THIN CAPITALISATION, TRANSFER PRICING AND THE ECJ

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1. Introduction

European Court of Justice (ECJ)[1] and domestic case law in the field of thin capitalisation/ transfer pricing has led to uncertainty, particularly as regards whether subsequent changes made to domestic legislation were necessary.

This paper starts by reviewing the role of the ECJ in direct tax cases and goes on to look at the principles of the UK's thin capitalisation regime, the changes made to UK domestic legislation over the past two decades and considers the effects of key judgements: in particular, what has been the ECJ's influence in this field? It then goes on to consider whether the ECJ has merely been using its powers to uphold the aims of the EC Treaty, or whether it has been instrumental in creating new law.

2. Role of the ECJ in direct tax cases

Whereas Article 93 of the EC Treaty (Article 113 TFEU) gives specific powers for the harmonisation of indirect taxes, no equivalent provisions exist for direct taxes[2]. So at first sight, it might appear that neither the European Commission nor the ECJ- the supreme court of the European Union (EU)- have powers in the field of direct taxation. In the Treaty of Lisbon, the EU shares competence with Member States in

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1 The Lisbon Treaty came into force on 1 December 2009 and the EC Treaty is now known as the Treaty for the Functioning of the European Union (TFEU). The Articles were renumbered. In this paper references are made to Articles by their numbers in the EC Treaty, and to Community law rather than European Union law, as the cases were decided on that basis.

2 The provisions in the direct tax field (although not directly referred to as such) are contained in Article 94 EC Treaty (Article 115 TFEU) - the general harmonisation provision- and Article 308 EC Treaty (Article 352 TFEU) - a 'sweep up' clause. In addition, under Article 293 EC Treaty (now repealed), Member States shall *"...enter into negotiations with each other with a view to securing for the benefit of their nationals...the abolition of double taxation within the Community"*.

certain areas including the Internal Market.[3] This means that both the EU and the Member States can make laws in these areas, but EU law prevails over national laws. The national legislation of the 27 Member States must not infringe the principles of the Internal Market (which include the fundamental freedoms) as set out in the Treaty and the role of the ECJ is to interpret the Treaty. But is the ECJ going further than this and creating new rules, particularly in connection with cross-border tax issues?

Up until the early 1990s, most of the tax cases decided by the ECJ were simple and often involved individuals, but became more complex as time went on.[4]

Some of the judgements emanating from the ECJ in recent years have caused major changes to be made to national tax legislation and documentation requirements in many of the Member States. Recent influential cross-border cases have included *Marks & Spencer*[5] which affects group relief, *Cadbury Schweppes*[6] in the CFC arena and *Thin Cap GLO*[7] for thin capitalisation issues.

The decisions can have huge effects on the budgets of Member States, which has a knock-on effect on taxpayers and those dependent on services provided by the State.[8]

Progress made to bring in direct tax provisions has been eclipsed by the effect of ECJ decisions: the focus of this article is on the consequences of the thin cap decisions.

In the next section, the principles of the thin cap regime are outlined followed by a summary and reasoning of the changes made to the UK legislation over the years.

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3 Article 4 (1) and (2)(a) TFEU. If there is a dispute over where the boundary lies, the Court of Justice decides.

4 Not all cases were simple however: see the discussion on comparability re *Finanzamt Köln-Altstadt v Roland Schumacker* C-279/93 [1995] ECR I-00225 in Michael Lang, 'Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions' (2009) 3 EC Tax Review p101 et seq.

5 *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* C-446/03 [2005] ECR I-10837 (*'Marks & Spencer'*)

6 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* C-196/04[2006] ECR I-7995 (*'Cadbury Schweppes'*)

7 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* C-524/04 [2007] ECR I-2107 (*'Thin Cap GLO'*)

8 For example, the UK government originally estimated that an unfavourable decision in *Thin Cap GLO* would cost EUR 300 million: *Thin Cap GLO* para 129

3. Thin capitalisation- the principles

Business activities may be financed by way of loan capital, share capital or a mixture of both. These different forms of finance will have different levels of risk, different payment periods and returns and the particular combination of debt and equity used will often depend on factors such as the economy and tax.

When looking at financing cross-border, the taxation of interest arising on debt generally (but not always) produces a more favourable result than the taxation of dividends arising from share capital. The main advantage is that interest paid by the borrowing entity is usually tax-deductible on the basis that it is an expense of pursuing business activities, whereas dividends are paid out of post-tax profits. Other advantages include withholding taxes- these can be at a lower rate than those applied to dividends- and wealth taxes, which are based on equity rather than debt.[9] The favourable tax treatment may lead the taxpayer to choose a higher proportion of cross-border debt. If the borrower is subject to tax in a country with a higher tax rate than the lender, the tax advantage of debt rather than equity funding is obvious. This is known as tax arbitrage: the UK is one of many jurisdictions which have introduced anti-arbitrage legislation[10] to counter this abuse, whereby interest on loans which are disguised equity is re-characterised as a profit distribution. The borrower cannot deduct all or part of its interest payment and the lender is subject to dividend taxation rules.[11]

4. Thin capitalisation- the UK rules

The legislation in the UK applying to thinly capitalised companies has been amended several times in the past two decades. Some of these changes have arisen as a direct result of ECJ judgements.[12] Throughout this time, the UK has used a version of the arm's length method to determine the deductibility of interest payments, rather than relying on a 'safe harbour' limit.[13]

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9 Roy Rohatgi, 'Anti-Avoidance Measures' in Roy Rohatgi *Basic International Taxation Volume 2: Practice* (second edition, BNA International Inc, London 2007) 215

10 Finance (No 2) Act 2005 s24-31 and Sch 3

11 Under Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (90/435/EEC), no withholding tax is charged on dividends paid by a company in one Member State to another.

12 For example, in 2004 the UK extended its thin cap regime to include UK-UK transactions following the case of *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* C-324/00 [2002] ECR I-11779 (*'Lankhorst'*)

13 'Safe harbour' refers to prescribed financial debt to equity ratios which are considered acceptable. See Inland Revenue Manual INTM581010 for a review of this in different jurisdictions.

4.1 The national position pre 1995

Before 1995, any interest paid by a UK-resident company on a loan was treated as a distribution of profits –a dividend- to the extent that the interest represented more than a reasonable commercial return on the loan.[14] This applied regardless of whether the lender was UK- or non UK-resident. Because the interest was re-categorised as a dividend, the borrower received no interest deduction for the amount over and above a reasonable commercial return and in addition became liable to pay ACT (advance corporation tax).[15]

Also, if interest was paid within a group by a UK-resident company to a non UK-resident, any interest not already re-categorised as a distribution would be so treated, even where the interest represented a reasonable commercial return on the loan.[16] This applied to loans made to a UK-resident subsidiary which was 75% owned by a non UK-resident company or where both lender and borrower were 75% subsidiaries of a non UK-resident company.

These provisions did not come into play if a double tax treaty (DTC) was in place.[17] To summarise, ***all*** interest paid to a non UK-resident affiliate was classed as a distribution unless overridden by a DTC.

4.2 Amendments made to the UK legislation in 1995

The effect of the 1995 amendments was to treat interest paid between group companies as a distribution only to the extent that it exceeded an arm's length

14 Income and Corporation Taxes Act 1988 ('ICTA1988') s209(2)(d)

15 ICTA1988 s14. When making a qualifying distribution, a UK resident company had to pay ACT to the tax authorities. This ACT was then set against that company's corporation tax liability. A 'group income election' could be made between UK resident companies so that subsidiaries did not pay ACT on their distributions. Following the joined cases of *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v Commissioners of Inland Revenue and HM Attorney General* C-397/98 and C-410-98 [2001] ECR I-1727, this treatment was deemed contrary to freedom of establishment. ACT was abolished in 1999. In the later case of *Test claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* C-374/04 [2006] ECR I-11673, it was held that a non-resident parent company was not entitled to a tax credit in respect of the distribution received from its UK subsidiary.

16 ICTA1988 s209(2)(e)(iv)and(v)

17 ICTA1988 s788(3). In some Double Taxation Conventions ('DTCs'), if the interest rate was in excess of an arm's length rate, the excess interest was taxable in accordance with domestic law.
In the newer DTCs, the amount of the loan was taken into account as well as the interest rate. From 14 May 1992, ICTA1988 s808A gives guidance on the circumstances in which the amount of the loan or interest rate exceeded the arm's length amount.

amount.[18] However, this rule did not apply where the borrower and the lender were liable to UK corporation tax.[19]

4.3 Amendments made to the UK legislation in 1998

In 1998 separate thin capitalisation rules were abolished and the Finance Act 1998 added Schedule 28AA to ICTA1988. This schedule contains rules for transfer pricing and these apply also to interest payments made between companies. A new approach was introduced: instead of treating any excessive interest as a distribution, it was simply disallowed. So, if two companies under common control[20] entered into a loan transaction under terms which were not at arm's length- in other words, on a more favourable basis than would be provided by an unconnected lender- the borrower's taxable profits would be increased by the interest costs on the excess debt with no availability of tax credits to the non UK-resident recipient.

4.4 Amendments made to the UK legislation in 2004

In 2004 the scope of the thin capitalisation provisions was increased to include, for the first time, loans made between two UK-resident companies[21]. These amendments were made in response to the *Lankhorst* decision- discussed in detail below.[22]

4.5 Measures introduced in 2009

As far as distributions were concerned, the UK historically had an exemption system for those received domestically and a credit system for foreign dividends. This

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18 ICTA1988 s209(2)(e)(iv)and(v) were replaced with s209(da). S209(8A) to 8(F) elaborated, specifying conditions under which interest was re-characterised as distributions and the extent of grouping to assess borrowing capabilities.

19 ICTA1988 s212(1)and(3)

20 ICTA1988 Sch28AA s1 sets out criteria for common control. It includes direct or indirect participation by a company in the management, control or capital of the other affected company and direct or indirect participation of a third person in the management, control or capital of each of the affected companies.

21 The exemption previously in ICTA1988 s 212(1) was withdrawn with effect from 1 April 2004. However, exceptions were made for small and medium sized enterprises (subject to certain conditions), recognising the fact that UK businesses will be exposed to significant extra documentation requirements.

22 HM Revenue & Customs 2003 Pre-Budget Report states: *'Some doubts have been expressed as to the interaction of these rules with European law. Whilst the government does not accept that there is any incompatibility, it recognises the importance for business of certainty in tax law.'* http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&propertyType=document&columns=1&id=HMCE_PROD_009669 (last visited 21 February 2010)

difference in treatment led to a number of ECJ cases[23] and the UK tax authorities decided to make changes to the regime for taxing foreign profits. The Treasury consultation on 'Taxation of Foreign Profits'[24] resulted in legislation being introduced in the Finance Act 2009[25] limiting the tax deduction for finance expenses for UK-resident companies in a group to the consolidated worldwide interest and finance expenses of the multinational group (known as the 'worldwide debt cap'). This affects UK companies with substantial intra-group borrowings which exceed the borrowings of the group as a whole.[26]

Now that thin cap principles and UK legislative changes have been outlined, this paper goes on to review the effects of specific ECJ judgements on national legislation and considers whether the changes went too far in an attempt to comply with Community law.

5. ECJ cases involving thin capitalisation/ transfer pricing issues

There are a handful of cases involving thin cap/ transfer pricing issues, and include *Lankhorst*, *Lastertec*[27], *Thin Cap GLO, Lammers*[28] and, most recently, *SGI*[29].

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23 For example, *Test Claimants in the Franked Investment Income Group Litigation v Commissioners of Inland Revenue* C-446/04 [2006] ECR I-11753 ('*FII*')

24 http://www.hm-treasury.gov.uk/d/consult_foreign_profits020707.pdf (last visited 25 March 2010)

25 FA2009 s35 and Sch15

26 Apart from the worldwide debt cap, other measures introduced in FA2009 were an exemption for foreign dividends and replacement of treasury consent rules with a post-transaction reporting requirement. As regards the reform of the controlled foreign company (CFC) rules, the government published a discussion document in January 2010 and aims to legislate in 2011. See http://www.hm-treasury.gov.uk/d/cfc_discussiondoc_260110.pdf (last visited 25 March 2010).

27 *Lasertec Gesellschaft für Stanzformen GmbH v Finanzamt Emmendingen* C-492/04 [2007] ECR I-3775 ('*Lasertec*')

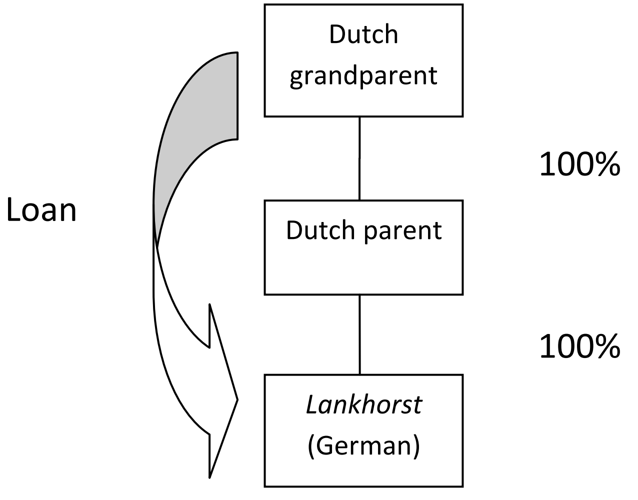
28 *NV Lammers & Van Cleef v Belgische Staat* C-105/07 [2008] ECR I-0000 ('*Lammers*'). The decision in this case followed and added little to the principles established in *Lankhorst* and *Thin Cap GLO* and is not considered further in this paper.

29 *Société de Gestion Industrielle SA(SGI) v Belgian State* C-311/08 [2010] ECR I-0000(not yet reported) ('*SGI*')

6. *Lankhorst*

6.1 Background

This case involved Lankhorst, a loss-making German company with a Dutch parent, borrowing from its Dutch grandparent, all shareholdings being 100%.



The loan was intended as a substitute for capital[30] and Lankhorst could not have obtained third party finance under identical terms[31] (and so failing the arm's length test[32]). It was interest-bearing, repayable in annual instalments over 10 years and accompanied by a letter of support guaranteeing priority of any claims to third parties.

Lankhorst claimed that the loan constituted a rescue attempt[33] and used the loan to repay bank debts. The German tax authorities denied a tax deduction for the inter-company interest payments, re-characterising them as distributions which were subject to tax at 30%.

6.2 German legislation

The German thin capitalisation rules came into play when the debt to equity ratio exceeded 3:1, as was the case here. This had the effect that non German-resident

30 *Lankhorst* para 8

31 Lankhorst was over-indebted and unable to provide security: *Lankhorst* para 12

32 *Test Claimants in the Thin Cap Group Litigation and Commissioners for Her Majesty's Revenue and Customs* [2009] EWHC 2908 (Ch) ('*Thin Cap GLO (High Court)*') paras 37,38

33 *Lankhorst* para 14

shareholders and companies exempt from German corporation tax were not entitled to a tax credit for the underlying corporate income tax. Significantly, if the loan had come from a German parent instead of the Dutch company, no interest would have been disallowed.

6.3 Which freedom applies?

In thin capitalisation/ transfer pricing cases, the relevant freedoms are freedom of establishment and free movement of capital. Which freedom applies has to be determined on a case-by-case basis. The particular fundamental freedom impacted upon is important because the free movement of capital is the only one which extends to third country situations; it also contains a 'standstill' provision.[34] Although capital movements are not explicitly defined in the EC Treaty, settled case law refers to Annex 1 of Council Directive 88/361 for a list giving the flavour of the types of capital movements covered. It includes direct investments, portfolio investments and loans, but does ***not*** involve the exercise of actual management or control.[35]

Lankhorst is a resident of a Member State (Germany) having cross-border activity in another Member State (the Netherlands), thereby falling within the scope of the EC Treaty. The level of shareholdings gave the Dutch lender a definite influence over Lankhorst's decisions and allowed the lender to determine the company's activities, so it was the freedom of establishment that was relevant[36].

Although the German thin cap provisions denied a tax credit to those German resident shareholders exempt from corporate income tax (such as legal persons governed by public law), the effect of the rule was to treat non-resident companies less favourably than resident companies: the German legislation imposed a restriction.[37]

6.4 Any justifications?

Three justifications were put forward, none of which was accepted:

i) Prevention of tax avoidance

The German thin capitalisation legislation contained no specific provisions for preventing wholly artificial transactions but applied generally to companies with a

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34 The EC Treaty Article on free movement of capital became directly effective on 1 January 1994

35 For a fuller analysis, see Tom O'Shea, 'Thin Cap GLO and Third-Country Rights: Which Freedom Applies?' (2007) Tax Notes International April 23, 2007 p371-375

36 *Lankhorst* para 20 refers to settled case law in *C Baars v Inspecteur der Belastingen Particulieren/ondernemingen Gorinchen* C-251/98 [2000] ECR I-2787 ('*Baars*')

37 *Lankhorst* para 32

non German-resident parent[38]. *Lankhorst* did not have the perceived motive of abuse – namely to move profits from a high to low tax rate jurisdiction – as it had used the loan to repay bank debt and prevent financial disaster.

ii) Effectiveness of fiscal supervision

No argument was advanced as to how the German legislation enabled the taxable income to be supervised!

iii) Coherence of the tax system

There was no advantage that could have offset the disadvantageous treatment of interest payments arising from having a non German-resident parent.[39]

6.5 German v UK thin cap provisions

The UK thin cap provisions differ from the German rules considered in *Lankhorst.* The German legislation provided for a simple formulaic approach to determine whether interest was re-characterised as a distribution, whereas the UK rules contained an (internationally-recognised) arm's length test which was supposed to identify artificial arrangements with a tax deduction being denied for only the excess. The German rules had no such capacity.

6.6 Comments

The UK government put forward submissions to the ECJ. This was a German case, so why did the UK need to get involved? It was because an unfavourable outcome would threaten the UK transfer pricing rules which treated debt received from a non UK-resident Member State company less favourably than debt from a UK-resident company.

Under the legislation in place at the time of this case, if a thinly capitalised UK company paid interest to a foreign lender where at least a 75% relationship existed between the two, there was a disallowance of the excessive (non arm's length) interest, whereas if the lender was a UK-resident company, the excessive interest would not be disallowed. As a result of the *Lankhorst* decision, some Member States - the UK and Germany among them- extended their thin capitalisation rules to

38 *Lankhorst* para 37

39 The case differs from *Hanns-Martin Bachmann v Belgian State* C-204/90 [1992] ECR I-249 as in *Bachmann*, where coherence was accepted as a justification, the taxpayer was one and the same person: *Lankhorst* para 42

include purely domestic intra-group payments.[40] In doing so, there no longer remained any difference between the tax treatment of interest paid to residents compared with non-residents, thus complying with the EC Treaty requirements.

It is, of course, up to national governments to amend domestic legislation as they see fit in order to comply with EU law. In this instance the UK government chose to extend the existing treatment to domestic cases, even though little risk of abuse exists in purely domestic situations. It is worth noting that in the opinion he delivered in the later *Thin Cap GLO* case, Advocate General Geelhoed noted that:

> *'...Such an extension of legislation to situations falling wholly without its rationale, for purely formulaic ends and causing considerable extra administrative burden for domestic companies and tax authorities, is quite pointless and indeed counterproductive for economic efficiency. As such, it is anathema to the internal market.'*[41]

The upshot of this is that the ECJ's decision in *Lankhorst* led to changes being made to the UK legislation in 2004 which arguably would not have been made in the absence of that decision. An alternative would have been to apply the thin cap rules to wholly artificial arrangements both domestically and cross-border. In doing so, UK-UK transactions would invariably be excluded from the need to make an adjustment. Reflecting on the outcome of the later *SGI* case, it could be argued that the UK-overseas transfer pricing adjustments were justified.[42]

Many of the Member States' governments also extended their existing cross-border transfer pricing rules to cover domestic situations[43], which has led to an increase in transfer pricing enquiries and increased documentation compliance costs. In contrast, Spain disapplied its thin cap rules for transactions between Member States.

It could be argued that if no corresponding adjustment is available to the non-resident lender, the domestic thin cap legislation ***causes*** double taxation: not only does this impede overseas trade and investments but it is contrary to the goal in the second bullet point of Article 293 of the EC Treaty.[44] This potentially has a large effect on the global tax liabilities of groups of companies, adversely affecting their

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40 In cross border situations, Member States often choose to abolish the preferential domestic tax regime rather than extend this treatment to other Member States, or to extend the unfavourable treatment affecting other Member States domestically.

41 Opinion of Advocate General Geelhoed delivered on 29 June 2006. Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue C-524/04 [2007] ECR I-02107, ('*Thin Cap GLO (Opinion)*'), para 68

42 This is based on the need to prevent tax avoidance and to maintain the balanced allocation of the power to tax, taken together: see section 9.5 below for a detailed analysis

43 For example, the UK by way of Finance Act 2004 s 30 (but small- and medium sized enterprises were largely exempted) and Germany.

44 Repealed in TFEU.

effective tax rate. The double taxation issue is largely addressed by bilateral Double Taxation Conventions ('DTCs'), the EU Arbitration Convention and harmonisation incentives.[45]

Although it might appear from ECJ case law decisions that the European Commission is not actively promoting the abolition of double taxation (preferring instead to concentrate on protecting the fundamental freedoms), there has in fact been considerable activity in this area. For example, the Joint Transfer Pricing Forum of the European Commission has been actively working on a revised Code of Conduct as regards the EU Arbitration Convention and this was approved in December 2009.[46]

The next thin cap case reviewed here- *Lasertec*- is interesting because it concerns a third country and whether the free movement of capital applies.

7. *Lasertec*

Lasertec involves Switzerland, a third country. A Swiss-resident company held two-thirds of the share capital of its German subsidiary to which it advanced a sizeable loan, breaching the German thin capitalisation rules. The case was brought before the ECJ under free movement of capital.

The ECJ decided that *'...national provisions relating to holdings giving the holder a definite influence on the decisions of the company concerned and allowing him to determine its activities...'* [47] fell within the scope of the freedom of establishment and any restrictive effects on the free movement of capital were an unavoidable consequence of the freedom of establishment.[48] As the freedom of establishment does not extend to third countries[49], the EC Treaty was not engaged.

45 See sections 10 and 11 below for further consideration.

46 See section 11.2 below. Also worthy of note here is the work carried out by the Organisation for Economic Cooperation and Development ('OECD'): in November 2009, the OECD released a revised draft of Article 7 (Business Profits) of the Model Tax Convention, dealing with the attribution of profits to permanent establishments and aiming to avoid double taxation. For details see http://www.oecd.org/dataoecd/30/52/44104593.pdf (last visited 25 March 2010)

47 *Lasertec* para 20

48 *Lasertec* para 25, referring to ECJ findings in *Lankhorst*

49 For a full analysis of third countries and the free movement of capital, see:
Tom O'Shea, 'News Analysis: Third Country Denied Freedom of Establishment Rights in *Lasertec*' (2007) Tax Notes International Volume 46, Number 10 p990

Continuing the review of the ECJ cases relating to thin cap, the next case again concerns freedom of establishment and the extent to which the thin cap rules in the UK prior to the changes in 2004 were acceptable in targeting tax avoidance.

8. *Thin Cap GLO*

8.1 Background

Thin Cap GLO followed hot on the heels of the ECJ's decision in December 2002 in *Lankhorst*, and was brought by a number of claimants against the UK tax authorities for restitution and compensation for tax disadvantages suffered.[50]

Each of these cases was selected to represent different company structures: they all involved a UK subsidiary that was directly or indirectly at least 75% owned by a foreign parent and had borrowed funds from its parent or another foreign group company. In the Lafarge and Volvo groups, the lending and parent companies were established in the same Member State (France and Sweden respectively). The first type of Caterpillar[51] group claim involved a loan from an Irish company in a US parented group; the second type of Caterpillar group claim involved a loan from a Swiss company in a US parented group. Finally, in the Pepsico[52] (another US parented group) group claim, the company granting the loan had its seat in Luxembourg but operated through a branch in Switzerland.

Broadly, the issue was this: the UK legislation[53] restricted the deductibility of interest on loans from a non-resident group company whereas if the lender was a domestic group company, no restrictions were made.

Ten questions were referred for a preliminary ruling, the issues being:

a) Which freedom was applicable?

b) Does the freedom apply if either the parent company and/or the lender company were both established in third countries?

c) Does it make a difference if the borrowing constituted an abuse of rights or was part of an artificial arrangement?

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50 *Thin Cap GLO* para 21

51 Caterpillar received its free movement of capital rights as it was allowed to set up and fund its Irish subsidiary

52 Pepsico received its free movement of capital rights as it was allowed to set up and fund its Luxembourg subsidiary

53 As outlined in section 4

d) How should the claims arising from the non-conformity of UK thin cap legislation with Community law be classified?[54]

Some of the companies had converted debt to equity to avoid interest being disallowed under the UK thin cap provisions, thus increasing the amount of corporation tax paid.

8.2 Which freedom applied?

In all changes made to the UK thin cap legislation over the years, the rules have always been applied in situations where, directly or indirectly, the lender had a definite influence or control over the borrower. Such legislation:

> *'...concerns only situations in which the [non-resident] company enjoys a level of control over other companies belonging to the same group which allows it to influence the financing decisions of those other companies, particularly the decision as to whether those companies are to be financed by way of loan or equity capital.'*[55]

This made loans from non UK-resident group companies more expensive than those from UK-resident companies and arises

> *'...not only because taxable profits cannot be reduced by the amount of the interest paid, but also because, by treating that interest as a distribution, that company may be liable to advance corporation tax when that transaction takes place.'*[56]

As in previous cases involving thin capitalisation issues, the freedom in question here is the freedom of ***establishment***: exercise of free movement of capital and freedom to provide services were *'...seen as an unavoidable consequence of any restriction on freedom of establishment and do not justify an independent examination of that legislation...'*[57]. It should be noted that the third country companies had in fact obtained free movement of capital rights as they were allowed to set up and fund subsidiaries in Member States.

The UK government claimed that the issue was not a restriction of the freedoms but was instead concerned with the exercise of fiscal competence in accordance with

54 This issue is beyond the remit of this paper.

55 *Thin Cap GLO* para 31

56 *Thin Cap GLO* para 39

57 *Thin Cap GLO* para 34

internationally recognised principles[58]. Furthermore, most DTCs permit the Competent Authorities to agree a compensating adjustment.[59] However, the ECJ commented that:

> *'...those provisions represented a unilateral choice on the part of the United Kingdom legislature'*[60]

and

> *'...the fact remains, that in exercising the powers of taxation allocated under them, the Member States are obliged to comply with the rules of Community law.... and, more particularly, the freedom of establishment...'*[61]

The application of the freedom of establishment over and above free movement of capital meant that some of the structures in issue (b) above were not protected by Community law. This is because those structures involved third country parent companies and freedom of establishment rights are not granted to these companies under the EC Treaty.

The tax position of a UK resident company paying interest to a non-resident lender was less favourable than if it had paid interest to a domestic lender, not only because an amount of interest was not deductible but also because ACT became due. The ECJ held that even if multinational groups are not in a comparable situation to resident groups (because only multinationals can avoid taxation in the state of the borrower by funding by way of debt rather than capital), the rules constituted a restriction of the freedom of establishment.[62]

8.3 Any justifications?

The UK failed in its obligation not to differentiate in the tax treatment of UK companies based solely on the location of the parent company. So, was this difference justified by imperative reasons in the public interest, appropriate and proportional? Two such justifications were put forward by the UK Government, namely:

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58 such as Article 9, Organisation for Economic Cooperation and Development Model Tax Convention (OECD MTC): the arm's length principle

59 so that increases in taxable profits of the borrowing company are matched by a corresponding reduction in taxable profits of the lending company (*Thin Cap GLO* para 48). However, this does not always occur (*ibid*, para 56).

60 *Thin Cap GLO* para 51

61 *Thin Cap GLO* para 53

62 *Thin Cap GLO* para 60

i) Cohesion of the tax system

The UK asserted that the thin cap rules ensured that profits earned domestically could not be artificially transferred to a different taxing jurisdiction. The ECJ found no direct link between the increased taxable profits of the UK borrowing company and a tax advantage granted through DTCs to the foreign lender.[63]

ii) Prevention of tax avoidance

The UK Government asserted that the thin cap provisions were targeted at a particular form of tax avoidance consisting of artificial arrangements to get around the tax legislation in the state of the borrower. They argued that the provisions go no further than is necessary – only the non arm's length interest is disallowed- and show flexibility in so far as an advance clearance procedure is allowed.[64] However, although this gives taxpayers the opportunity to agree their position as regards their exposure for thin capitalisation purposes, it is not an adequate method of demonstrating an absence of tax avoidance motive.[65]

It has been established in cases such as *Lankhorst*[66] and *Marks & Spencer*[67] that
'...a national measure restricting freedom of establishment may be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned...'[68]

Just because the lender is in a different jurisdiction to the borrower does not necessarily point to a wholly artificial arrangement. For example, in *Lankhorst* the funding was needed to keep the poorly-performing subsidiary afloat.

Although the UK's thin cap rules were considered an appropriate way of preventing wholly artificial arrangements, were they proportionate? Did the taxpayer have an opportunity to have all relevant factors taken into account? The arm's length principle contains an independently-verifiable objective element and the ECJ held that the thin cap legislation was proportionate provided it:

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63 As noted previously, the direct link referred to was established in *Bachmann:* the tax advantage and disadvantage must relate to the same tax and taxpayer.

64 *Thin Cap GLO* para 71

65 The efficacy and reliability of the procedure was disputed by the Test Claimants: *Thin Cap GLO (Opinion*), para 77

66 *Lankhorst* para 37

67 *Marks & Spencer* para 57

68 *Thin Cap GLO* para 72

> *'...first...provides for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allows taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question, and secondly....such legislation treats that interest as a distribution only in so far as it exceeds what would have been agreed upon at arm's length.'*[69]

The case was referred back to the UK national court to determine whether the regime allows commercial justification.

8.4 Comments

According to the ECJ, the granting of a loan not at arm's length constitutes

> *'...an objective element which can be independently verified in order to determine whether the transaction represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation...'*[70]

Is the arm's length test when used alone really a valid test for deciding whether there is an abuse of law? As it is objective it has its merits, but what about the subjective issues, such as commercial justification? As noted, the ECJ considered that the taxpayer should be allowed to show there were commercial reasons for the loan arrangement. In *Lankhorst* the loan was provided as an attempt to rescue the subsidiary. Other reasons why a parent might want to fund its subsidiary with debt instead of equity include:

- it often takes less time to put a loan in place than to increase share capital, which may necessitate changes made to Articles of Association and other administrative barriers
- redeeming share capital can be more troublesome than repayment of a loan
- in some jurisdictions, tax liabilities arise on share issues
- funding may be required short term, and so not have a 'capital flavour'.

The ECJ decided in *Thin Cap GLO* that the thin cap rules do not, in principle, apply to non-arm's length loans provided there was genuine commercial justification. This was then referred back to the High Court in the UK...

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69 *Thin Cap GLO* para 92

70 *Thin Cap GLO* para 81

8.5 The UK's response: *Thin Cap GLO (High Court)*

So, the ECJ gave its judgement on the UK's pre-2004 thin cap regime and the case was referred back to the national courts to decide whether the UK legislation allowed taxpayers to provide separate commercial justification.

The High Court decision of Justice Henderson was given in November 2009 and at 65,000 words, was lengthy. It contained evidence from HMRC, providing useful and illuminating evidence on the thinking behind the UK's various legislative changes. For example, following the *Halliburton*[71] case in 1994, HMRC was concerned that the freedom of establishment provisions might be offended by the disallowance of interest on loans from non UK-resident companies. This led to the changes in 1995 (whereby the position under the DTCs was reproduced by calculating the interest disallowance on an arm's length basis), the purpose of which was to protect tax revenues and 'Euro-proof' the legislation. Intra-UK transactions were left out of scope because they '*...do not normally give rise to the mischief that thin cap rules are designed to prevent.*'[72]

8.5.1 The infringement

The UK's thin capitalisation provisions pre- 2004 were at all material times contrary to the freedom of establishment: they were not proportionate to achieve the purpose of preventing abusive tax avoidance '*...because of their failure to provide a separate and independent defence of genuine commercial justification.*'[73]

The claimants submitted that it wasn't possible to construe the bilateral DTCs together with the national legislation in a way which complied with the freedom of establishment. Both before (when DTCs were in place) and after the 1995 amendments to the UK legislation, arm's length calculations had to be carried out. However,

> '*...the commercial rationale for the arrangements was regarded as relevant only to the extent that it would have been taken into account by such a lender*'[74]

i.e. only when calculating the arm's length amounts. In other words, the legislation applied even where such commercial rationale existed.

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71 *Halliburton Services BV v Staatssecretaris van Financiën* C-1/93 [1994] ECR I-01137 ('*Halliburton*')

72 *Thin Cap GLO (High Court)* para 313

73 *Thin Cap GLO (High Court)* para 363

74 *Thin Cap GLO (High Court)* para 82

8.5.2 Effect of the infringement

HMRC had argued that the commercial justification formed part of the arm's length test and so no further test need be considered. The taxpayers wanted the thin cap rules to be disregarded completely as the legislation contained no specific commercial let-out. But the Court held that where transactions had, either in whole or in part, a genuine commercial justification, the UK's thin cap provisions must be disapplied. The burden of proof is on HMRC to show that a transaction is not commercially justified: this must be by way of positive evidence, not just arising from the fact that the arm's length test is not satisfied.

The consequence of this is that, in the eyes of Henderson J., as the UK's thin cap rules have never provided for a separate commerciality test before the 2004 changes, they infringed the freedom of establishment Article in the EC Treaty. So it would appear that the 2004 changes made to extend the thin cap provisions to UK-UK transactions following the decision in *Lankhorst* – which led to burdensome compliance requirements- were unnecessary. Instead, the UK government could simply have introduced a separate test to demonstrate that the arrangements were not driven by tax avoidance motives.[75] [76]

And finally as regards the cases, the ECJ decision on the most recent in the series involving thin cap issues- *SGI*- was given in January 2010. It involves an interest-free loan granted to a subsidiary which did not need the cash. The case is interesting because of the justifications put forward.

9. *SGI*

9.1 Background

This case involves an interest-free loan granted by a Belgian company (SGI) to its French subsidiary (Recydem) and also excess director's remuneration granted to one of its shareholders. The latter issue is not considered further here.

SGI has a 65% shareholding in Recydem and is also a director of that subsidiary. Recydem made an interest-free loan to SGI. A sum corresponding to interest of 5% per annum was added to SGI's profits in respect of unusual or gratuitous advantages granted. No such adjustment would have been made if the lender was resident in Belgium.

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75 This is an example of when Member States could benefit from some form of guidance being handed down from the ECJ on how to amend national legislation to comply with the ruling.

76 This judgement will go to the Court of Appeal, so this is not the end of the matter.

The resulting double taxation can be eliminated by making use of the Arbitration Convention[77]. However, the procedure involves resolution by mutual agreement and then, if necessary, an arbitration procedure: this may take many years, and during this time the financial burden of the double taxation is borne by the taxpayer.[78]

9.2 Which freedom?

There is no third country involved and so the outcome does not depend on the particular choice of freedom i.e. free movement of capital or freedom of establishment. SGI's holding gave it a definite influence over the decisions and activities of its French subsidiary; moreover, as the Belgian legislation regarding the granting of an unusual or gratuitous advantage is only likely to apply in group situations, the case was examined under the freedom of establishment. This follows the pattern set by *Lankhorst, Thin Cap GLO et al.*

The ECJ considered that the Belgian income tax code imposed a restriction on the freedom of establishment as the difference in treatment between domestic and cross-border arrangements could potentially deter a non-Belgian resident company from *'...acquiring, creating or maintaining a subsidiary in Belgium.'*[79]

9.3 Any justifications?

'There was...no economic justification for that loan. Whereas, during the period in question, the subsidiary was in a secure financial position and generated profits, SGI was subject to a severe financial burden as a result of granting loans.'[80]

This contrasts with *Lankhorst* where the borrowing subsidiary needed to be rescued. Justifications were put forward:

i) Balanced allocation of the power to tax

If Belgian companies were allowed to transfer profits by way of an unusual or gratuitous advantage to companies in another Member State over which they have a relationship of interdependence, this could seriously undermine the balanced

77 The Arbitration Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises establishes the procedure to resolve disputes where double taxation arises as a result of upward adjustments made to the profits of one Member State. DTCs generally provide for a downward adjustment of the associated enterprise, but there is no binding agreement to fully eliminate double taxation.

78 *SGI* para 54

79 *SGI* para 45

80 *SGI* para 15

allocation of the power to impose taxes. So the rules in place allow Belgium to continue to tax activities carried on in its territory.

ii) Prevention of tax avoidance

Justification is possible in circumstances where:

a) *'...national measures specifically target wholly artificial arrangements designed to circumvent the legislation...'*[81] This follows on from earlier case law.[82]

b) *'...national legislation which is not specifically designed to exclude from the tax advantages it confers such purely artificial arrangements...[is] taken together with that of preserving the balanced allocation of the power to impose taxes between the Member States...'*[83]

As the Belgian rules prevented the transfer of profits to other Member States, these are justified in light of the need to maintain the balanced allocation of the power to tax together with the prevention of tax avoidance.

9.4 Proportional?

The ECJ considered the Belgian legislation to be proportionate provided that, where there is was suspicion that a transaction went beyond what the companies concerned would have agreed under fully competitive conditions two strict criteria are met, namely:

i) *'...the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification...'*[84], and

ii) *'...the corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence.'*[85] Presumably here the arm's length principle constitutes an appropriate test, as in *Thin Cap GLO.*

81 *SGI* para 65

82 For example, *Thin Cap GLO* para 72

83 *SGI* para 66

84 *SGI* para 71

85 *SGI* para 72

9.5 Comments and analysis

Based on this judgement, it appears that the changes made to the UK legislation in 2004 to extend the transfer pricing regime to purely domestic situations, with a compensating adjustment for the disadvantaged UK company, were not necessary. This is because the UK- overseas transfer pricing adjustments were needed to preserve the balanced allocation of taxing rights and ensure that profits were not transferred between group companies in different taxing jurisdictions. This risk would not be present in UK-UK situations. In light of this, will transfer pricing rules for purely domestic transactions now be deleted from the UK legislation? If so, the UK legislation will be back to the position it was in pre-2004, before the *Lankhorst* decision.

Now that case law and its effect on UK thin cap legislation has been evaluated, the article looks at how double taxation arising from thin cap adjustments can be mitigated, and the burden of compliance. The EU Arbitration Convention[86] sets out a process with the aim of eliminating double taxation arising from an increase in taxable profits in an enterprise in one Member State which is not matched by a corresponding reduction in taxable profits in the other Member State(s) involved.
Finally, the paper weighs up the findings before reflecting on whether the ECJ has been judicially active in this area of tax.

10. Double Taxation: the Arbitration Convention

Adjustments arising from thin capitalisation/ transfer pricing issues can give rise to double taxation if there is a difference between the interest charged to tax in one Member State and the interest allowed as a deduction in the other Member State. If the two tax authorities do not share the same view on the arm's length adjustment then Article 25 of the OECD MTC -always assuming that there is a DTC in place containing this provision- requires them to 'endeavour' to come to mutual agreement. The downsides are that (a) there is no obligation to come to an agreement, and (b) there are no time limits, so the mutual agreement procedure can grind to a halt. Some DTCs contain arbitration clauses, but these are reliant on approval by the tax authorities and allow those authorities to select the arbitrators!
In December 2009 the EU Council approved the revised Code of Conduct on the European Arbitration Convention.[87] This covers thin cap adjustments made on loan interest in accordance with the arm's length principle[88]. Instances of double taxation which cannot be resolved between the Competent Authorities by mutual agreement

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86 EU Arbitration Convention 90/436/EEC of 23 July 1990 binds Member States.

87 Based on the work of the EU Joint Transfer Pricing Forum.

88 Article 4 of the Arbitration Convention is based on the associated enterprises article (Article 9) of the OECD MTC

within the normal two year timeframe may be referred to the arbitration panel. Broadly, if thin cap adjustments have been made in accordance with the arm's length principle, then a corresponding adjustment is necessary: if agreement cannot be reached by the Competent Authorities then the Arbitration Convention procedure is initiated by the taxpayer. Whilst the intention of this procedure is excellent, the amount of time taken –and costs incurred- to bring disputes to a conclusion will deter some Member States from making use of it. Several years of an uncertain tax position is not desirable: a faster and more effective procedure would be welcomed.
The domestic compensating adjustment mechanism available on UK-UK transactions- and not available for cross-border transactions- is proving to be more effective than the mutual agreement procedure: is this a form of discrimination, albeit indirect?

In order to defend transfer pricing data, enterprises are required to comply with transfer pricing documentation requirements imposed by tax authorities. In the following section, these requirements are considered and in particular whether they constitute an obstacle to the freedom of establishment. The final part of this article then concludes by looking at judicial activism and judicial protection in the thin cap arena.

11. Compliance: how much of a burden?

11.1 Transfer Pricing Documentation

Transfer pricing documentation provides *prima facie* evidence that the transactions undertaken are at arm's length and that, as far as tax authorities are concerned, there is no tax avoidance intent. If a loan transaction is not made on third party terms (and so doesn't comply with the arm's length principle), the decision in *Thin Cap GLO (High Court)* states that the burden of proof as regards commerciality will lie with HMRC. But realistically, good practice within multinational organisations will result in further work being carried internally to document and record commercial justifications in case of an enquiry raised by HMRC some years down the line. The extent of this burden will only become apparent over time. Interestingly, the ECJ makes it clear that providing such evidence must not be subject to undue administrative constraints.

The transfer pricing documentation requirements vary wildly amongst the various Member States. Some have no formal documentation rules; some require translation to the national language. Because there is no harmonisation of documentation requirements, a company in one Member State which only has cross-border transfer pricing rules[89] might be less inclined to operate via a company in another Member State (particularly as compliance costs in doing so may not be insignificant),

89 Sweden, for example

preferring instead not to conduct activities cross-border. Do these rules hamper or render less attractive[90] the exercise of the freedom of establishment?[91]

The UK's transfer pricing documentation rules apply to both domestic and cross-border situations. Any reluctance to carry out cross-border activities with a company resident in another Member State which has more burdensome documentation rules arise because of a disparity between the tax systems and so the freedom of establishment principle is not brought into play.

11.2 Reducing the compliance burden

More recent developments which have an impact on reducing the compliance burden in the transfer pricing arena include soft law on transfer pricing documentation[92], an outline for home state taxation[93] and progress towards a CCCTB[94]. This proposed CCCTB would be based on 75% ownership and so transfer pricing within the group would be eliminated, removing the need to deal with 27 different sets of rules.

This article has discussed the implications and effect of ECJ judgements on national legislature in the UK insofar as thin cap issues are concerned. The cases reviewed in depth were *Lankhorst, Thin Cap GLO* and *SGI.* In all three cases, the ECJ has been seen to be protecting the fundamental freedoms set out in the EC Treaty. However, the justifications put forward following a restriction of freedom of establishment and their potential impact on UK legislation are still evolving – the *SGI* case is an example here- and so a clear-cut conclusion on whether the ECJ is judicially active

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90 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di MilanoC-55/94* [1995] ECR I-4165, para 37

91 For an in-depth review, see Eivind Furuseth, 'Can Procedural Rules Create Obstacles to Fundamental Freedoms in European Law?' (2007) International Tax Review 35 p264-277

92 http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm (last visited 21 February 2010) has details of:

- Code of Conduct for the effective implementation of the 'Arbitration Convention' and proposal for revision of September 2009 (approved on 22 December 2009)
- Code of Conduct on transfer pricing documentation for associated enterprises in the EU
- Guidelines for Advance Pricing Agreements (APAs) within the EU

93 COM(705)702 final on http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005_0702en01.pdf (last visited 21 February 2010). Under Home State Taxation, the tax base for EU operations of a group is calculated according to the tax code of their home state.

94 COM(2006)157 final on http://eur-lex.europa.eu/LexUriServ/site/en/com/2006/com2006_0157en01.pdf (last visited 21 February 2010). Under CCCTB, the tax base for EU operations of a group is calculated according to a new common tax code applicable within the EU.

in this field is not appropriate at this stage. However, there are some final comments to be made.

12. Final Comments

This final section reflects on whether the ECJ has (a) protected Community law (now EU law) or (b) created new principles.[95]

The ECJ interprets EU law through questions referred to it[96], giving judgements to the national courts. The cases arise on an ad hoc basis and the decisions are, of course, based on the facts provided. Furthermore, the extent to which the decisions can be applied to other areas is unclear. The ability of the ECJ to influence direct tax legislation of Member States is limited to the questions asked of it: these will be related to ensuring that national tax systems do not infringe EU law.

The ECJ judges are not necessarily specialists in tax matters and it is left to the national tax authorities to interpret the judgements and decide how to apply these to the issue in question. Although the ECJ provides some guidance to national courts to assist with a decision, no guidance is provided or suggestions given as to how the national legislation should be amended in order to be compatible with EU law: this is down to national governments as the ECJ has no competence to do this.[97]

Harmonisation in the direct tax field is limited to the Directives[98] which are adopted by the Member States. The role of the ECJ in this largely unharmonised area is to provide a balance between national tax systems and the aims of the Community. The ECJ has been doing so on a case-by-case basis. It is only when a number of cases

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95 For a discussion on judicial decision making in connection with ECJ case law, see Takis Tridimas, 'The Court of Justice and judicial activism' (1996) European Law Review 1996 21(3) 199-210

96 These come from two sources: (1) preliminary references by courts or tax tribunals in Member States- Article 267 TFEU, and (2) infringement actions initiated by the Commission's Taxation and Custom's Union Directorate-General- Article 258 TFEU

97 See: Bill Dodwell, 'More by luck than judgment' (2008) October Tax Adviser 6 for suggestions as to how the ECJ and national governments could work together. These include (a) a commentary on the provisions of the EC Treaty, (b) wider involvement in framing questions for the ECJ, and (c) appointing a panel of tax experts to advise the Treasury on tax implications of the judgement.

98 For example:

- Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (90/435/EEC)
- 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 and to the transfer of the registered office, of an SE or SCE, between Member States

have been considered that a settled pattern will emerge and Member States will be able to anticipate changes necessary to their domestic rules.

This can be seen in the thin cap cases, in that the ECJ has carefully considered the effect of national rules on the fundamental freedoms and has acted within its powers to protect any violations. This has led to changes made to national legislation from early decisions– in particular, where thin cap rules were extended to UK-UK transactions in the UK following *Lankhorst*- which may now prove to have been unnecessary following the decision in *SGI*. So the ECJ may have indirectly caused changes to national legislation where none was required.

To finally conclude, in all cases it is apparent that the ECJ has striven to protect and uphold Community law, particularly the freedom of establishment. Difficulties have been incurred at national level in deciding how best to amend legislation so that it complies with Community law without imposing unnecessary burdens on businesses.

The story will continue....