THE RELEVANCE OF EU LAW TO MOTIVE DEFENCES

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The tensions between UK anti-avoidance legislation and general principles of EU law have for the most part been clearly appreciated by tax advisers in the UK since at least the decision of the ECJ in *Cadbury Schweppes plc and another v Inland Revenue Commissioners* (Case C-196/04) [2006] STC 1908. It is perhaps then surprising that the UK Courts appear to have retained a trenchantly insular view when considering the impact of EU legislation on more general principles of UK law. If compatibility with EU law is not squarely and plainly in point it appears to get little consideration[2].

This point is particularly plain where the UK courts turn to considering what is meant by tax avoidance as that term is used in the context of a UK statute. The term appears most often as part of a motive defence where the presence or absence of a tax avoidance motive will have significant tax consequences. It is suggested that EU law may be of significant relevance in analysing this issue. The purpose of this article is to consider the extent to which the UK Courts have been deficient in giving sufficient consideration to EU law issues in their considerations of when tax avoidance has taken place and to consider how they should be adapting their approach to reflect the legal realities.

Before turning to the UK Courts' approach to tax avoidance, however, it is necessary to give some consideration to the interaction of UK tax law and EU law, primarily the freedoms of movement guaranteed to citizens of the EU and now contained in the Treaty on the Functioning of the European Union ("TFEU"). It is necessary in this respect to have regard to the extent to which EU law makes allowance for rules intended to prevent tax avoidance.

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2 Even where the point is raised it may be dismissed without proper consideration: see *Coll v HMRC* UKUT 114 (TCC) 2010

EU law and direct taxation

It is by now well established that while direct taxation falls within the individual competence of each Member State of the EU, that competence must be exercised in compliance with EU law and in particular with the freedoms of movement laid down in the TFEU[3]. It is, however, clear that this does not require any given Member State to draw up its tax rules by reference to those of another Member State so as to remove any disparities. This has the inevitable consequence that there exist differences in tax regimes which, while presently compatible with the EU law, may operate to the advantage or disadvantage of a taxpayer[4].

Where such differences do occur a taxpayer cannot complain that in exercising his freedom of movement he is in a less advantageous fiscal position. Equally relevantly, however, the Member State cannot act to restrict the exercise of such a freedom where it would result in the taxpayer enjoying a lower rate of tax. The ECJ has consistently made clear that the prevention of a reduction in tax revenues will not justify legislation which restricts a person's exercise of one of the freedoms[5].
A Member State can, however, restrict the exercise of a freedom of movement where such restriction pursues a legitimate objective compatible with the Treaty or is otherwise justified by overriding reasons in the public interest[6]. However, even where a justification for a restriction on freedom is established, that is not necessarily sufficient. It is also necessary to show that the application of the restriction is appropriate to its objective and also that it does not go beyond what is necessary to attain that objective[7].

Preventing tax avoidance

This is not to say that the existence of fundamental freedoms of movement gives a free pass to multi jurisdictional tax planning. The ECJ has made clear that a restriction on fundamental freedoms can in certain circumstances be justified on grounds that it prevents what is described as tax avoidance. In order for this justification to be available to a Member State seeking to restrict a freedom of

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3 See for example C-337/08 *X Holding BV v Staatssecretaris van Financien* [2010] STC 941 at paragraph 16 and the cases cited there.

4 C157/07 *Deutsche Shell v Finanzamt für Großunternehmen in Hamburg* [2008] STC 1721 at paragraph 43

5 C-196/04 *Cadbury Schweppes plc and another v Inland Revenue Commissioners*) [2006] STC 1908 per A.G. Leger at paragraph 52 and the cases and passages cited there.

6 C311/08 *Société de Gestion Industrielle v État belge* ("SGI") at paragraph 56

7 C524/04 *Test Claimants in the Thin Cap Group Litigation v Inland Revenue Commissioners* ("Thin Cap") [2007] STC 906 at paragraphs 82 and 83

movement, however, the legislation implementing the restriction must be specifically aimed at preventing such tax avoidance[8].

Although the ECJ has not spelt out what it means by tax avoidance in this context, it is apparent that the term does not have the same technical meaning as when it is used by the UK Courts (considered below)[9]. Equally, however, it is not a wide catch all for all arrangements aimed to save tax (as noted above preventing a reduction in tax revenues will not justify legislation which restricts a person's exercise of one of the fundamental freedoms[10]). Tax avoidance in this context requires some objective verification, and it cannot be inferred merely from the fact that a taxpayer uses his fundamental freedoms to establish his residence in another Member State that he pursues a fraudulent objective[11]. This is in contrast to many parts of the UK legislation which seem to assume tax avoidance merely by virtue of the fact that an offshore element is involved.

What the ECJ has said in this context is that legislation can be justified on grounds of preventing tax avoidance where it specifically targets arrangements which are (i) wholly artificial arrangements and which do not reflect economic reality and (ii) designed to circumvent the legislation which would otherwise operate to tax activities carried out in the Member State concerned[12]. The effect of such legislation must, however, be proportionate to the aim pursued.

Abuse of rights

There appears to be some relationship between the ECJ's conceptualisation of tax avoidance (such as it is) and the general Community law principle that the abuse of rights conferred under EU law is prohibited[13]. That principle (which is still developing) has been considered extensively in the VAT context. There the ECJ has

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8 C303/07 *Aberdeen Property Fininvest Alpha Oy* at paragraphs 64 and 65

9 Contrast, however, the discussion of the term as it appears in article 11 of Directive 90/434 in C352/08 *Modehuis A. Zwijenburg BV* and in particular the comments of A.G. Kokott at paragraph 45 where the approach to the meaning of the term is more in line with UK jurisprudence:
"Conduct merely taking advantage of the options presented by Community law ... cannot by itself justify suspicion of abuse or tax avoidance".

10 See *Cadbury Schweppes* per A.G. Leger at paragraph 52 and the cases and passages cited there.

11 C451/05 *Europeene et Luxembourgeoise d'investments SA v Directeur general des impots* ("ELISA") [2008] STC 1762 per A.G. Mazak at paragraph 102

12 See *Cadbury Schweppes* at paragraphs 50 and 55 and *Thin Cap* at paragraphs 72 and 74

13 See *Cadbury Schweppes* per A.G. Leger at paragraph 88

held that a tax advantage can be refused where two conditions are satisfied. Firstly it must be established that, notwithstanding formal compliance with the provisions of the relevant legislation, granting the tax advantage which would otherwise accrue would be contrary to the purpose of those provisions.

Secondly, it must be shown by reference to objective factors that the principal aim of the transactions concerned is to obtain the tax advantage. Objective factors in this regard include the purely artificial nature of the transactions and any links of a legal, economic or personal nature between the parties involved. Obtaining the tax advantage need not be the only aim, although it has been said that it is not enough that obtaining a tax advantage is one of the aims. It must be the principal aim pursued, notwithstanding the possible existence of other economic objectives[14].
As regards this latter point, it is also to be noted that where the objective circumstances suggest a purely artificial arrangement, entered into for tax reasons alone, it is necessary that the taxpayer is given an opportunity to provide evidence of any commercial justification that there may have been for that arrangement[15].

It is unlikely that a genuine exercise of a freedom of movement as guaranteed by the TFEU could be considered an abuse of rights. A restriction on freedom of movement is likely to be permitted on tax avoidance grounds where there has been no actual exercise of the freedom of movement, but rather only steps intended to give the impression of the exercise of a freedom of movement. This would seem to be what the ECJ is considering when it refers to 'wholly artificial arrangements'. Where, however, there has been a genuine exercise of one of the fundamental freedoms of movement it is difficult to see how that could be contrary to the purpose of the treaty.

Wholly artificial arrangements

It is clear that where there is a genuine and actual pursuit of an activity by a person in another Member State, prevention of tax avoidance is unlikely to be in point and the reasons for establishing that undertaking there are irrelevant[16]. The necessary nature and extent of such activities may be open to question, but this likely to be determined in part by what activities of the person in question are being taxed and

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14 C425/06 *Ministero dell'Economia e delle Finanze v Part Service Srl* [2008] STC 3132

15 Thin Cap at paragraph 82 of the judgment.

16 C201/05 *Test Claimants in the CFC and Dividend Group litigation* at paragraphs 77 to 79 and at paragraph 81:

> "A tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives, that CFC is actually established in the host Member State and carries on genuine economic activities there".

the extent to which they could be said to be carried on elsewhere. As noted by A.G. Mengozzi in *Columbus*:[17]

> *"... in order to find that there is a wholly artificial arrangement, there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective factors which are ascertainable by third parties with regard, inter alia, to the extent to which the CFC physically exists in terms of premises, staff and equipment, showing that, despite formal observance of the conditions laid down by Community law, the objective of integration into the economic life of the host Member State pursued by freedom of establishment has not been achieved".*

References to genuine and actual pursuit of an activity have generally appeared in the context of freedom of establishment. In *ELISA*, however, A.G. Mazak appeared to go even further when, in the context of free movement of capital, he suggested that the anti avoidance justification might only permit taxing measures where legal persons established in another members state have no economic reality[18]:

> *"100. According to the case law of the court, 'wholly artificial arrangements' are those which do not reflect economic reality. In the case of freedom of establishment, the court has held that economic reality presupposes actual establishment of the company concerned in the host state and the pursuit of genuine economic activity there.*
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> *101. If we apply this reasoning to the free movement of capital, this appears to suggest that a restrictive measure should not go beyond taxing effectively the immovable property of those legal persons which are formally established in another Member State, where the establishment in that other Member State has no economic reality".*

This suggests that the 'artificial' element is looking at transactions which are effectively shams. If correct that would severely limit the scope of the justifiable restriction based on tax avoidance to something which UK Courts are unlikely to recognise as tax avoidance at all[19]. That is likely to be going too far, however, and the comments are probably best understood as illustrating how little need be done in order to exercise free movement of capital.

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17 Case C-298/05 *Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt* per A.G. Mengozzi at paragraph 172

18 at paragraphs 100 and 101

19 Such arrangements would seem to be more properly categorised as tax evasion.

Activities otherwise carried on in the Member State concerned

If a restriction on the freedom of establishment is 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 of a Member State*. The important point in this respect is that it is not permissible to tax activities carried on in a *different* Member State simply on the grounds that those activities might have been carried on the UK but have been transferred to the other state to benefit from lower tax rates. Profits from such activities are taxable in the Member State in which they are carried on. There is no anti-avoidance justification for taxing them elsewhere.

In this respect the tax avoidance justification for restrictions on fundamental freedoms is related to the justification which is sometimes referred to as the need to ensure a balanced allocation of taxing rights. As such, legislation restricting arrangements which are have the effect of transferring profits normally taxable in a person's Member State of residence to another Member State are normally permissible to the extent that they are proportionate[20]. Legislation taxing profit making activities simply because they have been transferred abroad will not be. Clearly this calls into the question to overall compatibility of provisions such as the transfer of asset abroad provisions in Chapter 2, Part 13 ITA 2007 ("the TAA provisions") although the discussion of such is beyond the scope of this article.

UK law and tax avoidance

It is now relatively clear that as a matter of UK law there is no overriding rule which applies to prevent tax avoidance. The House of Lords has made clear that the *Ramsay* principle is a properly a principle of statutory construction and not a rule of law described as such[21]. As a consequence, legislative rules which apply a different treatment to a transaction depending upon the presence or absence of tax avoidance are now restricted to specific statutory contexts in which they appear, for example the motive defence to the TAA provisions in section 737 ITA 2007.

In this context the UK Courts have construed the term tax avoidance where it appears in a statute in a technical legal sense. Tax avoidance covers arrangements

20 C182/08 *Glaxo Wellcome GmbH & Co KG v Finanzamt München II* [2010] STC 244 at paragraph 82

21 See for example *Barclays Mercantile Business Financial Ltd v Mawson* [2005] 1 AC 684. A discussion of the relevant principles and how they have subsequently been interpreted by the lower Courts is beyond the scope of this article.

which are intended to reduce tax liability in a manner which is contrary to the intention of Parliament[22]. This is in contrast to tax mitigation (reducing tax liability, but a manner not inconsistent with the intentions of Parliament) and tax evasion (dishonest conduct intended to mislead the revenue authorities as to the true tax liability).

This conception of tax avoidance may not (when properly applied and understood in the context of the rights and obligations introduced by the EC treaty) be entirely dissimilar from the concepts applied and understood in the ECJ. It is difficult to see that there is much difference between a test which looks at arrangements intended to reduce tax liability in a manner which is contrary to the intention of Parliament and one which looks to the purpose of legislation in circumstances where its requirements have been formally complied with (the first part of the determination of whether there has been an abuse of rights).

Nevertheless, the UK concept of tax avoidance which is currently being applied by the Courts is plainly wider than the concept which the ECJ is considering when referring to tax avoidance as a justified restriction on fundamental freedoms. In particular, the UK concept of tax avoidance as presently applied is not restricted to ‘artificial transactions’ and plainly covers situations where activities are moved to another Member State to obtain a reduction in tax.

The ECJ would not consider this to be tax avoidance. If activities are genuinely transferred to another Member State there are no artificial arrangements, and in any event, the right to tax such activities is not to be allocated to the UK.

Tension between freedoms of movement and tax avoidance as applied by UK courts

The tension between the freedoms of movement guaranteed under EU law and the conceptualisation of tax avoidance by the UK Courts can be seen when one considers the situation where real property is placed in a foreign resident company. In *ELISA* the ECJ considered that placing immovable property in a foreign resident company where it was held passively was an exercise of the free movement of capital such that provisions which operated to restrict that right were held to be contrary to EU law.

A similar factual scenario was considered by Special Commissioner Nowlan in *Burns v HMRC* [2009] SpC 728 where he stated at paragraph 59:

> *“Indirectly retaining a UK real property, and simply achieving the technical change in status by putting the property into a non-UK resident company in a case where one of the purposes is to achieve the potential inheritance tax*

22 *IRC v Willoughby* [1997] STC 1003

> *('IHT') advantage, implicit by effecting those steps, does seem to me to cross the border between mitigation and tax avoidance. This is because it has involved no real change of investment, as in the two previous examples, but the retention of the UK property, accompanied by a step to change the normal tax consequences of that. Thus where it is shown that the CTT or IHT considerations were one of the purposes of the transfer, or rather where the appellants have not displaced the reasonable presumption that UK advantages were one of the purposes, I conclude that those purposes involve tax avoidance and not merely mitigation".*

On the Special Commissioners view exercising a fundamental freedom to reduce a charge to tax was tax avoidance. This was sufficient to permit the UK to tax the income of the non-resident company under the transfer of assets abroad provisions in Chapter 2, Part 13 ITA 2007. Would that same conclusion, have been reached, however, if the Special Commissioner had turned his mind the EU law issues inherent in his hypothesis?

Further in *Coll v HMRC*[23] the Upper-tier Tribunal considered that it was tax avoidance within section 137 TCGA 1992 to seek to move to another EU Member State shortly after exchanging shares for loan notes (with a view to reducing the tax charge on redemption of the loan notes), with the consequence that there was a charge on the exchange of the shares. The Upper-tier Tribunal was even prepared to go so far as to suggest[24] that the provision would be justified under EU law as preventing avoidance, notwithstanding that there was a reality to what the taxpayer undertook which is inconsistent with the ECJ approach to justifications based on tax avoidance.

More relevantly, however, the ECJ has previously held that an exit charge on unrealised gains applied to those exercising a freedom of movement where those remaining resident would benefit from a deferred charge was unlawful[25]. It is likely that refusing relief under section 135 TCGA 1992 simply on the basis that an exercise of freedom of movement was contemplated would be similarly unlawful since it would not be denied to those remaining resident (although the different CGT status of residents and non residents complicates matters somewhat and opens arguments as to a possible justification for different treatment).

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23 UKUT 114 (TCC) 2010

24 At paragraph 2, although the statement was an aside and not part of any detailed consideration of the merits or otherwise of the arguments on this point.

25 C-9/02 *de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie* [2005] STC 1722

Although the Tribunal considered that the arguments as to the compatibility of the relevant provisions with EU law were not open on appeal, they did not even address the issue as to whether they were relevant to the central question of whether there was any tax avoidance at all. It should, however, be pointed out that, leaving aside the question as to compatibility of the legislation with EU law, there probably was tax avoidance because there was both a contemplated exercise of the freedom of movement *and* a contemplated reliance on the double tax treaty to remove the charge from UK tax. It was the former point, however, which was the focus of the analysis.

Can exercising a fundamental freedom be tax avoidance?

There is clearly an issue as to whether conduct whereby a person exercises a fundamental freedom should properly be considered tax avoidance in the sense that term is applied by the UK Courts. While the exercise of a fundamental freedom to take a charge outside of UK tax (as in *Coll*) might be tax avoidance, it is difficult to see how the exercise of a fundamental freedom with the sole purpose of reducing a charge to tax on future profits and gains can be anything other than tax mitigation where those profits and gains are earned outside the UK.

In enacting the European Communities Act 1972 Parliament has expressed the clear intention that all of the rights and obligations of EU law should be incorporated into UK law and rank supreme to it. As such, Parliament has made clear that UK taxpayers should enjoy the rights set out in the TFEU and earlier treaties.

It would be a surprising conclusion to suggest that an exercise of those rights is contrary to the intentions of Parliament, particularly given that Parliament has indicated that those rights are to rank supreme over any other legislation. If that is correct, then the question arises as to whether exercising those rights to reduce a tax burden is contrary to the will of Parliament. While the point is not unarguable, it is suggested that since those rights rank supreme to the provisions of UK tax legislation they are to be given priority to that legislation, and their exercise cannot be said to be frustrating the will of Parliament. Any reduction in tax payable is simply an inevitable consequence of the exercise of freedoms of movement expressly conferred.

Furthermore, since the ECJ has made clear that the fundamental freedoms are exercisable regardless of any reduction in tax revenue of a Member State which results, it should follow that those rights are conferred to be exercised in any way an EU citizen sees fit including to reduce future tax liabilities. It would seem to follow, therefore, that in exercising a fundamental freedom to reduce a tax liability a taxpayer is not engaged in tax avoidance, but rather tax mitigation.

If the conclusion that the mere exercise of a fundamental freedom is not tax avoidance where it is exercised with a view to reducing future tax liabilities it would seem to have a significant effect on the current approach of HMRC to the application of motive defences in UK taxation statutes. Indeed, if such a conclusion is correct then many anti avoidance provisions will have a significantly shallower scope than previously understood.

Transfer of assets abroad and free movement of capital

An example of one area where such a revised interpretation of the term tax avoidance would be of significant relevance is in the context of the TAA provisions. The section 737 ITA 2007 motive defence provides *inter alia* that there is to be no liability to income tax under the main provisions if:

> *".. it would not be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected".*

There must be a reasonable argument that if a transfer of assets is an exercise of free movement of capital (albeit to reduce future tax charges) and nothing more, then it does not involve any tax avoidance and the motive defence is available.

Hypothetical restrictions

This raises an additional question. Is the exercise of a freedom of movement tax avoidance in circumstances where a restriction on that freedom of movement might be permitted? It is suggested that there is a difference between the scope of a freedom of movement and the extent to which it can be exercised. The scope is unaffected by restrictions but the extent to which the freedom can be exercised is.
Since the question of whether there is tax avoidance is concerned with rights conferred by Parliament, an actual restriction is needed. As such there are unlikely to be grounds for reading such a restriction into the term tax avoidance without substantially altering its currently understood meaning. Accordingly, it is suggested that the exercise of a freedom of movement could not be tax avoidance in the technical sense, even where a restriction on that freedom of movement could be legitimately introduced.

This is particularly relevant in the context of the transfer of assets abroad. Although it is unlikely that the transfer of assets abroad provisions are compliant with the freedom of establishment[26] to the extent that it is in point, the position for free movement of capital is less clear cut. Free movement of capital, however, is not restricted to intra EU movements.

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26 The provisions would seem to fall within the scope of both freedoms: *C157/05 Holböck v Finanzamt Salzburg-Land* [2008] STC 92 at paragraph 24

Application of free movement of capital to third countries

The provisions on free movement of capital are currently contained at articles 63 to 66 TFEU. Article 63(1) provides:

> *"Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited"*.

While this would appear to be much wider in geographical scope than the other freedoms, the ECJ has restricted the extent to which it can be relied upon in the face of conflicting national legislation. In particular as regards movements between Member States and EEA States (in the context of the EEA Agreement), or Member States and third states (in the context of free movement of capital) it has been said that different considerations apply as such movements do not necessarily take place in the same legal context[27]. In particular the absence of Council Directive 77/799/EEC (which permits Member States to request information from each other) has led to restrictions being upheld as between Member States and non-Member States.

Similarly Article 64 permits restrictions as between a Member State and third countries which were in place on 31 December 1993. This was clearly in point as regards the TAA provisions until at least 4 December 2005.

These provisions, however, only permit restrictions on the free movement of capital. They do not affect the scope of the free movement of capital and are therefore not relevant to the more fundamental question as to whether there has been an exercise of the right of free movement of capital and consequently whether a particular movement of capital is tax avoidance or tax mitigation.

If as suggested, such a movement is not tax avoidance, it becomes irrelevant that HMRC could rely on these provisions to resist an argument based upon directly enforceable treaty rights. Since those treaty rights are interwoven into the UK legislation and in particular the current approach to the technical meaning of tax avoidance, it may not be necessary to go so far as to consider whether the UK legislation is otherwise enforceable. If that is right, then given the scope of article 63 TFEU any movement of capital is tax mitigation and the motive defence will almost always be available.

This does, however, assume a relatively simple factual situation and it is not unlikely that the existence of complicating factors may bring the applicability of the motive defence into question, even accepting that the exercise of a fundamental freedom is tax mitigation and not tax avoidance.

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27 C540/07 *Commission v Italy* at paragraph 69

Conclusion

There is a tension between the current approach to the application of UK statutory provisions relating to tax avoidance and the rights conferred by the EC treaty. If it is correct that tax avoidance is aimed at transactions which operate to reduce the tax charge in a manner which frustrates the will of Parliament, then in cases where the exercise of fundamental freedoms are in point, it becomes necessary to ascertain what the will of Parliament is in conferring such freedoms.

Having regard to the application of the European Communities Act 1972 and the interpretation of the EC treaty by the ECJ it is difficult to see how a person exercising a fundamental right to reduce future tax liabilities can be engaged in anything other than mitigation as that term is currently explained by the UK Courts. The position, may, however, be different in relation to steps taken to remove accrued or unrealised income gains from the UK charge to tax.

This could be particularly relevant in the context of movements of capital where, since 1993 EU persons have enjoyed freedom of movement not only between Member States but also with third countries.