

VAT DUTIES & INDIRECT TAX LAW

ABUSE OF LAW AND VAT: THE ECJ'S DECISION IN WEALD LEASING

AN ARTICLE COMMENTING ON THE ECJ'S DECISION IN
HMRC v WEALD LEASING LTD (C-103/09)

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The Court of Justice of the European Union (www.practicallaw.com/5-107-6553) (ECJ) delivered its decision in HMRC v Weald Leasing Ltd (Case C103/09) on 22 December 2010. This followed Advocate General Mazak's opinion, which was delivered on 26 October 2010. For further information on the opinion and judgment, including the background to the case, see Legal updates, VAT: ECJ confirms leasing not abusive but open market terms must apply (Weald Leasing) (www.practicallaw.com/2-504-3545) and VAT: avoiding VAT open market value direction on lease rentals is abuse of rights (ECJ Advocate General in Weald Leasing) (www.practicallaw.com/3-503-7544).

This article looks at the decision in Weald Leasing in depth and considers its impact on the developing abuse of law principle in the context of VAT.

BACKGROUND TO THE JUDGMENT

The concept of abuse of law in the context of VAT is a relatively recent phenomenon. Although the general principle of abuse of law was formulated in earlier case law, such as *Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas* (Case C-110/99), it was only introduced into the sphere of VAT in 2005 in *Halifax plc and others v Commissioners of Customs & Excise* (Case C-255/02). This ground breaking case set out a two-stage test that has to be satisfied before a tax arrangement can be found to amount to an abuse of the Sixth Council Directive 77/388 on the common system of value added tax (Sixth Directive) (recast by Council Directive 2006/112 EC). Both limbs of the two-stage test must be satisfied:

- The transactions concerned, notwithstanding the 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.
- It must be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage.

A number of cases have subsequently applied the test set out in *Halifax*, such as *Ministero dell'Economia e delle Finanze v Part Service Srl, in liquidation* (Case C-425/06) and *Ampliscientifica Srl, Amplifin SpA v Ministero dell'Economia e delle Finanze, Agenzia delle Entrate* (Case C-162/07), but while there appears to be consensus as to the existence of a two-stage test there remains considerable confusion as to precisely how it should be applied. In particular, there remains significant debate as to the precise meaning and relevance of the phrase normal commercial operations, which was mentioned twice in *Halifax*, ignored in *Part Service* and later relied on in *Ampliscientifica*.

Given that taxpayers need to be able to order their affairs with reasonable certainty, the requirement for clarification of this area of the law has become increasingly pressing. Therefore, the judgment in *Weald Leasing* has been eagerly awaited by both taxpayers and practitioners alike.

The judgment handed down by the ECJ, however, is somewhat disappointing. It is relatively brief and does not provide the level of clarification that might have been hoped for on a number of issues. Furthermore, the judgment is so succinct in places that reference to the opinion of Advocate General Mazak is necessary to try and illicit the true meaning of what the ECJ has said. The judgment has some expected elements, such as the confirmation of the general two-stage *Halifax* test, but it also contains some more novel statements of law and is interesting not only for what is said, but also for what has been omitted. In the following passages I have sought to highlight six key aspects of the ECJ's judgment.

ABUSE OF LAW "EXCEPTIONAL" IN VAT

The concept of abuse of law is designed to combat the problem that, due to the inevitable restrictions of language, it is possible for a person to adhere to the letter of the law while breaching the spirit of it. Consonant with the purposive approach to interpreting legislation

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adopted by the ECJ, the principle of abuse of law seeks to prevent persons from committing the mischief that the legislation was designed to constrain or using the legislation to gain a benefit that it was not intended to provide.

However, in the sphere of VAT, there is a tension between the principle of abuse of law and other factors, namely, the principle of legal certainty and the freedom of taxpayers to structure their businesses to limit their tax liability. The pull between these three factors was specifically recognised in *Halifax* and the two-stage test was created in the light of those considerations. Therefore, a plain reading of *Halifax* would appear to indicate that the ECJ was aware of the problems with introducing the principle of abuse of law into the field of VAT and sought to reconcile the competing elements in the formulation of the test itself.

Advocate General Mazak similarly notes these factors in his opinion, but nevertheless seems to depart from the conclusions drawn by the ECJ in *Halifax*. Rather than regarding the tension between these factors as resolved in the two-stage test itself, he commented that a finding of abuse of law in relation to VAT should only occur in "exceptional cases where abuse is evident" and further states that "any remedies must be applied in a parsimonious manner solely to the extent of the abuse in question". The rationale for this is that "a finding of abuse of law in the field of VAT arises notwithstanding the fact that a trader has formally complied with the letter of the legislation".

Although the Advocate General went on to reiterate the *Halifax* test, the words clearly indicate a desire to constrain the impact of the abuse of law principle in the field of VAT. His comments on how the *Halifax* test should be approached suggest that the threshold for establishing that a tax arrangement is abusive, at least in the context of VAT, is now higher.

The ECJ has not adopted the language used by Advocate General Mazak and, therefore, the general approach to the application of the *Halifax* test would appear to remain unaltered. Nevertheless, it is interesting to note the nascent move to weigh in favour of the taxpayer when applying the *Halifax* test. Should a case come before the ECJ in which the taxpayer is in a particularly sympathetic position this could be a line of reasoning that the ECJ might want to develop.

NORMAL COMMERCIAL OPERATIONS

The phrase normal commercial operations has been the source of considerable confusion in the application of the *Halifax* test and clarification of its meaning and relevance has been needed for some time.

The ECJ confirmed the orthodox position that:

“the application of EU legislation cannot be extended to cover abusive practices by economic operators, that is to say, transactions carried out, not in the context of normal commercial operations” (*paragraph 26*).

The reference to the ECJ specified that the essential aim of the tax arrangements was to obtain a tax advantage so the ECJ had no need to consider the second limb of the *Halifax* test in any detail. Consequently, the ECJ went directly on to address the application of the first limb and identified certain factors that the national court would need to take into account when deciding whether the tax arrangement was abusive. In this context the ECJ stated:

“the fact that an undertaking which resorts to leasing transactions such as those at issue in the main proceedings does not engage in leasing transactions in the context of its normal commercial operations does not affect the foregoing considerations” (*paragraph 43*); and

“A finding that there was an abusive practice is inferred, not from the nature of the commercial operations usually engaged by the party which made the transactions in question, but from the object and effects of those transactions, as well as their purpose.” (*Paragraph 44*.)

At first glance it is not entirely clear what new meaning or position the ECJ intended to give the term normal commercial operations. At the beginning of its judgment the ECJ appears to affirm the continuing relevance of the concept and yet later the court seems to deny its relevance. However, when read in conjunction with Advocate General Mazak’s opinion, the judgment appears simply to be rejecting the concept of normal commercial operations as relevant to the first limb of the *Halifax* test. Advocate General Mazak directly addressed the meaning of the term and crucially considered that the concept of normal commercial operations only applied in relation to the second limb of the *Halifax* test. In essence, he

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regarded the concept as simply another way of asking whether the essential aim of the transactions was to gain a tax advantage.

If correct, this appears to represent a change from the previous case-law where arguably the term normal commercial operations related to the first limb of the *Halifax* test. In *Halifax*, the ECJ stated that, when determining whether the first limb of test was satisfied, it would be contrary to the principle of fiscal neutrality:

“To allow taxable persons to deduct all input tax even though, in the context of their normal commercial operations, no transactions conforming with the deduction rules of the Sixth Directive or of the national legislation transposing it would have enabled them to deduct such VAT” (*paragraph 80*).

This suggested that transactions that had no economic value to the taxpayer; in the absence of the tax advantage, would intrinsically infringe the principle of fiscal neutrality and would, therefore, fall outside the scope of the purpose of the applicable Community law.

The clear weakness in this approach is that it made the application of the first limb difficult to distinguish from the second limb. The notion that the two limbs of the *Halifax* test could be conflated was something that Advocate General Mazak seemed keen to avoid. In an earlier section of his opinion he specifically emphasised that it was

“not sufficient to prove that a particular transaction results in the accrual of a tax advantage or even that the transaction is essentially aimed at, or has no other rational or explanation other than, obtaining such an advantage... It is therefore necessary to go further and establish that the transaction results in a tax advantage which would be contrary to the purpose of the Sixth Directive and the legislation transposing it.” (*Paragraph 13*)

The affirmation of a clear division between the two limbs of the test is helpful on two counts:

- It helps to prevent the two-stage test from collapsing into a single test, which is satisfied once it is established that the sole purpose of the tax arrangements was to gain a tax advantage. The maintenance of the two-stage test ensures that the principle of legal certainty and the freedom of taxpayers to structure their

business to limit their tax liability are given appropriate weight and are properly respected.

- It is more intellectually honest. If the ECJ had intended that in certain situations a single stage test would suffice it could have said so. However, it has maintained a two-stage test in the context of VAT and blurring the lines between each stage only serves to make the law more uncertain and unpredictable.

DEFERRAL AND REDUCTION DISTINGUISHED?

The ECJ appears to draw a distinction between tax arrangements that defer the payment of VAT and tax arrangements that reduce the VAT payable. While reduction may potentially be offensive, it would seem that deferral is more acceptable.

The ECJ said in its judgment that:

“A taxable person cannot be criticised for choosing a leasing transaction which procures him an advantage consisting...in spreading the payment of his tax liability... provided that the VAT on that leasing transaction is duly and fully paid.”
(*Paragraph 34.*)

Similarly, a central part of the Advocate General's reasoning - that the leasing arrangements, in general, were not abusive - was because they did not in themselves

“result in the trader paying less VAT or deducting more VAT than that to which the trader is entitled. Thus while there may be cash flow advantages for the trader; there is no inherent VAT saving” (*paragraph 20*).

By contrast Advocate General Mazak found that the level of payments in the leasing arrangements was abusive because it artificially reduced the amount of VAT payable.

The implication of this would seem to be that arrangements designed to defer VAT liability, rather than reduce it, are much less likely to be found abusive. Nevertheless, this approach is slightly anomalous as deferral of payment ultimately means that a party has the use of that money, and the opportunity to earn interest on that sum for the period it is retained.

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Assuming that the national tax authority would have invested the money for the same period, it clearly suffers a reduction in revenue in real terms. It is, therefore, arguable that it is artificial to conclude that deferral of payment is not abusive simply because it does not directly result in less VAT being paid. Accordingly, caution should be exercised before assuming that adopting tax arrangements that defer the payment of VAT, rather than overtly reducing the VAT payable, will necessarily be at less risk of being regarded as abusive.

SCOPE OF THE ABUSE OF LAW PRINCIPLE

Perhaps the most curious aspect of the ECJ's judgment concerns its findings on the scope of application of the abuse of law principle. At the hearing an argument arose as to whether tax arrangements, which artificially prevented HMRC from being able to revalue the supply of goods at open market, pursuant to paragraph 1(1) of Schedule 6 to the Value Added Tax Act 1994, were abusive. The point of contention was that the domestic legislation had been adopted under Article 27(1) of the Sixth Directive, which allowed individual member states to derogate from the provisions of the Directive. Article 27(1) provided that:

"The Council, acting unanimously on a proposal from the Commission, may authorize any Member State to introduce special measures for derogation from the provisions of this Directive, in order to simplify the procedure for charging the tax or to prevent certain types of tax evasion or avoidance. Measures intended to simplify the procedure for charging the tax, except to a negligible extent, may not affect the amount of tax due at the final consumption stage."

There would seem to have been a good argument that the principle of abuse of law should not have applied to the national measure as it was not directly implementing a Community provision; indeed, it was concerned with an area of law in relation to which the Sixth Directive had accepted that member states could take divergent approaches. Nevertheless, the ECJ held that:

"Weald Leasing's argument that the principle of prohibiting abusive practices does not apply to breach of Paragraph 1 in Schedule 6 to the VAT Act 1994 because that provision is purely a question of national law cannot be accepted, because that provision was adopted on the basis of Article 27 of the Sixth Directive and forms part of the national legislation implementing that directive." (*Paragraph 42.*)

This followed the opinion of Advocate General Mazak who found that:

“For the purposes of the application by the national courts of the abuse principle as laid down in *Halifax*, any distinction between national provisions which implement the provisions of the Sixth Directive and those which were adopted in full compliance with a derogation permitted under that directive is, in my view, contrived and tends to undermine the integrity of the national VAT system and indirectly the EU VAT system”. (*Paragraph 24.*)

The ECJ's very broad findings on the scope of the application of the abuse of law principle mean that practitioners will need to exercise caution as regards when the principle will apply. In light of the ECJ's judgment, the fact that a domestic measure does not appear to be implementing a specific provision of the Sixth Directive will not necessarily mean that only domestic law principles apply.

PRINCIPLE RATHER THAN UNIFORM TEST?

The principle of abuse of law is of general application and has been relied on in a number of cases not concerned with VAT. An interesting question therefore arises as to the extent to which such cases can be relied upon to advance or resist an argument that a particular tax arrangement concerning VAT is abusive.

The ECJ has previously shown a willingness to read-across VAT cases on abuse of law into direct tax cases. For example, in *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue (196/04)*, the court cited both *Emsland Starke* and *Halifax* in support of its conclusions. In view of this, it might be expected that the ECJ would, in VAT cases, similarly rely on abuse of law cases in other fields. However, the ECJ, like the Advocate General, relied solely on abuse of law cases where the matter has been addressed in the context of VAT. Most noticeably, *Cadbury Schweppes* is not mentioned anywhere in the judgment or the opinion despite the European Commission having relied on paragraph 51 of the *Cadbury Schweppes* judgment in its submissions.

It could be argued that the adoption of this approach reflects the view that while abuse of law is a general principle, the exact test to be applied will depend on the specific area of law in issue. This distinction was first enunciated by Advocate General Maduro in *Halifax* itself.

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When discussing the appropriate test for abuse of law in the context of VAT he said:

“The test for the assessment of the abuse enunciated in *Emsland Starke* provides considerable guidance in that regard but the specificity of VAT as a tax of an objective character means that automatic transposition is not to be recommended. Moreover, the absence of a unitary test for the operation in every field of Community law of the principle of the prohibition of abuse must be regarded as perfectly natural in Community Law”. (*Paragraph 83*.)

The ECJ did not specifically address this point in *Halifax* beyond broadly stating that “the principle of prohibiting abusive practices also applies to the sphere of VAT”, but it nevertheless adopted a very similar abuse test to that set out by Advocate General Maduro.

While it is far from clear that the ECJ or Advocate General Mazak specifically intended to maintain the distinction, it would seem that they carefully avoided relying on abuse of law cases outside the sphere of VAT. This suggests that the ECJ might not be quite ready to create a uniform abuse of law test. From a practitioner's perspective, this is relevant insofar as it may restrict the extent to which case-law on the abuse of law principle, developed in the context of other legal areas, can be relied upon in VAT cases. It will be interesting to see if, going forwards, the ECJ continues to adopt this approach or whether it is content to see a greater degree of read-across between different areas of EU law where abuse of law has arisen.

REDEFINING ABUSIVE TRANSACTIONS

The fourth question asked by the referring national court was very specific:

“If the asset leasing structure or any part of it is found to constitute an abusive practice, what is the appropriate redefinition? In particular, should the national court or tax collecting authority:

- (a) Ignore the existence of the intermediate third party and direct the VAT be paid on an open market value of the rentals;
- (b) Redefine the leasing structure as an outright purchase; or

(c) Redefine the transactions in any other way which either the national court or tax collecting authority considers to be an appropriate means by which to re-establish the situation that would have prevailed in the absence of the transactions constituting the abusive practice.”

Despite the clear indication from the national court that detailed guidance in relation to this issue would be helpful, the ECJ’s judgment on this point failed to fully engage with the question raised.

Adopting the same language as the court used in *Halifax*, the ECJ stated that it was for the national court to redefine the transactions “so as to re-establish the situation that would have prevailed in the absence of the elements constituting [the] abusive practice.” In relation to the facts of the case, the ECJ then went on to comment:

“if the national court concluded that certain contractual terms of the leasing transactions at issue in the main proceedings and/or the intervention of Suas in those transactions constituted an abusive practice, that court would have to redefine those transactions disregarding the existence of Suas and/or by varying or disapplying those contractual terms.” (*Paragraph 51.*)

While it is clear from these statements that the national court cannot allow abusive terms or arrangements to remain in place, the ECJ provided no real assistance as to what should replace those terms or arrangements. The ECJ’s reluctance to tackle this question is to some extent understandable as the court is not designed to address complicated factual questions or to fully comprehend the potential consequences of suggested changes under national law. Nevertheless, unhelpfully, the ECJ does seem to have tried to provide the minimum level of guidance possible.

One aspect of the judgment that is useful is the ECJ’s statement that when redefining the abusive transaction the national court “must go no further than is necessary for the correct charging of the VAT and the prevention of tax evasion.” While this finding was foreshadowed by, and is a logical consequence of, the judgment in *Halifax*, it was not explicitly stated by the ECJ in that case. From the taxpayer’s perspective, therefore, the pronouncement by the ECJ provides a useful tool to argue that the national court must exercise restraint when redefining a tax arrangement that has been found to be abusive.

CONCLUSION

While the judgment of the ECJ in *Weald Leasing* has provided some further guidance on the application of the *Halifax* test, it still leaves many questions unanswered. It is to be hoped that the ECJ will amplify its reasoning the next time it has to consider the issue of abuse of law in the context of VAT.

Melanie Hall QC and Raymond Hill represented the Commissioners