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Tax Anti-avoidance Rules in Europe

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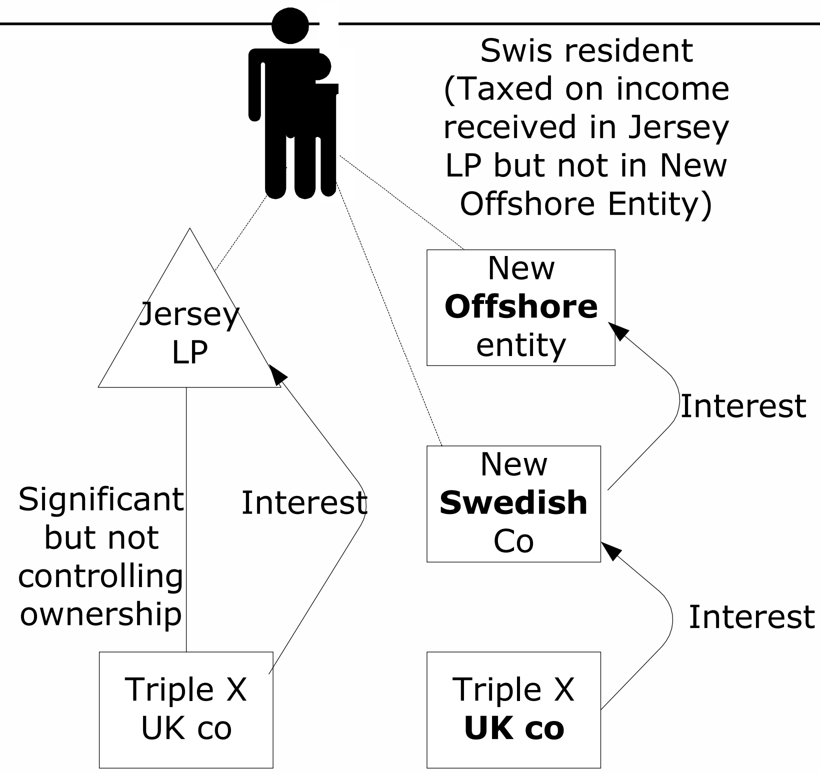
to North America
Jan Meyen (NO)
10°E
N
Iceland
Faeroe Is.
Norway
Sweden
Finland
Aaland Is.
500 km
1 px. = 10 km
Est.
Latvia
Lith.
Denmark
Russia
54°N
54°N
United Kingdom
Ireland
Isle of Man
Guernsey
Jersey
Neth.
Belg.
Lux.
Germany
Poland
Belarus
Czech
Slovakia
Ukraine
France
Liecht.
Aust.
Hungary
Switz.
Romania
Moldova
Italy
Monaco
Andorra
Yug.
Bulgaria
Georgia
Spain
Portugal
Vatican
Slovenia
Alb.
Mac.
Turkey
San Marino
Greece
Gibraltar
Malta
Bosnia-H.
Croatia
to Africa
10°E
Cyprus
to Middle East

Presentation outline

- Introduction
  - Material (your documentation)
  - Rodney's advice
  - Concepts
- Anti-avoidance in 8 selected countries
- Impact of ECJ decisions on domestic anti-avoidance
- The EC directives on direct tax

Item 1
Introduction

Client A (subject of Rodney's advice)



Current position

Proposal - main goal: to avoid Swiss tax on teh interest in teh LP (transaprent) but to avoid UK interest withholding tax; (no change to the ownership by LP of UK Co)

UK issues raised by Rodney

- See ”Inland Revenue arguments” (p 6)
- IR possibly consider it ”aggressive tax planning (perhaps 'unacceptable tax avoidance')”
- How would they attack it?
  – interest is not 'beneficially owned' by the Swedish company
  – the *Ramsay* and *Furniss v Dawson* cases could apply in that there has been a series of transactions and one of the steps (ie the assignment of the debt to the Swedish company) has been inserted for no commercial purpose other than the avoidance of tax
  – It may be argued that the Swedish company is not a 'resident of Sweden’ for the purposes of the DTA [due to lack of substance].

UK issues raised by Rodney

- How could we defend it?
  - Beneficial ownership of interest: avoid doing a simple back-to-back
  - *Ramsay* and *Furniss v Dawson* cases: ...doubt as to whether the principles (which are a rule of statutory construction) can apply to the interpretation of treaties. We do not yet have case law on this point. [I will leave these issues to Prof Richard Vann].
  - Not a 'resident of Sweden': [incorporation in Sweden ought to be enough, but some substance in the Swedish company would eliminate the risk].
  - EU: The *Gerritse* decision of the ECJ may well also preclude the UK from levying interest withholding tax - [irrespective of the treaty – and irrespective of domestic law general anti-avoidance principles].

Some concepts

- The Client A matter is primarily a UK issue: but what would the ”attacks” be and what would the defences be in *other* countries?
- First – some concepts
- The 8 countries (followed by EU law)

Concepts

- Scope of this presentation (p 8):
  - Direct tax
  - Not tax treaties
- Concepts
  - Measure v rule
    - » Rule – in the law; measure – broader – includes rules but also administrative practice (whether supported by the law)
  - General rules v specific rules
    - » GAAR (see below) v CFC, thin cap, tax haven rules
  - Anti-avoidance measures based on general principles in the law v GAAR (general anti-avoidance rules)

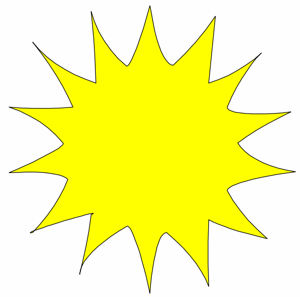
Concepts

- Anti-avoidance measures based on general principles in the law v GAAR (general anti-avoidance rules)
  - General principles: e.g., fraus legis, abuse of law, substance over form – where not codified in the legislation
  - GAAR
    - » legislation
    - » Covers wide range of tax avoidance
- Anti-avoidance?
- What is avoidance (p 11)?

Tax avoidance, evasion etc

- Tax avoidance:
  - Arranging affairs where the main object or purpose or one of the main objects or purposes of the arrangements is to obtain tax advantages, such arrangements being entered into whilst fully intending to comply with the law in all respects.
  - Various degrees of tax-avoidance.
- Tax evasion:
  - Evading tax by illegal means such as deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability.
- Conduit companies, base companies, etc (p 13 ff)

Degrees of ”wickedness”



Tax compliance
Tax management
Tax planning
Tax mitigation
Acceptable tax avoidance
Aggressive tax planning
Unacceptable tax avoidance
Tax avoision
Tax evasion

Anti-avoidance in 8 selected countries

- 1 Anti-avoidance (”AA”) measure based on general principles in the law
- 2 GAAR (General anti-avoidance rule)
- 3 CFC (Controlled Foreign Companies)
- 4 FPI’s (Foreign Portfolio Investments)
- 5 Thin capitalisation rules
- 6 Anti-tax haven rules
- 7 Transfer pricing (no)

Explanations: p 9 ff

Austria

- General principles:
  - Sec. 22 of the Federal Fiscal Code - that tax liability cannot be avoided by an abuse of legal forms or methods offered by civil law (abuse of law).
  - Applies where transactions are entered into, or entities are established, solely for the purpose of obtaining special tax advantages.
- GAAR:No
- CFC: No
- FPI’s: Yes. Undistributed income of certain foreign entities is attributed to the investor in proportion to its participation.
- Thin cap: Yes
- Anti-tax haven rules: No

France

- General principles: “abnormal act of management theory”
  - An act which deprives an undertaking of amounts it should have normally received, without this being justified by the undertaking’s business.
  - Allows the tax authorities to reassess companies with respect to management decisions that are considered contrary to the interest of the business.

France

- GAAR:
  - ”abuse of law” provisions - Articles L. 64 et seq. of the Livre des Procédures Fiscales (Tax Procedures Code.
  - May occur in two situations
    - » fictitious transactions; and
    - » legal structures intended to avoid tax.
  - Covers only some taxes
  - Only apply if there is a written document or a legal structure and where that is the subject of the abuse.
- CFC:Yes. Relaxed and being made ”EU compliant” from 2006?
- FPI’s: No

France

- Thin cap: Yes. Tightening up from 2006 & being made EU compliant.
- Anti-tax haven rules: Yes. Article 238 A
  - This article introduces a presumption that royalties, fees for services and interest charges paid by a French individual or company to a party in a privileged fiscal jurisdiction are unjustified.
- Consequence: No deduction for expenses - unless the payer can provide proof that
  - the payments relate to real transactions and
  - are neither abnormal nor exaggerated.

Germany

- General principles: No (not significant here).
- GAAR:
  - Sec 42AO 42 of the General Tax Code (AO) is an "abuse of legal form" provision.
  - Provides that a structure is considered an abuse if
    - » it is unusual and if
    - » it was chosen exclusively for tax reasons.
- Does not prohibit the use of fiscally advantageous structures if there is at least one economic reason for the structure – then an abuse of law cannot be assumed.
- If an abuse of law, structure is disregarded for tax purposes, and the tax arises in the same way as if a normal structure had been used.

Germany

- CFC: Yes
- FPI's: Yes
- Thin cap: Yes
- Anti-tax haven rules: No

Italy

- General principles: No
- GAAR: Limited GAAR. Art. 37-bis of DPR 600/73
  - tax authorities may disregard single or connected acts, facts and transactions intended to circumvent obligations and limitations provided under tax law and to obtain tax savings or refunds otherwise undue.
  - Only applicable if such acts, facts or transactions is/are included in limited list of transactions or events.
  - It is not a true GAAR because it only applies to this limited list.
- CFC: Yes
- FPI’s: No.
- Thin cap: Yes

Italy

- Anti-tax haven rules:
- Art. 110(10) of the TUIR limits the deductibility of expenses and other deductible items if they relate to transactions between resident and non-resident entities. Such expenses are not deductible unless the resident person proves that:
  - the non-resident company carries on a real business activity; or
  - the relevant transaction(s) had a real business purpose and actually took place.
- Only applies if foreign party is resident in a country or territory outside the European Union that has a "privileged tax regime".

Italy

- Privileged tax regime
  - List of ”tax havens”
  - 30 July 2004: removed Cyprus and Malta from the list.

Netherlands

- General principles:
  - Substance over form: Artificial or simulated transactions may be ignored by the tax administration through a determination of the facts rather than the form (substance over form).
  - The "just levy" (*richtige heffing*): the legal act in dispute may be ignored for tax purposes. Procedure is subject to prior approval by the MofF - rarely used
  - The abuse of *law (fraus legis*): an interpretation method developed in case law; the spirit of the law is decisive, rather than the exact wording. The transaction may be converted to the closest equivalent which does not give rise to an abuse of law. Can be used only as a last resort.

Netherlands

- GAAR: No
- CFC: No (but see FPI)
- FPI's: Yes
- Thin cap: Yes
- Anti-tax haven rules: No
- Other – **the AB regime**
  - – if the (5% +) shareholder is not in a treaty country
  - – if it has no business activity then
  - – 35% on everything that moves
    - » 35% tax on gain on sale of shares in Dutch co
    - » 35% tax on interest received
    - » 35% tax on dividends received

Spain

- General principles:No
- GAAR:
  - Spanish legislation contains a wide range of anti-avoidance measures
  - most important being Art. 16 of the General Tax Law (Ley General Tributaria, LGT)
  - provides that tax can be levied by reference to the substance and not the legal form of a transaction.

Spain

- CFC: Yes
- FPI's: Yes
- Thin cap: Yes
- Anti-tax haven rules: Yes
  - Payments for services supplied by parties resident in a tax haven
  - not deductible
  - unless the Spanish resident can prove that the expense is related to a transaction carried on by valid economic reasons.
  - 48 tax havens listed (see p 29)

Switzerland

- General principles: “tax avoidance by abuse of law” if the following three conditions are met:
  - the legal form chosen by the taxpayer is ‘unusual’ or inadequate to achieve the purported goal and contrary to ordinary business practice;
  - the taxpayer’s primary motive for choosing such legal form is to achieve substantial tax savings;
  - the taxpayer would, in fact, realize considerable tax savings if the legal form chosen were accepted
- GAAR: No
- CFC: No
- FPI’s: No
- Thin cap: Yes
- Anti-tax haven rules: No

United Kingdom

- General principles: Yes, but has no name.
  - Developed by the courts
  - Built on *WT Ramsay Ltd v. IRC* and *Eilbeck v. Rawling*, and as laid down by Lord Brightman in *Furniss v. Dawson* and reaffirmed in *IRC v. McGuckian*
  - transactions will be disregarded for tax purposes where:
    - » there is a composite or a preordained series of transactions which may or may not include the achievement of business purposes; and
    - » steps are inserted which have no commercial purpose other than the avoidance of a tax liability.
- GAAR: No (tried hard to introduce one, gave up).

United Kingdom

- CFC: Yes
- FPI’s: No
- Thin cap: Yes
- Anti-tax haven rules: No

Item 3

Impact of ECJ decisions on domestic anti-avoidance

(it's about stretching the imagination)

Six EC Treaty Freedoms

- Free movement of citizens of the Union
- Free movement of goods
- Free movement of persons (workers/establishment)
- Free movement services
- Free movement of capital
- Free movement of payments

Compliant with EC law? The analytical approach

Three steps:

- Does the EC Treaty apply?
- Is there a restriction on one of the six freedoms?
- Is the restriction justified
  - Coherence of the tax system
  - Prevention against tax avoidance?

Thin cap rules: Already ruled out - *Lankhorst-Hohorst*

- Judgement delivered December 2002 (p 37)
- The ECJ held that German thin-capitalization legislation
  - breached the freedom of establishment principles in European law
  - no possibility of tax evasion or avoidance through thin capitalization where the recipient of the interest would itself be subject to taxation in its EU state
  - was not justifiable.

CFC rule – a restriction with no justification?

Danish parent only taxed on a distribution (unless it chooses group taxation with Danish sub)

Danish parent

Danish sub

Danish parent taxed on the CFC income earned by German sub

According to Danish rules: Germany can be a CFC

Danish parent

German sub

CFC rules – next to fall?

- UK Group Litigation order (Paul Farmer)
- Sheltons-SITTI Conference on EU Taxation in Copenhagen (Nov 2004) –
  - Prof Dr Marjaana Helminen (Finland)
  - Prof Dr Pasquale Pistone (Italy)
  - Paul Farmer (ex-EU commission, Barrister UK)
  - Dr Dennis Weber (Netherlands)

  confident that CFC is doomed

What is at risk for the EU (due to non-compliance with the EC Treaty)

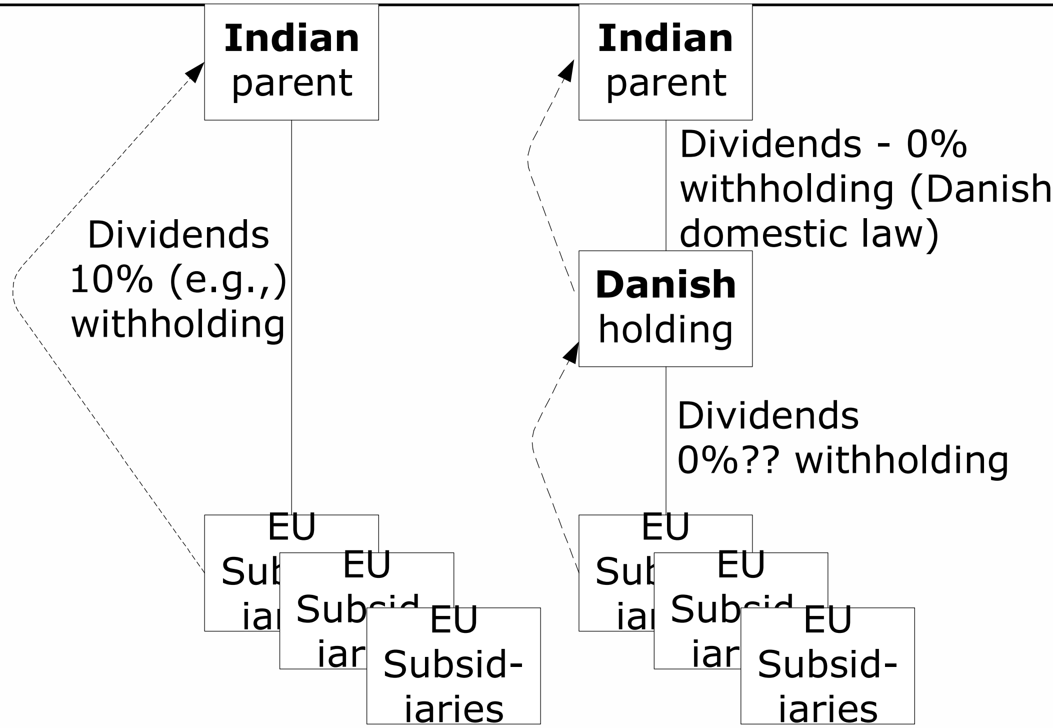
- Transfer pricing
- CFC (coming – eg. Paul Farmer and the UK Group litigation – p xx)
- Thin cap (done: p xx
- All anti-avoidance law that might differentiate between residents and other (many examples of EU members having already changed their law – but this is just the TOTI)
- In all 25 countries
- Plus: Liechtenstein, Norway and Iceland

Item 4
The EC directives on direct tax

Tax avoidance rules sanctioned by the EC Directives

- Three directives of interest
  - Parent-Subsidiary Directive
  - Mergers Directive
  - Interest & Royalties Directive.
- Directive overrides domestic law
- Parent-Subsidiary Directive (PSD) example:
  - PSD allows teh EU member state to introduce anti-avoidance rules to prevent the following:

India-EU example
Issue: What if EU sub is Austria?



Main goal: to avoid withholding tax on dividends from EU subsidiaries on dividends to the Indian parent.
Solution: Interpose a Danish holding company.
Issue here: Application of anti-avoidance rules in EU countries with regard to the dividend to the EU parent (Denmark) - will they all grant the benefits of the Parent-Subsidiary Directive?

India-EU example

- Austria (and several other countries, but less than half of the 25 EU members) have introduced anti-avoidance law which would apply so that they would not be forced to grant the benefits of the PSD under such circumstances
- Thus no PSD, so dividend withholding tax at the Austrian domestic rate
  - But Austria must still respect its tax treaty with Denmark
  - <u>And</u>: is the Austrian anti-avoidance law EU compliant (ie, in accordance with the fundamental freedoms set out in the EC Treaty)?
- Probably not. NB EC Treaty (primary law) overrides Directives (secondary law).

Implications (of previous conclusion)

- All anti-avoidance law introduced in the 25 EU member states, although fully within the meaning set out in the EC direct tax directives –

<u>may well be illegal (in violation of the EC Treaty)</u>

- If so
  - How far back can a claim reach?
  - What does it mean in money terms for the states
  - What exposure do advisers have with respect to claims against them for negligent advice?

Client A (subject of Rodney's advice) (it's about stretching the imagination)

- Implications for the UK
- Rodney raised various possible Inland Revenue arguments including *Furniss v Dawson*
- Conclusion:
  - Even if the IR succeeded with these arguments, in from the left flank comes an ECJ decision concerning a Dutch jazz musician who fought the German authorities over a German claim for USD 2,000, Mr Arnoud Gerritsen - the *Gerritsen decision (2003)*
  - *Gerritsen, being an ECJ freedom of establishment decision, overrides everything else*
  - Thus: even if the IR succeeded in all other arguments, the maximum tax payable in the UK would not be GBP 700,000 but around GBP 75,000 (see next slide).

Client A (subject of Rodney's advice)

	GBP
Principal	50,000,000
Interest rate on loan from Sweden	7%
Gross interest due	3,500,000
UK withholding (20%)	**700,000**
Received by Sweden	3,500,000
Interest rate on loan by Sweden	6.50%
Sweden pays	3,250,000
Sweden's profit	250,000
Max UK tax per Gerritsen (at 30%)	**75,000**

That's about it.
Thanks and enjoy the rest of the Conference

Comments very welcome - see first slide for contact details.

Ned Shelton