

**Institute of Advanced Legal Studies**  
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Are Portuguese CFC rules compatible with EU Law?

MA 2010-2011  
**Taxation (Law, Administration and Practice) (Tax)**

**Are Portuguese CFC rules compatible with  
EU Law?**

Candidate No R6655

**Institute of Advanced Legal Studies**

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**University of London**

2009/2010

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<i>Pupino</i>	Case C-105/03 <i>Maria Pupino</i> [2005] ECR I-5285
<i>Kerckhaert-Morres</i>	Case C-513/04 <i>Kerckhaert and Morres</i> [2006] ECR I-10967

<i>Knoors</i>	Case 115/78 <i>J. Knoors v Staatssecretaris van Economische Zaken</i> [1979] ECR 399
<i>Kofoed</i>	Case C-321/05 <i>Hans Markus Kofoed v Skatteministeriet</i> [2007] ECR I-5795
<i>Kolpinghuis Nijmegen</i>	Case 80/86 <i>Kolpinghuis Nijmegen BV</i> [1987] ECR 3969
<i>Rewe</i>	Case 33-76 <i>Rewe-Zentralfinanz eG and Rewe-Zentral AG v Landwirtschaftskammer für das Saarland</i> [1976] ECR 1989
<i>SGI</i>	Case C-311/08 <i>Société de Gestion Industrielle (SGI) v Belgian State</i> [2010] ECR 00
<i>Thin Cap</i>	Case C-524/04 <i>Test Claimants in the Thin Cap Group Litigation</i> [2007] ECR I-2107
<i>TV10</i>	Case C-23/93 <i>TV10 SA v Commissariaat voor de Media</i> [1994] ECR I-4795
<i>Van Binsbergen</i>	Case 33/74, <i>Johannes Henricus Maria van Binsbergen v. Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid</i> , [1974] ECR 1299
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<i>Vodafone 2</i>	<i>Vodafone 2 v Revenue and Customs Commissioners</i> [2009] EWCA Civ 446; [2010] Ch. 77 (CA (Civ Div))
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## Table of Abbreviations

AG	Advocate General
CFC (’s)	Controlled Foreign Companies
CIRC	Portuguese Corporate Income Tax Code
CJEU	Court of Justice of the European Union
(the) Court	Court of Justice of the European Union
DTC	Double Taxation Convention
EC	European Community
EEA	European Economic Area
EU	European Union
HMRC	Her Majesty’s Revenue & Customs
IFSC	International Financial Services Centre
OECD	Organization for Economic Cooperation and

	Development
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom

*'Nullus videtur dolo facere qui suo jure utitur'*

No one who exercises his legal rights is considered  
to have committed a wrong

Gaius Digest 50.17.55

## 1. Introduction<sup>1</sup>

Due to the widespread use of and similarity between CFC national legislations, the *Cadbury Schweppes*' judgement of the CJEU triggered a shockwave across the national tax systems in the EEA, which led most Member States to initiate the reforms of their CFC regimes. In contrast, the Portuguese CFC rules remain unaltered since their introduction in 1995 and, moreover, there are no announcements for a reform thereof for the near future. The potential impact of the *Cadbury Schweppes*' judgement for the Portuguese CFC rules is apparent. The latter might indeed have to be amended in order to comply with the requirements set out therein. Nevertheless, as seen in *Vodafone 2*, should a judicial dispute arise the CFC regime might be capable of being interpreted by national courts in conformity with the former judgement. Most importantly, however, the justification accepted by the Court in *Cadbury Schweppes* (ie CFC rules must specifically target at wholly artificial arrangements without economic reality) reduces considerably the scope of application of these rules and creates opportunities for substantial tax avoidance. An amendment of the Portuguese CFC rules solely in light of such justification might thus jeopardize legitimate taxing rights of the Member State.

The question whether these latter negative consequences can be overcome thus calls for a broader analysis under the overall framework of the case law of the Court in the areas of abuse and tax avoidance. In this context, there are several questions that need to be addressed. First, there is still no unanimity in the scholarship as regards to whether the

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<sup>1</sup> The author would like to thank Dr. Tom O'Shea for the guidance and for the comments on a draft of this dissertation. Any shortcomings are the sole responsibility of the author. Quoted excerpts from Portuguese books, journals and legislation have been translated into English by the author.

concept of prohibition of abuse constitutes a general EU principle<sup>2</sup>. Second, the reasoning of the Court in *Cadbury Schweppes* as to the role of the concept of abuse is blurred by references to abuse both whilst ascertaining Treaty entitlement as well as whilst assessing the justification of prevention of wholly artificial arrangements. In this context, the key question regards to the underlying meaning of the latter justification, namely, as to whether it should be seen under the national standpoint of tax avoidance (ie to prevent abuse of national fiscal provisions) or from the standpoint of a general EU principle of prohibition of abuse (ie to prevent abuse of EU provisions). Again, the answer to this question is also blurred since in the Court's case law prior to *Cadbury Schweppes* the issue of abuse and the justification of prevention of wholly artificial arrangements were addressed autonomously, which seems to point in the direction that the latter justification merely addresses tax avoidance. However, in and after *Cadbury Schweppes* the latter justification and the issue of abuse of the fundamental freedoms appear intertwined under the denomination of the justification on grounds of "prevention of abusive practices", which seems to point in the direction of a prohibition of abuse of EU provisions. Third, if the latter view is upheld, then the question that is triggered is whether, in light of its case law, the Court accepts any justification which aims directly at preventing the risk of tax avoidance, as such (ie to prevent abuse of national fiscal provisions).

Whereas Chapter 2 will serve to introduce the case law of the CJEU concerning CFC rules, the respective analysis will be left to Chapter 3 which aims at answering to the above questions in light of the broader context of the areas of abuse and tax avoidance

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<sup>2</sup> The doubts as to the existence of the said general principle are visible in Paolo Piantavigna, 'Conference Report: Prohibition of Abuse of Law: A New General Principle of EU Law?' (2009) 3 Intertax 37, 166.



(in 3.1.) and at explaining (in 3.2. and 3.3.) the scope of the justification accepted by the Court in *Cadbury Schweppes*.

Thereafter, the question in the title above will be addressed in Chapter 4. After setting out the Portuguese CFC regime and answering to the said question from the standpoint of the CJEU (see 4.1.) an attempt will be made to assess, firstly, whether the Portuguese national courts may interpret the CFC legislation in conformity with such a ruling (see 4.2.), and, secondly, the solutions that may be available – in this case, to the Portuguese Government - for drafting CFC legislation in line with EU law without being limited to targeting wholly artificial arrangements without economic reality (see 4.3).

In light of all the above, it is noted that the underlying purpose of this dissertation is, first, to assess whether the justification accepted in *Cadbury Schweppes* is sufficient to ensure the effectiveness of CFC rules. Second, shall the conclusion of such assessment be negative, the question is whether Member States may nevertheless resort to other justifications or alternatives which allow them to prevent artificial diversion and deferral of profits economically derived in their territories. Lastly, it is noted that only the freedom of establishment will be addressed herein since the assessment under the free movement of capital requires further analysis, which does not fit in the limits of this dissertation.

## 2. The Court's case law on CFCs

### 2.1. *Cadbury Schweppes*<sup>3</sup>

In *Cadbury Schweppes*, the concepts of abuse and establishment played an important role in the reasoning of the Court. Particularly regarding the former, the Court introduced for the first time in the direct tax area the two-pronged abuse test set out in *Halifax*.

The UK's CFC rules were assessed by the Court under the freedom of establishment seeing as they applied to "controlling holdings" of more than 50 per cent by resident companies which gave them a "definite influence" on the decisions of and allowed them to determine the activities of the CFCs.

Whilst outlining the concept of abuse, the Court reiterated that nationals of Member States must not improperly take advantage of EU law to circumvent national law. Nevertheless, it confirmed that, whilst engaging in tax planning, a taxpayer could rely on the Treaty and benefit from the tax advantages in another Member State<sup>4</sup>. It also

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<sup>3</sup> The case concerned a company resident in the UK (hereinafter, "CS") owning indirectly 100 per cent of two subsidiaries, both established in the IFSC in Ireland. The business of these subsidiaries was to raise and provide finance within the group. They had been established in Ireland for the purpose of benefiting from the 10 per cent tax rate and reducing the tax burden of the group. HMRC thus sought to apply the UK's CFC regime since those subsidiaries were subject to a "lower level of taxation" and none of the exclusions provided for in the said regime were fulfilled, including the "motive test." Accordingly, the respective profits were included in the tax assessment of CS.

<sup>4</sup> In *Barbier*, a Dutch national had engaged in tax planning by using the Dutch rules that recognised the separation between legal and financial ownership of immovable property. The Court accepted such tax planning (the arrangements were made solely with the intention to benefit from tax advantages) since it stemmed from a proper exercise of the freedom of movement.

repeated the judgements in *Centros*<sup>5</sup> and *Inspire Art* where it had noted that the freedom of establishment is intended to enable companies to set up establishment in other Member States in order to pursue activities there. Thus, it concluded that, the fact that the exercise of such freedom was exclusively tax motivated did ‘not therefore preclude reliance by CS on Articles 43 and 48 EC’.

As to the assessment of comparability, the Court highlighted the fact that the CFC legislation taxed the resident company on the profits of another legal person whereas resident companies with domestic subsidiaries or in a high-tax State were not taxed on such profits. Hence, it concluded that such different treatment hindered the exercise of the freedom of establishment dissuading resident companies to establish themselves in low-tax States.<sup>6</sup>

As to the justification submitted by the UK on grounds that the CFC legislation was intended to counter a specific type of tax avoidance, the Court reiterated its settled case law<sup>7</sup> that the tax advantages resulting from the low taxation in other Member States and the need to prevent the reduction of tax could not justify a restriction of the freedom of establishment. It also repeated its ruling in *ICI* that the setting-up of an establishment in another Member State does not necessarily entail tax avoidance and therefore cannot, by itself, trigger a general presumption thereof. Nevertheless, it confirmed that a restriction

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<sup>5</sup> In *Centros*, a UK company had been set-up by Danish nationals with the sole purpose of circumventing the requirements on the minimum paid-up capital of Danish company law. The UK company operated solely in Denmark through a branch and engaged in commercial activity there. Since the UK company did not carry on any activity in the respective territory, the Danish authorities refused to register the Danish branch on grounds of abuse of the freedom of establishment.

<sup>6</sup> *Cadbury Schweppes*, para 46.

<sup>7</sup> *Avoir Fiscal*, para 21.

of the freedom of establishment ‘may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned.’<sup>8</sup>

Whilst ascertaining the cases where the latter justification could apply, the Court explained in light of the settled case law concerning abuse of EU law<sup>9</sup> that it was necessary to take account of the objectives pursued by the freedom of establishment<sup>10</sup>. In this context, it stated that the concept of establishment presupposes an ‘actual establishment’ and the pursuit of a ‘genuine economic activity’ in the host State. Therefore, it concluded that, in order to be justified,

...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<sup>11</sup>.

Therefore, after confirming that the UK’s CFC rules were suitable to achieve such objective, the Court assessed whether they were proportionate. It noted in this regard that the “motive test” did ‘not suffice to conclude that there is a wholly artificial arrangement intended solely to escape that tax’<sup>12</sup> since it only excluded situations where there was no intention to escape UK tax.

Nevertheless, the Court set out the two-pronged test outlined in *Halifax* and in *Emsland-Starke*, according to which, both a subjective and an objective test must be fulfilled in

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<sup>8</sup> *Cadbury Schweppes*, para 51.

<sup>9</sup> See *Centros*, para 25 and *Paletta II*, para 25.

<sup>10</sup> *Cadbury Schweppes*, para 53.

<sup>11</sup> *Ibid*, para 55.

<sup>12</sup> *Ibid*, para 63.

order to conclude that ‘the objective pursued by freedom of establishment ... has not been achieved’<sup>13</sup>. As to the former, it consists in ascertaining on the basis of objective circumstances whether the incorporation of the CFC constituted an “actual establishment” intended to carry on “genuine economic activities” in the host Member State (“economic reality” test). The Court pointed out that such a finding must ‘be based on objective factors which 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’. The Court illustrated this with the existence of a “letterbox” or “front” subsidiary in the host State. In addition, it noted that ‘the resident company, which is best placed for that purpose, must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine.’<sup>14</sup>

Ultimately, the Court decided to refer the case back to the Special Commissioners to determine whether, as contended by the HMRC, the “motive test” could be interpreted in a way which could be restricted to wholly artificial arrangements or whether, on the contrary - where the intention to reduce the tax burden in the UK was central for the incorporation of the CFC - the “motive test” meant that the resident company was subject to the UK’s CFC rules even in the absence of objective evidence of a wholly artificial arrangement. In the former case, the UK CFC rules should not apply where, on the basis of the aforementioned objective criteria, it was proven that the CFC was actually established in the host Member State and carried on genuine economic activities there.

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<sup>13</sup> *Cadbury Schweppes*, para 64.

<sup>14</sup> *Cadbury Schweppes*, para 70.

## 2.2. CFC GLO

The *Cadbury Schweppes*<sup>15</sup> judgment was confirmed by the Court in its reasoned order delivered in *CFC GLO*, which, in part, also concerned the UK's CFC rules. Nevertheless, this case is important in that – although merely applying previous judgements - it seems to clarify the reasoning of the Court in *Cadbury Schweppes* regarding compliance requirements and the burden of proof.

Indeed, whilst breaking down its statement in paragraph 70 of *Cadbury Schweppes*<sup>15</sup> in two, the Court showed that it addressed in such sentence both the compliance requirements and the opportunity for taxpayers to produce evidence. It explained, regarding the former that, ‘the resident company is best placed to establish that it has not entered into wholly artificial arrangements which do not reflect economic reality’. Regarding the latter, it noted that ‘it must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine.’<sup>16</sup>

As to the compliance requirements, not only did the Court accept that they could be required by the Member States, as long as they do not entail undue administrative constraints, but also seemed to have the view that they were indeed necessary since they ‘are inherent in the assessment ... on which the compatibility of the legislation on CFCs rests.’<sup>17</sup>

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<sup>15</sup> See above, note 14.

<sup>16</sup> *CFC GLO*, para 82.

<sup>17</sup> *Ibid*, para 83.

Regarding the opportunity to produce evidence that the CFC is actually established and that its activities are genuine, the Court went on to reproduce its statement in *Thin Cap* that national legislation

... is to be considered as not going beyond what is necessary to prevent abusive practices where, on each occasion on which the existence of such an arrangement cannot be ruled out, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification.<sup>18</sup>

The Court thus seemed to draw a parallel with *Thin Cap*, where it had held that, firstly, the Member States' legislation must foresee objective and verifiable elements (such as the arm's length test) in order to ascertain whether a transaction represents a purely artificial arrangement and, secondly, at a subsequent level (ie 'on each occasion on which the existence of such an arrangement cannot be ruled out'), the resident company must be given an opportunity to provide evidence of any commercial justification that there may have been for that arrangement.

Additionally, the Court noted that free movement of capital applied since there was a portfolio shareholding of less than 10 per cent, which was seen as not conferring definite influence over the company's decisions or activities. Regarding the question whether the judgment of the Court would be different if third countries were involved, it recalled that only the free movement of capital is extended to third countries, and that, situations involving third countries take place in a different legal context because of the different degree of legal integration.

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<sup>18</sup> *CFC GLO*, para 84 and *Thin Cap*, paras 80 - 81.

### 2.3. *Columbus Container*<sup>19</sup>

In contrast with *Cadbury Schweppes*, the *Columbus Container* case provides an example of how Member States can put in place CFC rules without entailing different treatment.

The partners of Columbus argued that there was a restriction on the freedom of establishment since the German switch-over clause created a higher tax burden than they would have if they had invested in Germany. However, the Court held that there was no such restriction since Germany did not treat Columbus' profits differently from the profits of a German partnership. Whilst recalling the judgement in *Kerckhaert-Morres*, it noted that the adverse consequences which might arise resulted from the 'exercise in parallel by two Member States of their fiscal sovereignty'<sup>20</sup>.

Moreover, the contention - made by the taxpayer and supported in AG Mengozzi's Opinion<sup>21</sup> - that the German rules created a distortion on the choice of the Member State of establishment in favour of Member States where the legislation at issue did not apply was not accepted by the Court, which noted that in the current state of harmonisation of EU tax law Member States enjoy a certain autonomy and are therefore not obliged to adapt their tax systems to the differences between the systems of other Member States.

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<sup>19</sup>Columbus Container (hereinafter, "Columbus") was a Belgium non-transparent partnership - wholly owned by German residents - benefiting from the low tax rates of the Belgian coordination centres' regime. In Germany the partnership was treated as transparent and therefore its profits were taxed in the hands of the shareholders. The Germany-Belgium DTC provided for an exemption of German tax on the profits derived in Belgium. However, regarding "designated passive income" of CFCs, the German domestic legislation switched over the said exemption method to a method of set-off of Belgium tax against the taxable amount in Germany.

<sup>20</sup> *Columbus Container*, para 43.

<sup>21</sup> See Opinion of AG Mengozzi in *Columbus Container*, paras 120-121.



#### 2.4. *Vodafone 2* <sup>22</sup>

*Vodafone 2* provides a prime example of the issues that may arise before the Portuguese national courts whilst assessing the compatibility of the Portuguese CFC rules with EU Law. Following the *Cadbury Schweppes*' decision, the main issue was whether the UK's CFC legislation could be interpreted in conformity with EU law.

The ultimate decision, by the Court of Appeal, reversed Evans-Lombe J's ruling in the High Court, according to which, the addition of further conditions to the CFC legislation with a view to construe the latter in conformity with EU Law would constitute a legislative amendment of the wording rather than a judicial interpretation thereof. The initial decision of the Special Commissioners was thus upheld by the Court of Appeal, albeit on somewhat different grounds. Namely, it rejected the contention by *Vodafone 2*<sup>23</sup> that only the "motive test" could be considered for purposes of conforming interpretation. Firstly, the Court noted that the jurisdiction of the CJEU to give preliminary rulings concerned to the interpretation of the EC Treaty and not to the interpretation of national legislation. Secondly, it noted that 'the obligation of the national court is to examine the whole of the national law to consider how far it may be applied so as to conform to enforceable Community rights.'<sup>24</sup>

Whilst holding the view that the obligation of conforming interpretation was 'both broad and far-reaching', it ruled that the CFC legislation should be construed in such a way as

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<sup>22</sup> Whilst seeking to apply the UK's CFC rules, HMRC issued an enquiry notice to *Vodafone 2* regarding a Luxembourg subsidiary. *Vodafone 2* argued that the UK's CFC legislation was in breach of the freedom of establishment.

<sup>23</sup> Which relied, in particular, on para 72 of the *Cadbury Schweppes*' judgment.

<sup>24</sup> *Vodafone 2*, para. 34.

to introduce an additional exception to the application thereof if the CFC was actually established in another Member State and carried on genuine economic activities there. In that regard, Longmore LJ noted that

... Any inquiry as to motive as originally envisaged by the Act, is likely to encompass the question whether the resulting CFC is an artificial arrangement; the proposed insertion merely makes clear that CFCs which are not artificial arrangements will be exempt from the provisions of s 747(1).<sup>25</sup>

The Court of Appeal thus agreed with the view of HMRC that ‘the “grain” or “thrust” of the legislation was to cast the initial net wide as in s.747(3) and then narrow it by the overlapping exceptions set out in s.748(1)(a) to (e) and (3)’. Thus, the Court held that the UK’s CFC legislation was susceptible of conforming interpretation with the *Cadbury Schweppes*’ requirements.

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<sup>25</sup> *Ibid*, para 71.

### 3. Analysis

#### 3.1. The doctrine of Abuse

##### A) The prohibition of abuse as a general principle of EU Law

As noted since *Centros*<sup>26</sup> and *X and Y*<sup>27</sup>, the concept of prohibition of abuse used by the Court consists of impeding the improper use of a rule either through ‘measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly’ ‘or fraudulently taking advantage of provisions of Community law’. Such prohibition of abuse was expressly recognised in *Kofoed* as a ‘general Community principle.’<sup>28</sup> Hence, the rationale of such principle receives inspiration from the anti-avoidance doctrines and rules adopted by the Member States<sup>29</sup>. This is apparent, for example, from the Court’s decision in *Diamandis* where the defendant relied on a national general anti-abuse provision to ward off a claim made under the Second Company Law

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<sup>26</sup> *Centros*, para 24.

<sup>27</sup> *X and Y*, para 41.

<sup>28</sup> In *Kofoed* the issue was whether an arrangement set up by two Danish taxpayers amounted to an abuse of a direct tax exemption provided for by the Merger Directive. Under article 11(1) (a) of that Directive, Member States may withdraw the benefits of the provisions thereof where the arrangement has mainly tax avoidance objectives. The Court said that such article is the codification of the general EU principle that rights conferred by the Directive should not be abused.

<sup>29</sup> In *Algera* the Court stated that the recourse to general principles of EU law was made ‘by reference to the rules acknowledged by the legislation, the learned writings and the case-law of the Member States’. See, L. Neville Brown, ‘Is there a general principle of abuse of rights in European Community Law?’ in Dirdre Curtin & Ton Heukels (eds), *Institutional Dynamics of European Integration, Essays in honour of Henry G. Schermers* (vol II, Martinus Nijhoff Publishers, London, 1994), p 512-513.

Directive to invalidate a capital increase. The Court accepted the application of that provision for the purpose of establishing abuse of EU law as the rule allowed in each particular case to establish on the basis of objective circumstances that the intention (subjective element) to claim an advantage under the Directive that frustrated the objectives of the Directive in the given circumstances (objective element).

One of the basic elements in every avoidance conduct is that a given objective is attained through an inappropriate arrangement<sup>30</sup>, which, in order to be considered as such, presupposes the existence of and therefore requires a comparison with an appropriate arrangement. This comparison must take into account not the legal form logically appropriate to the economic aim pursued but rather the purpose and objectives of the allegedly abused provision. Following the reasoning held in *Centros* and *Paletta II*<sup>31</sup>, this view was clearly adopted in *Cadbury Schweppes* where the Court noted that ‘it is necessary, in assessing the conduct of the taxable person, to take particular account of the objective pursued by the freedom of establishment.’<sup>32</sup>

The rise of a EU law principle of abuse thus triggers an additional issue for the Member States having anti-abuse measures since the nature of the provisions whose objectives have to be assessed under the said principle (chiefly, the freedoms of movement) is different from that of the provisions whose objectives would otherwise be assessed under the national anti-abuse measures (ie, national tax rules). Furthermore, whereas in

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<sup>30</sup> Violeta R. Almendral, ‘Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?’ (2005) 33 *Intertax* 12, 560

<sup>31</sup> See above, note 9.

<sup>32</sup> *Cadbury Schweppes*, para 52. The same rationale is contained in article 334 (“Abuse of the right”) of the Portuguese Civil Code, which deems illegitimate the exercise of a right that clearly exceeds the limits imposed by ‘the social or economic purpose’ thereof.

the latter case it is the national courts' role, in that capacity, to interpret the objectives of the anti-abuse provisions, in the former case it is a matter of interpretation of EU law and therefore a task for the CJEU. Likewise, the recognition of the said principle means that EU primacy over national and treaty law requires these two levels of law to meet the compliance standards set forth by the CJEU concerning the design of national anti-avoidance measures<sup>33</sup>. Thus, one of the consequences of *Cadbury Schweppes* for the Member States is that any restriction on the exercise of the fundamental freedoms stemming from national anti-avoidance rules is only justified in the context of tax avoidance - it is noted, as a standalone defence<sup>34</sup> - if it specifically targets the improper use of the fundamental freedoms and not simply the improper use of national tax rules.

## **B) Prevention of abusive practices versus prevention of tax avoidance**

### **i) The justification of prevention of abusive practices**

In *Cadbury Schweppes*, the Court used the expression 'justification on the ground of prevention of abusive practices' when it was analysing whether the UK's CFC rules were specifically related to wholly artificial arrangements<sup>35</sup>. Although this does not constitute a new justification, it seems that the Court wants to make it clear that it does not focus on tax avoidance as such (ie on the abuse of national tax rules) but rather on the abuse of

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<sup>33</sup> F. Vanistendael, 'Halifax and Cadbury Schweppes: one single European theory of abuse in tax law?' (2006) EC T.R. 15, 195.

<sup>34</sup> This is explained below in 3.1. B), ii).

<sup>35</sup> *Cadbury Schweppes*, para 55. See also, *Thin Cap*, para 71.

EU provisions, being therefore a EU law concept of abuse<sup>36</sup>. As illustrated in *Cadbury Schweppes*, the Court only accepts a restriction of the fundamental freedoms on grounds of tax avoidance, as a standalone defence, if and to the extent that these freedoms are not being actually and genuinely exercised. Therefore, it is the assessment required by the Court as to the purposive scope of the applicable freedom of movement that defines the “freedom” by EU nationals to arrange their tax affairs. Thus, ‘legitimate tax mitigation or tax planning is nothing more than a side effect or an indirect consequence from the exercise of the free<sup>37</sup> movement in the European internal market.

Since it uses the yardstick of abuse of EU freedoms of movement, the Court has thus not distinguished between acceptable and unacceptable tax avoidance as such. Firstly, such constitutes a distinction of a fiscal nature - the interpretation of which, in the absence of harmonization at EU level, cannot be resorted to EU law - and therefore falls outside the competence of the Court<sup>38</sup>. Secondly, as explained below in 3.1. B), ii), the Court has not accepted until now the protection of tax avoidance, as such, as a standalone justification in the direct tax area. In particular, the Court made it clear in *X and Y*<sup>39</sup> and in *de Lasteyrie du Saillant*<sup>40</sup> that tax evasion or tax fraud ‘cannot justify a fiscal measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty’. Rather, provided there is a genuine exercise of the fundamental freedoms,

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<sup>36</sup> As noted by Luca Cerioni, in the field of tax law, wholly artificial arrangements are synonymous of abuse. Luca Cerioni, ‘The “abuse of right” in EU company law and tax law: a re-reading of the ECJ case-law and the quest for a unitary notion’ (26 February, 2010), 11. Similarly: Luc de Broe, *International Tax Planning and Prevention of Abuse - A Study under Domestic Tax Law, Tax Treaties and EC Law in relation to Conduit and Base Companies* (IBFD Publications BV, Amsterdam, 2008), p 808.

<sup>37</sup> Violeta R. Almendral (n 30).

<sup>38</sup> See Tom O’Shea, *EU Tax Law and Double Tax Conventions* (Avoir Fiscal Limited, London, 2008), 174.

<sup>39</sup> *X and Y*, para 61.

<sup>40</sup> *De Lasteyrie du Saillant*, para 51.

taxpayers can rely thereupon solely for tax purposes. Namely, in *Barbier*<sup>41</sup>, the Court held that the freedoms of movement could not be hindered ‘on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence’. This case law is also consistent with the decisions in the non-tax area, namely in *Centros*, *Inspire Art*, *Chen*<sup>42</sup> and *Akrich*<sup>43</sup> where the Court confirmed that, where the rights provided by EU law are genuinely exercised, the motives of the nationals of Member States or even of third countries cannot call into question the protection derived therefrom.

ii) The justification on grounds of prevention of (the risk of) tax avoidance

Notwithstanding the above, the Court’s judgement in *SGL*<sup>44</sup> came to reveal with clarity that national legislation not specifically designed to exclude purely artificial arrangements can still be justified with the need to prevent tax avoidance, provided – however - that it

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<sup>41</sup> See above, note 4.

<sup>42</sup> In *Chen*, two Chinese nationals set up an arrangement with a series of steps in order to obtain UK residency. Mrs. Chen travelled to Ireland to give birth to her child there in order for the latter to acquire Irish nationality and, thereby, be entitled to reside in the EU. The Court confirmed that the arrangements put in place had the sole purpose of enabling Mrs. Chen to reside with her child in the UK. Nevertheless, it held that since Irish nationality had been legally obtained, ‘it was not permissible for a Member State to restrict the effects of the grant of nationality of another Member State’.

<sup>43</sup> *Akrich* was a Moroccan national, which, after having married with a UK citizen, was deported to Ireland, where the latter had established herself to work there. Less than a year later, the latter applied for a revocation of his deportation order since she was returning to the UK. It was common ground that the couple had moved to Ireland in order to be entitled to return to the UK. The Court held that there was no abuse since the motives could not be taken into account where the marriage was genuine. See also, *Metock*.

<sup>44</sup> *SGL*, para 63. In *SGL*, a restriction was triggered by Belgium since suspicious advantages (namely, below arm’s length) granted to connected parties in other Member States were added-back and taxed upon residents.

can be “taken together” with the justification of preservation of a balanced allocation of taxing rights. As noted by Dr. Tom O’Shea, in *Marks & Spencer*<sup>45</sup> the Court had already dealt with tax avoidance in the context of the justification concerning the need to preserve a balanced allocation of taxing rights. This latter justification was, for the most part, accepted by the Court and consisted in preserving “symmetry” between the taxation of profits and the relief of losses, so that the UK was not under the obligation to grant relief for losses in respect of subsidiaries taxed in other Member States. Nevertheless, “understanding the relationship between these two uses of the concept of tax avoidance was (...) quite difficult because in the first instance, the justification involving the prevention of tax avoidance could clearly stand on its own, whereas in the second instance it was merely taken together with the need to safeguard a balance in the allocation of taxing rights between the member states.”<sup>46</sup> Indeed, afterwards in *Oy AA*, whilst assessing the latter justification and the justification of prevention of the risk of tax avoidance (ie “income trafficking”), the Court accepted that ‘even if the legislation at issue ... is not specifically designed to exclude ... purely artificial arrangements’ ... ‘such legislation may nevertheless be regarded as proportionate to the objectives pursued, taken as whole.’<sup>47</sup> Interestingly, this view of the concept of tax avoidance in the context of “symmetry” between the taxing rights of the Member States seems to resemble to the statement of the Court in *ICI* that, in that case, the setting up of an establishment did not

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<sup>45</sup> *Marks & Spencer*, paras 51 and 57. In *Marks & Spencer*, UK group relief was limited to losses of domestic subsidiaries. The Court accepted the three justifications put forward for the said restriction of the freedom of establishment, taken together: the danger that losses could be used twice, the risk of tax avoidance (ie “loss trafficking”) and the need to protect a balanced allocation of taxing rights. However, the Court held that, where the losses of those subsidiaries were terminal in the host State, it would be disproportionate for the UK to deny relief for those losses.

<sup>46</sup> Tom O’Shea, ‘ECJ Upholds Belgian Transfer Pricing Regime’ [2010] WTD 1.

<sup>47</sup> *Oy AA*, paras 65 and 66. In *Oy AA*, the restriction of the freedom of establishment stemmed from the limitation to domestic situations of the deductions of intra-group financial transfers provided for in the Finnish legislation.



“of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment.”<sup>48</sup>

As to the applicability of such justification in the CFC area, it must be noted that the Court observed in *Cadbury Schweppes* that the abusive conduct at issue was also capable of jeopardising the balance in the allocation of taxing rights. Thus, it seemed implicitly to accept that a justification on these grounds could also be suitable to counter the practices targeted by CFC legislation.

Whilst requiring that the justification of prevention of tax avoidance be taken together with the justification of the need to preserve a balanced allocation of taxing rights, the Court thus kept its consistency with the judgment in *Avoir Fiscal* where it had rejected any restriction of the freedom of establishment on grounds of the risk of tax avoidance<sup>49</sup>.

iii) Two different sets of justifications in the context of tax avoidance

In conclusion, it seems clear from the *SGI* decision that the Court accepts in the context of tax avoidance that a restriction be justified, either where it is specifically targeted at wholly artificial arrangements or, where that is not the case, by the objective of preventing tax avoidance taken together with that of preserving a balanced allocation of taxing rights<sup>50</sup>.

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<sup>48</sup> *ICI*, para. 26.

<sup>49</sup> See, *Avoir Fiscal*, para 25, and *ICI* para 26.

<sup>50</sup> See, Tom O'Shea (n 46).

Furthermore, in light of all the above said, it seems that the fundamental difference between those two sets of justifications lies on the fact that, whereas the latter takes into account fiscal concerns, the former constitutes, in essence, a prohibition of abuse of EU law. Therefore, in light of the broad scope of the fundamental freedoms, the Court adopts a narrow approach in dealing with the latter type of justification<sup>51</sup>. Conversely, the scope of the justification of the prevention of tax avoidance seems to be wider, being the Court satisfied to accept its application where there is a “risk” of tax avoidance (ie even where the freedoms are genuinely exercised). Thus, the latter justification should not be overlooked by the Member States.

### **C) Abuse, treaty entitlement and justification**

In contrast with the approach adopted in the AG Léger’s Opinion – which dealt with the issue of abuse for the purposes of ascertaining treaty entitlement - the Court in *Cadbury Schweppes* left the main part of the analysis of abuse to the moment of assessment of the justification. Although in its case law it distinguishes the question whether EU law is engaged from the question whether there can be said to be abuse<sup>52</sup>, in this case the Court did not draw a clear line between these two issues. Indeed, where the economic activity of the taxpayer lacks sufficient substance to be deemed as a genuine exercise of a freedom of movement, the Court may conclude that the taxpayer should not be entitled

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<sup>51</sup> Tridimas Takis, 'Abuse of Right in EU Law: Some Reflections with particular Reference to Financial Law' in *Queen Mary University of London, School of Law Legal Studies Research Paper No. 27/2009* (London, 2009), p 13. See Luc de Broe (n 36), p 766.

<sup>52</sup> In *Ninni-Orasche* (para 31), for example, the Court made this distinction by stating that the abuse of EU law ‘presupposes that the person concerned falls within the scope “ratione personae” of that Treaty’. See also, *inter alia*, *TV10*, and *Centros*, para 18.

to rely on such a freedom either on grounds of lack of treaty entitlement<sup>53</sup> or on grounds of the justification of prevention of abusive practices.<sup>54</sup> Whilst dealing with the issue at stake under the heading of abuse and at the level of the justification, the Court refrained from assessing it from a simplistic “all or nothing” standpoint (whereby, if successful, the freedom at stake would be simply set aside) and rather adopted the “Gebhard formula” as an instrument which allows it ‘to evaluate legislation which, like the curate’s egg, is only bad in part’<sup>55</sup>. Indeed, this seems to be a trend of the Court’s judgements in the area of abuse, at least, since the judgements in *Centros* and *Inspire Art*<sup>56</sup>.

### **3.2. Restriction of the freedom of establishment**

The Court reiterated in the case law on CFCs that the origin States are also obliged to eliminate any restrictions on the freedom of establishment on their ‘nationals or of a company incorporated under its legislation.’<sup>57</sup> Moreover, it confirmed in *Cadbury Schweppes* that comparability in origin State situations is assessed between a resident exercising a freedom of movement and a resident pursuing an equivalent action domestically.

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<sup>53</sup> The Court adopted this approach in its less recent case law, for instance, in *Gullung* where a “U-turn” had been created by a French national in order to avoid the prohibition to register as a lawyer in France. The Court held that the French rules should be interpreted as meaning that its provisions could not be relied upon in the case of an artificial arrangement.

<sup>54</sup> Concurring: Denis Weber, *Tax Avoidance and the EC Treaty Freedoms - A Study of the Limitations under European Law to the Prevention of Tax Avoidance* (Kluwer Law International, Amsterdam, 2005), 12.

<sup>55</sup> Vanessa Edwards and Paul Farmer, “The concept of abuse in the freedom of establishment of companies: a case of double standards?” in Anthnoy Arnall at al (eds), *Continuity and change in EU law - Essays in honour of Sir Francis Jacobs* (Oxford University Press, Oxford, 2008), 215.

<sup>56</sup> As noted in AG Geelhoed’s Opinion in *Akrich* para 105.

<sup>57</sup> *Cadbury Schweppes*, para 42 and *Columbus Container*, para 33.

Following the AG's Opinion in *Cadbury Schweppes*,<sup>58</sup> the Court not only compared a UK resident parent company setting up a CFC subject to low taxation with a UK resident parent company setting up an establishment of a controlled company in the UK but also equated the latter situation to the establishment by a UK resident parent company of a CFC in a State in which it is not subject to a lower level of taxation, since in the latter situation the UK's CFC rules did also not apply<sup>59</sup>.

This reasoning of the Court was neither confirmed nor rejected<sup>60</sup> in *Columbus Container* since - in contrast with the contention of the taxpayers and the AG Mengozzi's Opinion -<sup>61</sup>, the Court did not answer that argument in light of *Cadbury Schweppes* but rather from the standpoint of *Kerckhaert-Morres*.

### 3.3. Wholly artificial arrangements

#### A) Objective test

Whilst referring in *Cadbury Schweppes* to 'wholly artificial arrangements which do not reflect economic reality' the Court stressed the objective limb of the two-pronged abuse test set out in *Emsland-Starke*, according to which an abusive practice can only exist if it is

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<sup>58</sup> See AG Léger Opinion in *Cadbury Schweppes* paras 78 – 83.

<sup>59</sup> Tom O'Shea, 'The UK's CFC rules and the freedom of establishment: Cadbury Schweppes plc and its IFSC subsidiaries - tax avoidance or tax mitigation?' (2007) 16 EC T.R. 1, 13, p 29 and Luc de Broe (n 36), p 981.

<sup>60</sup> Differently, Chris Morgan and Jonathan Bridges, 'Columbus Container' (2008) 1 Tax Journal 918.

<sup>61</sup> AG Mengozzi's Opinion, para 133.

found ‘a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purpose of those rules has not been achieved.’<sup>62</sup> Indeed, as held in *Centros* (see above, 3.1. A), i)), an abusive practice consists of the object and purpose of the EU law provision at stake not being fulfilled by the action of the economic operator. On the other hand, the Court does not accept a restriction of the freedom of establishment where the objectives and purpose thereof may be fulfilled. Therefore, it requires that the “specific objective” of the national provision to exclude (only) the cases where the incorporation does not correspond to an “actual establishment” intended to carry on “genuine economic activities”. In *de Lasteyrie*<sup>63</sup>, for example, the Court held that the French exit tax rule constituted a disproportionate restriction of the right of establishment since it encompassed all French shareholders regardless of whether they sold their shares while being outside France<sup>64</sup>. Likewise, in *Cadbury Schweppes* it seemed to diverge from the AG’s Opinion, which accepted the use of a presumption of tax avoidance targeting services such as those of raising and providing finance, merely on the grounds of the risk of existing no real substance in the host State<sup>65</sup>. With effect, as held in *X and Y* the Court only accepts the prevention of wholly artificial arrangements, case by case, and ‘on the basis of objective evidence of abuse or fraudulent conduct on the part of the persons concerned.’<sup>66</sup>

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<sup>62</sup> *Emsland-Starke*, paras 52-53. See also *Halifax*, paras 74-75.

<sup>63</sup> The case concerned a French national who established himself in Belgium. As he was a substantial shareholder in French companies, France levied its exit taxation on migrating substantial shareholders on grounds of prevention of avoidance of capital gains tax.

<sup>64</sup> *De Lasteyrie*, para 54.

<sup>65</sup> AG Léger Opinion in *Cadbury Schweppes*, paras 134 to 140.

<sup>66</sup> *X and Y*, paras 42 - 43.

As to the criteria for finding an “actual establishment” and the pursuit of a “genuine economic activity”, the Court also required in *Cadbury Schweppes* a much higher level of artificiality than in the AG’s Opinion. Indeed, it did not address the test of genuine nature of the services provided by the CFC (which asks whether the subsidiary has enough control and competence to take decisions) and the test of the value added by the subsidiary’s activity - both set out in the AG’s Opinion. Rather, whilst referring to “letterbox” or “front” subsidiaries, the Court required the presence of objective factors, which 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. As noted in *Eurofoods IFSC*, ‘that objectivity and that possibility of ascertainment by third parties are necessary in order to ensure legal certainty and foreseeability’<sup>67</sup>, which, in their turn, constitute general principles of EU law.

Although it is not clear the reason why the Court did not mention the other two tests set out in the AG’s Opinion, there seems to be a difference between the nature of these tests and the nature of the CFC rules. Indeed, whereas the latter incorporate an all-or-nothing approach (whereby, where the CFC rules apply, all the profits are attributed to the shareholders), the former incorporate a transfer pricing assessment that proportionately tackle arrangements not fulfilling the arm’s length test but which may nevertheless have economic substance (ie partial rather than wholly artificial arrangements). It is thus doubtful whether these tests could be considered proportionate in this case since the CFC legislation in *Cadbury Schweppes* did not limit the taxation to the artificial part of the arrangement but, rather, it (“wholly”) encompassed all the profits of the CFC.

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<sup>67</sup> *Eurofoods IFSC*, para 33.

## B) Subjective test

The Court did not give much guidance in *Cadbury Schweppes* as to the manner how Member States should determine the subjective element. One of the reasons that might explain this is that, as submitted below, the subjective element may be superfluous or at least residual *vis-à-vis* the objective element.

The Court defined the subjective element in *Emsland-Starke* as an ‘intention to obtain an advantage from the Community rules *by* creating artificially the conditions laid down for it’<sup>68</sup>. Hence, ‘the Court links this subjective test to the finding that the situation giving rise to the application of a Community rule was purely artificial’<sup>69</sup>. Therefore, it requires a determination of the purpose of the arrangement – rather than of the motives of the parties – which is to be inferred from the artificiality thereof.

Indeed, in *Veronica* and in *TV10*, the Court implicitly accepted that the objective circumstances put before him were enough to find that ‘the broadcasting body was established there in order to enable it to avoid the rules which would be applicable to it if it were established within the first State’<sup>70</sup>. Also, in *Vonk* and in *Emsland-Starke*, the Court noted that the intention to abuse EU law could be established, in those cases, by evidence ‘that there was collusion between that exporter and the importer of the goods into the non-member country’<sup>71</sup>. This also seems to be in line with *Halifax* where the

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<sup>68</sup> *Emsland-Starke*, para 53.

<sup>69</sup> Luc De Broe (n 36), p 767.

<sup>70</sup> *TV 10*, para 26.

<sup>71</sup> *Emsland-Starke*, para 59 and *Vonk*, para 33.

Court found that the subjective test must ‘be apparent from a number of objective factors’<sup>72</sup>.

Nevertheless, it must be pointed out that in *Emsland-Starke* the Court required a ‘combination of objective circumstances’ and therefore, arguably, the mere existence of a legal, personal or economic relation should not in itself be enough to demonstrate an intention of abuse. In particular, ‘a party’s subjective intention of avoidance cannot be inferred from circumstances over which the party has no direct control’<sup>73</sup>.

To sum up, it seems that the intentions should be inferred from an objective assessment since ‘form reveals purpose’<sup>74</sup>. In any case, it must be borne in mind that the objective and subjective elements serve different purposes. Whereas the former pertain to the scope of the EU right being exercised, and is therefore for the CJEU to ascertain, the latter pertains to the intentions inherent in the conduct of the taxpayer, which is a matter for the national courts.

### **C) Onus of proof**

The Court did not seem to provide express guidance in *Cadbury Schweppes* regarding the burden of proof. Indeed, the statement referred in para 70 thereof<sup>75</sup> does not seem to

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<sup>72</sup> *Halifax*, para 75.

<sup>73</sup> Dennis Weber, (n 54), 191.

<sup>74</sup> Graemer Cooper, ‘International experience with general anti-avoidance rules’ (2001) 54 *Southern Methodist University Law Review* 83, 100.

<sup>75</sup> See above, n. 14.



impose the burden of proof upon the taxpayer<sup>76</sup>. Rather, as explained above in 2.2., concerning *CFC GLO*, the Court only confirmed that compliance requirements could be laid upon the taxpayers and that the tax authorities are required to show, in light of the evidence provided thereby, that the CFC does not have ‘economic reality’. This is fully consistent with the decision in *Cadbury Schweppes* where the Court held that there must be objective circumstances showing that the objective of the freedom of establishment has not been achieved. Thereafter, where the tax authorities succeed to prove these objective circumstances, the taxpayer must have the opportunity to prove that the CFC is actually established and that its activities are genuine.

Indeed, it seems to follow from the parallel drawn by the Court in *CFC GLO vis-à-vis Thin Cap*<sup>77</sup> that CFC legislation can only be justified if targeted at objective and verifiable elements showing that there is a wholly artificial arrangement that does not reflect economic reality. Like the arm’s length test in *Thin Cap*, these objective and verifiable elements do not seem to constitute definitive evidence but rather targeted presumptions<sup>78</sup> which, ‘on each occasion on which the existence of such an arrangement cannot be ruled out’, the taxpayer should be given the opportunity to rebut.

To sum up, and in accordance with the procedural rules of most – if not all – Member States<sup>79</sup>, the burden of proof of the fulfilment of the “economic reality test” seems to fall

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<sup>76</sup> Differently, Gerard T. Meussen, ‘Cadbury Schweppes: The ECJ Significantly Limits the Application of CFC Rules in the Member States’ (2007) ET, 17 and Anna B. Scapa Passalacqua and Lars A. Henie ‘The Norwegian CFC rules after the Cadbury Schweppes case’ (2008) 36 Intertax 8/9, 381.

<sup>77</sup> See above, 2.2..

<sup>78</sup> Concurring: Luc de Broe (n 36), 912, and Dennis Weber (n 46), 216 and 230. However, no conclusive view was set out by these authors as to what should be the objective criteria triggering the presumption.

<sup>79</sup> A conflict with procedural rules of the Member States would breach the EU principles of institutional and procedural autonomy of national courts set forth in *Reve*.

upon the tax authorities. On the other hand, such test seems to constitute a targeted presumption which must be able to be rebutted by the taxpayer.

## 4. Compatibility of the Portuguese CFC rules with EU Law

### 4.1. The Portuguese CFC regime

#### A) Overview

The Portuguese CFC legislation entered into force in 19 February 1995<sup>80</sup> with the purpose of preventing tax avoidance through the dislocation of the residence connecting factor and thereby diversion and deferral of passive or other base company income in low-tax countries via the setting-up of base companies therein<sup>81</sup>. It consists of attributing (undistributed) CFC profits to Portuguese residents in the proportion of their shareholdings.

#### B) First and second conditions: control and low-taxation

Under paragraph 1 of article 66 of the CIRC, resident shareholders are subject to CFC rules if:

- they own directly or indirectly (i) 25 per cent or, (ii) where more than 50 per cent of the capital is held by Portuguese residents, 10 per cent, of the capital

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<sup>80</sup> Introduced by Decree-Law no. 37/95, of 14 February.

<sup>81</sup> Francisco da Câmara, 'Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends - National Report (Portugal)' (2001) *Cahiers de Droit Fiscal International LXXXVI* (b), 777.

- of a non-resident company located in a country where it is subject to a ‘clearly more favourable regime’. The latter concept is defined (i) as a territory included in the Black List approved by Ministerial Order<sup>82</sup> or (ii) where the CFC is not taxed under income tax or (iii) where – and if - the tax effectively paid is less than or equal to 60 per cent of corporate income tax that would be due if the CFC was Portuguese resident.

### **C) Third condition: passive income and activity (“exclusion”)**

The Portuguese CFC regime only foresees an “exempt activities” exclusion. According to paragraph 4 of article 66 of the CIRC, it does not apply where, simultaneously:

- a) At least 75 per cent of the CFCs’ profits arise from an agricultural or industrial activity in the territory where it is situated, or from a commercial activity that does not have Portuguese residents as counterparties, or, having them, is directed predominantly to the market of the territory where it is situated;
- b) The CFCs’ main activity does not include:
  - (i) Banking activities;
  - (ii) Insurance activities, the income of which is derived primarily from insurance of property located outside the CFC’s territory of residence or related to persons not residing in that territory.
  - (iii) Transactions in shares or securities, intellectual property rights, provision of know how or technical assistance; and

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<sup>82</sup> Ministerial Order no. 150/2004, of February 13.

- (iv) Rental of assets other than immovable property situated in the CFC's territory of residence.

Thus, the Portuguese CFC legislation provides for one exclusion (sub-paragraph a)), on the basis of the type of income derived by the CFC. The said exclusion is, however, inapplicable (sub-paragraph b)) where the CFC engages in certain types of - passive - businesses. The motive of the shareholder in establishing the CFC is irrelevant (ie there is no “motive test” exclusion).

## **4.2. Testing the Portuguese CFC rules against EU Law**

### **A) Which freedom?**

The Portuguese CFC rules are intended to encompass shareholders which individually or jointly have a ‘definite influence on the CFC’s decisions and therefore, in principle, fall under the scope of the freedom of establishment’<sup>83</sup>. Nevertheless, they are also likely to apply to situations where there is no ‘definite influence’ over the CFCs’ decisions since, arguably, that is not necessarily the case where a shareholder has, for example, 25 per cent or 10 per cent (where more than 50 per cent of the capital is held by Portuguese residents) of the capital. Thus, where a ‘definite influence’ by a particular shareholder

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<sup>83</sup> See, *Cadbury Schweppes*, para 31, and *Baars*, para 22.

cannot be found, freedom of capital applies<sup>84 85</sup>. Thus, pursuant to article 63 TFEU, the Portuguese legislation may also apply to situations involving third countries.<sup>86</sup>

## **B) Restriction of the Freedom of Establishment**

The Portuguese rules treat differently residents incorporating CFCs in a State with a clearly more favourable regime *vis-à-vis* residents incorporating controlled companies in the Portuguese territory or in a State without such regime since only the former are taxed on the profits of another legal person. This difference in treatment is even more apparent if an incorporation of a subsidiary in the Madeira Free Zone - where, despite the favourable tax regime, CFC rules do not apply - is taken into account.

Thus, the difference in treatment and the disadvantage entailed in the Portuguese CFC rules hinders the exercise of the freedom of establishment and therefore, constitutes a restriction thereof.

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<sup>84</sup> The Portuguese rules entered into force in July 14, 1995. Hence, the standstill clause of article 58 of the Treaty does not apply.

<sup>85</sup> See, *CFC GLO*, para 46.

<sup>86</sup> Since this dissertation focuses only on the freedom of establishment, the assessment of the Portuguese CFC rules against the freedom of capital will not be made hereinafter.

### **C) Justification on the grounds of prevention of abusive practices**

#### **i) Admissibility of the justification**

The Portuguese CFC rules are suitable to achieve the objective they pursue as they provide for the inclusion of the profits of a CFC in the tax base of the resident company and therefore they can frustrate abusive practices with the sole purpose to escape tax due on activities carried out in that territory.

#### **ii) Proportionality**

As to the question whether the CFC rules go beyond what is necessary to achieve its purpose, it should be recalled that CFC taxation must be excluded where - under both the objective and subjective tests referred above - a wholly artificial arrangement not reflecting economic reality is not found in the particular case. The Portuguese CFC rules do not foresee objective factors ascertainable by third parties with regard to the extent to which the CFC physically exists in terms of premises, staff and equipment. Therefore, taxation is not excluded in all cases where the incorporation corresponds with an actual establishment intended to carry on genuine economic activities. Regarding the subjective test, the Portuguese CFC rules do not give any relevance to the motives of the taxpayers.

It is therefore apparent therefore that there is a conflict between the freedom of establishment and the wording of the Portuguese CFC rules. Since, in contrast with the rules under scrutiny in *Cadbury Schweppes*, the Portuguese CFC legislation does not

provide for a “motive test”. The key question is thus whether the “exempt activities” exclusion can lend itself to an interpretation whereby CFC taxation is restricted to wholly artificial arrangements without economic reality.

### 4.3. Conforming interpretation

#### A) The concept

Despite the existence of a conflict between the Portuguese CFC legislation and EU law, national judges are required by virtue of article 10 TEU to, as far as possible, conform national law through legal interpretation in order to achieve the result envisaged by EU law.

The content of the principle of conforming interpretation, described simplistically above, was jointly set out in *Von Colson*<sup>87</sup>, *Marleasing*<sup>88</sup> and *Murphy*. The first two cases concerned to Directives, which, under the respective facts, could not be enforced in judicial proceedings (ie did not have “direct effect”) and therefore the said principle was used in order to bestow “indirect effect” upon these Directives. In contrast, the *Murphy* case concerned to the application of article 141 of the EC Treaty, which, like the freedom of establishment in *Cadbury Schweppes*, has vertical and horizontal direct effect. It follows that, the resort to conforming interpretation in *Murphy* - and, likewise, in *Vodafone 2* - was intended to abide by the principle of proportionality since it is less burdensome for both

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<sup>87</sup> See, *Von Colson*, para 26.

<sup>88</sup> See, *Marleasing*, paras 8 and 9.



the national and the EU legal systems than the residual solution of simply not applying the national rule. In fact, in light of the submission made above in 3.1., A), that the case law of the CJEU has confirmed the existence of a (directly applicable) general EU principle of prohibition of abuse, the solution of simply not applying the CFC rules not only goes beyond the command provided by the freedom of establishment but also frustrates the effectiveness of the said principle. In any case, the application of the principle of conforming interpretation does not, in this context, create any obligations for the taxpayers but it rather constitutes a proportionate reduction of the scope of CFC rules in light of the freedom of establishment.

According to settled case law, the “inherent limits” of the principle of conforming interpretation are essentially (i) the prohibition of creating obligations for individuals or determine or aggravate the liability in criminal law<sup>89</sup>, (ii) the general principles of law, particularly those of legal certainty and non-retroactivity, and (iii) that it ‘cannot serve as the basis for an interpretation of national law *contra legem*.’<sup>90</sup> This also seems to be the view of the Portuguese Supreme Court of Justice<sup>91</sup>, which has stated that the national courts are bound by the obligation of conforming interpretation unless it constitutes *contra legem* interpretation. Nevertheless, some scholars consider that conforming interpretation can only be carried out where the national rule is ambiguous or leaves some discretion as to its interpretation<sup>92</sup>. Even if this view were to be upheld, it is submitted that the Portuguese CFC rules leave in fact some margin of discretion as regards to their interpretation and application. Firstly, as noted in the Preamble of the

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<sup>89</sup> See *Arcaro*, paras 41 and 42 and *Kofoed*, para 45.

<sup>90</sup> See, *Kolpinghuis Nijmegen*, para 13 and *Adeneler and Others*, para 110.

<sup>91</sup> *Inter alia*, judgement of the Portuguese Supreme Court of Justice, Proc. no. 03S2467, of 26 February, 2003.

<sup>92</sup> Tridimas Takis, 'Horizontal effect of Directives: a missed opportunity' (1994) 19 E.L. Rev. 6, 621.

Decree-Law which introduced these rules, their rationale is based on ‘the *presumably* instrumental nature’ of the CFCs. It follows that, pursuant to article 73 of the Portuguese General Tax Law, taxpayers must always have the opportunity to rebut a rule with a presumptive nature (of tax avoidance), even if the objective factors set forth in the CFC provision are verified. Secondly, it stems from its nature of anti-avoidance rule that its interpretation must take into account the purpose thereof since its rationale is foremost to prevent tax avoidance rather than to extend taxation to the factual situations described therein. This teleological approach in the interpretation of anti-avoidance rules has in fact been adopted by the Portuguese tax administration in several instances, for instance, regarding - the now amended - number 8 of article 47 of CIRC, which denied the carry-over of losses where there was a change in the ownership of more than 50 per cent of the share capital of a loss making company in order to avoid the indirect purchase of tax losses. According to the Portuguese tax administration<sup>93</sup>, having in mind the anti-avoidance purpose of the said provision, it should not be applicable where despite the verification of the circumstances foreseen therein there is only an indirect change of ownership of the loss making company (eg the acquired company remains in the same economic group) since in such a case a tax avoidance conduct can be excluded.

In any case, the fact that the Portuguese Supreme Court has set the bar up to the level of the interpretation *contra legem* shows that the principle of conforming interpretation has a ‘broad and far-reaching nature.’<sup>94</sup> Indeed, whereas the national rules at issue in *von Colson* and in *Murphy* implemented and executed the invoked EU provision, in *Marleasing* the Court went further and required a conforming interpretation even in the absence of any link between the national provisions and the Directive. Thus, it suffices that the meaning

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<sup>93</sup> *Inter alia*, Administrative ruling by the State Secretary of Fiscal Affairs, Proc. no. 104/2006, 2008.01.04.

<sup>94</sup> *Vodafone 2*, para 37.

of the EU provision should ‘go with the grain of the legislation’ and be ‘compatible with the underlying thrust of the legislation being construed’<sup>95</sup>. As noted in *Kofoed*, whilst preserving the principle of legal certainty, the effectiveness of EU law can ‘be achieved through a general legal context’<sup>96</sup>. Therefore, the Court accepts that a national ‘provision or general principle prohibiting abuse of rights or other provisions on tax evasion or tax avoidance may be interpreted in accordance with’<sup>97</sup> a Directive, namely, where the latter reflects the general EU principle that abuse of rights is prohibited.

### **B) Interpretative methods recognised in the Portuguese legal system**

As to the question whether the Portuguese legal system grants interpretative powers, which may allow national judges to interpret the CFC rules in accordance with EU law, it suffices to note that article 9 of the Portuguese Civil Code allows for the use of both subjective and objective elements of interpretation. As regards the subjective elements, it seems to be accepted<sup>98</sup> that, first, the thinking of the legislator can be resorted to the rationale of the law as long as there is a minimum of accordance with the wording thereof - in other words, teleological interpretation is accepted. Second, the meaning of the law in principle matches with the thinking of the legislator where the latter is clearly expressed in secondary legislative materials (such as the Preamble).

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<sup>95</sup> *Ibid*, para 38.

<sup>96</sup> *Kofoed*, para 44.

<sup>97</sup> *Ibid*, para 46.

<sup>98</sup> Pires de Lima and Antunes Varela, *Código Civil Anotado* (vol I, fourth edn, Coimbra Editora, 1987), 58.

**C) Can the Portuguese courts assess the possibility of conforming interpretation  
in light of the “exempt activities” exclusion?**

It seems that the fact that the Court in *Cadbury Schweppes* only referred to the “motive test” for purposes of interpretation by national courts in conformity with the respective ruling stemmed from the contention by HMRC before the referring court that proportionality could be achieved through the “motive test.” Arguably, it follows that the Court did not intend to limit conforming interpretation exclusively to the “motive test”. As held by the Court of Appeal in *Vodafone 2*, the UK’s CFC rules could be interpreted in the light of ‘the whole of the national law’<sup>99</sup> since what is at issue is ‘the application of interpretative methods recognised by national law’<sup>100</sup>, which is a competence that remains outside the jurisdiction of the CJEU. As observed in *Pfeiffer*, the principle of conforming interpretation ‘requires the referring court to do whatever lies within its jurisdiction, having regard to the whole body of rules of national law’<sup>101</sup>, to ensure that EU law is fully effective. In light of the above, the Portuguese national courts may and shall take the “exempt activities” exclusion - as well as the whole of the national law - into account whilst interpreting the CFC rules in conformity with EU law.

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<sup>99</sup> *Vodafone 2*, para 34.

<sup>100</sup> *Pfeiffer*, para 116.

<sup>101</sup> *Ibid*, para 118. See also, *Pupino*, para 47 and *Kofoed*, para. 44.

## **D) The purpose of the Portuguese CFC rules in light of the “exempt activities” exclusion**

As stated by Brian Arnold, ‘the exemption for CFCs engaged in active business (...) is one of the major factors that affects the scope of application of a country’s CFC rules and (...) reflects, in a fundamental sense, the policy of a country’s CFC rules.’<sup>102</sup>

The rationale of this exclusion stems from the fact that tax deferral should be preserved where resident taxpayers pursue a genuine business activity in the territory of another State<sup>103</sup> in order for CFC regimes not to adversely affect the international competitiveness of businesses. In this context, the criteria relied upon for the limitation of the scope of CFC rules concerns to the distinction between income that does not presuppose a functional organisation of assets and staff (passive income) and income derived from a genuine business activity carried on by the CFC (active income)<sup>104</sup>. Arguably, such a distinction stems mainly from the (broad) presumption that passive business income derived from and passive activities carried on in a low-tax country by a CFC indicate the existence of an artificial arrangement. As noted above in 4.3., A), in

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<sup>102</sup> Brian J. Arnold and Patrick Dibout, ‘Limits on the Use of Low Tax Regimes by Multinational Business: Current Measures and Emerging Trends - General Report’ (2001) 86 Cahiers de Droit Fiscal International b, p 59.

<sup>103</sup> See, OECD, *Controlled Foreign Company Legislation* (Paris, 1996), p 72, according to which, the “exempt activities” exclusion rests on the basis that ‘there is justification for exempting CFCs which engage in genuine business activities and have a substantial presence in the target territory’. Concurring: Brian J. Arnold and Patrick Dibout (n 102), p 40 and Rui Duarte Morais, *Imputação de Lucros de Sociedades Não Residentes Sujeitas a um Regime Fiscal Privilegiado* (Universidade Católica, Porto, 2005), p 367.

<sup>104</sup> International Fiscal Association, ‘Taxation of Domestic Shareholders on Undistributed Income of Foreign Affiliates: Objectives, Techniques and Consequences’ (1987) 11 Cahiers de Droit Fiscal International - Congress Seminar Series a, p 16.

Portugal this presumptive nature of the CFC rules seems to be confirmed in the Preamble of the respective Decree-Law.

In light of the above, it is submitted that the “exempt activities” exclusion shows that the difference between the requirements outlined in *Cadbury Schweppes* and the Portuguese CFC legislation is more a question of degree than of policy since, in essence, the purpose of both is to exclude from taxation CFCs reflecting economic reality. Thus, the difference lies on the fact that, whereas the former requires a case-by-case assessment, the latter resorts to a presumption of artificiality of the CFC where passive income or activities are derived or carried on. In fact, whilst addressing the “exempt activities” exclusion, the Court observed in *Cadbury Schweppes* that ‘the performance by the CFC of trading activities excludes, for its part, the existence of an artificial arrangement which has no real economic link with the host Member State’.

#### **4.4. Solutions for drafting CFC legislation in line with EU Law**

The *Cadbury Schweppes*’ decision entails important consequences for the CFC legislations of the Member States. In particular, the formal nature of the “economic reality test” set forth therein creates considerable opportunities for abusive tax avoidance in particular through the transfer of mobile assets to or rendering of services under cover of a base company in a low-tax country. As a result, high-tax Member States may be obliged to either raise their effective tax rates on other taxpayers or on non-mobile income or reduce their government spending. Furthermore, such consequences also jeopardize the ultimate economic and social aims of the EU set forth in article 2 TEU, which underpin the establishment of the Common Market. Such consequences ensue from the fact that,

as explained above in 3.1., B), i), the justification of prevention of abusive practices does not address the issue of tax avoidance as such but solely the issue of abuse of EU law.

In this context, the justification on grounds of tax avoidance (taken together with the need to prevent a balanced allocation of taxing rights) set forth in *SGI* should not be overlooked by the Member States, namely since it has a wider scope than the justification dealt with in *Cadbury Schweppes*<sup>105</sup>. Therefore, it is submitted that Member States – namely, Portugal – should not be satisfied in merely amending their CFC legislations in order to simply limit its scope to wholly artificial arrangements without economic reality<sup>106</sup> but should rather find a way to reform it in such a way as to tackle effectively tax avoidance whilst complying with EU law. Therefore, some proposals will be briefly outlined below.

#### **A) Extension of the piercing of the veil approach<sup>107</sup>**

The *Columbus Container* case demonstrates that a resident shareholder can be taxed on the profits of a CFC on an arising basis without entailing different treatment as long as both domestic and foreign subsidiaries are treated as fiscally transparent. In such a case, it must be borne in mind that equal treatment would only be ensured if fiscal transparency

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<sup>105</sup> See above in 3.1. B), iii).

<sup>106</sup> Compare with Communication on the application of anti-abuse measures in the area of direct taxation - within the EU and in relation to third countries (COM(2007) 785 final) and Guglielmo Maisto and Pasquale Pistone, 'A European Model for Member States' Legislation on the Taxation of Controlled Foreign Subsidiaries (CFCs) – Part 1' (2008) ET 10, p 510 (s.d.) where the idea of developing an EU Model or establishing common definitions focusing on abuse and wholly artificial arrangements is supported.

<sup>107</sup> This proposal, and the detailed aspects thereof, are formulated in Alexander Rust, 'CFC Legislation and EC Law' (2008) 36 Intertax 11, 492.

were also attributed to subsidiaries resident in all Member States and – where freedom of capital is engaged – in third countries. On the other hand, Capital Export Neutrality can be achieved by providing for an ordinary tax credit for the domestic and foreign corporate income taxes levied upon the domestic or foreign subsidiaries. As long as the credit method is applicable equally to all Member States, there is no different treatment. In such a case, any disadvantages arising from the differences in the tax rates of the Member States constitute merely a disparity and are therefore not in breach of EU law<sup>108</sup>.

**B) Justification on grounds of tax avoidance taken together  
with the justification of preserving a balanced allocation of taxing rights**

As noted above, the Court highlighted in *Cadbury Schweppes* that the type of conduct targeted by CFC rules also undermines the balance in allocation of taxing rights of the Member States.

Additionally, it confirmed in *SGI* that legislation not specifically related to wholly artificial arrangements can still be justified by the need to prevent tax avoidance, taken together with the preservation of a balanced allocation of taxing rights. Indeed, the thin capitalisation cases constitute a good illustration for the purposes of drafting anti-abuse legislation in such a way as to be encompassed by the aforementioned justification.

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<sup>108</sup> Differently, Alexander Rust (n 101), p 499 who holds the view that ‘the credit entitlement depends on the amount of taxes paid by the controlled companies. This differential treatment is justified by the need to preserve the cohesion of the tax system.’



In this regard, it must be noted, firstly, that there are fundamental distinctions between the manner how thin capitalisation and CFC legislation have been traditionally drafted, due to which the Court could not have applied the reasoning held in *SGI* to the CFC legislation at issue in *Cadbury Schweppes*. With effect, on the one hand, the use of the arm's length test in the thin capitalisation legislation constitutes an objective element which allows to ascertain whether the transaction in question represents 'in whole or in part, a purely artificial arrangement', and, consequently, to disregard only the artificial part of the arrangement (ie the part exceeding the arm's length value). In contrast, like in *Cadbury Schweppes*, the Portuguese CFC legislation adopts an all-or-nothing approach whereby the establishment is fully disregarded, regardless of the extent of the degree of economic substance thereof. Therefore, the Court requires the existence of a "wholly" artificial arrangement.

Secondly, the Court has drawn a distinction between rules of the host state pertaining to access and rules pertaining to the exercise of an activity<sup>109</sup>. Namely, in *Centros*, the Court noted that 'the provisions of national law, application of which the parties concerned have sought to avoid, are rules governing the formation of companies and not rules concerning the carrying on of certain trades, professions or businesses.'<sup>110</sup> Nevertheless, the Court stressed that Denmark was not precluded "from adopting any appropriate measure for preventing or penalising fraud."<sup>111</sup>

Thus, it made it clear that, since "the right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the

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<sup>109</sup> See, Tridimas Takis (n 51), 14.

<sup>110</sup> *Centros*, para 26.

<sup>111</sup> *Centros*, para 38.

exercise, in a single market, of the freedom of establishment guaranteed by the Treaty”<sup>112</sup>, Member States could not impede nationals from acquiring, creating or maintaining an establishment in another Member State (ie prevent jurisdiction shopping) as long as there were genuine economic activities being carried on. Similarly to *Centros*, in *Cadbury Schweppes* also access rules were at stake since the CFC rules disregarded - for tax purposes - the creation of establishments in other Member States (preventing thereby tax jurisdiction shopping). Therefore, the Court held that there could be deemed to exist a wholly artificial arrangement only where the elements of the concept of establishment (ie an actual establishment intended to pursue genuine economic activities) did not exist.

It follows that, drafting anti-abuse legislation in the light of transfer pricing principles (namely, by allocating profits in accordance with the economic substance of an enterprise, as set out, for instance, in the Authorized OECD Approach) rather than simply disregarding the establishment of a CFC in another Member State could allow such legislation to be justified on the grounds of prevention of tax avoidance taken together with the need to preserve a balanced allocation of taxing rights, since:

- a) the right of the resident shareholder to acquiring, creating or maintaining a CFC would not be affected, and, therefore, anti-abuse rules could be justified regardless of the existence or not of a “wholly” artificial arrangement; and
- b) only the proportion of the profits accruing to the CFC in excess of its economic substance and genuineness of its services would be added to the resident shareholder (which would preserve proportionality).

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<sup>112</sup> *Centros*, para 27.

This approach somewhat resembles to that reflected in the UK's section 751A ICTA 1988, which, following the *Cadbury Schweppes* decision, was introduced to ensure compatibility with EU law. According thereto, the resident company may be entitled to reduce the chargeable profits of the CFC thereupon up to the extent of the "net economic value" of the latter, which, in its turn, is considered to being created by individuals working for the CFC. Nevertheless, a more perceived view of the benefits of a transfer pricing approach seems to be inherent in the latest discussions on the ongoing consultations on the proposed CFC improvements in the UK. Namely, as per the minutes of the working group meeting held in September 16, 2010<sup>113</sup>, the HMRC/HMT suggested, as regards the definition of commercial justification, that it 'should be based on what would have been the allocation of profits had the entities in question been unconnected and operating in a fully competitive environment.' Some Members also suggested that transfer pricing rules would ensure the appropriate allocation of profits between the UK and the CFC and therefore questioned why both transfer pricing and CFC rules were needed. In this regard, the HMRC/HMT - apparently addressing the issue of the transfer of highly-mobile income generating assets and finance services to low-tax States - restated their view that transfer pricing rules do not adequately protect the UK tax base in all circumstances. This approach is also somewhat implicit in the Council Resolution of 8 June 2010 on coordination of the CFC and thin capitalisation rules within the EU<sup>114</sup>, which provides a non-exhaustive list of indicators suggesting that profits may have been artificially diverted. Those indicators go beyond the guidance

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<sup>113</sup> HM Treasury, 'Minutes: CFC interim improvements working group meeting', 16 September 2010, <[http://www.hm-treasury.gov.uk/d/cfc\\_working\\_group\\_minutes\\_16092010.pdf](http://www.hm-treasury.gov.uk/d/cfc_working_group_minutes_16092010.pdf)> last accessed 10 November 2010.

<sup>114</sup> Council Resolution of 8 June 2010 on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union, 2010/C 156/01.

provided by the Court in *Cadbury Schweppes*<sup>115</sup> and include, namely, the cases where there are insufficiently valid economic or commercial reasons for the profit attribution. Apparently in the wake of the *SGI* decision, this Resolution also acknowledged the justification of the need to prevent tax avoidance taken together with the need to preserve a balanced allocation of taxing rights.

In light of the above, it is submitted that, provided that an all-or-nothing approach - whereby the CFC would be disregarded - is not adopted, it seems that anti-abuse rules targeting the use of base companies could be justified if operating on the basis of profit attribution according with the degree of economic substance of the CFC (which could vary between nil and 100 per cent). In this regard, the criteria set out in the OECD Report on the Attribution of Profits to Permanent Establishments<sup>116</sup> could constitute a starting point. This Report provides guidelines for a functional and factual analysis (ie a case-by-case approach) which, whilst identifying the economically significant activities and responsibilities undertaken by the foreign enterprise, allows to ascertain the functions, risks and economic ownership of assets and capital of that (hypothesised) distinct and separate enterprise. The said Report is drafted in such a way (ie supplementing article 9 of the OECD Model) as to solve the issues created by the absence of any legal transaction between different parts of a single entity<sup>117</sup>. Similarly, the purpose of anti-abuse rules targeting the use of base companies is to address artificial arrangements through which the legal ownership of assets, risks and capital is transferred

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<sup>115</sup> Tom O'Shea, 'Winds of Change on the EU Fiscal Coordination Front' [2010] 204-4 WTD 10 .

<sup>116</sup> OECD, 'Report on the Attribution of Profits to Permanent Establishments, Part I: General Considerations', (17 July 2008).

<sup>117</sup> Nevertheless, the criteria set out in the said Report has also been applied to cases involving separate entities. See, OECD, *Report on the Transfer Pricing aspects of business restructurings, Chapter IX of the Transfer Pricing Guidelines* (22 July 2010), para 9.19 *et seq.*

to the CFC whilst the economic ownership remains with or should be attributed to the resident shareholder. Thus, by attributing the risks, economic ownership of assets and an arm's length amount of interest funding (commensurate with those functions, assets and risks attributed) to the CFC in light of the criteria set out in the said Report, the profits of the CFC could be determined in accordance with the economic substance thereof. Moreover, the criteria provided by the said Report goes beyond the correction of a non-arm's length price in transactions between related parties and allows to prevent the erosion of the tax base of the origin State where highly-mobile income generating assets (eg IP and cash) and services are artificially transferred through legal conduits to a CFC.

### **C) Harmonisation of the concept of “tax avoidance” at EU level**

As noted above, the EU law general principle of prohibition of abuse ‘serves as a residual anti-evasion doctrine to ensure fulfilment of the purposes of<sup>118</sup> EU law. Therefore, its effect on the prevention of the circumvention of national law - in particular, as regards tax avoidance - remains limited. As a result, the final goal of the EU of establishing the Common Market to promote harmonious, balanced and sustainable social and economic development may not be fully achieved. Indeed, the achievement of an Internal Market through the abolition of obstacles to the freedom of movement constitutes a mean rather than an end in itself. Nevertheless, in the absence of harmonisation at EU level, the Court cannot allow any breach of the freedoms of movement even if that may jeopardise the said political objectives of the EU. Since they affect the establishment or functioning of the common market, one of the means that could be adopted in order to legitimise the fight by the States against tax avoidance beyond wholly artificial

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<sup>118</sup> Tridimas Takis (n 51), p 36.

arrangements without economic reality is the harmonisation at EU level of the concept of tax avoidance. In this regard, a prime example can be seen in the area of financial law, where the concept of abuse has acquired specific statutory meaning in the Directive 2003/6 on Market Abuse, which prohibits “market manipulation”. Indeed, enacting a Directive containing a prohibition of tax avoidance would make it less necessary for the Member States to rely on the general doctrine of abuse since the purpose would be to tackle practices that not only ostensibly constitute tax avoidance but also cases where there is likelihood of the existence of tax avoidance. As to the well-known resilience by Member States to transfer their tax competences to the EU, such a Directive could be drafted in such a way as to not precluding the Member States from choosing the means deemed convenient to tackle the abusive practices at stake. Lastly, the possibility of such a solution has been favoured by the adoption of the Lisbon Treaty in December 2009, which provides for an “enhanced cooperation” legislative procedure whereby it suffices the participation of nine Member States thus displacing the “veto” power of the Member States.

## 5. Conclusion

In spite of the evolution in the Court's case law in the area of tax avoidance, the discussion above has demonstrated that it seems possible to answer the questions raised in Chapter 1 whilst taking into account the whole body of case law.

### *Prohibition of abuse of EU law*

As shown above in 3.1., it seems apparent that there is a general EU principle of prohibition of abuse reflected in the Court's case law. First, such principle has been expressly recognised by the Court in *Kofoed*. Second, and most importantly, following the reasoning held namely in *Centros*, *Inspire Art* and *Paletta II*, the existence of such a principle is implicit in the *Cadbury Schweppes* decision. With effect, similarly to the approach seen in the anti-abuse doctrines adopted by the Member States (namely, in Portugal), the assessment of abuse – in particular, of the artificiality of the arrangement - by the Court consists in a comparison between the arrangement used by the taxpayer and the purpose and objectives of the allegedly abused provision. In this regard, as seen in *Cadbury Schweppes*, the abused provision taken into account by the Court is the EU law provision granting freedom of movement rights to the taxpayer rather than the national fiscal provision being circumvented. Thus, also materially, it is clear that the Court adopts an autonomous EU concept of abuse.

*Justification on grounds of abusive practices (wholly artificial arrangements)*

The confirmation of the existence of a general EU principle of prohibition of abuse thus triggers the question whether the aforementioned justification constitutes in essence a justification on grounds of tax avoidance as such (i.e. to prevent abuse of national fiscal provisions) or, rather, a justification in line with the said EU principle (ie to prevent abuse of EU law provisions). Despite the fact that in *ICI, X and Y* and in *de Lasteyrie* the Court dealt with the issue of abuse separately from the aforementioned justification, it has been explained above that as from *Cadbury Schweppes* onwards (including, namely, in *Thin Cap* and *CFC GLO*) the Court adopted a more perceived approach and intertwined such justification with the EU principle of abuse under the denomination of “prevention of abusive practices”. Indeed, in *Cadbury Schweppes* the Court stressed that, even where the set up of a CFC is solely motivated by tax considerations, a restriction of the freedom of establishment is only encompassed by the aforementioned justification to the extent that such freedom is not being actually and genuinely exercised. Thus, it is clear that the aforementioned justification focuses on the abuse of EU provisions rather than on tax avoidance as such (i.e. abuse of national fiscal provisions). Moreover, the above submission is also confirmed by the fact that the Court has shifted the analysis of abuse towards the context of justification, when, in fact, it could have dealt with it – as it had done, namely, in *Van Binsbergen* and in *Gullung* - as a Treaty entitlement issue. The conclusion that the aforementioned justification does not address, on a stand-alone basis, the issue of tax avoidance as such is consistent with the Court’s case law since *Avoir Fiscal* - as well as in *X and Y* and in *de Lasteyrie* - where the Court stressed that tax evasion could not justify any restriction of the fundamental freedoms. Likewise, it is also consistent with the Court’s case law in the non-tax area, namely, in *Centros*, *Inspire Art*, *Chen* and *Akrich*, where the Court confirmed that there is no abuse – and, therefore, a restriction



of the fundamental freedoms cannot be justified - where the rights provided by EU law are genuinely exercised.

*Justification on grounds of prevention of (the risk of) tax avoidance*

In light of the conclusions above that (i) there is a general EU principle of prohibition of abuse, (ii) the justification concerning anti-avoidance rules specifically targeted at wholly artificial arrangements is a corollary of such principle and (iii) the Court has not upheld any stand-alone justification on grounds of tax avoidance (as such), the question arises as to whether the Court accepts any justification involving tax avoidance as such.

As seen above in 3.1. B), *ii*), following the decisions in *Marks & Spencer* and in *Oy AA* the Court made it clear in its recent decision in *SJI* that national legislation not specifically designed to exclude wholly artificial arrangements could still be justified with the need to prevent tax avoidance, provided that it could be taken together with that of preserving the balanced allocation of the power to impose taxes between the Member States. The Court thus seems to accept two different sets of justifications in the context of tax avoidance. Therefore, Member States should not overlook the latter justification, since it seems to have a wider scope than the former.

### *Two-pronged abuse test*

The assessment of the two-pronged abuse test made above in 3.3. has also shown that, due to the high level of artificiality required by the Court in *Cadbury Schweppes*, the scope of the justification concerning measures specifically targeted at wholly artificial arrangements is rather narrow and may thus not be sufficient to prevent abusive tax avoidance. This is enhanced by the conclusion that the Court's judgement in *Cadbury Schweppes* did not seem to lay the burden of proof upon the taxpayer but, as demonstrated with *CFC GLO* and *Thin Cap*, it rather requires Member States to show that the CFC does not have "economic reality". As to the subjective test, it has been shown that it plays a residual role *vis-à-vis* the objective test since it is also based in objective circumstances.

### *Are Portuguese CFC rules compatible with EU Law?*

It is apparent that, at a first moment, there is a conflict between the freedom of establishment and the wording of the Portuguese CFC rules. Due to the similarity of the latter with the UK's CFC rules in *Cadbury Schweppes* it can be seen above in 4.2. that such conclusion was, for the most part, carved out from the said judgement. In particular, the Portuguese CFC rules do not foresee objective factors ascertainable by third parties with regard to the extent to which the CFC physically exists in terms of premises, staff and equipments. In contrast, however, they do not contain any "motive test".

Notwithstanding such conflict, like in *Vodafone 2*, it has been concluded above in 4.3. that the Portuguese CFC rules may be interpreted in conformity with the *Cadbury Schweppes*

decision. Similarly to the reasoning of the Court in its decision in *Murphy*, this ensures proportionality in the direct applicability of the freedom of establishment and, moreover, the effectiveness of the general EU principle of prohibition of abuse implicit in *Cadbury Schweppes* since, otherwise, the Portuguese CFC rules might have to be removed. The said conclusion follows, first, from the fact that, as is apparent in the Preamble that introduced the CFC rules, they have a presumptive and anti-avoidance nature. Second, and foremost, the “exempt activities” exclusion reflects, in a fundamental sense, that the policy of these rules is to exempt CFCs which engage in genuine business activities and have a substantial presence in the target territory. In other words, the purpose of these rules can be equated to the one in the *Cadbury Schweppes*’ decision. Third, the Portuguese Supreme Court seems to only refuse conforming interpretation where the result is *contra legem*.

#### *Solutions for drafting CFC rules compatible with EU Law*

It follows from the discussion in Chapter 3 that, since the justification set out by the Court in *Cadbury Schweppes* is aimed at tackling abuse of the freedom of establishment rather than preventing the circumvention of national tax rules, its scope in the context of national anti-abuse rules is narrow. As observed in Chapter 4, the design of CFC rules merely in light of the said judgement seems to create considerable opportunities for tax avoidance, which, jeopardizes the ultimate aims of the Common Market. Thus, three possible solutions for tackling tax avoidance through the use of base companies have been put forward.

As a concluding remark, it is submitted that resorting - under the justification on grounds of tax avoidance (taken together with the need to preserve a balanced allocation of taxing rights) set forth in *SGI* - to an economic allocation of profits under transfer pricing principles would perhaps constitute the best solution for a reform of the Portuguese CFC regime. This would safeguard several features which are desirable in a tax system. First, it would be proportionate, for only the artificial part of the profits would be encompassed. Second, it would protect horizontal fairness, in that it constitutes an effective anti-avoidance measure which, namely, tackles the transfer of income generating assets abroad. Lastly, it would not be dependent on the amendment of other fundamental features of the tax system nor on an agreement with the other Member States. Nevertheless, it is acknowledged that – just as with the current CFC rules – such a solution requires a sophistication of the means and personnel in the Portuguese tax administration.

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