10), para. 42.
156. UK: ECJ, 22 Dec. 2010, Case C-277/09, *The Commissioners for Her Majesty's Revenue & Customs v. RBS Deutschland Holdings GmbH,* ECJ Case Law IBFD.
157. *See Thin Cap* (C-542/04), paras. 49-50.
158. *See Thin Cap* (C-542/04), para. 51.
159. *RBS Deutschland* (C-277/09), paras. 52 and 53.

setting up of wholly artificial arrangements.[160] This is seen from a number of ECJ cases.[161] In the absence of a wholly artificial arrangement, Member States must recognize each other's tax systems regardless of how different they may be.[162]

Weber (2005) concludes that:[163]

> […] utilizing an advantageous legal system is precisely one of the objectives of the internal market and therefore that profiting from this is in itself not viewed as avoidance. That this concomitantly entails avoidance of the legal system of another Member State may be suspect from the point of view of national law but from the point of view of Community law it is simply the other side of the coin and a logical consequence of the basic principles of the internal market […].

Moreover, the author states at page 205 that, "[f]rom the above grounds it is clear that the Court does not permit a Member State to levy compensatory tax in order to remove the advantage of another legal system […]".[164]

It can be argued that the deductibility of dividends or the deductibility of payments that are classified inconsistently due to the application of different principles of domestic tax legislation of the Member States is merely a subset of deviations that may cause a company to be considered a low tax company under the applicable CFC legislation of a Member State.

Further, it may be argued that the anti-arbitrage legislation actually ensures the taxation of corporate income in question at the level of the state of origin or at the level of the state of residence.

With regard to international tax arbitrage, the idea is simply to utilize the differences between the domestic tax legislation of different countries. The opinion of the European Commission regarding tax arbitrage has clearly been stated on various occasions.[165] In light of the Commission's conclusion that new coordinated solutions need to be developed, tax arbitrage does not seem (in the view of the EU Commission) to be considered abuse de lege lata. The basic question, i.e. whether or not an arrangement leading to double non-taxation abuses EU law, remains unanswered.[166] Moreover, it should be recalled that the ECJ has accepted (juridical) double taxation as a consequence of a lack of harmonization and the application of different tax legislation in different Member States. This reasoning works both to the benefit of Member States and taxpayers.

Based on this analysis, it is arguable that a tax advantage arising as a consequence of classification differences of HFIs between Member States should not be considered abusive.[167]

7. Proportionality

The final step in the ECJ approach, assuming the discrimination or restriction may be justified on the basis of either of the permissible grounds stated in section 6., is to examine whether or not the national legislation in question is in accordance with the principle of proportionality. Under the proportionality test, an analysis is made of whether the domestic tax legislation that applies is broader than its aim and whether its means and ends correspond. Based on the above, it appears there are no justifications available with regard to coordination rules if they are considered restrictive. Therefore the proportionality test is of less interest. It can be remarked, however, that the domestic coordination rules reviewed rely either on generally applicable rules that leave no room for the taxpayer to demonstrate the genuine economic content of the HFI at hand or allow for a business purpose test. The latter seem to stand a better chance against the scrutiny of the ECJ.

160. *See* L. De Broe, *Some observations on the 2007 communication from the Commission: 'The application of anti-abuse measures in the area of direct taxation within the EU and in relation to third countries'*, 17 EC Tax Rev. 3, p. 142 at p. 146 (2008).
161. *See Lenz* (C-315/02); *Eurowings* (C-294/97); *Danner* (C-136/00); SE: ECJ, 23 Oct. 2001, Case C-422/01, *Försäkringsaktiebolaget Skandia (publ) and Ola Ramstedt v. Riksskatteverket,* ECJ Case Law IBFD; and *Cadbury Schweppes* (C-196/04).
162. De Broe, *supra* n. 160, at p. 146.
163. Weber, *supra* n. 140, at p. 196.
164. *See also* D. Weber, *Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ – Part 1,* 53 Eur. Taxn. 6, p. 251 et seq. (2013), Journals IBFD and D. Weber, *Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ – Part 2,* 53 Eur. Taxn. 7, p. 313 et seq. (2013), Journals IBFD, presenting the concept of abuse of law under European tax law and recent trends. The above conclusion is repeated on p. 328. *See*, moreover, M. Helminen, *The Problem of Double Non-Taxation in the European Union – To What Extent Could This Be Resolved through a Multilateral EU Tax Treaty Based on the Nordic Convention?*, 53 Eur. Taxn. 7, p. 307 (2013), Journals IBFD.
165. *See* COM(2006) 823 final (19 December 2006), para. 2.3: "2.3. Preventing non-taxation and abuse. Hiatuses between tax systems due to a lack of co-ordination may also lead to unintended non-taxation and provide scope for abuse. Non-taxation and abuse are equally detrimental to the interests of the Internal Market because they undermine the fairness and the balance of Member States' tax systems. This problem can also be addressed by better co-ordination of Member States' rules and improved co-operation with respect to enforcement. This will be an essential element of the Commission's initiatives, and the Commission proposes to examine this area together with Member States in a working group in the near future depending on the progress of relevant ECJ case law". This was followed up specifically regarding HFIs by the following statement in COM(2007) 785 final (10 December 2007), p. 6: "[…] Lack of concerted interaction between MS's 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 a 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 […]".
166. De Broe, *supra* n. 160, at p. 142 et seq.
167. De Broe, *supra* n. 160, at p. 146 – correctly – concludes that a mismatch does not in itself constitute an abusive tax practice if the terms of the HFI are at arm's length and the instrument satisfies a genuine financial need of the borrower. The author, however, notes that the ECJ is not indifferent towards double non-taxation. The author also analyses the question of compensatory taxation and prevention of double non-taxation in his thesis (*See* De Broe, *supra*. n. 140, at p. 921) wherein it is concluded that tax jurisdiction shopping is only illegitimate if the taxpayer has set up a wholly artificial arrangement with no other purpose than to avoid taxation. In that event, compensatory taxation is permitted in the view of the author. *See* moreover Weber, *supra* n. 140, at p. 210 et seq. Under the heading "Making Use of Disparities in Tax Cases", the author concludes that abusive tax avoidance does not exist merely because a taxpayer is subject to an (advantageous) tax system in another Member State.

8. Conclusion

It should be recalled that the objective of this research contribution was to analyse the influence of EU law on HFIs. Two primary issues were analysed in the context of HFIs and EU law, neither of which have been addressed by the ECJ.

The first question was whether or not Member States can have different classification regimes for HFIs or even reclassify HFIs. In light of this, the issue was whether or not an inconsistent classification of HFIs may lead to a result that is considered incompatible with EU law.

This article has concluded that the simultaneous application of different autonomous domestic classification principles is generally acceptable from an EU law perspective. The difference is a natural consequence of the simultaneous exercise of the taxing rights of Member States in the absence of harmonization measures. Accordingly, there are no legal remedies based on primary EU law available to EU corporations facing the consequences of different classifications of HFIs in different Member States if such consequences not only target cross-border transactions and, accordingly, are based on nationality.

The second main question was whether or not Member States that have introduced coordination rules with the objective of ensuring single taxation of all income may actually be violating the EU fundamental freedoms. It is fully recognized that an affirmative answer to this question may be viewed as counter intuitive.

It is not possible to conclude firmly whether or not, in principle, a Member State is allowed to exclude from the scope of the participation exemption regime certain dividend payments arising from a Member State in which the dividend payments are treated in a favourable manner involving deductibility without violating the fundamental freedoms. In the view of this author it is, however, likely that the ECJ will find that such coordination efforts may be restrictive in the sense of the TFEU.

Similarly, it is not possible to firmly conclude whether or not, in principle, a Member State is allowed to restrict the deductibility of interest payments that are paid to another company that is a resident of a Member State in which the interest payments are treated in a favourable manner involving a tax exemption. In the view of this author it is, however, also likely that the ECJ will find that such coordination efforts may be restrictive in the sense of the TFEU.

With respect to both potential restrictions it is concluded that the acceptable objectives that can justify restrictions likely would not apply in this context.

Against this background and in light of the high priority given to coordination rules by the European Union and the OECD it is recommended that the impact of the TFEU be fully clarified before all Member States fall completely in love with such provisions in the global battle against tax arbitrage.

Cumulative Index

[*continued on page 602*]

