

## ABUSE OF RIGHTS – THE EFFECT OF THE DOCTRINE ON VAT PLANNING

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Following the ruling of the European Court of Justice in *Halifax*<sup>1</sup> on February 21, 2006 (which applied the doctrine of abuse of rights to the VAT regime) there has been much speculation as to the extent to which the doctrine can be applied to strike down planning arrangements which purportedly mitigate liability to VAT. Soon after the release of the judgment, HMRC issued a statement in their Business Brief<sup>2</sup> that, of the 175 or so cases then stood over pending the ECJ's ruling, they anticipated the vast majority of their disputed decisions would be maintained. HMRC have subsequently relied on the doctrine at almost every opportunity, not just on substantive issues, but also in the course of interim proceedings to obtain disclosure from traders.

Far from being an outright prohibition on tax planning, the ECJ was clear that the doctrine was not a general anti-avoidance principle, nor could it be used to invalidate all structures where tax mitigation comprised merely one of a number of drivers. Indeed, the doctrine does not operate in a vacuum - it must be considered in conjunction with other well-established principles of Community law, such as legal certainty and fiscal neutrality.

This article examines the development of the underlying purpose and scope of the doctrine and the emergence of general principles for its application. It goes on to address the interaction of the ECJ's test in *Halifax* with other principles of Community law and the evidence the courts will consider when assessing whether abusive practices exist. The article concludes with a summary of the areas where, in the author's opinion, potential VAT planning opportunities may still lie.

So far, the VAT and Duties Tribunal has considered abuse in three decisions post-dating *Halifax*: *RBS Deutschland Holdings GmbH*<sup>3</sup>, *MMO2 Plc*<sup>4</sup> and *Redcats (Brands) Limited*<sup>5</sup>. Where relevant, this article reviews the transposition of the doctrine into the UK system of VAT to date.

### The Purpose and Scope of the Doctrine

There is still no precise definition of "abuse of rights". Instead there is an evolving body of EU case-law, formulating the circumstances in which abuse may be present. In the absence of a national abuse provision prescribing those circumstances, the purpose of the doctrine is to catch cases where either a person is attempting to rely on a European legal right to circumvent or displace national law, or a person is looking to gain a financial or other advantage by way of an abusive use of Community law.

The former situation arises in relation to direct tax, where taxpayers seek to rely on a fundamental Community freedom to influence the domestic tax treatment arising thereon (see, for instance

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<sup>1</sup> Case C-255/02, [2006] STC 919

<sup>2</sup> BB 02/06: 27 February 2006

<sup>3</sup> VAT Decision 19055; released on 3 May 2005, after the Advocate General's Opinion in *Halifax*, but before the decision of the ECJ

<sup>4</sup> VAT Decision 19514; released on 16 March 2006

<sup>5</sup> VAT Decision 19648; released on 26 May 2006

*Cadbury Schweppes plc*<sup>6</sup> on freedom of establishment and the UK CFC legislation). In the context of VAT, abusive practice primarily manifests itself in the purported recovery of input tax or the reduction of liability to output tax by mitigating the effect of non-deductible VAT in circumstances which are directly contrary to the purpose of the provisions of the Sixth Directive.

The doctrine is by no means a general anti-avoidance provision such that all transactions obtaining a tax advantage are caught. On the contrary, the unequivocal language used in decisions of the ECJ suggests that forfeiture of a taxpayer's rights should only be justified in circumstances where the taxpayer's actions are so extreme that they severely distort or frustrate Community law.

In *Diamantis*<sup>7</sup>, the ECJ defined the scope of abusive actions as those where a person sought to rely on a provision of Community law for the purpose of deriving "an improper advantage, manifestly contrary to the objective of that provision"<sup>8</sup> where those actions "will cause such serious damage to the legitimate interests of others that it appears manifestly disproportionate."<sup>9</sup> (Emphasis added) The Advocate General in *Halifax* echoed what he referred to as the "consistent pattern" in the existing case-law and stated that a person's right to rely on a provision could be limited only where it is "manifestly beyond the aims and objectives pursued by the provision abusively relied upon"<sup>10</sup>.

Where Member States have enacted national provisions prohibiting abuse, such provisions have been emphatically worded. For example, Article 281 of the Greek Civil Code (which has been approved by the ECJ in both *Diamantis* and *Kefalas and Others*<sup>11</sup>) provides that, "the exercise of a right is prohibited where it manifestly exceeds the bounds of good faith, morality or the economic or social purpose of that right."

Similarly, continental European legal systems with their own established notions of abuse (applying to all areas of law, not just to tax law) do not recognise the principle as a first resort. Previous articles in this Review by Harris<sup>12</sup>, and Douma and Engelen<sup>13</sup> offer discerning insights into, respectively, the French notion of *abus de droit* and the Dutch *fraus legis*.

Harris comments that the French tax administration is faced with a presumption that agreements are reputed to be real and transactions that are reciprocal or multi-party are deemed to be economically balanced. This places the question of *abus de droit* within a series of rebuttals, such that it does not fulfil the administration's prayer for an absolute right to state that a taxpayer may not use a legal right in a manner for which it may not have been designed. Douma and Engelen observe that the Dutch *fraus legis* is considered the *ultimum remedium* and can only be applied if other methods of interpretation have been exhausted.

The European Commission appears to concur: in its previous submissions to the ECJ, the Commission has sought to restrict the scope of the doctrine to prevent excessive curtailment of

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<sup>6</sup> Case C-196/04, [2006] STC 1908

<sup>7</sup> Case C-373/97, [2000] ECR I-1705

<sup>8</sup> *Diamantis*, ECJ, para 33

<sup>9</sup> *Diamantis*, ECJ, para 43

<sup>10</sup> *Halifax*, AG, para 79

<sup>11</sup> Case C-367/96, [1998] ECR I-2843

<sup>12</sup> Peter Harris, "Abus de Droit in the field of Value Added Taxation" B.T.R. 2003, 2, 131-152

<sup>13</sup> Sjoerd Douma and Frank Engelen, "Halifax plc v Customs and Excise Commissioners: The ECJ applies the Abuse of Rights Doctrine in VAT Cases" B.T.R. 2006, 4, 429-440

traders' rights. In *EC Commission v Italy*<sup>14</sup>, the Commission argued that, "... the principles of effectiveness would be observed only if cases of rejection of repayment claims were exceptional and maintains that the exercise of rights derived from the Treaty cannot be impeded by general measures based on a presumption of abuse of rights."

Accordingly, it is clear that only extreme and aggressive tax planning is caught, not merely the structuring of commercial transactions in a way that simply falls outside the range of options contemplated by the draftsman when Community law was transposed into the UK system of VAT.

### **Evolution of the Abuse Test**

The European authorities principally responsible for formulating the doctrine illustrate a shift in emphasis from a subjective application of the doctrine, towards a more objective approach.

Earlier cases (although not expressly addressing the doctrine of abuse) considered the *bona fide* nature of commercial transactions in order to determine whether those transactions had been effected for "the sole purpose of wrongfully securing an advantage under [Community] regulations"<sup>15</sup>.

In *General Milk Products*, the ECJ held that monetary compensation amounts ("MCAs") were allowed where an immediate onward shipment followed an importation. Nothing prevented an importer from claiming MCAs unless the national courts decided that, as a question of fact, the importation and re-exportation were not "realised as *bona fide* commercial transactions but only in order wrongfully to benefit from the grant of monetary compensation amounts."<sup>16</sup>

This was superseded by the test in *Emsland Stärke*<sup>17</sup> (a case concerning export refunds) which examined firstly, the objective circumstances in which, despite formal observance of Community rules, the purpose of those rules had not been achieved and secondly, whether there had been the subjective intention to obtain an advantage by the artificial creation of the conditions laid down for obtaining it. The ECJ held that it was for the national courts to establish the existence of these elements on the evidence adduced, subject to maintaining the effectiveness of Community law. Evidence of collusion and personal and commercial links between the parties involved could be taken into account in establishing the subjective element<sup>18</sup>.

Greater significance was placed on the objective nature of the doctrine in *Halifax*, where Advocate General Poirares Maduro emphasised that the doctrine was a principle of interpretation: whether or not the Community law provision at issue conferred the right so claimed<sup>19</sup>. Both the

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<sup>14</sup> Case C-129/00, [2003] ECR I-14637, ECJ

<sup>15</sup> *General Milk Products* Case C-8/92, [1993] ECR I-779, para 21

<sup>16</sup> *General Milk Products*, ECJ, para 22

<sup>17</sup> Case C-110/99, [2003] ECR I-11569, ECJ

<sup>18</sup> See more recently *Test Claimants in the Thin Cap Group Litigation v CIR*, Case C-524/04, AG, para 66, "To use the reasoning of the Court developed in the indirect tax sphere and other non-tax spheres, the arm's length test represents in this context an objective factor by which it can be assessed whether the essential aim of the transaction concerned is to obtain a tax advantage."

<sup>19</sup> Neither the Advocate General nor the ECJ had trouble applying the doctrine to the VAT regime, notwithstanding that VAT (unlike the MCAs that were the subject of *General Milk Products*, or the export refunds in *Emsland Stärke*) is not "an own resource collected directly for the account of the Communities", per the argument advanced by Harris against the doctrine's applicability to VAT.

Advocate General and the ECJ restricted the subjective element of the test in *Emsland Stärke* by elaborating the objective nature of the second limb: the state of mind of the taxpayer was no longer considered relevant. Only if the “essential aim” of the transactions, which must be apparent from a number of objective factors, is to obtain a tax advantage will the prohibition of abuse be relevant<sup>20</sup> - a far higher hurdle than the “main purpose” test for which HMRC had been hoping.

As the Advocate General stated, when defining what he referred to as the “element of autonomy”<sup>21</sup>, “The purpose - which must not be confused with the subjective intention of the participants in those activities – is to be objectively determined on the basis of the absence of any other economic justification for the activity than that of creating a tax advantage.”<sup>22</sup>

The result of the ECJ’s deliberation in *Halifax* was the two-stage test for abuse. Readers will be familiar with the objective and subjective limbs respectively:

“... first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.

Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. ... the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages.”

The Court’s retreat from the consideration of purely subjective factors such as motive and intention is encouraging for tax planning. Provided there is a sound commercial basis for embarking on a series of transactions, it suggests that the *manner* in which those transactions are performed is up to the individual taxpayer and should not be called into question.

The Advocate General in *Cadbury Schweppes* chose to apply the *Halifax* test, notwithstanding that the case did not concern VAT, but the application of the UK’s CFC legislation in the context of freedom of establishment<sup>23</sup>. He stated that it would be contrary to the objective of freedom of establishment if a subsidiary and transactions involving that subsidiary were not genuine (where the companies had no real substance and could be termed ‘letter-box’ companies), but existed for no purpose other than obtaining a reduction in tax. However, “the existence of a wholly artificial arrangement cannot be inferred from the parent company’s avowed purpose of obtaining a reduction of its taxation in the State of origin”<sup>24</sup> and must therefore be determined objectively. He continued<sup>25</sup>, “... the subjective reasons for which an economic operator has exercised the rights conferred on it by the Treaty cannot call into question the protection it derives from those rights once the objective pursued by them is fulfilled.” In its decision, the ECJ stated that an

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<sup>20</sup> *Halifax*, ECJ, para 75

<sup>21</sup> *Halifax*, ECJ, para 87

<sup>22</sup> Readers are referred to the erudite case note on the Advocate General’s Opinion in *Halifax* by R. Cordara Q.C., “Halifax: A conservative Opinion” B.T.R 205, 3, 267 - 270

<sup>23</sup> The *Halifax* test has also been referred to in other non-VAT cases before the ECJ, such as *Agip Petroli SpA*, Case C-456/04 in relation to cabotage, and the *Thin Cap Group Litigation*.

<sup>24</sup> *Cadbury Schweppes*, AG, para 115

<sup>25</sup> *Cadbury Schweppes*, AG, para 116

“avowed purpose of benefiting from [a] favourable tax regime”<sup>26</sup> was insufficient to constitute abuse.

Although the Advocate General applied *Halifax* in *Cadbury Schweppes*, it is the author’s opinion that readers should not be misled into believing that the *Cadbury Schweppes* formulation<sup>27</sup> is necessarily interchangeable with the *Halifax* test, such that for VAT purposes, only wholly artificial transactions fall foul of the objective limb: it is further-reaching than that. Readers will be aware from the ruling of the ECJ in *Halifax* itself that there can still be an abuse of the Sixth Directive, notwithstanding that, as a matter of European law, the disputed transactions actually constituted supplies and an economic activity.

The distinction arises from the relevant Community rights at issue: in the context of direct taxes, the taxpayer is seeking to invoke some fundamental freedom of Community law, from which the tax advantage is merely a national law consequence. However, in the context of VAT, the tax advantage itself is the Community right at issue. For instance, the *Cadbury Schweppes* analysis could be applied to determine the “place of supply” under the Sixth Directive, only insofar as freedom of establishment may fix the geographic location of the purported supplier. For entitlement to a particular VAT advantage, it must still be shown that there *was* a supply *from that place* and that that supply was not an abuse. Artificiality may be the only bar to claiming a freedom, but it is not necessarily the only bar to deriving an advantage under the Sixth Directive.

### **General Principles in applying the Doctrine**

It is now clear, since *Halifax*, that the Sixth Directive must be interpreted as precluding the right to deduct input tax where the transactions from which that right derives constitutes an abusive practice<sup>28</sup>.

However, the doctrine of abuse is not confined to those provisions of Community law that confer a tax advantage *per se*. The VAT Tribunal in *Redcats* held that the doctrine applies equally to all provisions, with the result that articles having the neutral purpose of classifying certain transactions (such as article 5 defining “taxable transactions”, article 11 defining “taxable amount” and article 13 defining the exemptions) could also be interpreted subject to the doctrine<sup>29</sup>. This must necessarily be correct, following the Advocate General’s opinion in *Halifax* that the term “prohibition of abuse of Community law” was to be preferred to “abuse of rights”, which he considered misleading<sup>30</sup>.

### *Deferral Schemes*

In principle, there is almost certainly no distinction between tax advantages derived by outright VAT savings, and timing or cashflow advantages created by deferral schemes – both are subject to the prohibition of abusive practices. In view of the Advocate General’s clear statement in

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<sup>26</sup> *Cadbury Schweppes*, ECJ, para 38

<sup>27</sup> See also *Test Claimants in the Thin Cap Group Litigation*, AG, para 67 (concerning the compatibility with the Treaty free movement provisions of the UK’s thin capitalisation rules) where the Advocate General refers to “wholly artificial [transactions] designed purely to gain a tax advantage”.

<sup>28</sup> *Halifax*, ECJ, para 99.2

<sup>29</sup> *Redcats*, para 235

<sup>30</sup> *Halifax*, AG, para 71 and Cordara, page 269

*Halifax* linking deferral schemes to abuse<sup>31</sup>, it would appear that there is no reason why such schemes cannot be abusive if the conditions are met. Indeed, the question in one of the joined cases (*University of Huddersfield*) involved a deferral scheme, albeit in one sense it was not a true deferral scheme as the VAT Tribunal had found as a fact that the intention of the university was to create an absolute VAT saving (by terminating various leases comprising the VAT arrangements early, as opposed to letting them run their course).

However, it is the author's view that, provided there is substance to a leasing arrangement resulting in a VAT deferral, such an arrangement should not fall foul of the abuse doctrine. If the leases in question are at market rates and the lessor is more than a mere conduit (for example, has commercially real ownership rights or administrative obligations), it would be difficult for HMRC to argue under the objective limb of the *Halifax* test that such an arrangement frustrates the purpose of the relevant European provisions<sup>32</sup>. Moreover, there would be a considerable distortion of competition if exempt or partially exempt traders were precluded from leasing on the basis that spreading the burden of VAT payments in this way was found to be abusive.

### *Zero-rating*

It remains unclear whether the doctrine can strike down planning arrangements deriving their tax advantage from domestic zero-rating legislation, as this is a *national* measure permitted by way of derogation under Article 28.2(a) of the Sixth Directive, not a *Community* right. Although Article 12(1) of the Directive states that "the rate applicable to taxable transactions shall be that in force at the time of the chargeable event", this is concerned merely with timing and does not entitle a taxpayer (as a matter of Community law) to a particular rate<sup>33</sup>. Accordingly, as taxpayers have no directly enforceable right to zero-rating under EC law, in the absence of national measures precluding abusive practices, it would seem these provisions fall outside the ambit of the doctrine.

In theory, this argument is an extremely attractive one, especially since the judgment of the ECJ in *Talacre Beach*<sup>34</sup>, where the court held that, in respect of ascertaining the scope of the supplies for which the Sixth Directive allows an exemption to be maintained, the national legislation was decisive. Indeed, in that case, it had been HMRC themselves that had argued that zero-rating gave rise to no form of Community law right.

However, it is the author's view that this argument is restricted to a fairly narrow range of cases, where it is the *classification* of subject matter that is in dispute, not whether there has been a zero-rated supply of that subject matter. VAT Tribunal *obiter dicta* in *Redcats* partially illustrates this analysis: the appellant was a mail order company, selling clothing and household goods advertised in bi-annual catalogues. The catalogues were originally supplied to customers free of charge; however, the company amended its trading conditions by purporting to introduce a zero-

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<sup>31</sup> *Halifax*, AG, para 96

<sup>32</sup> Readers are referred to the case of *Weald Leasing Limited* (involving an equipment leasing arrangement), which was heard by the VAT Tribunal at the end of September 2006. A decision in that case is imminent, at the time of this article going to print.

<sup>33</sup> See *Marks and Spencer plc v Customs and Excise Commissioners* [2005] STC 1254, HL, particularly the speeches of Lord Hoffman (paras 6-11) and Lord Walker (paras 52-54).

<sup>34</sup> *Talacre Beach Caravan Sales Ltd v Customs and Excise Commissioners* Case C-251/05, [2006] STC 1671

rated charge for each catalogue and making a commensurate reduction in the price of the mainly standard rated goods ordered from it.

The taxpayer argued that the principle of abuse could not apply here, as the advantage sought arose from the zero-rating legislation. Although the Tribunal did not flatly reject this proposition in principle, it commented that the case was founded on other provisions of the Sixth Directive and principles of Community law, including Articles 2 and 11(A)(1)(a) of the Sixth Directive (on supply and construction) and neutrality and distortion of competition. A case for abuse could be founded on those Community rules as the dispute centred on the transactions comprising the *supply* of the catalogues to customers.

However, had it been accepted that there was a supply, with the only question being (say) whether or not the catalogue was a “brochure” within the Group 3 meaning, this scenario (albeit somewhat artificial) would fall squarely within the domestic legislation, therefore arguably outside the scope of the doctrine. In which case, it would also be irrelevant whether permitting this classification would be contrary to the principle of neutrality and lead to distortion of competition, as the zero-rating provisions do not transpose the Sixth Directive, so cannot infringe the general Community principles with which member states must comply when implementing Community legislation<sup>35</sup>.

#### *Option to Tax*

The author suspects that, for a similar reason, HMRC have chosen not to make submissions on abuse of rights in recent challenges to VAT deferment schemes involving an election to waive exemption, pursuant to para 2(1) of Schedule 10 to the Value Added Tax Act 1994. The *Newnham College case*<sup>36</sup> (which post-dates *Halifax*) is a perfect example of this, as both parties accepted that the only purpose of the disputed arrangements had been the recovery of VAT.

In that case, the college decided to renovate its library, but was concerned that, given it was exempt from VAT, it would not be able to recover input tax on the cost. It therefore set up a company wholly owned by the college, whose directors were college members and granted the company a lease of the library. In addition, the college sold its books and seconded its library staff to the company, before hiring back the assets and paying the company a fee for the provision of library services. The issue for the Tribunal was whether the college could be said to be in “occupation” of the library, in which case, it would be precluded from opting to tax pursuant to Schedule 10.

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<sup>35</sup> *Idéal Tourisme SA v Belgium* Case C-36/99 [2001] STC 1386, [2000] ECR I-6049, ECJ, para 38. See also, more generally, para 23 of the post-*Halifax* Opinion of Advocate General Kokott in *Albert Collée v Finanzamt Limburg an der Lahn*, Case C-146/05, “The underlying premise is that the Sixth Directive is not intended fully to harmonise Member States’ VAT systems. Rather ‘[i]t is clear from the Sixth Directive as a whole that it is intended to establish a uniform basis so as to guarantee the neutrality of the system’. As the Court has already held in *BP Supergaz*, Member States however ‘enjoy a relatively wide discretion in implementing specific provisions of the Sixth Directive’. In that regard Advocate General Fennelly explained inter alia in the Opinions in *Molenheide* and in *Schmeink & Cofreth*, that it can be said, more generally, ‘that Member States enjoy... the responsibility for managing the entire VAT system’.”

<sup>36</sup> *Principal and Fellows of Newnham College in the University of Cambridge v Revenue & Customs Comrs* [2006] STC 1010, CA. See also *Centralan Property Ltd v Comrs of Customs & Excise* Case C-63/04, [2006] STC 1542, ECJ, paras 22 - 23, where HMRC did not challenge the replacement of non-deductible VAT paid during the course of construction of a building with non-deductible VAT on rents paid on a 20-year lease resulting from a sale and lease-back scheme.

The VAT Tribunal, in finding for HMRC stated<sup>37</sup>:

“The documents clearly show that a scheme was constructed in order to recover VAT. The contracts were entered into within a very short period and it is clear that from the Bursar’s witness statement that the intention was to mitigate VAT. It is clear that the College had no purpose in leasing its library, selling its books and seconding its staff other than for the recovery of VAT. To allow the election to waive exemption to stand would be an abuse of the legislation and go against its spirit and intentment. The conditions for VAT recovery in the legislation should not be artificially created.”

As respondents, it was therefore open to HMRC to raise abuse of rights on appeal to the Court of Appeal. However, the Commissioners expressly sought not to argue the doctrine, nor to uphold the tribunal’s reasoning in that regard<sup>38</sup>. Accordingly, the court did not consider *Halifax*. However, in his judgment, Chadwick LJ was clear that any right of election pursuant to para 2(1) arose purely from domestic legislation. Article 13C of the Sixth Directive made it plain for each member state to decide whether to allow a right to opt for tax in cases of letting and leasing immoveable property and how, if at all, that right was to be restricted<sup>39</sup>.

HMRC’s approach in *Newnham College* is certainly not indicative of indifference on their part to deferral schemes. On the contrary, HMRC have sought to invoke the doctrine in respect of such schemes involving the leasing of moveable property, in which taxpayers rely purely on their Community right to deduction under Article 17<sup>40</sup>.

Although HMRC have been granted leave to appeal the *Newnham College* judgment, the author speculates that (notwithstanding any procedural bars), HMRC will certainly not try to resurrect abuse of rights before the House of Lords, as the case is focused on the meaning of a term (“occupation”) that plainly belongs to the domestic VAT legislation.

Contrasting Article 13C (option to tax) with Article 28.2(a) (zero-rating) in the context of abuse raises an interesting academic conundrum: can it be said that the UK’s zero-rating legislation is in fact ‘more domestic’ than its option to tax counterpart? Possibly, yes. Whereas under Article 13C, “Member States may allow taxpayers a right of option for taxation in certain cases” (in which case, it is implicit that, if such a right is allowed, it must *prospectively* be enacted in accordance with Community law), the transitional provisions under Article 28.2(a) allow *pre-existing* exemptions to be maintained (albeit provided they too are in accordance with Community law). Arguably, compliance with Community law will be policed more actively in the enactment of new provisions compared to the retention of existing ones.

What is however clear is that the risk of a high-profile loss for HMRC in this area is too great whilst the extent to which the doctrine applies to zero-rating remains a moot point: should it be

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<sup>37</sup> VAT Decision 18936

<sup>38</sup> The Court of Appeal (at para 21) quoted the Commissioners’ skeleton argument: “However it appears that the Tribunal may have been particularly influenced by the (admitted) fact that the Appellants were engaged in tax avoidance. Tax avoidance is relevant to this appeal only to the extent that Schedule 10 contains anti-avoidance provisions which should be construed where possible to achieve the legislative purpose... The Commissioners do not seek to uphold the Tribunal’s reasoning to the extent (if any) that it accorded the tax avoidance motive a wider significance. Moreover, the Commissioners do not (and did not below) rely upon the principle of abuse of rights or abuse of law.”

<sup>39</sup> *Newnham College, CA*, para 57

<sup>40</sup> Readers are again referred to *Weald Leasing Limited*.

found that arrangements predicated on the option to tax are outside the scope of abuse, by default, so too will zero-rating.

### **Interaction of the *Halifax* Test with Established EC Principles**

The *Halifax* test cannot be applied in isolation, but operates alongside existing principles of EU law, predominantly: fiscal neutrality, legal certainty and legitimate expectation. Furthermore, the interaction of the doctrine with these principles influences what evidence is relevant when evaluating whether or not abusive practices exist.

#### *The Contrary to VAT Purpose Test<sup>41</sup> - the First Halifax Limb*

Whilst the courts will not invalidate an arrangement simply because it affords a trader the most favourable tax treatment, the transactions comprising the arrangement must be properly characterised in the context of the trader's normal commercial operations. To allow otherwise would be contrary to the principle of fiscal neutrality and, therefore, contrary to the purpose of the Sixth Directive. In *Redcats*, the VAT Tribunal held that, although it was open to the trader to choose between exempt and taxable transactions in ordering its affairs, artificially portraying standard-rated transactions as zero-rated would be abusive. The final consumption of goods would not be taxed in a neutral manner, accordingly distorting competition.

Fiscal neutrality dictates that VAT should be neutral as regards the tax burden on a business<sup>42</sup>. In this regard, the ECJ in *Halifax* stated<sup>43</sup>:

“... it must be borne in mind that the deduction system under the Sixth Directive is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of VAT consequently ensures complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT.”<sup>44</sup>

When determining whether economic activities are themselves subject in principle to VAT, arbitrary distinctions between transactions are contrary to fiscal neutrality and are therefore be prohibited. An example of this is the case of *Gabalfrisa*, where the ECJ held that the first investment expenditure incurred for the purposes of and with the view to commencing a business should not be distinguished from expenditure incurred during exploitation itself, with only the latter constituting an economic activity on which input tax could be reclaimed<sup>45</sup>. Consequently, HMRC would not be able to rely on such arbitrary distinctions to support a case for abuse.

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<sup>41</sup> The VAT Tribunal in *Redcats* referred to the two limbs of the test as “the contrary to VAT purpose test” and “the essential aim test” respectively. The author adopts these definitions in the following analysis.

<sup>42</sup> *Halifax*, ECJ, paras 78 & 80.

<sup>43</sup> *Halifax*, ECJ, para 78

<sup>44</sup> In addition, the judgment further stated at para 92 that measures adopted by Member States “may not therefore be used in such a way that they would have the effect of undermining the neutrality of VAT, which is a fundamental principle of the common system of VAT established by Community legislation.” This passage has since been referred to in the Opinion of Advocate General Kokott in *Albert Collee v Finanzamt Limburg an der Lahn* Case C-146/05, para 25

<sup>45</sup> *Gabalfrisa*, ECJ, para 45

That is not to say, however, that commercially equivalent transactions must be afforded the same VAT treatment. In *BLP*<sup>46</sup>, the ECJ precluded the deduction of VAT charged on accountants' and legal advisers' fees, paid for the purposes of executing a share sale to raise funds to enable the company to continue trading, notwithstanding that VAT charged on equivalent fees would have been deductible if funds for the same purpose had been raised via a bank loan instead<sup>47</sup>.

Similarly, the ECJ considered in *Cantor Fitzgerald*<sup>48</sup> that, although the sub-letting of property by a tenant for a lower rent or the payment of compensation to the landlord for early termination of the lease (exempt transactions) would have been comparable in economic impact to the assignment of the original lease for a fee payable by the original tenant, it did not follow that the assignment should have the same VAT treatment. Although alternative courses of action were open to the parties to the transaction to take, it was not the course actually adopted<sup>49</sup>. The ECJ stated conclusively that, "The principle of neutrality of VAT does not mean that a taxable person with a choice between two transactions may choose one of them and avail himself of the effects of the other."<sup>50</sup>

The converse must also be true: the ECJ should preserve those transactions actually undertaken by a trader which confer deliberate VAT benefits. So long as the transactions are genuine and are not shams<sup>51</sup>, they will not be invalid simply because HMRC can prove that a commercially equivalent route exists with less beneficial VAT consequences: neutrality does not require economic decisions to be taken independently of tax considerations<sup>52</sup>.

In addition, Community institutions and Member States must observe the principles of legal certainty and legitimate expectation, not only when exercising their powers, but also when interpreting Community law provisions<sup>53</sup>. The Tribunal in *Redcats* justified their ruling that the doctrine of abuse applied to all Community law provisions on this basis. It would be contrary to legal certainty if a distinction had to be made as to whether Community provisions were considered to be advantageous, neutral or disadvantageous to the taxpayer in order to determine whether the prohibition for abuse could apply.

However, whilst permitting a general application of the doctrine, legal certainty limits the doctrine from being extended too far so that it affects legitimate trade. The Advocate General was clear in *Halifax* that defining the scope of abuse was<sup>54</sup>,

“...ultimately a problem of determining the limits applicable to the interpretation of the provisions of the VAT directives that confer certain rights on taxable persons... taxpayers must be entitled to know in advance what their tax position will be and, for that purpose, to rely on the plain meaning of the words of the VAT legislation.”

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<sup>46</sup> *BLP Group plc v Customs & Excise Comrs* Case C-4/94, [1995] ECR I-983, ECJ

<sup>47</sup> *BLP*, ECJ, para 25

<sup>48</sup> *Cantor Fitzgerald International* Case C-108/99, [2001] ECR I-7257, ECJ

<sup>49</sup> *Cantor Fitzgerald*, ECJ, para 31

<sup>50</sup> *Cantor Fitzgerald*, ECJ, para 33

<sup>51</sup> See, by way of comparison, the ruling of the ECJ in *Agip Petroli*, where sham voyages frustrating the aim of the relevant Community regulation relating to cabotage were not permitted, notwithstanding that technically they satisfied the conditions of the regulation under which the advantage was sought.

<sup>52</sup> *BLP*, ECJ, paras 15 & 26

<sup>53</sup> See *Gemeente Leusden* Joined Cases C-487/01 & C-7/02, [2004] ECR I-5337, ECJ, paras 57 & 65

<sup>54</sup> *Halifax*, AG, para 84

The ECJ supported this view, adding that Community legislation must be certain and foreseeable especially where rules were liable to entail financial consequences<sup>55</sup>. A procedure for advance clearance would, to a certain extent, reduce uncertainty over the application of the doctrine<sup>56</sup>. However, in the absence of the introduction into UK legislation of an indirect tax general anti-avoidance regulation, it is unlikely that such a procedure will be proposed, as the abuse doctrine as it currently stands is simply a principle of interpretation.

Under the contrary to VAT purpose test, legal certainty and legitimate expectation dictate that, (provided there is a commercial purpose for embarking on a series of transactions - determined by the essential aim test), the *manner* in which those transactions are performed is a matter for the individual taxpayer and should not be called into question. Intention and motive cease to be relevant and abuse does not arise simply because transactions have been constructed in a different and economically effective way.

This impacts on the evidence a court will consider when determining the objective limb of the *Halifax* test:

Firstly, where a commercial purpose is plainly apparent on the face of an arrangement, the tax advice received by a trader is irrelevant. In *RBS*, the tribunal refused HMRC's request for disclosure of advice, records of meetings and calculations on the grounds that preliminary discussions, or any thoughts of the company's board members or professional advisors were irrelevant, as was the question of whether the board or its advisers perceived there was a tax advantage. The transactions in question had economic reality, therefore actions were relevant, advice was not and the facts were clear as to what had happened. Furthermore, the substantive issue focused on the correct application of the law; there was no real dispute on the facts. The Tribunal distinguished *RBS* from *Halifax* on the basis that the latter case involved a scheme whereby transfers of rights in land appeared to have no commercial basis or rationale other than the avoidance of tax: the artificiality of the transactions spoke for itself when viewed objectively.

Secondly, "unusual" particulars of transactions are also irrelevant when determining the contrary to VAT purpose test, unless they are so unusual that they can be said in fact, to be artificial. In *RBS*, the Edinburgh Tribunal rejected as "startling" HMRC's submission that a lease of vehicles for "an unusual duration" (namely, 2 years) could show an abuse of rights. The Tribunal's approach must necessarily be right: just as matters such as the duration of a lease are irrelevant when considering whether or not something constitutes an economic activity (provided that the particular period of time was strictly necessary in the circumstances)<sup>57</sup>, so should these matters be irrelevant when considering whether or not there has been an abuse (again, provided that the period was strictly necessary in order for an arrangement to fulfill its supposed commercial objectives). Whether a right exists and whether it can be retained are both questions that must be answered absolutely, as the right to deduct input VAT cannot, in principle, be limited<sup>58</sup>. Accordingly, it would not be in accordance with legal certainty were the doctrine capable of striking down arrangements for (say) two years, but not five, if both had commercial purpose.

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<sup>55</sup> *Halifax*, ECJ, para 72

<sup>56</sup> Cf. the position in France, where there is a procedure for advance clearance that presumes automatic clearance if there is no reply after six months: Harris, page 136.

<sup>57</sup> see *Fini H*, Case C-32/03, [2005] ECR I-1599, ECJ, para 29

<sup>58</sup> *Gabalfrisa and Others* Case C-147/98, [2000] ECR I-1577 at para 43

This freedom to keep tax expenditure at a minimum is supported by a consistent body of EC authorities<sup>59</sup> and remains the case even if the taxpayer is taking advantage of a lacuna in the legislation<sup>60</sup> or there is doubt over the morality of a particular business structure<sup>61</sup>. Provided a taxpayer complies with the tax obligations arising, its legality cannot be questioned.

### *The Essential Aim Test – the Second Halifax Limb*

If an arrangement falls foul of the contrary to VAT purpose test, it will only be abusive if additionally, its “essential aim” is to obtain a tax advantage. It must be the “essential aim” of the whole series transactions viewed collectively, not just of one particular step, included to make the arrangement technically viable.

Douma and Engelen observe that the introduction of a “subjective tax avoidance motive” removes the conflict with legal certainty and foreseeability of the law, as a cautious balance is struck between two general principles of Community law: certainty and the need to prevent abuse of Community provisions<sup>62</sup>.

If there is another explanation or economic justification driving an arrangement, the principle of abuse is no longer operative and the tax authorities have no discretion to inquire whether the transactions were *predominantly* motivated by tax avoidance. However, “essential” may not simply mean “sole”, otherwise why did the ECJ not express the test in these terms?

The author believes there is some scope for the test being equivalent to a “but for” test: if it is the case that, but for the potential tax advantage, the trader would in any event have embarked upon the series of transactions, then there has been no abuse. Accordingly, any commercial justification for a particular arrangement must be of sufficient significance that it is more than merely ancillary or incidental.

Indeed, the second limb of the *Halifax* test has caused some uncertainty as to its precise meaning: there is currently a reference for a preliminary ruling from La Corte Suprema di Cassazione (Italy) where one of the two questions referred is:

“Does the concept of abuse of rights, defined in the judgment of the Court of Justice in Case C-255/02 as *transactions, the essential aim of which is to obtain a tax advantage*, correspond to the definition *transactions carried out for no commercial reasons other than a tax advantage*, or is it broader or more restrictive than that definition?”<sup>63</sup>

This limb of the *Halifax* test is to be assessed objectively. Therefore, if a disputed arrangement arises out of a change in business practice, the relevant question is whether the arrangement standing alone is commercially justified, not whether the circumstances of the restructuring are. Otherwise this would distort competition between a trader who changes its commercial practice

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<sup>59</sup> Such as *BLP Group*, ECJ, para 26 and *Cantor Fitzgerald*, ECJ, para 33

<sup>60</sup> *Gemeente Leusden*, ECJ, para 79

<sup>61</sup> *Halifax*, AG, footnote 85

<sup>62</sup> Douma and Engelen, page 436

<sup>63</sup> Reference for a preliminary ruling from the Corte Suprema di Cassazione (Italy) lodged on 16 October 2006 – *Ministero dell’Economia e delle Finanze v Part Service Srl, in liquidation*, Case C-425/06.

during the course of its business and one who commences trading adopting the disputed practice from the outset.

The fact that other traders have implemented a scheme identical or very similar to the one in dispute is not, in the absence of any other justification, sufficient to give that scheme a commercial purpose<sup>64</sup>. That said, if two traders operate truly identical schemes, it cannot be held that only one is an abuse of Community law. This would offend the overarching principles of distortion of competition and the uniformity of application of Community measures. Moreover, this would enable the tax authorities to choose which schemes to strike down: a discretion to which they are not entitled, due to the nature of the abuse doctrine as a principle of interpretation.

It is in relation to the essential aim test that tax advice received becomes relevant. Either the advice will illustrate the purpose of a scheme, or it will shed light on the objective circumstances in the context of which the decision to enter into the scheme was made (for example, business or personal links between operators). The Tribunal in *MMO2* allowed HMRC's request for disclosure of various classes of documents relating to tax advice under Rule 20(3). It held that the obtaining of advice, the nature of that advice and the circumstances in which it was given were all objective factors, on which the essential aim of the arrangement could be assessed. Accordingly, recommendations to decision-makers and their advisers will be relevant where the commercial purpose of an arrangement is not immediately apparent or where the genuineness of transactions is called into question<sup>65</sup>.

Similarly, any unusual particulars of a scheme constitute objective evidence of its essential aim<sup>66</sup>. For example, it would be difficult to justify the commercial purpose of a scheme if one step comprised the lease of a building for a single day. Although the lease may be genuine, in the sense that it is *factually* real (if it is properly executed and not a sham), it is not easy to see how it is *economically* real as (without intending to rewrite the essential aim test into something it is not) the lessee would not gain any commercial use or benefit from it.

### **VAT Planning post-*Halifax***

Although, in the context of VAT, the definition of abusive practices may not be restricted only to wholly artificial arrangements, the author believes that there remains scope for VAT planning in certain circumstances:

- In the absence of a national provision prohibiting abuse, it is arguable that the doctrine does not extend to domestic legislation, such as zero-rating or opting to tax;
- Post-*Cadbury Schweppes*, place of supply planning opportunities may be available;
- Deferral schemes involving the use (by exempt or partially-exempt traders) of genuine leases on proper commercial terms will most likely fall outside the ambit of the first limb of *Halifax*, even if the arrangements are between connected parties with the essential aim of obtaining tax advantages;

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<sup>64</sup> *Redcats*, para 239

<sup>65</sup> Distinguished from *RBS*, in which disclosure of similar material was refused as the economic reality of the disputed transactions was self-evident.

<sup>66</sup> *RBS*

- Deferral schemes involving third party leasing arrangements are likely to result in immediate financing and cashflow benefits as well as VAT advantages. Accordingly, neither of the *Halifax* limbs will be satisfied;
- For the same reason, intra-group leasing arrangements involving foreign subsidiaries should also not fall foul of the abuse doctrine: there may be immediate cashflow and withholding tax benefits (depending on the financing in place), as well as the deferral of VAT;
- If an arrangement affords significant mitigation of direct or stamp taxes, as well as the VAT advantage, then arguably the VAT advantage is not ‘essential’: due to other tax savings, the arrangement would have been entered into in any event, so the second limb of *Halifax* is not satisfied; and
- As the *Halifax* test requires the courts to consider an arrangement in its entirety, not just one or two particular steps, it seems likely that VAT planning as an element of a company reconstruction will also fall outside the essential aim test.

Those involved in VAT mitigation can take heart from recent judgments of the ECJ to the extent that VAT planning is not synonymous with abuse. Provided the arrangements are *economically* real and/or fuelled by a commercial objective, they should be immune from attack - though doubtless, HMRC will persist.

HUI LING McCARTHY<sup>67</sup>

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