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Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance

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ARTICLE

Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance

Maria Hilling*

The article[1] deals with the limitations imposed by the free movement provisions of the Treaty on the Functioning of the European Union (TFEU) on Member States' ability to prevent tax avoidance and protect national tax bases through law.[2] It focuses on some recent case law developments in the Court of Justice of the European Union (ECJ). Among other changes, a significant reason for justification has been added and the proportionality test has been elaborated. Conclusions regarding the development in case law during the last few years will be contrasted with the statements made in previous case law, namely that provisions that do not only apply to wholly artificial arrangements cannot be justified with reference to the need to combat tax avoidance. One central question concerns the implications of the current legal situation for Member States' tax legislators' ability to prevent tax avoidance and to protect their national tax base. The implications of this development for the EU compatibility of the Swedish General Anti-Avoidance Rule (GAAR) and the rules for the limitation of interest deduction are analysed. The article also discusses the case C-318/10 SIAT.

1 Introduction

The creation of an internal market where the treaty-based rights to free movement of individuals and companies can be exercised without hindrance is in tension with the fact that the Member States need effective tax systems that prevent the erosion of their tax bases due to misuse or unintended tax exemptions.[3] The ECJ is tasked with balancing these conflicting interests by accepting that restrictions upon movement are sometimes justified.[4] The ECJ has expressly stated that losses in tax revenue cannot justify a tax rule that restricts free movement and that the protection of Member States' tax bases is not by itself a legitimate justification.[5] However, some of the justifications[6] that have been accepted do in fact constitute such a protection.[7] This goes primarily for *the need to maintain the balanced allocation of taxing rights*.[8] At the core of this justification is the idea that a Member State has the right to ensure that incomes subject to the balanced allocation of taxing rights in a given country can in fact be taxed there. This has been invoked as a justification for restrictive tax laws on several occasions,[9] sometimes by itself but more often in conjunction with the goal of preventing tax avoidance.[10] The fact that these two motives, considered together, can serve to justify the Member States' restrictive rules makes sense given that such actions that may be considered instances of tax avoidance often entail that tax bases are moved from one

Notes

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1 I would like to extend warm thanks to the participants of the EU Law Discussion Group at the Lund University faculty of law on 26 Sep. 2012, for their comments on parts of this article. I am also grateful for the feedback I received in a seminar arranged by the Association for research on tax law at Lund University (Gruppen för skatterättslig forskning vid Lunds universitet) on 17 Oct. 2012. For valuable discussion and continuous inspiration, I would like to thank Justice of the Swedish Supreme Administrative Court Kristina Ståhl. I welcome comments on this article via email, maria.hilling@jur.lu.se.

2 Also secondary law, especially the merger directive (2009/133/EG), the parent/subsidiary directive (90/435/EEG) and the interest/royalty directive (2003/49/EG), contain rules that entail limitations on Member States' freedom in this area. However, these will not be discussed in the present article.

3 See e.g. Council Resolution of 8 Jun. 2010 on coordination of the Controlled Foreign Corporation (CFC) and thin capitalization rules within the EU and COM (2007) 785 final.

4 See Cordewener et al., *The Clash Between European Freedoms and National Direct Tax Law: Public Interest Defences Available to the Member States*, Com. Mkt. L. Rev. 1951 (2009).

5 See e.g. case 270/83 *The Commission vs. France* and case C-10/10 *The Commission vs. Austria*.

6 By 'justification' I refer to the imperative interests, which is an open-ended category first conceived by the ECJ in the case 120/78 Rewe-Zentral AG v Bundermonopolverwaltung für Branntwein (the so-called Cassis de Dijon case). See Hilling, *Free Movement and Tax Treaties in the Internal Market* 94–106 (Iustus 2005).

7 Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) p. 167. For a similar conclusion, see Terra & Wattel, *European Tax Law* 895 (2012).

8 For further details about this justificatory ground, see s. 3.3. The expressions 'the need to preserve the balanced allocation of taxing rights' and 'the need to maintain the balanced allocation of taxing rights' as well as their abbreviations are used synonymously.

9 The designation of this justification varies in ECJ jurisprudence. Some cases use the expression *to prevent tax avoidance* or *tax evasion*. This article will mostly use the expression *to prevent tax avoidance*.

10 See ss. 3.3 and 3.4. Tax avoidance is commonly described as the reduction of tax liability by legal means (see for instance IBFD International Tax Glossary, 31 (2009)).

state to another.[11] Such actions, in other words, entail that a balanced allocation of taxing rights is not maintained.[12]

This article is concerned, first, with changes in the ECJ's case law regarding how the prevention of tax avoidance and the preservation of a balanced allocation of taxing rights are invoked as justifications; and, second, with changes in the assessment of proportionality. The outcome of the analysis, therefore, has an impact primarily on various national income tax rules that serve similar purposes – from traditional rules against tax avoidance[13] to rules aiming to protect the national tax base. The motivation for treating these two grounds jointly is that the ECJ has come to invoke them jointly in justifying national tax provisions. The purpose of this article is then to establish whether the conclusion drawn from previous case law regarding the compatibility of national tax avoidance rules with EU law – that is, that anti-avoidance rules cannot be justified if they prevent typical instances of avoidance in a general manner, without ascertaining in each individual case that it is indeed an instance of tax avoidance – must be revised in light of developments in case law over the past few years. As part of this aim, the article will also analyse some changes that have occurred at the last stage of justificatory assessment: the proportionality test.

The ECJ's assessments as to whether a Member State's income tax rule conflicts with the provisions on free movement follows a pattern that can be described in three steps. The first step is to determine whether the taxpayer has exercised any of the rights established in the articles on free movement. If that is the case, the second step consists in determining whether the national rule constitutes an obstacle[14] to free movement. Only when that question is answered in the affirmative does the process proceed to the third step, which assesses whether the rule can be justified and, if so, whether it adheres to the principle of proportionality. These steps will be discussed one at a time in sections two, three and four. In section five, the results of the previous sections will be applied to select rules in the Swedish tax system. Section 6 will offer some general conclusions.

2 Is the national rule an obstacle to free movement?

2.1 *A Question of Comparability*

As is well-known, national tax rules may be in breach of the provisions on free movement. The taxpayer enjoys the right to free movement as established in the Treaty insofar as the transaction or arrangement at issue transcends national borders. Purely national cases are not protected by the provisions.[15] Furthermore, the taxpayer's exercise of the right to free movement must not be an instance of abuse.[16] The ECJ has stated on several occasions that whoever abuses the rights established by the Treaty forfeits his right to rely on its provisions on free movement.

In assessing whether a national tax provision constitutes an obstacle to free movement, the crucial question is whether the rule treats the cross-border situation less favourably than a comparable national situation.[17] The comparability analysis is therefore often a key element.[18]

2.2 *Different Forms of National Anti-Abuse Rules*

National anti-abuse rules may take a variety of forms. For purposes of this article, the following categorization is applied. To the first category belong rules that, like Controlled Foreign Corporation (CFC) provisions, target cross-border situations exclusively.[19] The second category consists of rules that have a general application, i.e., they cover both national and cross-border transactions. The Swedish General Anti-Avoidance Rule (GAAR) falls into this category.

The assessment of provisions of the first category, which target cross-border situations specifically, is based on the wording of the rule. If the rule is applicable only to cross-border situations and imposes less favourable treatment than the comparable internal situation, the rule is likely to constitute an obstacle to free movement. The assessment as to whether a provision of the second category constitutes

Notes

11 See for instance Case C-231/05 *Oy AA* (grand chamber), para. 62.

12 Grounds for justification are discussed further in s. 3.2.2.

13 There are, in addition, the interpretive methods, developed through case law, serving to prevent tax avoidance.

14 The terms 'obstacle' and 'restriction' are used synonymously.

15 See e.g. Case C-107/94 *Asscher*, case C-403/03 *Schempp*, Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) paras. 71-72 and See also Zalasinski, *Proportionality of Anti-Avoidance and Anti-Abuse Measures in the ECJ's Direct Tax Case Law*, 35 Intertax 314 (2007).

16 See e.g. Case C-212/97 *Centros*, para. 24, Case C-417/10 *3M Italia*, paras. 30–33, Ståhl, EG-rätt och skatteflykt SN 2007/10 p. 581 and von Bahr, Skatteflykt i EG-rättslig belysning SN 2007/11 pp. 646-650.

17 The only exceptions to this general rule are cases where the national tax law is relevant only in cross-border situations. See Case C-293/06 *Shell*.

18 See Lang, *Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions*, EC Tax Rev. 98 (2009) and Hilling, *Free Movement and Tax Treaties in the Internal Market* 67–68, 71–79 (Iustus 2005).

19 See e.g. Case C-196/04 *Cadbury Schweppes*.

an obstacle is usually more complicated. For a rule of general applicability to constitute an obstacle, it must, as previously noted, be *applied* in a discriminatory manner. Ståhl has shown convincingly that the Swedish GAAR, though it lacks elements expressly targeting cross-border transactions, may well be applied in a discriminatory way.[20] This is so if the rule is applied in a cross-border situation but not in a comparable internal situation. A court applying such a rule must make a hypothetical assessment as to whether the rule would have been applicable in a comparable internal situation as well.

3 The justification assessment

3.1 *A New Method and New Justifications*

Since 2005,[21] a new method for assessing whether a national tax law is justifiable has gained ground in the ECJ. Whereas previously the different arguments were separated and placed in clearly defined categories according to the grounds invoked for justification, the ECJ now tends to make a summary assessment, considering the grounds collectively.[22] This development, together with the fact that the ECJ has come to accept new justifications, has made it difficult to establish what the ECJ takes each justification to mean. The difficulty is increased by the fact that unlike Treaty derogations, justifications are determined solely by the ECJ's own case law.[23]

Section 3.2 is concerned with the meaning of *the need to prevent tax avoidance* when invoked as the sole justification. Section 3.3 concerns *the need to maintain a balanced allocation of taxing rights* as sole justifying ground. Section 3.4 gives an account of the meaning of the aforementioned justifications when considered in conjunction and thus investigates the arguments the ECJ makes when considering these grounds together. The section also mentions national rules that have been accepted by appeal to those grounds. Section 3.5 offers conclusions and discusses the significance of this development in case law for Member States' legislators.

3.2 *The Need to Prevent Tax Avoidance*

3.2.1 *To Prevent Artificial Arrangements*

The goal of preventing tax avoidance may be invoked as a justification for restrictive national laws. In order to be accepted as a legitimate ground by itself, the national tax law must be designed so as only to target artificial arrangements. The notion of an artificial arrangement is found in several ECJ decisions[24] but only in 2006, in case C-196/04 *Cadbury Schweppes*, which was decided in grand chamber, did the ECJ elaborate on what exactly it takes an artificial arrangement to be.[25] The case in question concerned the compatibility of British CFC rules with the freedom of establishment. CFC rules prevent the diversion by resident taxpayers of income to companies they control and which are typically residents in countries imposing low or no taxation.[26]

Although in the *Cadbury Schweppes* case, the CFC rules were found to restrict the freedom of establishment, the ECJ deemed this restriction justified given the need to prevent tax avoidance. The rule was considered justified only in cases where it targeted wholly artificial arrangements which did not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory. The ECJ stated, further, that such arrangements jeopardize the balanced allocation of taxing rights between Member States.[27] Thus the ECJ emphasized the connection between the two justifications; the need to prevent tax avoidance and the need to maintain a balanced allocation of taxing rights between Member States. At that time, the latter justification had only just been accepted as such by the ECJ.

The decision in *Cadbury Schweppes* implies that Member States are allowed to have rules that aim at hindering transfers of taxable profits out of a country in an artificial manner. In its decision, the ECJ identified the circumstances required in order for a transfer of profits to qualify as a wholly artificial arrangement. There must, first of all, be a subjective element, i.e., an intention to

Notes

20 Ståhl, EG-rätt och skatteflykt, SN 2007 pp. 584-585. In the Swedish Supreme Administrative Court case RÅ 2010 ref. 51, a similar line of reasoning was used in assessing whether an application of the tax avoidance rule constituted a hindrance.

21 Starting with the Case C-446/03 *Marks & Spencer*.

22 In other words, a summary assessment takes into consideration several reasons. See Lang, *Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions*, EC Tax Rev. 106–108 (2009) and Helminen, *EU Tax Law* 121 (IBFD 2011).

23 Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) pp. 149–151, 167.

24 See e.g. Case C-264/96 *ICI*, para. 26 and Case C-324/00 *Lankhorst-Hohorst*, para. 37.

25 For an account of the development of this justification prior to Case C-196/04 *Cadbury Schweppes,* see Terra & Wattel, *European Tax Law* 913–922 (2012).

26 IBFD International Tax Glossary, 97 (2009).

27 Case C-196/04 *Cadbury Schweppes,* para. 56.

achieve a tax advantage.[28] Second, it must be apparent from the objective facts of the matter that the purpose of the freedom of establishment has not been achieved even though the requirements of EU law have been fulfilled formally speaking. In other words, it must be evident from the objective circumstances that no genuine establishment has been made and that no actual business is being conducted in other Member States.[29] Among such objectively verifiable circumstances are the extent of the CFC company's physical presence – such as buildings, staff and equipment – in the host country.[30] If an investigation into these circumstances yields the conclusion that that CFC company is a fictitious establishment which is not engaged in any actual economic activity in the host country, the company is to be considered an artificial arrangement.[31] However, the parent company is entitled to explain its reasons for establishing a subsidiary in another country and to show that it is actually conducting business in the host country.[32]

The notion of an artificial arrangement was crucial to the 2007 case *Thin Cap Group Litigation* which, like *Cadbury Schweppes*, was decided in grand chamber. At issue was whether British thin capitalization rules constituted a hindrance to the freedom of establishment. Briefly, thin capitalization rules are rules establishing that interest paid to affiliated foreign companies is in some cases to be reclassified as non-deductible dividends. In its attempt to justify the British thin capitalization rules with reference to the aim of preventing tax avoidance, the United Kingdom claimed that its thin capitalization rules targeted a particular form of tax avoidance which consists in using fictitious arrangements designed to evade the tax legislation of the borrower's state of residence.[33] Consistent with its decision in *Cadbury Schweppes*, the ECJ argued that restrictive laws may be justified when they specifically target fictitious arrangements made solely to evade the tax legislation in the Member State in question.[34] The ECJ found that the thin capitalization rules were specifically intended to prevent such behaviour. Therefore the need to prevent tax avoidance was found to justify the restriction in this case.[35]

In order to be considered proportional,[36] the thin capitalization rules in *Thin Cap Group Litigation* could not be such as to strike interest payments to foreign companies generally. Interest payments could only be reclassified as non-deductible dividends if, and to the extent that, the payment exceeded the amount those companies would have agreed upon on arm's-length basis, i.e., the conditions to which the transaction would have been subject if the companies had not been part of the same group.[37] The reference to commercial terms is crucial in order for a rule to be covered by the definition of wholly artificial arrangement, as it is only economically ungrounded arrangements that are considered tax avoidance. The factors that are decisive in the assessment as to whether a certain situation is within the scope of wholly artificial arrangements are the objective and verifiable circumstances, i.e., whether the loan was made in accordance with market conditions.[38] The taxpayer must always be given the opportunity to provide evidence of genuine economic motivations for its actions.[39]

As in the *Cadbury Schweppes* case, the ECJ stated in the *Thin Cap Group Litigation* case that the kind of behaviour that is prevented by the thin capitalization rules can undermine the right of Member States to exercise their taxing rights on activities carried out in their territory, which jeopardizes the balanced allocation of taxing rights between Member States.[40] Once more, the ECJ emphasized the close connection between the need to prevent tax avoidance and the desire to maintain a balanced allocation of taxing rights when it comes to justifying national rules that aim at hindering transfers of taxable profits out of a country.

3.2.2 *Conclusions*

The conclusion of the decisions considered above is that in order to be justified, restrictive tax rules implemented for

Notes

28 Case C-196/04 *Cadbury Schweppes,* para. 64.

29 Case C-196/04 *Cadbury Schweppes,* para. 64.

30 Case C-196/04 *Cadbury Schweppes,* para. 67. Based on the *Cadbury* case, among others, the Council has published its view of what constitutes an artificial arrangement. See the Council's resolution as of 8 Jun. 2010 on coordination of the Controlled Foreign Corporation (CFC) and thin capitalization rules within the EU (the resolution is not legally binding).

31 The Court mentions letter box companies as an example of a wholly artificial arrangement (para. 68).

32 Case C-196/04 *Cadbury Schweppes,* para. 70.

33 Case C-524/04 *Thin Cap Group Litigation*, para. 71.

34 Case C-524/04 *Thin Cap Group Litigation*, para. 72.

35 Case C-524/04 *Thin Cap Group Litigation*, paras. 74 and 77.

36 Regarding the proportionality assessment, see s. 4 below.

37 Case C-524/04 *Thin Cap Group Litigation*, para. 80.

38 Case C-524/04 *Thin Cap Group Litigation*, para. 81. For further discussion, see Ståhl, EG-rätt och skatteflykt, SN 2007/10 p. 589.

39 Case C-524/04 *Thin Cap Group Litigation*, para. 83.

40 Case C-524/04 *Thin Cap Group Litigation*, para. 75.

purposes of preventing tax avoidance must target artificial arrangements. To be considered artificial, the arrangement must contain a subjective element: it must have been made with the intention of achieving a tax advantage. The assessment as to whether an arrangement is artificial must be based on objective circumstances verifiable by third parties and must be tied to the specific purpose of the national law. Circumstances indicative of an artificial arrangement in one situation need not be assessed the same way with reference to a different rule with a slightly different purpose.[41] In sum, rules that apply to artificial arrangements and economically motivated arrangements alike cannot be justified only on grounds of the need to prevent tax avoidance.

3.3 *The Need to Maintain a Balanced Allocation of Taxing Rights*

3.3.1 *A Significant Justification*

The need to maintain a balanced allocation of taxing rights was first invoked as a justification in the 2005 case *Marks & Spencer*.[42] In the ensuing case law, this justification has played a central role in several justification assessments.[43] The last few years have seen a trend towards leniency in the ECJ's attitude towards Member States' attempts to justify their income tax laws. Member States' chances of successfully defending restrictive rules have increased somewhat.[44] The trend is due in large part to Member States successfully appealing to the need to maintain a balanced allocation of taxing rights. This justification has primarily been tried in conjunction with other justifications, though at times it has been accepted as a separate justification.[45]

3.3.2 *Member States' Right to Prevent Cross-border Transfers of Tax Bases*

As stated above, the crucial point in the preservation of a balanced allocation of taxing rights as a justification for restrictive tax rules is that a Member State has the right to ensure that incomes which the state, in accordance with the balanced allocation of taxing rights, is allowed to tax are in fact subject to taxation in that state. In other words, if the Member State has a reasonable[46] tie to either the tax subject or the tax object (or both), then the state is entitled to protect that tax claim through legislation. On the premise that the rules in question meet the demands of the proportionality test, a Member State may invoke rules that prevent the transfer of tax bases outside its tax jurisdiction. The cases C-337/08 *X Holding* and C-18/11 *Philips Electronics* confirm this conclusion.[47] In *X Holding*, the Netherlands' fiscal unity regime which in effect served to limit the possibility of loss relief to internal situations were accepted.[48] The need to maintain a balanced allocation of taxing rights was invoked as the sole justification. The decisive factor in the case appears to be that expanding the fiscal unity regime to include foreign subsidiaries would enable companies to choose the country in which their subsidiary's losses would be considered.[49] The decision shows that the need to maintain a balanced allocation of taxing rights can be invoked as a justification for national tax laws if they turn out to be necessary to prevent the transfer of tax bases between Member States.[50] In the case *Philips Electronics*, the ECJ found that the need to maintain a balanced allocation of taxing rights could not be invoked as a justification. The case concerns British laws that allowed the transfer of losses between a Dutch company's permanent establishment in the UK and a company based in the same country only if the losses in

Notes

41 Ståhl, EG-rätt och skatteflykt, SN 2007/10 p. 590, reaches the same conclusion.

42 Case C-446/03 *Marks & Spencer*.

43 See e.g. Case C-414/06 *Lidl* and case C-371/10 *National Grid Indus*.

44 Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) p. 74.

45 In case C-337/08 *X Holding* and in case C-371/10 *National Grid Indus*, the justification was accepted as a separate justification.

46 Below I return to the question what constitutes a *reasonable* tie.

47 The decision was announced by the ECJ on 6 Sep. 2012. Cejie & Hilling commented on the decision in Aktuellt om EU-domstolens praxis, SN 2012/12 881–883.

48 Thus the system of tax integration did not admit of any cross-border loss relief for final losses; nor did the ECJ demand the possibility of such relief by way of justification. (The rules were considered proportional.)

49 Case C-337/08 *X Holding*, para. 31. An equivalent line of reasoning is found also in Case C-231/05 *Oy AA*, para. 55 (in relation to subsidiaries) and in case C-414/06 *Lidl*, para. 34 (in relation to permanent establishments).

50 In case C-414/06 *Lidl*, paras. 31 and 33, the Court stated that maintaining the allocation of taxing rights can make it necessary to apply only *one* state's tax laws on gains as well as losses. That is, there is an aspiration for symmetry between the right to tax surpluses and the right to deduct losses. For more on this, see Hilling, Skatteavtalen i EG-domstolens praxis: Skatteavtalens inverkan vid prövning av interna skattereglers förenlighet med den fria rörligheten, SvSkT 2008/9 pp. 621-622.

question were considered final losses.[51] The question was whether the principles of cross-border loss relief that was established in case C-446/03 *Marks & Spencer* would be applicable in this situation as well. The ECJ explained that the balanced allocation of taxing rights did not depend on whether or not the losses were final, invalidating the balanced allocation of taxing rights as a justification. My conclusion based on the *Philips Electronics* case is that this justification cannot be applied if what is at issue is a limitation on the possibility of loss relief within the tax jurisdiction of one country. The case at hand concerned a transfer where the UK had taxing rights on gains and losses in the permanent establishment as well as in the receiving company in the UK. It was not a question, then, of restrictive national rules that were necessary to prevent the transfer of tax bases from one Member State to another.

The question that arises is what principles articulate the balanced allocation of taxing rights. What constitutes a reasonable allocation of taxing rights? That is, what distribution of taxing rights does the EU care to ensure? The ECJ has explained on several occasions that because EU law does not give general criteria for the distribution of taxing rights between Member States, it is reasonable to expect Member States to apply the criteria of international tax law.[52] As a consequence, the principles on which the OECD-model-tax treaty is based must be considered expressions of the balanced allocation of taxing rights. The development in case law to date confirms this conclusion.[53] Case C-347/04 *Rewe* represents a situation in which the preservation of the allocation of taxing rights is not applicable as a justification.[54] This case tried German rules regarding the deduction of losses due to devaluations of the value of shares in subsidiaries. The conditions for deductions were stricter for foreign subsidiaries than for German ones.[55] The ECJ held that the balanced allocation of taxing rights cannot in itself justify a Member State in systematically refusing to grant a tax advantage to a resident parent company on the ground that the company has developed a cross-border economic activity which does not have the immediate result of generating tax revenue for that state. This means that the balanced allocation of taxing rights cannot serve as a ground for justifying a Member State in systematically preventing a company from taking advantage of tax benefits simply because the company conducts cross-border business that cannot be taxed by that state.

There are striking similarities between the justification of maintaining a balanced allocation of taxing rights and other justifications, as the ECJ has itself pointed out. In the 2011 case C-371/10 *National Grid Indus*, which was decided in grand chamber, the ECJ stated that the applicability of the need to maintain a balanced allocation of taxing rights as a justification overlapped with that of the goal of safeguarding the cohesion of the tax system.[56] Another similarity obtains between the preservation of a balanced allocation of taxing rights and the principle of territoriality, both of which concern a state's right to tax income from activities in that country. Increasingly, the former justification is invoked also when the latter is applicable.[57] The need to prevent a double use of losses is similar to the goal of maintaining a balanced allocation of taxing rights, too.[58] That is because double-loss deductions entail that profits do not need to be taxed at all.[59]

3.3.3 *The Freedom of Establishment and Article 7 of the OECD Model Treaty*

The case law in which the goal of maintaining a balanced allocation of taxing rights has been accepted as a justification has primarily concerned the freedom of establishment. In such circumstances, it's clear that the goal can serve to justify national rules that prevent the transfer of tax bases between Member States. As suggested above, Article 7.1 of the OECD model treaty defines the balanced allocation of taxing rights in this area. The provision reads as follows:

> Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment …may be taxed in that other State.

Notes

51 The losses at issue had occurred in the British branch.

52 See e.g. case C-336/96 *Gilly*, paras. 24 and 30, case C-513/04 *Kerkhaert & Morres*, paras. 22 and 23; as well as case C-524/04 *Thin Cap Group Litigation*, para. 49 and Terra & Wattel, *European Tax Law* 884–886 (2012).

53 In case C-311/08 *SGI*, para. 64, for instance, it is evident that a Member State has a protection-worthy right to tax income from business conducted in the country (Art. 7 of the OECD model treaty). Poulsen, *Freedom of Establishment and the Balanced Allocation of Tax Jurisdiction*, 40 Intertax 204 (2012), shares this view.

54 Some additional cases where the Court found this justification not applicable are case C-284/09 *Commission vs. Germany* and case C-30/07 *Jobra*.

55 Case C-347/04 *Rewe*, para. 43.

56 See para. 80 in the case.

57 See Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) pp. 152 and 161–162.

58 Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) p. 166.

59 A recently closed case where neither was deemed a valid justification is C-18/11 *Philips Electronics*.

Article 7.1 expresses both the state of residence principle and the source state principle. The source state principle is applied when a permanent establishment is at issue. If the economic activity meets the criteria listed in Article 5 – that a sufficient tie obtains between the activity and the source state – a permanent establishment exists. The source state is thereby entitled to tax any income that can be allocated to the permanent establishment. If there is no permanent establishment, the state of residence enjoys an exclusive right to tax the income, regardless of where it was earned.

On the basis of the currently existing ECJ case law, I have concluded that the justificatory core of the goal of maintaining a balanced allocation of taxing rights consists in the Member States' right to prevent the transfer of tax bases from one tax jurisdiction to another.[60] The ECJ has also repeatedly stated that a Member State has a protection-worthy right to tax activities conducted on its territory.[61] My understanding of the circumstances in cases where the invocation of the balanced allocation of taxing rights has been accepted as a justification is that the income has been earned in the residence state; that is, the residence state and the source state are one and the same. But what applies in cases where these principles point in opposite directions? Consider a possible situation like the following. A company based in Sweden conducts business that constitutes a permanent establishment in EU country X. The foreign income is taxed in Sweden due to the company's unlimited tax liability. Country X has the right to tax any income that can be allocated to the permanent establishment and Sweden allows a tax credit for taxes paid in country X. According to current case law, Sweden has a protection-worthy right to ensure that income earned in Sweden is taxed in Sweden. But the interesting question in this situation is whether Sweden can successfully invoke the goal of maintaining a balanced allocation of taxing rights to justify a restrictive tax rule that aims to ensure that income earned in country X does not leave the Swedish tax jurisdiction without tax consequences. In other words, does the goal of maintaining a balanced allocation of taxing rights justify a Swedish rule seeking to ensure Sweden's right to tax an income even though the income was earned elsewhere? My conclusion is that this question is not answered by current case law. The ECJ's future assessments in this question are therefore of principled importance.

3.3.4 *Conclusions*

The crucial point of the goal of maintaining a balanced allocation of taxing rights for justification is that the Member States have a protection-worthy interest in having tax legislation that ensures that income which, according to the balanced allocation of taxing rights, may be taxed in the country can in fact be taxed there. This is not possible if taxpayers are free to choose where their income is to be taxed.

3.4 *Summary Assessment: The Combination of Several Justifications*

3.4.1 *The Requirement of Artificial Arrangements is not Maintained*

The most significant difference between cases where the need to prevent tax avoidance enters in as one among several justifications and cases where it is invoked as the sole ground is that in the former, the ECJ has not been insisting on the requirement about artificial arrangements. By combining the need to prevent tax avoidance with the aim to preserve a balanced allocation of taxing rights, the mere risk of tax avoidance can suffice to motivate restrictive rules.[62] According to the literature, the ECJ disregards the requirement on artificial arrangements only in exceptional situations.[63] In my assessment, currently available case law does not bear this out. Rather, I draw the conclusion that when overall assessments are made of the justifications mentioned above, the requirement on artificial arrangement is generally disregarded.[64] This conclusion is seconded by Advocate General Kokott, who has repeatedly pointed out that preventing tax avoidance does not by itself constitute a ground – alongside the need to maintain a balanced allocation of taxing rights – for justifying rules that restrict cross-border transfers of tax bases.[65] Case C-311/08 *SGI* is particularly relevant in this regard. In this case, the ECJ found that Belgian transfer-pricing rules could be justified with reference to the risk of tax avoidance and the need to preserve the balanced allocation of taxing rights. The fact that the requirement on artificial arrangements does not apply to such situations is stated explicitly in paragraph 66:

Notes

60 See s. 3.3.2.

61 See e.g. Case C-311/08 *SGI*, para. 64.

62 See e.g. Case C- 231/05 *Oy AA*.

63 See e.g. Helminen, *EU Tax Law* 125 (IBFD 2011).

64 See e.g. Case C-446/03 *Marks & Spencer*, Case C-231/05 *OY AA*, Case C-311/08 *SGI*.

65 Advocate General Kokott's opinions in the following cases: Case C- 231/05 *Oy AA,* paras. 62–63, C-337/08 *X Holding*, para. 71, C-18/11 *Philips Electronics,* paras. 41–42 and C-123/11 *A Oy*, paras. 49–50.

> Even if the specific purpose of a national legislation is not to exempt from tax benefits prescribed in the law fictitious arrangements that are not economically viable and that were created for the sole purpose of avoiding taxation to which profits made in the country would normally be subject, such legislation may nonetheless be considered justified in this context by the aim to prevent tax avoidance in conjunction with the aim to maintain a balanced allocation of taxing rights between member states.[66]

A joint assessment of these two grounds may thus serve to justify rules not specifically designed to prevent typical evasive transactions but with a broad applicability, serving to protect the national tax base more generally. Examples include limitations on the possibility of cross-border loss relief[67] and transfer-pricing rules.[68] In my view, future overall assessments should accept also CFC rules[69] and thin capitalization rules. There are two reasons for this.[70] First of all, these rules prevent essentially the same kinds of transfer. Like limitations on loss relief and transfer-pricing rules, CFC rules and thin capitalization rules prevent the transfer of tax bases from one state to another.[71] Second, in *Cadbury Schweppes* and *Thin Cap Group Litigation*, the ECJ pointed out the close connection between the two justifications – the need to prevent tax avoidance and the balanced allocation of taxing rights – in justifying this kind of rules.[72]

3.5 *Conclusions and Consequences for Member States' Legislators*

If a national anti-avoidance rule is to be justified with reference solely to the need to prevent tax avoidance, the requirement that the rule only target artificial arrangements must be strictly observed. There are two necessary conditions for an arrangement to qualify as artificial: an objective element, which may consist in the absence of a genuine establishment; and a subjective element, which consists in an intention to achieve a tax advantage by artificial means.[73] Legislation which prevents certain types of avoidance mechanically without assessing in each individual case whether it is an instance of tax avoidance cannot be justified according to these criteria.[74] Ståhl concludes that the development in case law by which an artificial arrangement is required could entail that current anti-avoidance rules which state clearly defined conditions could begin to be replaced with more open-ended and flexible rules and principles for the prevention of tax avoidance.[75] In order to bar such a development, which would decrease predictability, Ståhl calls for Member States to be as specific as possible in their legislation as to what kinds of arrangements will not be accepted and will occasion special tax consequences. To ensure compatibility with EU law, she suggests that the rules be complemented with some kind of provision of exclusion enabling taxpayers to evade an application of the rule following an individual assessment. I second this view. The legislative technique recommended by Ståhl appears to be a wise strategy for ensuring EU compatibility, especially against the background of the 2012 case C-318/10 *SIAT*, in which a condition in Belgian legislation was rejected precisely for its vagueness. I discuss this in section 4, below.[76]

The need to balance the allocation of taxing rights can be invoked as a justification for rules that protect the national tax base. In case law, this has concerned primarily rules ensuring Member States' ability to tax activities conducted within its territory. Because such rules do not need to target only artificial arrangements, Member States have a greater ability to defend them. Obviously the rules are still required to be proportional. I return to this in section 4.

When making summary assessments of these justifications, it is sometimes the case that the national rule at issue involves an evaluation as to whether the transaction constitutes an artificial arrangement, the ECJ occasionally refers to the requirements on artificial arrangements that have been developed in case law.[77] This should not be taken to imply that the rule has to be

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66 See case C- 231/05 *Oy AA,* para. 63 for a similar line of reasoning.

67 See e.g. Case C-446/03 *Marks & Spencer*, Case C- 231/05 *Oy AA*, Case C-414/06 *Lidl*, and Case C-337/08 *X Holding*.

68 Case C-311/08 *SGI*.

69 In case C-196/04 *Cadbury Schweppes*, CFC rules were justified with reference to the need to prevent tax avoidance but the Court emphasized the relevance of the need to maintain a balanced allocation of taxing rights for such rules (see s. 3.2.1).

70 In case C-524/04 *Thin Cap Group Litigation*, the need to prevent tax avoidance was found relevant but the Court emphasizes the relevance of the need to maintain a balanced allocation of taxing rights as a justification for this type of national rules (see s. 3.2.1).

71 See Case C-446/03 *Marks & Spencer,* para. 49, Case C-196/04 *Cadbury Schweppes,* para. 56 and Case C-524/04 *Thin Cap Group Litigation*, para. 75.

72 See s. 3.2.1.

73 See case C-196/04 *Cadbury Schweppes,* para. 64 and s. 3.2.1.

74 Ståhl, EG-rätt och skatteflykt, SN 2007/10 591.

75 Ståhl, EG-rätt och skatteflykt, SN 2007/10 594.

76 See s. 4.2.3 for more on this.

77 See e.g. Case C-311/08 *SGI*, para. 71.

limited to artificial arrangements in order to be justified with reference the need to prevent tax avoidance and the need to maintain a balanced allocation of taxing rights.

In this context I would like to make a comment on the relevance of the referring national court's description of the national rule at issue for the preliminary decision procedure as set out in Article 267 FEUF.[78] The ECJ's assessment is based on the way rules are described by national courts.[79] When a rule is presented as an anti-avoidance measure, the assessment is likely to be conducted using the strict criteria about artificial arrangements.[80] If instead the national rule is presented as a general protection of the national tax base, where the prevention of tax avoidance is one among several purposes, the ECJ is more likely to make an overall assessment of several justifications, so that the requirement of artificial arrangements is not maintained in cases where multiple justifications are thought to apply. Should the ECJ not be convinced by the description offered of the national law, the ECJ may find that the rule does not fulfil the requirements of the proportionality test.[81] National legislators therefore do well to reflect upon the significance of the anti-avoidance measure in its national tax system.

4 The Proportionality Test

4.1 *The Last Step of the Assessment*

In cases where a national rule is found to be justified, the rule must also pass the proportionality test.[82] The purpose of this stage of the process is to ascertain that the purpose of the rule is achieved and that the rule does not overreach. A restrictive tax law must be structured in such a way that free movement is not impeded to a greater extent than what is necessary for attaining the goal of the rule.[83] The proportionality test consists in balancing the law's effect with its purpose.[84] The nature, extent and duration of the law must be proportional to the end which the law aims to attain.

Even though the test of proportionality constitutes the cornerstone of a fair balance between the interests involved, the proportionality test has not traditionally played a decisive role in the case law of the ECJ in the area of direct taxation. This has now changed due to the fact that the ECJ has been more willing to accept justifications for restrictive national rules.[85] As is shown below, it is clear that that the test of proportionality is in an ongoing state of development.

The outcome of the proportionality test may be that a national tax rule is found to be disproportionate in certain situations while proportionate in other situations.[86] The result need not be an 'all or nothing' assessment.[87] Such outcomes are evident in cases involving loss relief, specifically concerning so-called final losses.[88] The national rules were then found to go beyond what was necessary in order to achieve its goal with regards to final losses. A loss is final if all the possibilities available in the state where the subsidiary is resident have been exhausted; that is, if the subsidiary is neither able to having the losses taken into account for the accounting period concerned nor take them into account in the future. The ECJ found the prohibition against cross-border loss relief incompatible with the Treaty only in such situations. In all other situations, the restriction upon loss relief was found to be proportional. As part of the proportionality test, the ECJ has stated that the taxpayer must be given the opportunity to prove that the transactions at issue were carried out for commercially sound reasons.[89] Taxpayers must, then, be allowed to put forward counter-evidence when tax authorities present circumstances suggesting an artificial arrangement.[90]

Notes

78 Note that the Member State always has the right to intervene and supplement the description presented by the referring national court.

79 See e.g. Case C-524/04 *Thin Cap Group Litigation*, para. 54.

80 Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) p. 155.

81 Case C-55/94 *Gebhard*, para. 37.

82 See Case C-55/94 *Gebhard*, para. 37 and Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) pp. 149–151. The proportionality principle as an institutional legal principle is stated in Article 5 of the TEU. For more on its significance and status in tax law, see Moell, Proportionalitetsprincipen i skatterätten (2003).

83 See e.g. case C-524/04 *Thin Cap Group Litigation*, para. 64.

84 See e.g. case C-169/91 *Council of the City of Stoke-on-Trent*, para. 20. See also Zalasinski, *Proportionality of Anti-Avoidance and Anti-Abuse Measures in the ECJ's Direct Tax Case Law*, 35 Intertax 310–312 (2007).

85 See Lang, *Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions*, EC Tax Rev. 106–108 (2009) and Helminen, *EU Tax Law* (IBFD 2011) 110.

86 See e.g. Case C-446/03 *Marks & Spencer* and Case C-414/06 *Lidl*.

87 Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) p. 163.

88 Regarding final losses, see Case C-446/03 *Marks & Spencer* and case Case C-414/06 *Lidl*.

89 Case C-524/04 *Thin Cap Group Litigation*, 80 (see s. 3.2.1. above).

90 See case C-524/04 *Thin Cap Group Litigation* (see s. 3.2.1 above) and Ståhl, Persson Österman, Hilling and Öberg, EU-skatterätt (Iustus 2011) p. 154.

4.2 *Legal Certainty and Proportionality*

4.2.1 *The SIAT Case*

In the recently decided case C-318/10 *SIAT*,[91] the ECJ makes several significant statements regarding the conditions that a national tax rule must fulfil in order to be considered proportional.[92] The question was whether a Belgian rule relating to the deduction of business expenses was compatible with the free movement of services. As an exception to the main rule for deductible business expenses, which allowed deductions for expenses necessary for acquiring or retaining taxable income, the provision at issue entailed that payments for supplies or services were not to be considered business expenses unless the Belgian taxpayer provided proof that such payments related to a genuine and proper transaction and did not exceed the normal limits.[93] This special rule applied in two types of situation. First, when the payment was made by Belgian taxpayers to recipients in another Member State, in which the latter were not subject to income taxation. Second, when the recipient was subject to a tax regime which is appreciably more advantageous than the applicable tax laws in Belgium. In the absence of a statutory definition, or administrative instructions, as to what is to be understood by 'a tax regime which is appreciably more advantageous than the applicable regime in Belgium', the assessment concerning the applicability of the rule in question was carried out on a case-by-case basis by the tax authority, under the supervision of the national courts.[94]

The Belgian company SIAT was denied the right to deduct certain business expenses. The reason was that the recipient – a holding company based in Luxemburg – was not subject to income tax in Luxemburg. The ECJ found that the conditions for deductions prescribed by the special rule were stricter than the conditions in the main rule, so that permissions for deductions were harder to come by when the service provider was not based in Belgium. Because a recipient of a service from a national company was deemed to be in a situation comparable to the recipient of a service form a foreign company, the ECJ concluded that the Belgian rule constituted a restriction to the free movement of services. Belgium and intervening states argued that the special rule could be justified as a means of preventing tax avoidance, maintaining a balanced allocation of taxing rights and ensuring effective tax supervision. The ECJ made a summary assessment and found the Belgian rule justified.

As to the proportionality test, the ECJ made it clear that requiring the taxpayer to prove that the transactions in question were genuine and proper and that the compensation did not exceed normal levels was compatible with the principle of proportionality.[95] The fact, however, that the special rule was to be applied when the taxation level in the country where the service provider was based was appreciably more advantageous than the Belgian one meant that it could be applied also in the absence of objective evidence verifiable by third parties that the transactions were part of an artificial arrangement.[96] The ECJ also pointed out that it was impossible to determine the scope of the rule with sufficient precision and its applicability remains a matter of uncertainty.[97] Thus the ECJ found that the rule failed to fulfil the requirements of the principle of legal certainty and as such could not be considered proportionate to the objectives pursued.[98]

4.2.2 *Legal Certainty Making Its Way into the Proportionality Test*

Due to lack of clarity as to its applicability, the rule at issue in the *SIAT* case was found not to meet the requirements of the principle of legal certainty. This meant, in turn, that the rule was not deemed proportional. The EU principle of legal certainty requires that 'rules of law must be clear, precise and predictable as regards their effects, in particular where they may have unfavourable consequences for individuals and undertakings'.[99] In the area of direct taxation, the *SIAT* case was the first case in which legal certainty was assessed as part of the proportionality test. It should be noted that the assessment of legal certainty is apparently disconnected from the core of the proportionality test, which consists in balancing a rule's s purpose against its effect.[100]

Why then was legal certainty included as part of the proportionality test? One possible explanation is that because the scope of applicability of the rule was unclear, the ECJ was unable to carry out the balancing between the

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91 The decision was delivered on 5 Jul. 2012.

92 The case was commented on by Cejie & Hilling, Aktuellt om EU-domstolens praxis, SN 2012/10 pp. 705–706.

93 Case C-318/10 *SIAT*, paras. 22–23.

94 Case C-318/10 *SIAT*, para. 26.

95 Case C-318/10 *SIAT*, para. 53.

96 See s. 3.2.1.

97 Case C-318/10 *SIAT*, para. 57.

98 Case C-318/10 *SIAT*, para. 59.

99 Case C-318/10 *SIAT*, para. 58. For other cases involving this definition of the principle of legal security, see the joint Cases C-72/10 and C-77/10 *Costa & Cifone*, para. 74.

100 See Prechal, *Free Movement and Procedural Requirements: Proportionality Reconsidered*, 35 Leg. Issues Econ. Integration 201–216 (2008).

rule's purpose and its effect. The ECJ therefore did not make its traditional assessment but simply stated that the rule did not meet the criterion of predictability, a crucial component of legal certainty. A partly different and, in my view, more convincing explanation is that the ECJ is following a trend that has become apparent in other areas of EU law in recent years regarding the interpretation of the proportionality principle.[101] As part of the proportionality test, the ECJ has made demands on Member States' rules pertaining to principles of good governance.[102] Thus in case C-341/05 *Laval*,[103] the ECJ stated that collective action cannot be justified where the negotiations on pay, into which that action seeks to require an undertaking established in another Member State to enter, are part of a national context characterized by a lack of provisions precise and accessible enough that it is not impossible or excessively difficult in practise for such an undertaking to determine what its obligations are. This development in case law has been referred to as 'the proceduralization of proportionality' and entails that the proportionality test is sometimes supplemented with demands about, for example, legal certainty and transparency.[104] The proportionality test in the *SIAT* case can be seen as evidence that this case law development has made its way into tax law as well.[105] There is therefore good reason to view the SIAT case not as an *in casu* judgment but as a decision of wide relevance.

4.3 *Concluding Remarks and Assessment of the Consequences for Member States' Legislators*

We can expect the ECJ's assessment of legal certainty in the *SIAT* case to have repercussions for certain types of conditions that are part of national anti-avoidance rules and that may be found lacking in proportionality for being unclear and imprecise. Given that the EU requirement on predictability is now part of the proportionality test, Member States' legislators must refrain from replacing anti-avoidance rules where definitive conditions are specified in the legal text with open-ended and more flexible rules and principles intended to combat tax avoidance.[106] Member States' legislators should rather seek to specify in the legal text what kinds of arrangement will not be accepted and will be subject to special tax consequences. Insofar as the criterion of artificial arrangements is to be fulfilled, rules of exception must be in place, allowing taxpayers to evade application of the rules following an individual assessment of a particular case. It is not altogether simple, however, to design rules that allow for such individual assessments while at the same time being predictable and easy to apply.

The Belgian rule at issue in the *SIAT* case is extreme insofar as its applicability depended on an assessment as to whether the tax in the service provider's home country was 'appreciably more advantageous' than the Belgian one. The legislator does not appear to have aimed for predictability in drafting that law. Predictability could have been achieved by specifying the minimum tax level required in order for deductions to be allowed.[107] In my view, we can expect the ECJ in its future assessment to take into consideration whether a national legislator appears to have made every effort to achieve predictability without compromising the effectiveness of the law. If a degree of vagueness appears necessary in order for the rule in question to be effective, I think the ECJ may well permit such vagueness. The next section deals with the significance of the *SIAT* case for Swedish tax laws.

5 The EU Compatibility of Swedish Rules in Light of Recent Case Law Developments

5.1 *Introduction*

This section investigates how the EU compatibility of Swedish GAAR and the provision limiting interest deductions are affected by the developments we have seen in case law in the last few years. It is noteworthy that after this article was submitted, the commission has questioned the compatibility of the latter rules with Article 49 TFEU. In its response, the Swedish Government does not share that view.

Notes

101 See Groussot & Thor Petursson, *Balancing as a Judicial Methodology of EU Constitutional Adjudication*, in *Balancing Fundamental Rights with the EU Treaty Freedoms: The European Court of Justice as 'tightrope' Walker* 50–51 (de Vries et al. eds., 2011) and Barnard, *The Substantive Law of the EU*, 187 (Oxford University Press 2010).

102 See e.g. Case C-95/01 *Greenham and Abel*, paras. 35 and 50, Case C-244/06 *Dynamic Medien*, paras. 49–50.

103 Paragraph 110 of the judgment.

104 For more on this case, see Groussot & Thor Petursson, *Balancing as a Judicial Methodology of EU Constitutional Adjudication*, in *Balancing Fundamental Rights with the EU Treaty Freedoms: The European Court of Justice as 'tightrope' Walker* 50–51 (de Vries et al. eds., 2011). Tridimas refers to 'the public law element of proportionality' (The General Principles of EU Law, 2007) and Hettne refers to 'structural guarantees' (Administrative Laws as a Key to Market Integration? in Cardonnel, Rosas & Wahl, Constitutionalising the EU Judicial System – essays in honour of Pernilla Lindh (2012)).

105 Also the demand that tax payers always be given the opportunity to provide evidence of commercial motives can be viewed as an expression of this trend. See e.g. Case C-524/04 *Thin Cap Group Litigation*, para. 83 (see s. 3.2.1).

106 See s. 3.5.

107 Compare ch. 24 s. 10 d 1 para. 1 p. SITA (the so-called 10% rule).

5.2 *The Swedish GAAR*

The Swedish GAAR provides a general possibility of combating the avoidance of tax laws.[108] The conditions of the rule are fairly open and flexible, enabling case-by-case assessments. I would like to focus specifically on two aspects in which the Swedish GAAR might be found incompatible with TFEU provisions on free movement. Ståhl has noted the first one, which is the fact that the GAAR may in some situations be considered harsher than allowed by EU law.[109] The rule states, for instance, that it is applicable if achieving a tax benefit appears to be the 'predominant consideration' behind a decision to make a certain arrangement or transaction, which would appear to include not only artificial arrangements but have a wider application.[110] Taking this into consideration when the law is applied could, according to Ståhl, remedy the problem. In my view it is only on rare occasions that the need to maintain a balanced allocation of taxing rights is relevant as a ground for justifying obstacles to free movement in the form of taxation as stipulated in the GAAR. This makes the requirement on artificial arrangements relevant despite the development of the past few years.

The second potentially problematic aspect of the GAAR is the fact that it contains some relatively open-ended conditions which may be at odds with the principle of proportionality on which the ECJ insisted in the *SIAT* case. This concerns particularly the condition in section 2 paragraph 4, according to which the legal action is to be disregarded if '… the action would contradict the purpose of the law, as suggested by the general design of the regulations and those particular regulations that are directly applicable or that have been evaded through the action'. Critics have charged the law precisely with failing to meet the Swedish principle of legality, of which predictability is a core element.[111] The Swedish Supreme Administrative Court has been criticized in the literature in the last few years for failing to clarify the legal situation through its decisions.[112] In cases where the GAAR is applied in a way that hinders free movement, it is possible, then, to successfully argue that the law fails to fulfil EU requirements on legal certainty and that it should therefore fail the proportionality test on account of its vagueness. What speaks against this line of reasoning is the fact that GAARs are used by several Member States and are generally accepted means of preventing tax avoidance.[113] It should be nearly impossible to formulate a GAAR without any vague conditions.[114] In my view, it is understandable that Member States' legislators fail to achieve the desired degree of predictability in drafting GAARs.

5.3 *Rules Limiting the Deduction of Interest*

There are no thin capitalization rules in the Swedish income tax system. Traditionally, deductions on interest have been regulated by Chapter 16 section 1 Swedish Income Tax Act (SITA). For cross-border situations the transfer pricing adjustment rule in Chapter 14 section 19 SITA is of relevance.[115] In response to the pervasive practice among Swedish companies of using interest deductions to avoid Swedish taxes on income earned in Sweden, certain limitations were imposed on interest deductions in 2009.[116] The prohibition against interest deductions seeks to target certain tax planning arrangements, specifically, transfers of assets between related companies which are more or less done for the sole purpose of creating interest deductions within the company group.[117] The Swedish legislator finds the limitation on deductions necessary in order to protect the Swedish corporate tax base.[118] These rules are constructed in such a way that the principal rule specifies conditions under which interest deductions will not be allowed. A number of other rules stipulate exceptions to this rule. Thus according to Chapter 24 section 10 d paragraph 1 SITA, deductions are allowed if either of the following two conditions are fulfilled: (1) the income corresponding to the interest deductions is taxed by at least 10% in the recipient's country (this is known as 'the 10% rule')[119] or (2) that the main purpose of both making the acquisition

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108 Law (1995:575) against tax avoidance.

109 Ståhl, EG-rätt och skatteflykt, SN 2007/10 593.

110 See section 3.2.

111 See primarily Hultqvist, Legalitetsprincipen vid inkomstbeskattningen (1995) pp. 413-422.

112 Tjernberg & Newey Herrman, Regeringsrätten och skatteflyktslagen – mönster eller monster, SN 2011 p. 158.

113 See e.g. national reports to IFA 2002 in Cahiers de droit fiscal international, Kluwer 2002 and de Monés et al., *Abuse of Tax Law across Europe*, EC Tax Rev. 85–96, 123–137 (2010).

114 See the argument in s. 4.2.3.

115 The same limitation is found in ch. 9 s. 5 SITA.

116 RÅ 2007 ref. 84 and RÅ 2007 ref. 85 show that the transactions cannot be prevented by an application of the GAAR.

117 See Samuelsson, HFD avvaktar EU-domstolen om ränteavdragsbegränsning, SvSkT 2011/6-7 p. 558.

118 Swedish Government Bill [Proposition] 2008/09:65 p. 68 and Swedish Government Bill [Proposition] 2012/13: 1 at 215.

119 A company's right to deduct its interest payments is thus dependent upon the way in which the recipient is taxed.

and incurring the debt on which the interest payments are based has a true business purpose.

Questions have been raised about the EU compatibility of the limitations on interest deductions. When they were first introduced, it was argued that they constituted a violation of EU law.[120] One objection appealed to the idea that the prohibition on deductions ought to apply only to artificial arrangements. In particular, the requirement that the main motive of the transaction be commercial was criticized. The Swedish Supreme Administrative Court has addressed a number of questions about the interpretation of the rules and their EU compatibility. This Court found that the rules did not constitute an obstacle to free movement,[121] and it therefore did not consider the viability of possible justifications for the rules, nor any assessment of the laws' proportionality. Notably, the Swedish Supreme Administrative Court did not seek a preliminary ruling from the ECJ. Unless a Swedish lower court demands a preliminary ruling, the interest deduction limitation rule in its original formulation is unlikely to be tried by the ECJ, which might otherwise have reached a different conclusion than the one implied by the Swedish Supreme Administrative Court's decision. Seeking to make the rules in question more effective, the government has proposed certain modifications to the current rules. These revisions are set to take effect in January 2013.[122]

How does the recent case law development bear on the EU compatibility of the Swedish interest deduction limitations? I would like to emphasize two points of relevance. The first concerns the possible justification for the deduction limitation rules should they ever be deemed to constitute obstacles to free movement.[123] The second concerns the fact that the business purpose test is difficult to apply.

The first point thus concerns possible grounds for justifying restrictions on free movement. The rules limiting the deduction of interest are intended to prevent the use of interest deductions for purposes of avoiding Swedish tax.[124] Because deductions for interest decrease the taxable profit, interest deductions move tax bases from one state to another. This is precisely what the ECJ allows Member States to prevent, in my view, by accepting appeals to the need to maintain the balanced allocation of taxing rights as justifications for limiting free movement.[125] My conclusion is therefore that if the ECJ were to try the EU compatibility of the Swedish rules limiting interest deductions today, these rules could be justified by appealing to the need to maintain a balanced allocation of taxing rights, especially in conjunction with an appeal to the need to prevent tax avoidance.[126] I find it probable that the justifications would be accepted. The demand for artificial arrangements would thus not come into play.[127] Whether the rules would also pass the proportionality test is another question, however.

As stated above, the second point of relevance concerns the fact that the interest deduction limitation rules contain vague conditions. The crucial point, both in its current and in its proposed wording, is that the limitation on interest deductions does not apply to transactions that have a true business purpose.[128] At issue are transactions that need not meet the 10% criterion. The condition that a transaction has a true business purpose is vague and thus difficult to apply.[129] In the preparatory works to the 2009 rules, the expression 'true business purpose' is only sparsely explained.[130] According to the preparatory works, transactions must be based on sound economic and commercial considerations, beyond any considerations involving taxes.[131] The preparatory works state, further, that an overall assessment should be made, wherein all relevant factors are taken into consideration. Finally, the preparatory works call for a restrictive use of the business purpose test in order that the purpose of the interest deduction limitations – preventing the erosion of the Swedish tax base – be achieved.[132] The preparatory works for the planned changes to the interest deduction limitations call for disregarding tax effects when assessing whether a transaction has a true business purpose or

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120 Swedish Government Bill [Proposition] 2008/09:65 at 69–70.

121 See HFD 2011 ref. 90, HFD 2012 ref. 6, HFD 2012 n. 3, case nr 6062-11 and 6063-11.

122 Swedish Government Bill [Proposition] 2012/13:1 at 213–275. In January 2013, the commission questioned the compatibility of these roles with Article 49 TFEU. See EU pilot 4437/13/TAXu-Sweden.

123 See s. 1.

124 Swedish Government Bill [Proposition] 2008/09:65 at 68 and Swedish Government Bill [Proposition] 2012/13:1 215.

125 See case C-446/03 *Marks & Spencer*, case C-231/05 *OY AA*, Case C-311/08 *SGI*. For more on this argument, see s. 3.4.1.

126 For a different view about the applicability of this justification, see Johansson, Ränteavdragsbegränsningar – med anledning av att kapital är fungibelt, SN 2011/9 p. 609.

127 See s. 3.4.

128 Chapter 24, s. 10 d para. 1, at 2 SITA.

129 See Hultqvist, Affärsmässigt motiverad, SvSkT 2012/2. pp. 126-139.

130 Swedish Government Bill [Proposition] 2008/09:65 at 68.

131 In the income tax code, 'mainly' means about 75% or more, Swedish Government Bill [Proposition] 2008/09:65 p. 68.

132 Swedish Government Bill [Proposition] 2008/09:65 at 68.

not.[133] The problem involved in applying the business purpose test is apparent also in the decisions by the Swedish Supreme Administrative Court mentioned above. The decisions specify criteria that should give guidance to assessments regarding the business purpose test. The decisions, however, are not unanimous.

In my view, it is the structure of the interest deduction limitation rules that most speaks in favour of their adhering to the principle of proportionality, the last step of the justificatory assessment.[134] The rules are constructed in accordance with the principles advocated by the ECJ's case law regarding artificial arrangements; that is, that the taxpayer should be able to evade an application of the rules by showing that the transactions at issue have a true business purpose.[135] The ECJ is likely to appreciate the difficulties involved in specifying conditions for the business-purpose test. What speaks against the rule's compatibility with the principle of proportionality is above all the fact that it may be deemed impossible to predict with sufficient precision whether the rule will be applicable or not.[136]

6 Concluding remarks

The overall impression of case law in the last few years is that the ECJ is more generous in its assessment of the grounds to which Member States appeal for justification but more demanding in its assessment of proportionality. The proportionality test now includes, additionally, requirements of legal certainty.[137] This development of the proportionality test mirrors developments in other areas of free movement law. It is my conclusion, therefore, that legal certainty is now a permanent feature of the proportionality test applied in the area of direct taxation.

Analysis has shown that in order to justify a rule with reference to the need to prevent tax avoidance as a sole justification, a GAAR targeting typical evasive arrangements must be combined with individual assessments, such that it is established for each particular case whether it is really an instance of tax avoidance. This well-established conclusion thus holds also in light of the case law development of the last few years. Yet this is only part of the truth. The conclusion must be modified as regards cases where the national law has the broader purpose of ensuring that income earned in the country at hand can in fact be taxed there. In these situations, where a national law is justified by concerns with both tax avoidance and the need to maintain a balanced allocation of taxing rights, the demand that such laws target only artificial arrangements no longer applies.[138] In conclusion, it is possible to draft anti-avoidance rules that are compatible with EU law. Strict conditions apply, however, to rules whose sole purpose is the prevention of tax avoidance. If the rules serve the wider purpose of preventing taxpayers from freely moving tax bases and thereby deciding on their own where their income is to be taxed, then these rules need not target only artificial arrangements.

The desire to maintain a balanced allocation of taxing rights is considered a significant ground for justifying anti-avoidance rules. It has been successfully invoked to justify rules by which Member States try to ensure that incomes earned in the country are in fact possible to tax there. Member States are thus entitled to rules that prevent taxpayers from deciding on their own where their income is to be taxed. Transfer pricing rules as well as rules limiting the possibility of loss relief are examples of rules for which this justification has been successfully invoked. Personally, I find it perfectly reasonable that Member States should be entitled to preventing taxpayers from freely choosing the country in which their income is taxed. That is because the harmonization of the internal market includes neither common rules for the calculation of income nor common tax rates, and because Member States still carry the responsibility for welfare systems. It would have been preferable, however, for the ECJ to be more precise in developing the two grounds invoked to justify such rules: the need to prevent tax avoidance and the need to maintain a balanced allocation of taxing rights.

Notes

133 Swedish Government Bill [Proposition] 2012/13:1 at 217.

134 See s. 4.

135 See e.g. case C-524/04 *Thin Cap Group Litigation*, paras. 80 and 83 (s. 3.2.1).

136 See case C-318/10 *SIAT*, para. 57 and s. 4.

137 See e.g. case C-318/10 *SIAT*, paras. 57–59.

138 Conclusions as to what this means for legislators are drawn continuously in the body of this article.

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