Tax avoidance in Europe

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Federico Cincotta asks where should the line be drawn between legitimate financial planning and 'abusive' arrangements?

What is tax avoidance?

The Oxford English dictionary defines tax avoidance as follows *"the arrangement of one's financial affairs to minimize tax liability within the law"*. From this definition a key feature is the legality of the manner in which the tax liability is reduced. Meanwhile tax evasion is referred to as *"the illegal non-payment or underpayment of tax"*. A clear difference emerges between the two concepts, one being a legitimate part of financial planning, the other being illegal. In recent times the government has become keen to differentiate between legitimate financial planning, to which they have no interest in pursuing and abusive arrangements contrived with the sole purpose of reducing tax liability. Where should the line be drawn between legitimate financial planning and these *"abusive arrangements"*?

Many people legitimately reduce their tax bill by making simple changes to their personal tax affairs, for example a self-employed person in the UK may pay income tax, at a rate of 40 – 50 per cent if a high earner, could set up a company and start paying corporation tax at a rate of 20 per cent and therefore reduce his or her tax liability. Another example involves group of companies such as Google who bills UK companies from Ireland in order to take advantage of the low Irish corporation taxes.

Are these examples of legitimate tax planning or abusive arrangements? Both examples appear to be legitimate tax planning yet have the sole purpose of reducing tax liabilities. It is a genuine strategic business decision to move a company headquarters to a location, where it could be taxed more efficiently and hence, result in a reduced tax bill for the group. One might even go so far as to say that a company advised by professionals to transfer its headquarters to a tax efficient host, by not doing so could potentially be accused of "*not acting in the best interests of the company*". It is legitimate to make use of the legal remedies available within the law to reduce the tax liability.

The EU Treaty poses an additional dynamic. In an EU context why isn't tax just another cost standing in the way of a single borderless market? Just as a company can legitimately be set up in a member state which charges lower costs on the formation of a company (eg. Inspire Art) why can't the promoters of a company chose to put its business in the member state with the lower effective tax burden and do so for that reason alone?

The UK position

With the spending cuts the government has recently announced and an austere future for Britain on the horizon, tax avoidance has become a key area, which the government is keen to tackle. The government wants to ensure that the UK projects an image of an attractive place to do business and has affirmed a commitment to improving predictability and stability through a new tax policy, with an emphasis on clear policy objectives, transparency and consultation. The government estimates that the tax gap in the UK is around £40 billion, of which more than a sixth is due to tax evasion, and a further one sixth is estimated to be due to tax avoidance.

Where should the line be drawn between legitimate financial planning and these "abusive arrangements"?

HM Treasury has published in March 2011 a paper named *Tackling tax avoidance*. The British government has invested heavily in tackling tax evasion by putting forward over £900 million in funding to HMRC, which has estimated that it will bring in around £7 billion per year in additional revenue by 2014-2015. HMRC have made clear that their focus is particularly on large business cases and on wealthy individuals, where the immediate tax at risk is greater.

HMRC's new anti-avoidance strategy will focus in three core areas:

- preventing avoidance at the outset where possible;
- detecting it early where it persists;
- countering it effectively through challenge by HMRC.

GAAR

With the aim of addressing tax avoidance, Graham Aaronson QC was in charge a committee responsible for producing a report on General Anti-Avoidance Rule (GAAR) (*GAAR Study* dated 11 November 2011). The aim of such a rule is to deter and counter tax avoidance but at the same time retain a tax system that is attractive to business and minimises costs for businesses and HMRC.

In his findings it was reported that a moderate rule would be beneficial for the UK tax system. A rule that does not apply to responsible tax planning but instead is targeted directly at abusive arrangements. The report states that a GAAR should initially be applied to direct taxes such as income tax, capital gains tax, corporation tax, petroleum revenue tax and to national insurance contributions. However, Graham Aaronson QC goes on to warn against the introduction of a broad-spectrum general anti-avoidance rule. The Government is in consultation with a view to introducing legislation in the Finance Bill 2013.

HMRC closing tax avoidance schemes

The Finance Act 2004 has introduced the disclosure rules which have now been extended and apply to direct tax, SDLT, VAT, pension contributions and national insurance contributions. The idea behind the disclosure rules is to provide HMRC with the necessary information so that HMRC can assess potential tax avoidance schemes and introduce legislation where appropriate and which could have retrospective effect.

For example, the media has reported that Barclays voluntarily disclosed to the revenue 'abusive' tax schemes, which were blocked with retrospective effect by the Treasury. The scheme used by Barclays allowed the bank's commercial profits, from a buyback of its own debt, to be used to avoid corporation tax payments. A further scheme involved Authorised Investment Funds and intended to give non-taxable income a repayment of tax credits from HMRC for tax that has never been paid. Barclays contends the scheme is legal and in compliance with the tax code.

A further example where HMRC has attempted to take control of the situation is with the closure of the Channel Island VAT loophole whereby mail order companies could send low value items to the UK without payment of VAT and then be re-imported to the UK (a circularity similar to that of many others tax avoidance schemes).

Thin capitalisation legislation

The UK has introduced the thin capitalisation legislation, to counter tax avoidance by groups of companies through the parent company financing a subsidiary by means of loans rather than equity, with interest payments on loans being deductible for the purposes of calculating taxable profits. The effect of the thin capitalisation legislation was to treat any interest paid on a loan, which exceeded what would be paid on an arm's length transaction as distribution of profits.

The thin capitalisation legislation was recently challenged in the case *Test Claimants in the Thin Cap Group Litigation* where the Court of Appeal in February 2011 stated that the application of the arm's length test did not automatically breach art 43 of the EC Treaty (Freedom of Establishment) provided that: the taxpayer was given an opportunity to present his case to the tax authorities to show that the transaction was on an arm's length terms; that the taxpayer could challenge the decision before national courts and that the effect of the legislation was limited to those aspects of the advantage conferred by the taxpayer company that do not satisfy that test. This is one of many cases where the lawfulness of the UK tax regime has been challenged in light of European Union law.

The other side of the coin

Whilst the British Government has invested over £900 million with HMRC to tackle tax avoidance, HMRC recently settled a dispute with Vodafone in 2010 in a deal that was reported by the media to have cost the taxpayers billions of pounds.

When Vodafone took over Mannesman in 2000, through a Luxembourg subsidiary, Vodafone became the biggest telecommunications company in the world and began making profits through Luxembourg's tax haven. HMRC said that the controlled foreign companies legislation meant that Vodafone's profits in Luxembourg should be taxed. After a legal dispute with Vodafone, a settlement was eventually agreed whereby Vodafone was to pay £800 million with a further £450 million over the next five years. This was reported as £1 billion less than what Vodafone had originally set aside to resolve any tax issue.

What is the rest of Europe doing?

Tax-Evasion.org reports that tax evasion in Europe has a value of approximately €860 billion a year and tax avoidance of around €150 billion a year. Within Europe, Italy is considered one of the countries making the biggest loss as a result of tax evasion, with Estonia making a larger loss when the tax lost is expressed as a proportion of the government spending (more than 28% of its spending is lost to tax evasion).

Looking more closely at individual European countries, in France there is no requirement to disclose avoidance schemes in advance to the company's tax returns. Tax avoidance schemes could be challenged under abuse of law provisions provided the schemes is fictitious or intends to benefit from a tax advantage that is contrary to the intentions of parliament and is exclusively tax driven. If the tax has to be reassessed under the abuse of law procedure an 80% penalty applies. The penalty is reduced to 40% if the taxpayer is not the initiator of the scheme or its main beneficiary. Moreover, French law also provides for regulations limiting transfer pricing.

In Luxembourg, the tax authorities can challenge sham transactions under the so-called abuse of law doctrine in the field of direct taxes, but not to capital duty and transfer taxes. It remains unclear whether VAT is covered.

Spain appears to be taking an active approach to tackling tax avoidance, however, there is no general anti-avoidance rule nor is there a necessity to disclose avoidance schemes in advance of the company's tax returns. The new Spanish law from 2006 on tax avoidance sets up new regulations regarding transactions between related parties and new scenarios under which companies incorporated in overseas 'tax haven jurisdictions' could be deemed as a tax resident in Spain.

In February 2012 Greece has signed the Convention on Mutual Administrative Assistance in Tax Matters. The Convention facilitates international co-operation for a better operation of national tax laws, while respecting the fundamental rights of taxpayers. The Convention provides for all possible forms of administrative co-operation between states in the assessment and collection of taxes, in particular focus to combating evasion and tax avoidance. Thirty-four countries are signatories to the Convention so far.

Sweden currently has a general anti-avoidance rule. The Swedish tax authorities and the courts in Sweden apply a 'substance over form' approach in establishing whether or not there was tax avoidance. The transactions are analysed in order to establish their 'real economic meaning'.

Italy, with the purpose of combating tax avoidance, is planning to adopt enquiries into bank accounts using a new computer system named 'Serpico' and to cut off cash transactions at a maximum of €969.

A tax evasion treaty has been signed between Germany and Switzerland, which according to the German's Finance Ministry could help Germany raise €8.3 billion in revenues next year.

Final remarks

European countries appear to be taking serious measures to tackle tax avoidance and tax evasion, highlighted as a priority given the current economic climate and the estimated sums of money involved. Whilst tax evasion is illegal, tax avoidance remains a form of legitimate financial planning. In their essence, legitimate financial planning and tax avoidance are mechanisms of how to be financially efficient acting within the law consistently with the essential feature of the single market – competitiveness without the restriction of borders.

Just as businesses are encouraged to take advantage of the lowest costs structures, tax savings too are a legitimate target. It could be said that the differences between legitimate financial planning and tax avoidance, seem more a question of semantics.

The real player appears to be the amount of money involved for the parties. This does not mean that legislation shouldn't be amended where there is a loophole so that that loophole could not continue being exploited by artificial means. Such legislation however should not be introduced retrospectively unless there are transitional arrangements compatible with European law. ■

Federico MA Cincotta is a Tax Advisor at Dorsey & Whitney LLP