

ABUSE OF RIGHTS – EUROPE’S LEGAL ELEPHANT¹

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Following the ruling of the European Court of Justice in *Halifax v Customs and Excise Commissioners* (C-255/02) [2006] STC 919 on 21 February 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 designed to mitigate VAT. Soon after the release of the judgment, HMRC issued a statement in their Business Brief (27/02/06) that, of the 175 or so cases then stood over pending the ECJ’s ruling, they foresaw 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. However, far from being the answer to HMRC’s prayers for 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 components. Instead, it is a principle of interpretation that must be considered in conjunction with other well-established concepts of Community law, such as legal certainty and fiscal neutrality.

This article examines the development 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 Community law principles and the evidence the courts will consider when assessing whether abusive practices exist, before concluding with a summary of potential VAT planning opportunities². So far, the VAT and Duties Tribunal has considered abuse in four decisions post-dating *Halifax*³. 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

“Abuse of rights” is evolving into a bit of a legal elephant. By which, I mean that the term still has no precise definition, yet we reckon we know it when we see it (albeit your elephant looks somewhat different if you are viewing it through the eyes of tax collector rather than tax payer). The body of EU case law dictating the circumstances in which abuse may be present is continually refining. In the absence of a national abuse provision prescribing those circumstances, the purpose of the doctrine is to catch cases where either -

- (i) a person is attempting to rely on a European legal right to circumvent or displace national law, or
- (ii) 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, *Cadbury Schweppes plc* (C-196/04) [2006] STC 1908 on the interplay between the freedom of establishment and the UK CFC legislation). The latter arises in the context of VAT via 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. However, far from catching all transactions obtaining tax advantages, the unequivocal language used in decisions of the ECJ suggests that forfeiture of a taxpayer’s rights cannot be justified on a whim, but only where the taxpayer’s actions are so extreme that the purpose of Community law would otherwise be severely frustrated.

ECJ Case Law

Cases such as *Diamantis* (C-373/97) determine there may be abuse where taxpayers seek to rely on Community law to derive “an *improper* advantage, *manifestly* contrary to the objective of that provision” which “will cause *such serious* damage to the legitimate interests of others that it appears *manifestly* disproportionate.” 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”. (*Emphases added*).

Member States' Established Concepts

Member States' own national provisions tackling abuse are also emphatically worded. For example, Article 281 of the Greek Civil Code (approved by the ECJ in *Diamantis*) 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." (*Emphasis added*) Similarly, continental European legal systems with their own established notions of abuse (that have existed before the doctrine was adopted by Community law and apply to all their domestic laws, not just to tax) do not recognise the principle as a first resort to frustrate tax planning. The French tax administration is faced with a presumption that agreements are real and that reciprocal or multi-party transactions are deemed to be economically balanced. This places the question of *abus de droit* within a series of rebuttals, such that it does not answer 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. The equivalent Dutch doctrine of *fraus legis* is considered the *ultimum remedium* and can only be applied if other methods of interpretation have been exhausted.

The European Commission

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 traders' rights. In *EC Commission v Italy* (C-129/00), 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 transactions* contemplated by the draftsman when Community law was transposed into the UK system of VAT.

Evolution of the Abuse Test

The key European authorities responsible for formulating the doctrine show a shift from a subjective to an objective approach. Earlier cases⁴ (although not expressly addressing 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. This was superseded by the test in *Emsland Stärke* (C-110/99), 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 for obtaining it.

Greater significance was placed on the objective nature of the doctrine in *Halifax*, where Advocate General Poiares Maduro emphasised that the doctrine

was a principle of interpretation, to be employed in deciding whether or not the Community law provision at issue conferred the right so claimed. Both the 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 - a far higher hurdle than the “main purpose” test for which HMRC had been hoping.

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 should be

encouraging for tax planning.

It appears that the Advocate General and the ECJ advanced the *Halifax* test a stage further in *Cadbury Schweppes*, notwithstanding that the case did not concern VAT, but the application of the UK’s CFC legislation in the context of freedom of establishment. Both the AG and the ECJ placed the emphasis on *genuineness*: provided that the companies involved had real substance and were more than just ‘letter-box’ companies, then even an “avowed purpose of benefiting from [a] favourable tax regime” was insufficient to constitute abuse. However, I do not think the *Cadbury Schweppes* formulation is precisely interchangeable with the *Halifax* test, such that (for VAT purposes) the sole question is one of genuineness, with only wholly artificial arrangements falling foul of the objective limb of the test: it is more far-reaching than that. The ruling of the ECJ in *Halifax* itself states 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 (staunchly upheld by the ECJ), 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. The *Cadbury Schweppes* analysis fits in determining “place of supply” questions under the Sixth Directive, insofar as freedom of establishment may fix the geographic

location of a 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 a VAT advantage.

General Principles in applying the Doctrine

Halifax resolved the previous uncertainty as to whether abuse of rights applied to VAT. The VAT Tribunal in *Redcats* subsequently held that the doctrine is not confined to Community law provisions that themselves directly confer tax advantages, but also to those with a neutral purpose (for example, Article 5 defining “taxable transactions”, Article 11 defining “taxable amount” and Article 13 defining the exemptions). However, there still remains some residual uncertainty as to the precise extent of its application.

Deferral Schemes

In principle, a tax advantage derived from an outright VAT saving is no different from timing or cashflow advantages created by deferral schemes, to the extent that both should be subject to the prohibition of abusive practices. In view of the Advocate General’s clear statement in *Halifax* linking deferral schemes to abuse, there is no reason why such schemes cannot be abusive. 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, because 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, simply choosing to lease an asset rather than purchase it outright is not in itself abusive: exempt traders need not bear the immediate burden of input tax and are not precluded from spreading irrecoverable VAT over a period of time, provided that the leases in question are on commercial terms and are not themselves artificial in nature (for example, at an artificially low rent or with a predetermined early termination as in *University of Huddersfield*).

Domestic legislation v. Community rights

It is still uncertain whether the doctrine can strike down planning arrangements deriving their tax advantage from purely domestic legislation, as these are national measures permitted by way of derogation, rather than being Community rights *per se*. Three measures that have been the focus of recent authority (albeit not necessarily in the context of abuse) are

- (i) zero-rating (permitted by way of derogation under Article 28.2(a) of the Sixth Directive),
- (ii) the election to waive exemption for buildings and land permitted under Article 13C; enacted in Schedule 10, para 2 VATA 1994), and

- (iii) Commissioners' directions to use the open market value of a supply in certain cases (permitted under Article 27; enacted in Schedule 6, para 1 VATA 1994).

(i) Zero-rating

Taxpayers have no directly enforceable right to zero-rating under EC law. In the absence of national measures precluding abuse, therefore, it might seem these provisions fall outside the ambit of the doctrine. At first sight, this argument is an extremely attractive one, especially since the judgment of the ECJ in *Talacre Beach Caravan Sales Ltd v Customs and Excise Commissioners* (C-251/05), where the Court held that national legislation decisively determined the scope of the supplies for which the Sixth Directive allows an exemption. 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 my view that this argument is restricted to a fairly narrow range of cases, where the *classification* of subject matter is in dispute, not whether there has been a zero-rated supply of that subject matter.

VAT Tribunal *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-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. The Tribunal did not flatly reject this proposition. However, it commented that the case was founded on other provisions of the Sixth Directive and on principles of Community law, including Articles 2 and 11(A)(1)(a) of the Sixth Directive (on supply and construction), 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.

(ii) Election to Waive Exemption

HMRC have chosen not to make submissions on abuse of rights in the *Newnham College* case⁵ (postdating *Halifax*), a recent challenge to a VAT deferral scheme involving an election to waive exemption. In this 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. The College then 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; both parties accepted that the only purpose

of the scheme had been the recovery of VAT. HMRC won in front of the VAT Tribunal on the basis that it was clear the intention had been to mitigate VAT, and it would be an abuse of the legislation to allow the election to waive exemption to stand as the conditions for VAT recovery had been artificially created. Curiously, HMRC expressly disclaimed a case for abuse on appeal to the Court of Appeal. Accordingly, the Court did not consider *Halifax*, but, 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 immovable property and how, if at all, that right was to be restricted.

(iii) Open Market Value

The VAT Tribunal in *Weald Leasing* considered whether the introduction of an unconnected company (yet one which was set up by the group's VAT consultant and used for the purposes of the scheme) prevented HMRC from making directions under Schedule 6, paragraph 1, to substitute open market value resulted in the accrual of tax advantages contrary to the Sixth Directive and to the domestic legislation. The Tribunal acknowledged that this would involve a widening of the *Halifax* test in order to encompass national legislation enacted by way of derogation. However, since HMRC neither made submissions nor adduced evidence in this respect, the point was not analysed further.

In light of the VAT Tribunal’s comments in *Weald Leasing*, it will probably not be too long before HMRC attempt to extend the abuse doctrine to domestic legislation enacted in this way.

Interaction of the *Halifax* Test with Established EC Principles

The *Halifax* test cannot be applied in isolation: each limb operates alongside existing principles of EU law – predominantly those of fiscal neutrality and prevention of the distortion of competition, legal certainty and legitimate expectation.

The “Contrary to VAT Purpose Test”⁶ - the First Halifax Limb

(i) Fiscal Neutrality

Fiscal neutrality dictates that VAT should be neutral as regards the tax burden on a business: the deduction system is meant to relieve a trader entirely of the burden of VAT payable or paid in the course of his economic activities, and Member States should not adopt any measures that would have the effect of undermining that neutrality. That is not to say, however, that commercially equivalent transactions must be afforded the same VAT treatment: traders may not choose one set of transactions, yet avail themselves of the tax consequences of the other⁷. This works both ways: conversely, HMRC cannot recharacterise a set of transactions simply because a commercially equivalent route exists with less beneficial VAT consequences for a

trader; neutrality does not require economic decisions to be taken independently of tax considerations. 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. However, if a disputed arrangement arises out of a change in business practice, the relevant question is whether the new practice standing alone is commercially justified, not whether there was a commercial justification for making the change. Furthermore, restrictions cannot be placed on traders according to their status as fully taxable, exempt or partially exempt: this would conflict with fiscal neutrality and distort competition (*Weald Leasing*). However, although it is open to a trader, in ordering its affairs, to choose between exempt and taxable transactions, artificially portraying standard-rated transactions as zero-rated would be abusive (*Redcats*), because the final consumption of goods would not be taxed in a neutral manner.

(ii) Legal Certainty and Legitimate Expectation

Legal certainty limits the doctrine from being extended so far that it affects legitimate trade: taxpayers must be entitled to know in advance what their tax position will be and to rely on the plain meaning of the words used in the VAT legislation. Community legislation must be certain and foreseeable, especially where rules entail financial consequences. A procedure for advance clearance would, to a certain extent, reduce

uncertainty over the application of the doctrine. The procedure in France, for example, presumes automatic clearance if the tax authorities do not reply within 6 months. However, in the absence of the introduction into UK legislation of an indirect tax GAAR, it is unlikely such a procedure will be adopted, because the abuse doctrine as it currently stands is no more than a principle of interpretation.

Under this limb of the test, legal certainty and legitimate expectation dictate that, (provided there is a commercial purpose for embarking on a series of transactions – to be 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 are irrelevant, and abuse does not arise simply because transactions have been constructed in a different and economically effective way. This impacts in two ways on the evidence a court will consider when determining the objective limb of the *Halifax* test.

- (i) 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 various advice and records on the grounds that preliminary discussions and the thoughts of the company’s board members and professional advisors were irrelevant. It was equally irrelevant whether there was a perceived tax

advantage as the transactions in question had economic reality (compared to *Halifax* where the artificiality of the transactions spoke for itself).

- (ii) “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 to be, in fact, 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 “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”, assessed objectively, of the whole series transactions viewed collectively, not just of one particular step, included to make the arrangement technically viable. If there is another explanation or economic justification for an arrangement, there is no abuse, and HMRC 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? There may be some scope for saying that the test is 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. Indeed, the second limb of the *Halifax* test has led to uncertainty as to its precise meaning: a reference for a preliminary ruling was lodged on 16 October 2006 in *Part Service* (C-425/06) as to whether the “essential aim” test is satisfied by *transactions carried out for no commercial reasons other than a tax advantage*, or is broader or more restrictive. It is in relation to *this* limb that tax advice received becomes relevant, as does evidence of collusion or personal or commercial links between the parties involved. These factors will either illustrate the purpose of a scheme, or shed light on the objective circumstances in the context of which the decision to enter into the scheme was made.

The Tribunal in *MMO2* allowed HMRC’s request for disclosure under Rule 20(3) of various classes of documents relating to tax advice. 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 *essential aim* could be assessed, given that there was no apparent commercial purpose for adopting the arrangements in question. Similarly, any unusual particulars of a scheme constitute objective evidence of its *essential aim*. For example, it would be difficult to justify the commercial purpose of a 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, because (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, there remains scope for VAT planning in certain circumstances, even if a trader may be taking advantage of a *lacuna* in the legislation:

- 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, opting to tax or the open market value rules;
- 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 at a commercial rate should 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;
- deferral schemes involving third party leasing arrangements are likely to result in immediate financing and cashflow benefits

as well as VAT advantages and accordingly, neither of the *Halifax* limbs will be satisfied;

- for the same reason, intra-group leasing arrangements involving foreign subsidiaries should not fall foul of the abuse doctrine, even though there may be immediate cashflow and withholding tax benefits (depending on the financing in place), as well as the deferral of VAT;
- inserting a ‘true’ third party such as a bank into a chain of transactions may prevent HMRC from making directions under Schedule 6, para.1, to substitute open market value, provided that the third party is more than a mere conduit;
- if an arrangement affords significant mitigation of direct or stamp taxes, as well as a VAT advantage, then arguably the VAT advantage is not ‘essential’, because, 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
- since 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 or fuelled by a commercial objective, they should be immune from attack – though, doubtless, HMRC will persist.

¹ A longer version of this article appeared in the second edition of the 2007 British Tax Review published by Sweet & Maxwell at [2007] BTR 160

² Readers should be aware that, if an arrangement comes before the VAT Tribunal, as well as deciding whether or not abuse exists (the focus of this article), an equally fundamental part of determining a trader's eventual liability is the redefinition of the disputed transactions in the event abuse is found. A finding of abuse does not guarantee a "windfall" for HMRC. Submissions as to how transactions should be redefined should not be neglected and can often be as complex (if not more so) as the question of whether abuse exists at all. Due to space constraints, it is not possible to provide a meaningful analysis here. However, paragraphs 152 – 172 of the VAT Tribunal decision in *Weald Leasing Limited* (Decision 20003) provide an interesting starting point, as well as summarising the VAT Tribunal's current thinking.

³ Chronologically, these decisions are *RBS Deutschland Holdings GMBH* VAT Decision 19055, *MMO2 Plc* VAT Decision 19514, *Redcats (Brands) Limited* VAT Decision 19648 and *Weald Leasing*.

⁴ For example, *General Milk Products* (C-8/92).

⁵ *Principal and Fellows of Newnham College in the University of Cambridge v Revenue & Customs Comrs* [2006] STC 1010, CA.

⁶ 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. I adopt these definitions in the following analysis.

⁷ See *BLP Group plc* (C-4/94) and *Cantor Fitzgerald International* (C-108/99).