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Substance over Form in the Case-Law of the ECJ

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I. INTRODUCTION

A. Importance of substance over form doctrine

The issue of how to fight against tax avoidance is probably the hottest topic in the international tax policy at the time of writing this thesis. Recently, the worldwide known media and certain NGOs brought into the spotlight that MNEs, such as Google, Starbucks, Amazon, Apple, Vodafone etc., are paying small and 'unfair' amount of taxes due to profit shifting to the low tax countries.¹ For instance, BBC News announced that Google paid only £10m in UK corporate taxes on revenues of £11.9bn between 2006 and 2011.² Also, the IMF Coordinated Direct Investment Survey in 2010 provided very interesting data which showed that Barbados, Bermuda and the British Virgin Islands received and invest more into the world than Germany.³ It means that tax havens receive a huge amount of money. It is no wonder that, according to the Tax Justice Network, as much as \$123 trillion could be held in tax havens by various taxpayers worldwide.⁴ Those enormous amounts of money led to a very broad concern about how to tackle tax avoidance. Taking into consideration that it is impossible for a legislator to foresee all possible loopholes and provide for appropriate specific anti-avoidance rules, there is a big tendency to introduce the doctrine of substance over form which appears as the general anti-avoidance rule into the nationals' tax law systems.⁵

B. Application of substance over form doctrine is not harmonized at the EU Law

From the creation of the European Economic Community, cooperation regarding common criteria between the Member States has played a primary role in economic and monetary policy, but only a secondary role in tax policy.⁶ This is a reason why there is a lack of consensus on tax harmonization between Member States, since all tax decisions taken at the EU level are subject to the unanimity rule.⁷ Thus, at this moment there is no binding rules for application of substance over form principle in tax law matters at the EU level. However, the Commission recently has published the Communication⁸ where some recommendations to adopt a common substance over form doctrine in their national tax legislation are provided. However, it is only a recommendation which is not binding upon Member States and it means that Member States are not obliged to adopt the substance over form doctrine at all. Hence, the substance over form doctrine is not harmonized at the EU level and, accordingly, this doctrine varies from country to country. It follows that if a company decides to undertake a cross-

¹ H. van den Hurk, 'Starbucks versus the People', 2014, Bulletin for International Taxation (Volume 68), No 1, p. 33

² <http://www.bbc.co.uk/news/business-22676080>

³ OECD, Addressing Base Erosion and Profit Shifting ['BEPS'], 2013, OECD Publishing

⁴ <http://taxjustice.blogspot.co.uk/2013/02/new-tax-haven-cover-story-in-economist.html>

⁵ China and Indonesia introduced the GAAR in 2008, Belgium revised the GAAR in 2010, the UK introduced the GAAR in 2013, India is expected to introduce the GAAR in 2016 and etc. See: Ernst & Young, 'GAAR rising, Mapping tax enforcement's evolution', 2013 February, available at: [http://www.ey.com/Publication/vwLUAssets/GAA_rising/\\$FILE/GAAR_rising_1%20Feb_2013.pdf](http://www.ey.com/Publication/vwLUAssets/GAA_rising/$FILE/GAAR_rising_1%20Feb_2013.pdf)

⁶ P. Lampreave, 'An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union', March 2012, Bulletin for International Taxation, p. 161

⁷ Article 115 of the Treaty on the Functioning of the European Union ('TFEU')

⁸ On 6 December 2012, the Commission published a Communication titled An Action Plan to strengthen the fight against tax fraud and tax evasion (COM(2012) 722 final)

border investment, it will have to consider the all relevant anti-avoidance measures, including very wide substance over form doctrine, in several tax jurisdictions. As a result, the Member States, which have introduced a substance over form doctrine into their domestic tax law systems, are less attractive for investors because a very wide and unpredictable scope this doctrine prevents investors from predicting how the tax authorities could treat their arrangements. Therefore, uncertainty of how substance over form doctrine could be applicable at the EU level creates a lot of problems.

C. Problems by Interpreting Substance over Form at the EU level

It is important to recognize that the principle of legal certainty is a starting point in the application of the law. It requires that rules of law are clear, precise and predictable as regards their effects, in particular where they may have unfavourable consequences for individuals and undertakings. Therefore, a taxpayer must be completely sure that before entering into certain tax mitigation schemes, his arrangements will not be tackled by some anti-avoidance measures.

It follows that anti-avoidance measures, including substance over form doctrine, have to be specific enough for taxpayers to predict the amount of the tax obligation. However, the objective analysis of the prohibition of abuse has to be balanced against the principles of legal certainty and protection of legitimate expectations that also 'form part of the Community legal system'.⁹ Since substance over form doctrine is very wide and covers many situations, it is very difficult to find a 'balance' between the protection of legitimate expectations and the state's fiscal interests. With respect of this problem, the main purpose of this thesis is to find out how the EU law is entitled to limit the application of the substance over form doctrine. Not surprisingly, one of the best ways to do this is an analysis of the case-law of the ECJ. However, it should be noted that, at this moment, the ECJ has only ruled against an application of the Specific Anti-Avoidance Rules, so the substance over form doctrine has not been the direct object of any decision.¹⁰ Despite this fact, in order to protect taxpayer's rights, the Author will try to identify occasions in which the substance over form doctrine could be limited by the EU law. The analysis will be based on criteria provided in the settled case-law of the ECJ.

In particular, the Author will discuss the concept and relevant features of substance over form (Section II), the possibilities of Member States to introduce the substance over form principle as the general anti-avoidance rule (Section III) and the possibilities to limit an application of substance over form principle under the EU law (Section IV). At the end some conclusions will be provided (Section V).

⁹ Opinion of Advocate General Poiares Maduro in Cases C-255/02 Halifax, C-419/02 BUPA Hospitals, C-233/03 University of Huddersfield [2005], para 84

¹⁰ V. R. Almendral, 'Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?' INTERTAX, Volume 33. Issue 12, p. 569

II. THE CONCEPT AND FEATURES OF SUBSTANCE OVER FORM DOCTRINE

A. The OECD approach

Firstly, the OECD provides that substance over form is described as the doctrine which allows the tax authorities to ignore the legal form of an arrangement and to look to its **actual substance** in order to prevent artificial structures from being used for tax avoidance purposes.¹¹ In other words, this doctrine provides that a substance of the transaction, rather than its form, determines the tax consequences. Thus, the substance over form doctrine provided by the OECD covers situations where achieving a tax benefit appears to be the 'predominant consideration' behind a decision to make a certain arrangement or transaction, which would appear to include not only artificial arrangements but also have a wider application. Accordingly, the 'actual substance test' in substance over form definition allows a very wide applicability.

The OECD Model Tax Treaty and its Commentary also regularly pay attention to the substance over form doctrine.¹² For instance, substance over form is applicable to establish a fact of actual employment's relationship:

In many States, however, various legislative or jurisprudential rules and criteria (e.g. substance over form rules) have been developed for the purpose of distinguishing cases where services rendered by an individual to an enterprise should be considered to be rendered in an employment relationship (contract of service) from cases where such services should be considered to be rendered under a contract for the provision of services between two separate enterprises (contract for services).¹³

Hence, the OECD considers substance over form as a doctrine, which is, *inter alia*, applicable to the situation where the parties of a transactions had other arrangements in mind than those reflected in the legal form of the transaction. The OECD does not stress a requirement of economic or commercial substance and provides that it is enough to find only the 'actual substance' in order to apply the substance over form doctrine.

Secondly, IBFD Glossary provides that substance over form is an anti-avoidance doctrine under which the legal form of an arrangement or transaction is ignored, tax being levied in accordance with the **economic substance**.¹⁴ Thus, IBFD explains substance over form similarly as the OECD, however, IBFD provides two relevant additional features of this principle: (i) it is an anti-avoidance doctrine and (ii) it focuses on economic substance of a transaction. It means that definition provided by IBFD is narrower than the OECD definition because the former tells us that substance over form focuses only

¹¹ The OECD Glossary of Tax Terms: <http://www.oecd.org/ctp/glossaryoftaxterms.htm>

¹² B. Kusters 'Substance over Form under Tax Treaties' Asia-Pacific Tax Bulletin, 2013 (Volume 19), No. 1, IBFD

¹³ Paragraph 8.4 and 8.8 of the Commentary on Article 15 of the OECD Model Tax Treaty

¹⁴ J. Rogers-Glabush, 'IBFD International Tax Glossary', IBFD, p. 406

on economic substance of transaction and ignores all other purposes provided in the legal form of transaction.

Unfortunately, neither OECD, nor IBFD explicitly explain whether it is possible to apply substance over form only if a transaction is without any economic substance or is it also possible to ignore a transaction, which has a real substance but it differs from the actual intention of the parties. The latter could be very harmful for a taxpayer because it would allow to plan taxes, and therefore the tax administrator's activity might be seen as arbitrary if they treat a taxpayer's preference for a milder tax regime as automatically constituting tax avoidance on the taxpayer's part.¹⁵

Thirdly, a doctrine of 'abuse of law' brings even more confusion into this field. The OECD explains that abuse of law is a doctrine, which allows the tax authorities to disregard a civil law form used by the taxpayer which has **no commercial basis**.¹⁶ Thus, abuse of law is treated like a substance over form doctrine, however the most significant difference is that a concept of abuse of law is applicable only where transactions do not have commercial basis at all, while the principle of substance over form is applicable where the legal form of transactions has a different meaning than the actual purpose of transactions.

Hence, taking into consideration that definitions of substance over form and other similar concepts provide for the (i) 'actual substance test', (ii) 'economic substance test' and (iii) commercial substance test, it leads to a legal uncertainty when and which test should be applicable in concrete situations. Whereas the IBFD provides that substance over form doctrine is generally associated with common law legal systems, it is worthy to start analysis of substance over form by looking at the case-law of the US and the UK.

B. Origin of the substance over form doctrine

The origin of the substance over form doctrine derives from an analysis of *Gregory v. Helvering* case,¹⁷ which was issued by the US Supreme Court. In that case a taxpayer was the sole owner of a corporation (United) which owned stock in another company (Monitor). The taxpayer subsequently incorporated a new company (Averill) and transferred the securities to the new corporation to convert ordinary income on the securities into capital gains. The former corporation distributed the stock of the latter corporation, and, immediately afterwards, the new corporation was liquidated and the securities sold.¹⁸ The taxpayer argued that the gain from the sale was a capital gain while the tax authorities argued that in terms of economic substance there really was no 'business reorganization'.

¹⁵ T. Grauberg, 'Anti-tax-avoidance Measures and Their Compliance with Community Law', XVI/2009, *Juridica International*, p. 142

¹⁶ The OECD Glossary of Tax Terms: <http://www.oecd.org/ctp/glossaryoftaxterms.htm>

¹⁷ *Gregory v Helvering*, 293 U.S. 465 (1935)

¹⁸ P. Lampreave, 'An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union', March 2012, *Bulletin for International Taxation*, p. 156

The US Court examined a purported reorganization in which a corporation was created and liquidated with the sole purpose of avoiding the taxes. The Court explicitly ruled that:

Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having **no business or corporate purpose** – a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of [the statutory provision], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and **nothing else**. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.¹⁹

Thus, the Court concluded that the operation had no ‘business or corporate purpose’, but was, rather, a mere device, which put on the form of a corporate reorganization as a disguise for concealing its real character. This case shows that substance over form focuses on economic purposes.

Furthermore, in the UK, the similar substance over form doctrine was introduced in the iconic *IRC v. Duke of Westminster*²⁰ case. In this case the Duke of Westminster wanted to deduct servants’ salaries from his income in order to reduce his tax burden. Such deductions were not allowed under British tax law but the law did allow taxpayers to deduct annuities and other ‘annual payments’ they made. The Duke therefore reached an agreement with his servants that instead of paying them a salary he would pay them an annuity for a period of seven years, supposedly unrelated to the services that they were providing.²¹ He then claimed that these payments could be deducted from his income, while the tax authority argued that that substance of the matter is more important and that the legal position could be ignored. However, the Court refused to look at the substance of the transaction because such a substantive approach would involve substituting the uncertain and crooked cord of discretion for the ‘golden and straight met wand of the law’ adding that every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be.²² Thus, this case shows that the substance over form principle is not absolute and requires case-by-

¹⁹ *Gregory v Helvering*, 293 U.S. 465 (1935) 468-470

²⁰ *IRS v Duke of Westminster* [1936] A.C. 1; 19 TC 490

²¹ P. Lampreave, ‘An Assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union’, March 2012, *Bulletin for International Taxation*, p. 157

²² *Ibid.*

case analysis. Also, a certain balance between powers of the tax authorities and the rights of taxpayers should be achieved.

The *Ramsay* case,²³ which was handled down by the House of Lords is the other crucially important one. In that case the Court denied the taxpayer's deduction of an alleged capital loss resulting from a series of circular and self-cancelling transactions with the purpose of tax avoidance. The Court had to deal with previously established precedent in *Duke of Westminster* and affirmed that the principle established in *Duke of Westminster* could not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs.²⁴ Thus, substance over form doctrine is usually called *Ramsay principle* which involves treating steps having no commercial purpose inserted in a composite transaction or series of transactions as a 'fiscal nullity' and disregarding them for tax purposes.²⁵

As a result, the case-law of the common law countries shows that when assessing the validity of a transaction and its effects by the substance over form doctrine, it is important also to consider the economical sense of the transaction. Thus, the substance over form doctrine allows the tax authorities to examine the legal form of the transaction to establish its underlying economic reality.

C. The EU law approach

The concept of substance over form is very rarely found in the EU legal acts or the case-law of the ECJ. However, certain guidelines of the substance over form principle can be found in the EU soft law.

Firstly, the definition of the substance over form principle can be found in the Commission Staff Working Document.²⁶ It provides that substance over form principle is defined when the law is formally complied with but there is a lack of substance supporting the transaction or restructuring so that the tax authorities can disregard its form. In other words, this definition focuses rather on the 'actual substance test' than the 'economic substance test' which deals with possibility to apply substance over form doctrine only in cases when there is no economic logic in the transactions.

Secondly, the Communication regarding the anti-abuse measures in the area of direct taxation provides interesting expressions and tells us that the detection of a wholly artificial arrangement thus amounts in effect to a substance over form analysis.²⁷ This means that the EU considers a substance over form doctrine as an instrument for detecting wholly artificial arrangements. In such a situation,

²³ *Ramsay Ltd. v Inland Revenue Commissioners* [1982] A.C. 300

²⁴ C. A. Alvarrenga 'Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?' *Bulletin for International Taxation*, 2013 (Volume 67), No. 7, p. 352

²⁵ J. Rogers-Glabush, 'IBFD International Tax Glossary', IBFD, p. 413

²⁶ The Commission Staff Working Document: Impact Assessment Accompanying the Communication from the Commission to the European Parliament and the Council - An Action Plan to strengthen the fight against tax fraud and tax evasion the Commission Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters the Commission Recommendation on aggressive tax planning /* SWD/2012/0403 final */

²⁷ Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee - The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries /* COM/2007/0785 final */

substance over form would be applicable only if the taxpayer's arrangements were wholly artificial and without any economic substance.

Thirdly, the only EU legal act containing the substance over form principle is the International audit standard which is approved by the Commission's regulation.²⁸ The principle of substance over form is also mentioned several times in the case-law²⁹ of the Court of First Instance in the context of international audit standards, however neither the International audit standard nor the case-law provide further significant explanation about the features of the substance over form principle.

Finally, although the Council has stated that tax evasion and tax avoidance cannot be combated solely with national measures, whose effect does not extend beyond State boundaries³⁰ and the Commission issued the Communicate, which suggests establishing the general anti-avoidance measure with the EU³¹, there is still no legally binding general anti-avoidance rule at the supranational level at this moment. Thus, the anti-avoidance measures, especially the general anti-avoidance rules, which contain substance over form principle, vary from country to country and it is very difficult to identify boundaries of such rules.

In conclusion, at the EU level the legal acts, the soft law and the case-law does not provide a clear-cut definition and relevant features of the substance over form principle. However, one of these approaches which is provided by the European Commission³² obviously considers a substance over form principle as an instrument to detect wholly artificial arrangements, therefore this approach will be analysed in detail further in this thesis (see Section IV.A.iii).

D. Tax law doctrine approach

The tax law doctrine provides three different tests, which are related to the application of the substance over form doctrine in the tax cases: **(i)** the existence of a tax advantage, which includes all kind of benefits (deduction, exemption, deferral of taxation and etc.); **(ii)** the use of transactions that are inadequate, artificial or improper in order to hide a real substance of transactions; and **(iii)** the absence of other purposes, apart from tax savings, to justify the choice of transactions.³³ These criteria show that the substance over form doctrine is used by the legislator to express the intent to preclude manipulation of the tax incentives set out in law. Despite the fact that a first criterion is quite common

²⁸ Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council

²⁹ Case T-417/05 Endesa, [2006], Case T-299/05 Shanghai, [2009]

³⁰ Council Resolution of 10 February 1975 on the measures to be taken by the Community in order to combat international tax evasion and avoidance, OJ C 35 1975.

³¹ Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee - The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries /* COM/2007/0785 final */

³² Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee - The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries /* COM/2007/0785 final */

³³ C. A. Alvarrenga 'Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?' Bulletin for International Taxation, 2013 (Volume 67), No. 7, p. 361-362

and clear, the second and the third criteria are more problematic. Looking from the second criterion's perspective, some substance over form doctrines are limited to the wholly artificial arrangements, and some substance over form doctrines apply to the improper or inadequate transactions even though these transactions have substance. This means that it is not clear in which situations the transaction, which is carried out not only for the purpose of obtaining tax savings, but also for the purpose of producing relevant economic effects, could be challenged using the substance over form doctrine. Furthermore, the third criterion is also not clear, since some doctrines consider only 'the sole purpose test' while the others are also applicable to the transactions where a taxpayer is having 'the main purpose' to get a tax advantage despite the fact that these transactions are also based on economic principles. Thus, taking into consideration that the main purpose of this thesis is to check whether and in which situation the EU law could limit the domestic substance over form doctrine, the Author below provides an analysis of the case-law of the ECJ with a purpose to investigate how the case-law interprets the second and the third criteria (artificiality and the purpose test).

III. SUBSTANCE OVER FORM IS A DOMESTIC ANTI-AVOIDANCE RULE

Before starting an analysis of the case-law of the ECJ with regard to opportunities for the EU law to limit the application of domestic substance over form rules, it is worthy to stress that substance over form doctrine is a domestic anti-avoidance measure.

A. The EU law is aimed at combating tax avoidance and tax evasion

Within the European Union, a prevention of international tax avoidance and tax evasion has been one of the longstanding objectives. Many years ago, the EU directives were adopted with regard to practices of tax evasion and tax avoidance extending across the frontiers of Member States which lead to budget losses and violations of the principle of fair taxation and are liable to bring about distortions of capital movements and of conditions of competition and, therefore, affect the operation of the common market.³⁴ The will of the EU to combat tax avoidance and tax evasion remains visible nowadays. For instance, recently the Council has adopted some amendments in the harmonized VAT sphere in order to strengthen fight against tax evasion and tax avoidance³⁵ and some changes were made in the non-harmonized direct tax sphere, which are aimed to prevent the double non-taxation of dividends distributed within corporate groups deriving from hybrid loan arrangements.³⁶

³⁴ Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation

³⁵ Council Directive 2008/117/EC of 16 December 2008 amending Directive 2006/112/EC on the common system of value added tax to combat tax evasion connected with intra-Community transactions

³⁶ Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

In addition, the ECJ also fully acknowledges that the objective of countering tax avoidance is generally accepted by the EU law. For instance, in *Kraft Foods* case, the ECJ explained that:

Measures to prevent tax evasion or avoidance may not, in principle, derogate from the rules relating to the taxable amount except **within the limits strictly necessary for achieving that specific aim**. They must have as little effect as possible on the objectives and principles of the VAT Directive and may not therefore be used in such a way that they would have the effect of undermining VAT neutrality, which is a fundamental principle of the common system of VAT established by the relevant European Union legislation.³⁷

Hence, not only the EU legal acts but also the soft-law and the case-law of the ECJ are unanimous in declaring that the EU law is aimed to combat tax evasion and tax avoidance. The domestic measures aimed to prevent tax evasion or avoidance should be applicable strictly for achieving that specific aim. This means that the Member States are only entitled to adopt anti-avoidance measures, which may not undermine or infringe any of the freedoms guaranteed by the Treaty. Thus, an analysis of the case-law of the ECJ is relevant because it gives guidelines for the Member States on designing national anti-avoidance rules.

B. The EU tax directives refer to the domestic anti-avoidance measures

An analysis of the EU direct tax directives shows that the EU law gives a right to the Member States to adopt domestic anti-avoidance measures, including a substance over form principle, with regard to prevention of taxpayers' abusive and fraudulent behaviour.

Firstly, Article 1(2) of the Parent-Subsidiary Directive³⁸ permits the application of domestic and agreement-based provisions that are intended to prevent "fraud or abuse".

Secondly, Article 5 of the Interest and Royalties Directive³⁹ also allows Member States to apply the anti-avoidance measures in case of abusive behaviour of the taxpayer:

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

Member States may, in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraws the benefits of this Directive or refuse to apply this Directive.

Thirdly, Article 11 of the Merger Directive⁴⁰ establishes that Member States may deny the directive benefits if a merger transaction appears to be conducted for the purpose of tax evasion or tax

³⁷ Case C-588/10, *Kraft Foods Polska*, [2012], para 28, and Case C-271/12 *Petroma Transports and Others*, [2013], para 28

³⁸ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

³⁹ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States

⁴⁰ Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States

avoidance. No such abuse is deemed to be present if the operation is carried out for valid commercial reasons, such as restructuring or rationalization of the activities of the participating companies.

Finally, the VAT Directive⁴¹ also authorizes the Member States to take measures to prevent abuse of the Directive⁴² and permits derogations to prevent avoidance⁴³. It should be stressed that even though the VAT is harmonized within the EU, the VAT Directive still does not provide any restrictions on how Member States should apply their anti-avoidance measures.

Therefore, the EU law allows the Member States to adopt and apply their own anti-avoidance measures, since those measures are aimed to the prevention of tax avoidance and tax evasion.

C. The case-law of the ECJ confirms that Member States have a competence to establish a fact of fraudulent or abusive behaviour

The fact that only Member States are entitled to adopt anti-avoidance measures is confirmed by the case-law of the ECJ which provides that only Member States have a competence to establish a fact of the taxpayer's fraudulent and abusive behaviour.

Firstly, in *Leur-Bloem* case⁴⁴, the ECJ explained that the tax authority should assess tax liability according to the specific details of the transaction, taking into account the individual nature of each case, which must be open to judicial review.

Also, in *X&Y AB* case⁴⁵, the ECJ said that:

The national courts may, case by case, take account – on the basis of the objective evidence, of **abuse or fraudulent conduct** on the part of the persons concerned in order, where appropriate, to deny them the benefits of the provisions of the Community law on which they seek to rely.

Finally, in *FIRIN* case⁴⁶ the ECJ recently has stated that:

European Union law cannot be relied on by individuals for abusive or fraudulent ends. It is therefore **for the national courts and judicial authorities to refuse the right of deduction** if it is shown, in the light of objective factors, that that right is being relied on for **fraudulent or abusive ends**.

The Author believes that such a position of the ECJ is reasonable and justified by the fact that only domestic courts have a right and ability to evaluate the relevant facts and circumstance and, therefore, have a right establish an occurrence of abusive or fraudulent behaviour. This is confirmed by the settled case-law of the ECJ.

⁴¹ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

⁴² Article 131 of the VAT Directive

⁴³ Article 395 of the VAT Directive

⁴⁴ Case C-28/95 *Leur-Bloem* [1997], para 24

⁴⁵ Case C-436/00 *X&Y AB* [2002], para 42

⁴⁶ Case C-107/13, *FIRIN*, [2014], para 42

IV. SITUATIONS IN WHICH SUBSTANCE OVER FORM CAN BE LIMITED BY THE EU LAW

An analysis of the case-law of the ECJ has showed that it is possible to establish three different types of limitations of substance over form principles under the EU law, i.e.: (i) when application of such principle restricts the EU freedoms, (ii) when it is contrary to the harmonized VAT Directive and (iii) when it is contrary to the tax directives.

A. Substance over form can be limited if the EU freedoms are violated

In an EU internal market context, the fundamental freedom provisions may interact with national tax rules and rules contained in the DTCs. When this happens, the freedoms must prevail unless the Member State's rules, if directly discriminatory, can be justified on grounds allowed by the TFEU; and if indirectly discriminatory or non-discriminatory, it can be justified on general interest grounds, which comply with the principle of proportionality.⁴⁷ Thus, in order to limit the substance over form doctrine, it is necessary to establish that (i) the EU freedom is involved; (ii) the EU freedom is restricted, (iii) the restriction could not be justified and (iv) it is not proportional.

i. The EU freedom shall be involved

The Treaty on the Functioning of the European Union ('TFEU') provides that the EU citizens are entitled to the following five fundamental freedoms: (i) free movement of goods⁴⁸; (ii) free movement of workers⁴⁹; (iii) freedom of establishment⁵⁰; (iv) freedom to provide services⁵¹; and (v) free movement of capital⁵². All Member States of the European Union must ensure that their national laws are consistent with the fundamental freedoms guaranteed by the TFEU. As a result, even though Member States retain considerable competence to deal with such abuse and to take proportionate action in the general interest⁵³, all the domestic anti-avoidance rules, including a substance over form principle, may not infringe any of the freedoms guaranteed by the TFEU. However, it should be noted that the Member States have a wider discretion to apply anti-avoidance rules in cases where the EU freedom is not involved. In *Asscher* case⁵⁴, the ECJ stated that national tax rules may be in breach of the provisions on free movement only if a taxpayer enjoys the right of free movement. Therefore, purely national cases are not protected by the limitation of free movement rights. In particular, the Court stated that:

Although the provisions of the Treaty relating to **freedom of establishment cannot be applied to situations which are purely internal to a Member State**, [the scope of guaranteed rights] nevertheless cannot be interpreted in such a way as to exclude a given Member State's

⁴⁷ Tom O'Shea, 'Tax Avoidance and Abuse of EU Law', The EC Tax Journal, Volume 11, 2010-11

⁴⁸ Article 28 of the TFEU

⁴⁹ Article 45 of the TFEU

⁵⁰ Article 49 of the TFEU

⁵¹ Article 54 of the TFEU

⁵² Article 63 of the TFEU

⁵³ T. O'Shea, 'Tax Avoidance and Abuse of EU Law', The EC Tax Journal, Volume 11, 2010-11

⁵⁴ Case C-107/94 *Asscher*, [1996]

own nationals from the benefit of Community law where by reason of their conduct they are, with regard to their Member State of origin, in a situation which may be regarded as equivalent to that of any other person enjoying the rights and liberties guaranteed by the Treaty.⁵⁵

In addition, the recent decision of the ECJ in *3M Italia* case⁵⁶ is also very important. In this case, the domestic dispute primarily concerned the tax consequences of an international dividend stripping scheme arranged by the taxpayer. However, the referral was issued due to particular legislative developments in Italy, which provided that taxpayers could avail themselves of procedural relief, in certain cases that have been pending before the courts for at least 10 years. Under this rather specific tax amnesty, the taxpayer could choose to pay 5% of the disputed tax and the judicial proceeding would be closed. The Supreme Court of Italy was uncertain whether this provision is compatible with the EU law.⁵⁷ The ECJ observed that the dispute in the main proceedings was not one in respect of which a taxpayer would typically rely on a provision of EU law for fraudulent or abusive ends, so the case-law which provides explanations of abusive taxpayer's behaviour is not relevant.⁵⁸ However, the most importantly, the Court stated that:

Finally, in any event, it is clear that **no general principle exists in European Union law** which might entail an obligation of the Member States to combat abusive practices in the field of direct taxation and which would preclude the application of a provision such as that at issue in the main proceedings where the taxable transaction proceeds from such practices and European Union law is not involved.⁵⁹

Hence, the settled case-law of the ECJ confirms that (i) the purely national cases are not protected by the limitation of the free movement rights, and (ii) there is no general principle within the EU law which would provide certain obligations for the Member States on how to combat abusive practice. It follows that the Member States are free to apply substance over form doctrine in the purely domestic cases and the EU law cannot restrict such an anti-avoidance measure. Accordingly, a substance over form rule could be limited by the EU law only if it applied to the cross-border situation.

ii. The EU freedom shall be restricted

The fundamental freedoms, in terms of abolishing 'obstacles' to intra-Community trade and investments, are closely linked to the general 'non-discrimination on grounds of nationality' rule contained in Article 18 of the TFEU and the granting of right to move and reside to EU citizens under Article 21 of the TFEU.⁶⁰ For instance, the freedom of establishment comprises the right of individuals to take up and pursue activities as self-employed persons as well as the right of a company to set up

⁵⁵ Ibid., para 32

⁵⁶ Case C-417/10, *3M Italia*, [2012]

⁵⁷ A. Zalasinski, 'The Principle of Prevention of (Direct Tax) Abuse: Scope and Legal Nature – Remarks on the *3M Italia* Case', September 2012, *European Taxation*, p. 447

⁵⁸ Case C-417/10, *3M Italia* [2012], para 30, 31

⁵⁹ Ibid., para 32

⁶⁰ T. O'Shea, 'EU Tax Law and Double Tax Convention', 2008, *Avoir Fiscal Limited*, p. 32

agencies, branches or subsidiaries in another Member State. Consequently, this rule is aimed to ensure free market principles while also promoting market equality and it requires the Member States to treat all EU residents equally and makes them subject to the same rules and conditions, regardless of in which Member State they reside in.⁶¹ Hence, if a domestic law discriminates the foreign entities in comparison with the domestic entities upon one of the fundamental freedoms, such a situation could be challenged before the ECJ. For instance, in *Saint Gobian* case⁶², the ECJ dealt with a situation where Germany refused certain tax advantages to the German branch of a French company that it ordinarily granted to German resident regarding dividends received from foreign companies. The refusal was based on the fact that a measure is designed to prevent such dividends from being taxed again in Germany on the grounds that the DTCs restricted the reliefs to German resident companies.⁶³ The ECJ explained that:

The national treatment principle requires the Member State which is party to the treaty to grant to permanent establishments of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies.⁶⁴

Thus, the case-law of the ECJ disallows any domestic provision that in comparable situation discriminates between resident and non-resident and, therefore, restricts free movement rights throughout the territory of a Member State.⁶⁵ Accordingly, if a substance over form doctrine restricts free movement rights by discriminating taxpayers, then the ECJ would analyse whether such a restriction is nonetheless justified and whether it complies with the principle of proportionality.

iii. The restriction of free movement rights shall not be justified

In order to establish a fact that substance over form doctrine could violate the EU freedoms, a restriction of free movement rights shall not be justified. A restriction based on direct discrimination can only be justified on grounds allowed by the TFEU⁶⁶, while indirect discrimination also can be justified on general interest grounds. There are several justification grounds which are formed by the case-law of the ECJ, however, in this section the Author will focus only on the prevention of tax avoidance because this justification is the most related to the substance over form doctrine. In this section, the Author analyses the evolution of the 'wholly artificial arrangements doctrine', which has been applied for many years in most ECJ decisions dealing with taxation.

⁶¹ C. A. Alvarrenga 'Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?' *Bulletin for International Taxation*, 2013 (Volume 67), No. 7, p. 359

⁶² Case C-307/97, *Saint Gobain* [1999]

⁶³ T. O'Shea, 'EU Tax Law and Double Tax Convention', 2008, *Avoir Fiscal Limited*, p. 37

⁶⁴ Case C-307/97, *Saint Gobain* [1999], para 58

⁶⁵ However, it should be noted that in *Schumacker* case (C-279/93 [1995]) the ECJ stated that the situations of residents and non-residents are not, as a rule, comparable. Therefore, case-by-case analysis is always relevant with regard to establish comparable situations.

⁶⁶ Articles 52(1) of the TFEU

In *ICI* case⁶⁷, two companies resident in the United Kingdom formed a consortium through which they beneficially owned 49% and 51%, respectively of a holding company. The sole business of the holding company was to hold shares in some trading companies, which operated in many countries. The matter in dispute was whether or not UK group tax relief could be allowed in respect of losses realized by companies not resident in the United Kingdom. It is obvious that there was a restriction of freedom of establishment and the main question was whether it could be justified. The ECJ stated that:

As regards the **justification based on the risk of tax avoidance**, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing **wholly artificial arrangements**, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment.⁶⁸

In other words, the Court explained that the UK rules did not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but generally applied to all situations in which the majority of a group's subsidiaries were established outside the United Kingdom. Thus, in such a situation the ECJ has created a test for identifying an abuse of the EU freedoms, which is also the main instrument to identify a possible justification for the fundamental freedoms on the grounds of prevention of tax avoidance. However, even though in *ICI* case the ECJ did not explain the meaning of 'wholly artificial arrangements', *ICI* case was the first case where the ECJ referred to 'wholly artificial arrangements' set up to circumvent Member States tax legislation.⁶⁹

In the iconic *Cadbury Schweppes* case⁷⁰, the ECJ has provided more details with regards to the doctrine of the 'wholly artificial arrangements'. In this case, a UK resident company indirectly held 100% of the shares of two Irish subsidiaries. The Irish subsidiaries were subject to the low 10% corporate income tax rate. As the tax paid in Ireland was less than 75% of what would have been paid if the subsidiaries had been UK-resident, the UK tax authorities raised an assessment charging on CFC profits. Cadbury Schweppes challenged the UK's CFC legislation as a restriction of the EC Treaty's freedoms. Therefore, there was a difference between a UK company setting up a subsidiary in another Member State, which conducts genuine economic activities, and a UK company setting up a subsidiary involving arrangements, which artificially divert profits from the UK. In the former situation, the UK cannot tax the UK parent company on the profits of the CFC whereas in the latter situation it

⁶⁷ Case C-264/96, *ICI*, [1998]

⁶⁸ *Ibid*, para 26

⁶⁹ J. S. Schwarz, 'Abuse and EU Tax Law', 2008, *Bulletin for International Taxation*, p. 290

⁷⁰ Case C-196/04, *Cadbury Schweppes*, [2006]

can.⁷¹ Thus, it was a restriction of the freedom of establishment, so the main question was whether this restriction could be justified. In this situation the ECJ explained that:

In order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation **of wholly artificial arrangements which do not reflect economic reality**, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.⁷²

Thus, it means that the EU Member States should accept all transactions with a purpose to get some tax benefits, unless these transactions are wholly artificial arrangements. It should be noted that the tax law doctrine agrees that the language of the 'wholly artificial arrangements' formula represents only *the sole purpose* of transaction to get a tax advantage.⁷³ Hence, transactions which have *the main purpose* to get tax benefits should be considered as out of the scope of 'wholly artificial arrangements'.

This decision is also relevant because it limits the scope of the domestic anti-avoidance rules. It means that in order to be consistent with the fundamental freedoms, a substance over form doctrine applied by the Member States must be carefully drafted and interpreted to counter only wholly artificial arrangements, as defined by the subjective and objective criteria designed in *Cadbury Schweppes*.⁷⁴ Therefore, if the legal norm, implementing the substance over form doctrine, covered not only wholly artificial arrangements, such a norm and a consequent restriction of the free movement rights could not be justified.

In *Thin Cap Group Litigation case*⁷⁵, the issue was whether the Member States concerned could impose tax restrictions on financing arrangements between related companies. The Court ruled that thin capitalization legislation, which is only applied to interest payments to non-resident lenders, constitutes, in principle, a restriction on the freedom of establishment. Such restriction may be justified by the prevention of tax avoidance provided that it is proportionate to that aim. The Court, in general, repeated the explanation provided in *Cadbury Schweppes* case and stated that the legislation, which provides verifiable elements to identify purely artificial arrangements, could be considered as a justification of restriction of free movements rights which is based on the prevention of tax avoidance and tax evasion. In addition, the Court explained that anti-avoidance measure which was applicable only to that part of the interest that exceeds the arm's length standard, was justified and proportional with regard to restriction of freedom of establishment.

⁷¹ T. O'Shea, 'The UK's CFC rules and the freedom of establishment: Cadbury Schweppes plc and its IFSC subsidiaries – tax avoidance or tax mitigation?' 2007/1, EC Tax Review, p. 67

⁷² Ibid, para 55

⁷³ J. S. Schwarz, 'Abuse and EU Tax Law', 2008, Bulletin for International Taxation, p. 292

⁷⁴ C. A. Alvarrenga 'Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?' Bulletin for International Taxation, 2013 (Volume 67), No. 7, p. 360

⁷⁵ Case C-524/04 Thin Cap Group Litigation, [2007]

It should be noted that the ECJ has consistently applied and explained the wholly artificial arrangements doctrine in the recent case-law of the ECJ.⁷⁶ In all of these cases, the ECJ held that an abusive practice can be defined as transactions carried out for no commercial reasons other than to profit from a tax advantage.

In addition, the most recent decision of the ECJ, which has applied wholly artificial arrangement doctrine, is *SCA Group Holding case*⁷⁷. The ECJ ruled in three joined cases that the Dutch fiscal unity rules are in breach of the freedom of establishment for not allowing (i) a fiscal unity between a Dutch parent company and a Dutch sub-subsidiary that is held through an EU intermediate subsidiary or (ii) a fiscal unity between two Dutch 'sister' companies that are held through a joint EU parent company. The ECJ found that the domestic and the cross-border situation was comparable in the light of the objective of the fiscal unity regime, which is, to treat a group constituted by a parent company with its sub-subsidiaries in the same way as an undertaking with a number of establishments. Therefore, the Court concluded that there was a restriction of freedom of establishment. Therefore, the main question was whether this restriction could be justified. The ECJ concluded that a justification of the prevention of tax avoidance and tax evasion is not applicable in this situation because the fiscal unity rules are not specifically designed to prevent tax avoidance and tax evasion.

Thus, the settled case-law of the ECJ shows that substance over form which restricts the EU law freedoms can only be justified if it restricts only with respect to wholly artificial arrangements. However, even if the substance over form doctrine was justified, it should also be in line with the principle of proportionality.

iv. Justifications shall not be in line with the principle of proportionality

Application of the substance over form principle must be proportional and mindful of the balance of different interests. The tax authority cannot have unlimited rights in resolving tax issues, as it was mentioned before, a certain balance between the principle of legitimate expectations and the state's fiscal policy should be found. The ECJ has established certain principles through case law for judging when tax avoidance measures are to be considered proportional. The principle of proportionality is of considerable weight in the EU law and it must be respected as part of the aims and basic values of the Treaty.⁷⁸ The Author analyses the case-law of the ECJ dealing with the principle of proportionality with regard to anti-avoidance measures.

In *Hughes de Lasteyrie du Saillant case*⁷⁹, the ECJ has dealt with the assessment of a French exit tax on emigrating French residents owning a substantial shareholding. The Court has compared situations

⁷⁶ Case C-105/07 Lammers [2008]; Case C-311/08 SGI [2010]; Cases C-436/08 and C-437/08 Haribo [2011]; Case C-318/10 SIAT [2012]; Case C-383/10 Commission v Belgium [2013]; Case C-322/11 K [2013]; Case C-282/12 Itelcar [2013]; Case C-80/12 Felixstowe Dock [2014] and etc.

⁷⁷ Cases C-39/13, C-40/13 and C-41/13 SCA Group Holding [2014]

⁷⁸ T. Grauberg, 'Anti-tax-avoidance Measures and Their Compliance with Community Law', XVI/2009, *Juridica International*, p. 148

⁷⁹ Case C-9/02 Hughes de Lasteyrie du Saillant [2004]

and decided that there is a restriction of the freedom of establishment since a French resident are subject to the immediate taxation of not realized capital gains only if he moves to another EU member state.⁸⁰ Thus, the ECJ concluded that this anti-avoidance rule restricts freedom of establishment. However, the question was whether this restriction could be justified. The Court agreed that although the prevention of tax evasion may be justified by the need to prevent tax avoidance, the ECJ concluded that the measure in question should also be proportional to its anti-avoidance purpose. In particular, the ECJ stated that:

As regards justification based on the aim of preventing tax avoidance, referred to by the national court in its question, it should be noted that [French exit tax rule] **is not specifically** designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French tax law, but is aimed generally at any situation in which a taxpayer with substantial holdings in a company subject to corporation tax transfers his tax residence outside France for any reason whatever.⁸¹

In other words, the fact that anti-avoidance measure is not specific and covers all possible situations, means that this anti-avoidance measure is not proportional and cannot justify a restriction of the free movement rights.

In *Rewe Zentralfinanz* case⁸², the ECJ dealt with a situation where a German company, which has established a subsidiary in another Member State, could only claim a depreciation of the shares of the subsidiary in limited circumstances, while such a limitation was not applicable in case of German subsidiary. The ECJ has confirmed that these situations are comparable and, therefore, the freedom of establishment is restricted. Further, the Court has analysed whether this restriction could be justified on general interest grounds. In relation to Germany's argument that its rules were necessary to prevent tax avoidance, the Court decided, on proportionality grounds, that the German rules went too far.⁸³ The German tax rules did not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent a Member State's tax legislation, but were targeted to any situation in which subsidiaries are established, for whatever reason, outside Germany.⁸⁴

Therefore, the Author agrees with Adam Zalasinski that tax avoidance measures, including a substance over form principle, are not proportional if they do not consider specific details of transactions and are based only on predetermined circumstances. The measure taken must be usable as a general provision and be relevant to a variety of situations, provided that the transaction bears no economic substance and its only aim is to obtain a tax advantage.⁸⁵

⁸⁰ Ibid., para 22

⁸¹ Ibid., para 50

⁸² Case C-347/04 *Rewe Zentralfinanz* [2007]

⁸³ T. O'Shea, 'Further Thoughts on *Rewe Zentralfinanz*', *Tax Notes Int'l* 134 (Apr. 9, 2007), p. 134

⁸⁴ Case C-347/04 *Rewe Zentralfinanz* [2007], paras 50-53

⁸⁵ A. Zalasinski, 'Proportionality of Anti-Avoidance and Anti-Abuse Measures in the ECJ's Direct Tax Case Law' (2007) 35 *INTERTAX*, Issue 5, p. 310-321

v. Interim conclusion

A discussed case-law of the ECJ can only be understood bearing in mind that every element of tax avoidance legislation must be defined in accordance to the fundamental freedoms which, more often than not, entail that an arrangement carried out in the exercise of such freedoms shall not be considered avoidance.⁸⁶ The ECJ consistently held that anti-avoidance measures could only justify a restriction of free movement rights if these measures cover only wholly artificial arrangements, which are aimed solely to get a tax advantage. Accordingly, if a transaction has an economical purpose or is not artificial, then anti-avoidance measure would be considered incompatible with the EU law. However, this incompatibility could only be established if the EU freedoms are restricted.

Therefore, on the one hand, a substance over form doctrine shall be limited under wholly artificial arrangements doctrine when it has been entered into in the exercise of a fundamental freedom and, on the other hand, if a substance over form doctrine restricts the freedom of establishment with respect to arrangements that are not wholly artificial, such a rule shall be considered as inconsistent with EU law.

To sum up, it is possible to challenge a domestic substance over form principle in situation where: (i) one of the EU freedoms is involved, (ii) those freedoms are restricted, (iii) this restriction is not justified and (iv) proportional.

B. Substance over form can be limited by the direct tax directives

The ECJ has determined that Community law did not simply apply at the Member State level; it also granted rights to nationals of the Member States that could be invoked before national courts and tribunals.⁸⁷ Consequently, certain Community law rules had immediate effects in the domestic legal systems of the Member State – including their direct taxation systems.⁸⁸ In particular, the EU has adopted some directives, which effect national direct taxation systems (i.e. the Mergers Directive, the Parent-Subsidiary Directive, the Interest and Royalties Directive). Therefore, all domestic rules, including anti-avoidance measures, should not be contrary to the provisions of direct tax directives.

It should be noted that the most comprehensive case-law of the ECJ concerns the Mergers Directive, thus the Author will focus on the analysis of abusive mergers.

In *Leur-Bloem* case⁸⁹ the ECJ dealt with situation where Mrs. Leur-Bloem was the sole shareholder of two Dutch companies which were both engaged in the temporary recruitment business. She was also planning to acquire the shares in a holding company in exchange of shares of both Dutch companies. According to the Dutch law, such an exchange of shares was taxable, however, under the Mergers

⁸⁶ V. R. Almendral, 'Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?' INTERTAX. Volume 33. Issue 12, p. 574

⁸⁷ Case C-26/62, Van Gend en Loos, [1963]

⁸⁸ T. O'Shea, 'EU Tax Law and Double Tax Convention', 2008, Avoir Fiscal Limited, p. 12

⁸⁹ Case C-28/95 Leur-Bloem [1997]

Directive the gain was not taxed immediately, since a roll-over provision was applicable. The Court confirmed that:

A merger or a restructuring carried out in the form of an exchange of shares involving a newly-created holding company which does not therefore have any business may be regarded as having been carried out for valid commercial reasons. Similarly, such reasons may render necessary the legal restructuring of companies which already form an entity from the economic and financial point of view. Even if this may constitute evidence of tax evasion or tax avoidance, it is nevertheless **possible** that a merger by exchange of shares **with the aim of creating a specific structure for a limited period of time and not on a permanent basis may have valid commercial reasons**.⁹⁰

In other words, a fact that a taxpayer gains a tax advantage by creating a specific structure does not in itself mean that a taxpayer is acting abusively. Further, the Court clarified that 'valid commercial reasons' is a concept involving more than the attainment of a purely fiscal advantage. A merger by way of exchange of shares having only such an aim cannot therefore constitute a valid commercial reason within the meaning of that article.⁹¹

It means that the ECJ clarified that the attainment of a purely fiscal advantage does not constitute a valid commercial reason and that a reorganization having only such an aim cannot constitute a valid commercial reason.⁹² The ECJ also observed that the commercial reason may depend on various factors, none of which should be considered decisive. The Author believes that 'the absence of valid commercial reasons' is the same as 'wholly artificial arrangements' provided in abovementioned cases (see Section IV.A.iii). Accordingly, it is possible to conclude that the case-law of the ECJ is consistent and disallows the EU law benefits if they are achieved without commercial basis and using only wholly artificial arrangement.

In *Kofoed* case⁹³, two Danish residents were owners of a Danish company. They each acquired shares in an Irish company and later on increased its share capital by issuing new shares. Further, they exchanged all their shares in Danish company for all the new shares in Irish company with the result that later on Danish company paid a dividend to Irish company which distributed profits to those two Danish residents. At the end of the day, a taxpayer argued that the exchange of his shares in Danish company for the new shares in Irish company should be exempt on the grounds of Mergers Directive. Thus, the question arose whether such a situation could be considered as abuse of law and aimed to the tax avoidance. The ECJ explained that:

[Mergers Directive] reflects the general Community law principle that abuse of rights is prohibited. Individuals must not improperly or fraudulently take advantage of provisions of Community law. The application of

⁹⁰ Ibid, para 42

⁹¹ Ibid, para 47

⁹² Case C-28/95 Leur-Bloem [1997], para 47

⁹³ Case C-321/05 Kofoed [2007]

Community legislation cannot be extended to cover abusive practices, that is to say, **transactions carried out not in the context of normal commercial operations**, but **solely for the purpose** of wrongfully obtaining advantages provided for by Community law.⁹⁴

In this case the ECJ more explicitly stated that benefits from the Mergers Directive are not applicable if transaction is carried out not in the context of normal commercial operations and with a sole purpose to get a tax advantage.⁹⁵ Thus, the ECJ consistently agrees that tax benefits could be ignored only in situations where a taxpayer is acting abusively. Accordingly, a domestic substance over form rule, which is applicable not only in abusive situations, could be found incompatible with the EU law if such a rule does not allow taxpayers to receive tax benefits provided by the Mergers Directive.

In *Zwijnenburg* case⁹⁶, the ECJ dealt with a situation where a Dutch couple planned to transfer the family business to their son. To finalize the transfer, the family undertook a merger of two Dutch companies that owned the two buildings where the stores were located. In doing so, the family avoided the Dutch real estate transfer tax. The ECJ pointed out that:

Under <...> the merger directive, member states may refuse to apply, or may withdraw the benefit of, all or any part of the provisions of that directive when the exchange of shares has tax evasion or tax avoidance as **its principal objective or as one of its principal objectives**. That same provision also provides that the fact that the operation **is not carried out for valid commercial reasons**, such as the restructuring or rationalisation of the activities of the companies participating in the operation, **may constitute a presumption that the operation has such an objective**.⁹⁷

Thus, the ECJ consistently held that Member States shall prohibit enjoyment of tax benefits provided by the Mergers Directive only if transaction is not carried out for valid commercial reasons. Unfortunately, in comparison with *Kofoed* case, which considered 'the sole purpose' to obtain tax advantage, *Zwijnenburg* case only talks about 'the principal aim' to get a tax advantage. At first glance, it provides some legal uncertainty, however, the Author believes that the most important criterion is the commercial reasons which is consistent through the settled case-law of the ECJ. The sole or the principal intention to get a tax advantage is not the core criterion to determine abuse of law, since legal tax mitigation schemes are allowed within the EU law⁹⁸. Also, the Author thinks that the absence of commercial reasons is directly related to the wholly artificial arrangements and those two concepts could only be found to exist in the transaction if a taxpayer had the sole purpose to avoid taxes.

⁹⁴ Case C-321/05 *Kofoed* [2007], para 38

⁹⁵ See also: T. O'Shea, 'ECJ Looks at Danish Tax Rules Concerning Exchange of Shares', *Tax Notes Int'l* 29 (Oct. 1, 2007) p. 29

⁹⁶ Case C-352/08 *Zwijnenburg* [2010]

⁹⁷ *Ibid*, para 43

⁹⁸ In *Halifax* (C-255/02), the ECJ ruled taxpayers may choose to structure their business so as to limit their tax liability. Also, in *RBS Deutschland* C-277/09, the ECJ stated that taxable persons are generally free to choose the organisational structures and the form of transactions which they consider to be most appropriate for their economic activities and for the purposes of limiting their tax burdens.

To sum up, the settled case-law of the ECJ has showed that the substance over form principle could be found incompatible with the EU law if it disallowed tax benefits established in tax law directives while a taxpayer acted not abusively and transactions had commercial reasons.

C. Substance over form can be limited by the harmonized indirect tax directives

Although VAT is harmonized within the EU law, there is no general anti-avoidance measure provided in VAT directive. Therefore, domestic anti-avoidance measures, such a substance over form principle, could be found incompatible with the EU law only if it improperly limits tax benefits provided in VAT directive.

Firstly, it should be noted that a test for abusive tax practices in VAT sphere has been set out by the ECJ in the iconic *Halifax* case.⁹⁹ In this case, Halifax wished to set up four new call centres, on which ordinarily it would only have been able to reclaim 5% of the input VAT because of the mainly exempt nature of its outputs in financial services. Halifax used a tax scheme involving associated companies and a series of transactions at the end of which it was effectively able to reclaim all of the input VAT. The question arose whether this situation could be considered as abusive behaviour under the EU law. The Court said that a practice is abusive if (i) the transactions were contrary to the purpose of the VAT directive and the national legislation transposing it and (ii) it must be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. The Court went on to stress that the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages.¹⁰⁰

At first glance, it seems that the ECJ uses different purpose test in direct and indirect tax cases. As noted, *Cadbury Schweppes* identified tax abuse as 'wholly artificial agreements' which deals with 'the sole purpose test', whereas *Halifax* provides that 'the essential aim' to obtain a tax advantage is tax abuse ('the main purpose test').¹⁰¹ Therefore, *Halifax* case gives a little bit of confusion whether 'the sole purpose test' or 'the main purpose test' shall be applied in indirect tax cases. In order to correctly understand the case-law of tax abuse in indirect tax cases, the further analysis is required.

Firstly, *Cadbury Schweppes* case, which explicitly implies 'the sole purpose test' in direct tax abuse cases, came up 2 years later than *Halifax* case. Even though *Halifax* case talks about tax abuse with regard to the essential or the main purpose to get tax advantage, it provides that tax abuse will not exist where a transaction has substance of economic activity. In other words, even if a transaction has the essential purpose of obtaining a tax advantage, but was also concluded with regard to genuine economic activity of the taxpayer, such a transaction cannot be treated as abusive. Thus, the Author

⁹⁹ Case C-255/02, *Halifax*, [2004]

¹⁰⁰ T. O'Shea, 'CFC Reforms in the UK – Some EU Law Comments', *The EC Tax Journal* Volume 13, 2012-13

¹⁰¹ F. Vanistendael, 'Halifax and Cadbury Schweppes: one single European theory of abuse in tax law?', 2006, 15 *EC Tax Rev.* 4, p. 195, P. Pistone, 'The Need for Clarity and the Application of the Acte Claire Doctrine to Direct Taxes', 2007, 35 *INTERTAX* 10, p. 534-536

believes that, in *Cadbury Schweppes* case, the ECJ clarified the explanation of *Halifax* case and explicitly provided that 'the sole purpose test' is a key element of tax abuse.

Secondly, 'the sole purpose test' can also be found in the recent indirect tax case-law. In *RBS Deutschland Holdings* case¹⁰², the ECJ cited *Halifax* case but provided more precise explanation regarding tax abuse:

In the sphere of VAT, an abusive practice can be found to exist only if, first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of the relevant provisions of the directive and, second, it is apparent from a number of objective factors that **the essential aim** of the transactions concerned is **solely** to obtain that tax advantage.¹⁰³

Furthermore, in *Tanouarch* case¹⁰⁴, the ECJ dealt with the issues of VAT abuse, and provided references and very similar language to the *Cadbury Schweppes* case regarding definition of tax abuse:

The effect of the principle prohibiting abuse of rights is therefore to prohibit **wholly artificial arrangements** which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage.¹⁰⁵

It seems that a formulation of the subjective element of the sole purpose to get tax advantage is not different in indirect and direct tax cases, as the ECJ is using the 'sole' or 'essential' aim doctrine in both contexts.¹⁰⁶ Accordingly, the evolution of VAT jurisprudence appears to be going in the direction of giving the principle of prohibition of abuse a single structural content for both direct and indirect taxes. Therefore, there are sufficient indicators to agree with A. M. Jiménez opinion that the general prohibition of abuse of EU law has a homogeneous meaning for direct and indirect tax purposes in the ECJ's case law.¹⁰⁷

In conclusion, the settled case-law of the ECJ has showed that the ECJ consistently explains abusive behaviour of a taxpayer in direct tax and indirect tax cases. Therefore, a substance over form principle which limits tax benefits of the VAT Directive could be found incompatible if it is applicable to the transaction which has a real economic purpose and where a taxpayer has only the ancillary purpose of obtaining a tax advantage.

¹⁰² Case C-277/09, *RBS Deutschland Holdings*, [2010]

¹⁰³ *Ibid*, para 49

¹⁰⁴ Case C-504/10 *Tanoarch*, [2011]

¹⁰⁵ *Ibid*, para 51, see also: Case C-653/11 *Paul Newey* [2013]

¹⁰⁶ W. Schon, 'Abuse of Rights and European Tax Law', 2008, *Comparative Perspectives on Revenue Law*, p. 75

¹⁰⁷ A. M. Jiménez, 'Towards a Homogeneous Theory of Abuse in EU (Direct) Tax Law', April / May 2012, *Bulletin for International Taxation*, p. 292

V. CONCLUSION

There is no general anti-avoidance measure within the EU law. The EU law refers to the domestic anti-avoidance measures and gives them priority over general provisions of EU directives. This means that, in general, Member States are free to adopt anti-avoidance rules, such as a substance over form rule, and which can differ from country to country. An analysis of the case-law of the ECJ has showed that the substance over form doctrine, in general, is not used in the EU legal acts and the case-law, however, some examples of its application could be found.

Firstly, the OECD considers substance over form as a doctrine which is applicable to the situation where the parties of a transactions had other intentions (substance) than those reflected in the legal form of the transaction. This approach gives a very wide discretion for the tax authorities to re-characterize transactions, even though these transactions have certain economic logic. A different approach can be seen in the EU law. During an analysis of the case-law of the ECJ, the Author has revealed that a substance over form rule could be incompatible with the EU law only if (i) it violates the EU freedoms, (ii) it violates direct tax directives, or (iii) it violates harmonized indirect tax directives. According to the settled case-law of the ECJ, the substance over form rule can infringe the EU freedoms only by the different treatment of domestic and foreign entities in comparable situations of same treatment in different ones. This restriction cannot be justified by the need to fight wholly artificial arrangements, since it also tackles transactions which are not completely artificial. Finally, such justification shall not be proportional, since the substance over form rule could be considered as not specific and covering a lot of possible situations.

Secondly, an analysis of the case-law of the ECJ has showed that the ECJ uses a different subjective criteria while explaining 'the wholly artificial arrangements' doctrine. In case of restriction of the EU freedoms, the ECJ uses 'the sole purpose test', in case of limitation of direct tax directives, the ECJ uses 'the principal purpose test' and in case of limitation of VAT directive benefits, the ECJ uses 'the essential purpose test'. Despite this fact, the Author believes that the wholly artificial arrangement itself represents the sole purpose of getting a tax advantage, otherwise other purposes, such as to get an economic advantage, would not be caught by the concept of wholly artificial arrangements.

Thirdly, an analysis of the case-law has showed that a different position between the common-law courts and the ECJ can be noticed. In the case-law of the US courts, the substance over form rule has a very wide range and could be applicable to transactions, which have some substance. In the ECJ's case-law, the substance over form rule, if it restricts free movement, would be treated as justifiable only if the transactions lack any substance and are purely artificial. Hence, the case-law of the ECJ seems to be targeted more to the 'abuse of law' doctrine than to the 'substance over form' doctrine as it is provided by the OECD Tax Glossary (see Section II.A).

Finally, taking into consideration that purely national cases are not usually protected by the prohibition on limitation of free movement rights, purely domestic situations give wider discretion for the national tax authorities in applying the substance over form principle. In purely domestic situations the substance over form principle can be applied not only in cases of wholly artificial arrangements but in other situations as well. Therefore, the Author suggests that, a taxpayer should always consult domestic advisors on the status of the substance over form principle in the domestic case law since it may differ significantly from state to state. The EU law and the case-law of the ECJ should be looked at as well but only as one source out of several. It is always advisable to have a closer relationship and communication with the tax authorities before entering into tax mitigation schemes, in order to avoid any misunderstandings with the tax authorities.

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