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CONTENTS

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Avoidance and *abus de droit*: The European Approach in Tax Law

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Abstract
Defining tax avoidance has been always a nearly impossible quest for tax lawyers. In Continental Europe, however, it could be said that the notion of "avoidance" is strongly embedded to the concept of "abuse" of a right, being an "abuse", according to the Roman law tradition, the exercise of a right inconsistently with the general principles of correctness, good faith or even with the basic rules of ethics. Therefore the definition of avoidance is not purely legal, but it depends also on other disciplines which influence it. In EU law qualifying avoidance is even more complex as the law of the Union is nearly deprived of any influence by other systems of values, the only general principles to rely on are the fundamental freedoms and the nondiscrimination principle both enshrined in the Treaty. That is why when in recent cases the Court had to rule on the "abuse of law" it did its best to find principles or values to build the concept on. The results were different in direct tax

between the legal form of the commercial operations and the substance of the aims pursued by the taxpayers.

The purpose of this contribution is therefore less far-reaching. The basic assumptions are that (1) the problems avoidance raises are not limited to tax law and (2) it is necessary to analyse avoidance of law in order to understand better the features and the characteristics of it when dealing with tax law. Another assumption is that (3) the

Some authors noted that a line should be drawn between avoidance considered as the outcome of loopholes in statutes and avoidance that is the result of different interpretations of statutory law or common law.

While the difference is theoretically correct, it must be remembered that this distinction is in any case based on interpretation of the rule of law, and that understanding the rule is an *a priori* condition to ascertain any loopholes or gaps in the system.

This requirement was well known in the continental (it could be said Roman) experience since the Middle Ages, when the debates on the notion of "abuse" of law

However, there's enough to understand the Roman reasoning in respect to interpretation, avoidance and abuse of law. That approach constituted the base on which the medieval commentators in Italy (and first of anywhere in the world, in Bologna) built up medieval law in the form of comments (*glossa*) to the

whom tax law linked the payment of a tax …".[14] From Blumenstein's point of view,[15] however, tax avoidance occurs when "… According to a carefully planned and intentional procedure the taxpayer enters into a contract or sets up a specific operation which is capable of reducing the amount of the tax otherwise due, or to prevent it; thus far the avoidance is different from the tax evasion. In this latter case the tax is due to all the effects but the determination of its amount by the Tax Administration is prevented by an unlawful behaviour of the taxpayer …".

Only in the latter case, therefore, (tax evasion) do the authors qualify the behaviour of the taxpayer as unlawful, while in the former it is consistent with law although in conflict with the normality of business activity or the exercise of the same rights.

Arguably it is also here where the legal traditions of the common law countries and the civil law ones began to diverge sensibly from this specific point of view.

The need to levy taxes on the business effectively carried on was achieved by the first ones through the "business purpose test" as developed later on in the case law by English, Australian and American courts[16], and by the second ones through the notion of "abuse of law".

Even if the effect of the application of the two anti-avoidance provisions should be the same (limiting the taxpayer in the exercise of his business economic freedoms when no other goal seems to be pursued other than an improper tax saving), in common law countries the courts seek to understand what the normal business practice should include, while the continental ones seem to stress the importance of what is not reasonably included in the specific right attributed to the taxpayer.

The outcomes of the two interpretive approaches do not necessarily coincide.

As was mentioned before, Roman law vastly influences the continental interpretations summarised by the German and Swiss authors.

Under the Roman civil law, at first stage, the current notion of "abuse of law" was nonsensical (as it is probably nowadays in common law). In the case of property rights, for example, no abusive enjoyment was conceivable.

The owner of any goods either enjoyed them under law or in an illegal way.

In the second case, civil law had remedies for any person who claimed to be injured by the improper exercise of the right; in the first one, no limit could be imposed on the owner of any goods. The rule of law was clearly expressed in "*Nullus videtur dolo facere qui suo iure utitur*"[17] or, even better in our perspective, Ulpianus added: "… *is qui iure publico utitur non videtur iniuriae faciendae causa hoc facere: iuris enimi*

[14] A. Hensel, *Steuerrecht*, Berlin, 1924. Translation by the Author from the Italian version by D. Jarach, *Diritto tributario*, Milan, 1956.

[15] E. Blumenstein, *System des Steuerrechts*, Zurich, 1951. Translation by the author from the Italian version by F. Forte, *Sistema di diritto delle imposte*, Milan, 1954.

[16] See for instance Y. Keinan, The many faces of the economic substance's two-prong test: time for reconciliation?, N.Y.U. J. L. & Bus., 2005, 371 ss.; J. Rector, A review of the economic substance doctrine, 10 Stan. J.L. Bus. & Fin., 2004, p. 173.

[17] Dig. 50, 17, 55. "It is never in bad faith for one to exercise his right".

executio non habet iniuriam,"[18] which is not completely new to the UK legal tradition, where "*… if it was a lawful act, however ill the motive might be, he had a right to do it* …".[19]

The situation was clear, for instance, in the case of slavery. The owner of a slave had any right over him (or better, *it*, according to the Roman law) including the right to kill him at will (*ius vitae necisque*): a right that was accorded to the *pater familias* over all his family in the early stage of Roman law.

After centuries, however, during the later Empire era, this absolute right was somehow clarified without being explicitly limited. In other words, the property right had to be

So here began a sort of war of attrition between two sets of rules: legal on one side, moral or religious on the other, with the latter influencing the former, or at least their interpretation.

In this early stage of the evolution of the *ius commune* the abuse of law or any avoidance of the law (including, arguably, tax avoidance) were behaviours consistent with the first set of rules, but not with th

try to achieve the scope the right was intend

The new concept of abuse was grounded on the necessity for the Courts (especially in Italy) to control the use of civil rights, such as those with regards to property, in a way consistent with the social function the Constitution attributed to them.[25] To this extent an abuse could be considered to take place whenever the exercise of any right was not consistent with the social function recognised and protected by the Constitution[26].

today take the place of what once was the morality of some religion or the general principles of the *ius commune*.

to identify the avoidance, on the other hand, under a more practical approach, it is difficult for everybody, and for the ECJ in particular, to assess in some cases the existence of reasonableness in a business activity[38] carried on by a communitarian taxpayer in the exercise of a fundamental right.

The second feature of the "rule of reason" is so evident that even in recent papers and seminars some influential authors stressed the fact that the ECJ seems to be losing the route followed in more recent years, deciding tax avoidance cases (both in direct taxation and in VAT) without a clear general picture.

The situation may be different from the one represented in the past: the ECJ approach has not changed through the years, but rather the objects of judgement of many recent cases are taking the ECJ into the maelstrom of harmonising its tax approach to an issue that may not be clear also within a national perspective.

At first glance, a provision like this could impair the freedom of establishment

In tax cases, such as *Cadbury*, the distinction is not so straightforward, and the artificial nature of the subsidiary could constitute a reasonable limit to the fundamental freedoms of the Treaty.

So far, the EU approach to tax avoidance is "two way": the ECJ in cases like *Cadbury* judges the limits imposed by the Member States according to limits imposed on those States by the Treaty.

Cadbury is once more helpful to this extent, because the Court set out, albeit not for the first time, the circumstances in which a business operation falls outside the scope of the EU law protection. This situation occurs, just like in the specific case, when together with the "subjective element of obtaining a tax advantage" objective circumstances exist and show that "despite formal observance of the conditions laid down by community law, the objective pursued by freedom of establishment has not been achieved"[48] .

In other words, that there has been a *detournément*, that is, a deviation, of the *ratio* of the rule in question. The taxpayer invoked the freedom of establishment, but the operation he set out is not intended to establish anything in the other Member State.[57]

In this way the Court sought to strike a balance between the two abuses underlined before: on one hand, the abuse of the taxpayer exercising his freedoms and rights in a improper way (inconsistent with the duty to

9. ABUSING NEUTRALITY? PLAYING WITH THE VAT DEDUCTION IN *HALIFAX*

The most striking difference between *Cadbury* and *Halifax*[60] is clearly summarised by the court in §§ 57 and 62 of the latter judgement.

According to the first paragraph of the sentence, the notion of abuse (if any) in the VAT mechanism is not qualified by any subjective element.[61] In other words, the VAT application must be necessarily inspired by two general principles, facility in the application and certainty of the legal relationship between businesses.

From this point of view, any possibility of tax reassessment which is grounded on subjective factors, such as the deliberate will to avoid the payment of taxes by setting up a complex commercial operation, could constitute, *per se*, an unacceptable impairment of that goal, introducing an element of uncertainty and unpredictability to the reassessment which could interfere with the application of the VAT mechanism.

without such a priority) in cases involving direct taxation and fundamental freedoms. The first and foremost effect, as mentioned above, is that the anti-avoidance provisions have to pass a tougher control of their compatibility with EU law.

It is not a matter of abuse here, considered as a balance between fundamental rights and the need of every Member State to raise money for welfare, but also a matter of predictability of the tax consequences[65]. The dimensions of the overall judgement are therefore different, and we could argue that the concept of avoidance and abuse is no longer the same.

Looking to this issue from the point of view of the taxpayer, then, the need for neutrality of the tax and the priority of legal certainty become the two fundamental benchmarks with which to assess the compatibility of the anti-avoidance provision to EU law.

That's why it is not entirely accurate to state that the step-transaction approach followed by the ECJ in all the cases involving avoidance of VAT allows more loopholes to be abusively exploited by the fraudulent taxpayer. Rather, it is the mechanism of the tax that imposes this approach.

The Court implicitly clarifies this point later on in the *Halifax* judgement, when it notes that even if the step-transaction approach has to be favoured in VAT cases, and even if it's up to the national Courts to assess the eventual abuse of the neutrality (in most of the cases, of the VAT deduction input by the taxpayer), taking into account the specific characteristics of the operation.

From the ECJ approach, the "purely artificial nature"[66] of the operation from an objective point of view and the "legal, economic or personal relations"[67] between the parties (that is, the seller and the purchaser of the goods, for instance) are significant. If these conditions are met,[68] the operation can be disregarded for VAT purposes and the deduction of the tax denied by the Tax Administration.

The Court is walking once more on a minefield[69] and seems quite aware of that. It is contradictory to stress the importance of legal certainty and soon after to introduce elements of judgement recalling a sort of "substance over form" approach that is quite unfit to give *ex ante* a clear solution, depending as it does on the specific circumstances of the case.

That is probably why soon after, the Court clarifies that, anyway, the abuse must be assessed under "a number of objective factors" and that only after that positive

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[65] This aspect was not debated in *Cadbury* as far as it involved the existence of an anti avoidance provision. Even if its compatibility with EU law was discussed, every taxpayer was aware of its existence and applicability to all qualifying cases.

[66] *Halifax*, at § 81.

[67] *Halifax*, at § 81.

[68] Even if the Court is not clear on this point, it could be argued that the subjective conditions (special relationships between the involved parties) could be considered a factor emphasising the artificial nature of the operations.

[69] This could constitute a partial answer to the provocative thesis by H. Rasmussen in *On law and Policy in the European Court of Justice. A Comparative study in judicial policymaking*, Dordrecht, 1986, *passim*.

assessment of the operation it is possible to say that the essential (not only the main) reason for the existence of the specific operation is to obtain a tax advantage.

All in all, the approach seems to recall the one analysed before, where the Court stressed the importance of the effective exercise of a fundamental right or freedom enshrined in the Treaty (freedom of establishment, of movement of capital, etc., …), but here the soundness of the business is the condition to be met and the neutrality of the tax the feature to be preserved as far as possible.

10. CONCLUDING REMARKS: WHERE DO WE GO FROM HERE?

The first part of this brief research began with a quotation from an author[70] indicating that the issue relative to tax evasion and, first of all, avoidance, is an eternal one. After ten years the same author implicitly confirmed his opinion some months ago at another academic meeting[71]. Moreover, other academics recently presented a different and original approach[72] to the notion of tax avoidance, which seems to focus not only on legal issues but also on different factors derived from the business experience, such as risk management and the need for an overall different approach to the taxpayer by the HMRC, at least in the UK. In a relationship based on trust, there is no space for avoidance[73].

Both the approaches are absolutely correct, and where the first underlines a problem, the second tries to offer a new solution with different means.

However this is intended to be an investigation made from a legal point of view and therefore in a quite traditional way. The purpose has not been to provide another approach to tax avoidance, tax evasion and abuse of law. Such a purpose would be too far-reaching and impossible to achieve. The goal has been, to a certain extent, to try to understand the notion of avoidance and abuse of law from a different perspective.

The basic assumption of this research was that the notions of tax avoidance and abuse of tax law must be understood and interpreted according to what happens in the other fields of the national legal system. The historical evolution of each of them, and of the Roman law, is determinant in clarifying when abuse takes place.

This perspective has supported the idea that avoidance is not an "eternal problem" in tax law, but an issue that arises when legal provision collides with other sets of rules

[70] F. Vanistendael, at footnote 1.

[71] F. Vanistendael, *Halifax and Cadbury Schweppes: one single European theory of abuse in tax law ?*, in EC Tax Review, 2006, p. 192; see also the report by J. Freedman, G. Loomer and J. Vella, *Moving beyond avoidance? Tax risk and the relationship between large business and HMRC*, pp.18 and 42.

[72] J. Freedman, G. Loomer, J. Vella, *Moving beyond tax avoidance? Tax risk and relationship between large business and HMRC*, Oxford, 2007.

[73] Commenting on the Varney Delivery Plan and the relationship between specific taxpayers and the HMRC, J. Freedman, G. Loomer and J. Vella noted that a vital element "… is the desire from both sides for a relationship based on mutual trust" (see J. Freedman, G. Loomer and J. Vella, *cit.*, p. 5).

of a non-legal nature: of course this conflict depends on the national background and on the strength (real or perceived) of the non-legal rules[74].

When the ECJ tries to harmonise the different tax systems as far as this is allowed by the Treaty, it progressively has to solve the same problems faced by the different national States across the centuries. However, while in every Member State the abuse is always a judgement of comparison between an individual right (not necessarily of the taxpayer) and other principles enshrined in the legal system (ability to pay, solidarity, etc., …), in Europe these principles are missing, in so far as something more of a Treaty between States will not be implemented.

This is helpful towards explaining why the Court, in some cases, seems to wander in obscurity[75], recalling concepts such as "genuine business" or even "non-artificial business" that although sufficient to solve the problem from a theoretical point of view are of little use from a practical point of view. The practitioners need something more, as the same ECJ implicitly admits in all cases involving VAT.

The answers now provided, even if workable in direct taxation, are not sufficient. Assessing avoidance only in cases of letterbox companies (a case that in the Italian point of view could be qualified, to a certain extent, as tax evasion and not as avoidance) is of little help for all those States that are striving to defend constitutional principles of economic solidarity, while it could be considered enough by others which made a different choice, providing limited welfare and at the same time requesting a lower level of taxes.

All in all, tax avoidance and abuse of tax law are not "eternal problems" in tax law, but issues that are only partially related to tax law and depend first and foremost on the culture and the historical evolution of every State, issues about which the European tax lawyer has little to say, especially without a constitutional background.

[74] Avoidance varies according to the legal tradition of each State and to the specific tax it refers to.

[75] M. Cappelletti, *Is the European Court of Justice "running wild"?*, in European law Review, 1987, p. 3.