

**Fiscal neutrality in the financing of the companies.
The Spanish case.**

César García Novoa¹

1. The principle of neutrality.

Globalization has supposed that the economic agents, both public and private ones, had restated their strategies and behaviours. VALLEJO CHAMORRO-GUTIERREZ LOUSA² says: "in the area of the public thing, the public powers had to restate both the postulates to which their policies have to serve, and the instruments that they have for it. This way, there have been giving up interventionist positions, in which the State was using actively all the instruments of monetary and fiscal policy that it had to his disposition to act on the functioning of the market; the principle of redistribution and intervention of the public power was imposed as a consequence of the bigger autonomous functioning of the economy. The public powers have had, therefore, to adapt themselves to the idea of that their action must orientate to the achievement of the efficient functioning of the economy, and for that aim they must use neutral policies".

Neutrality means the no interference of the tax system when the economic operators make a decision, for example at the moment of placing the savings or at the moment of deciding the forms of private social security.

The neutrality is a principle that, in the last years, has been defined as proper principle in tax matter: the principle of tax neutrality.

The principle of neutrality has its origin in the postulate of the *distributive neutrality* that J. STUART MILL has formulated, according to which the taxation

¹ Professor of Tax Law at the University of Santiago de Compostela, Spain.

² J.M., VALLEJO CHAMORRO-M., GUTIERREZ LOUSA, "Los Convenios para evitar la doble imposición: análisis de sus ventajas e inconvenientes", *Instituto de Estudios Fiscales, Documento nº 6*, 2002, pp. 14-15.

must not modify at all the relative economic-financial situation of the taxpayers. NEUMARK has indicated that taxes must not provoke distortions in the competition, considering the principle of neutrality like an institution *essentially transcendent for the economic order*. For NEUMARK, the neutrality, *correctly interpreted*, is an orientation of the fiscal policy that advises not to intervene in the competitive mechanisms of the market, there where an almost perfect competition exists. A stage of *perfect competition* only turns out to be imaginable in a juridical order that contemplates the economic freedoms as values to protect³. In this sense, the principle of neutrality acquires special importance in sectors of the legal system where the transcendental thing is a free economic action, which would be raised in transcendental value, and where the application of certain taxes would disturb this free economic action, especially with regard to the choice of the territory to carry out the investment. It is especially important the rule of the neutrality with regard to the European Community law, which is a legal system of economic freedoms, and which has as aim the protection of the *four fundamental freedoms* - free circulation of workers (art. 39 of the constitutive Treaty of the Economic European Community - EEC Treaty-, after the reform of the Treaty of Amsterdam, free movement of services (art. 49),), the right of establishment (art. 52), and the free movement of capitals (art. 56)⁴.

2. The neutrality in the European Community Law.

In the European Community Law, neutrality is not a proper principle. It is rather a general rule, which has the function of an interpretive criterion. And, on the other hand, it is a rule limited to certain areas of the regulation of the Community. There are two very clear cases where the neutrality has an important role in the European Law.

With regard to the operations of restructuring, the Summary of the Directive 90/434/EEC 1990 on the common system of taxation applicable to mergers,

³F., NEUMARK, *Principios de la imposición*, IEF, Madrid, 1974, pp 316 and 317.

⁴ EC Treaty.

divisions, transfers of assets and exchanges of shares concerning companies of different Member States says: *the mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States may be necessary in order to create within the Community conditions analogous to those of an internal market and in order thus to ensure the establishment and effective functioning of the common market; whereas such operations ought not to be hampered by restrictions, disadvantages or distortions arising in particular from the tax provisions of the Member States*⁵. This *neutrality* is the one that inspires the so called *regime of tax deferral*, that the Directive 90/434/EEC includes as a fundamental principle in the regulation of the restructuring of companies⁶.

The Directive 90/434/EEC 1990 establishes a tax benefit. It is a optional regime for the taxpayer, named *regime of tax deferral*. This regime supposes that, during reorganizations, no money should be paid for the capital gains -difference between the normal value of market of the transmitted elements and the net countable value, while the transmitted elements are valued by their fair value - that are generated as consequence of the transmission of goods and rights on the occasion of the operations of restructuring. These assets will preserve the value that they had in the company that transmits them. The taxation of capital gains is deferred until, eventually, the assets are sold⁷. The Directive establishes a rule of *continuity in the valuation*. It imposes the continuity in the determination of the profit and permits the Members States to allow the companies to assume the losses of the transferor companies.

In the Official Journal of the European Union of November 25, 2009 the Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States, is

⁵ Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States.

⁶ M., NAVARRO EGEA, *Fiscalidad de la reestructuración empresarial*, Marcial Pons, Madrid, 1997, pp 138 and 139.

⁷ M.A. CAAMAÑO ANIDO., "Comentarios al régimen jurídico de las operaciones de fusión empresarial y figuras afines", *Estudios sobre el Impuesto de Sociedades*, Yebra-García Novoa-López Díaz, Ed. Comares, Granada, 1998, p. 342.

published⁸. This Directive says in his article 4: *a merger, division or partial division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes*. Mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States may be necessary in order to create within the Community analogous conditions to those of an internal market and in order thus to ensure the effective functioning of such an internal market. Such operations ought not to be hampered by restrictions, disadvantages or distortions arising in particular from the tax provisions of the Member States. To that end it is necessary, with respect to such operations, to provide for tax rules which are neutral from the point of view of competition, in order to allow enterprises to adapt themselves to the requirements of the internal market, to increase their productivity and to improve their competitive strength at the international level.

The Directive establishes a measure as the tax deferral that it exempts from the payment of taxes for the earnings of the capital of the operations of restructuring. It creates a fiscal benefit to create economic conditions and of competitiveness in the European Union equal than the ones that exist in a domestic market, and to allow the companies to adapt themselves to the requirements of the home market, increase their productivity and reinforce their position of competitiveness in the international level. For this purpose, it is necessary to facilitate the adjustment of the economic operators to an environment of international competition. For this, it is indispensable the neutrality of the fiscal systems in relation with the operations of adjustment of the economic structures, avoiding a penalty of these operations.

Neutrality means that taxation does not suppose an impediment when it comes to make business decisions tending to the accomplishment of operations of restructuring or enterprise reorganization. But it is clear that not taxing the operations of restructuring is an incentive, so neutrality, taking into account that

⁸ Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States.

they do not receive taxes for an operation of restructuring, is a stimulus. For all this, neutrality, in relation with the operations of restructuring, makes easier certain economic behaviour because these restructuring operations are stimulated⁹.

The neutrality has also an important role in the definition of the Value-Added Tax (VAT). The VAT model differs from the indirect taxes with *waterfall effect*, in which the taxpayer remains completely liberated of his economic load, which is obtained by the deduction of the supported VAT. It is a consequence of the neutrality, linked, in a direct way, to the deduction of the tax supported by the ones who make *not exempt* operations. The neutrality of the tax burden is, therefore, a feature that characterizes the VAT model.

The common system of the VAT, as the decision *Ghent Coal Terminal* of the European Court of Justice ("ECJ") of January 15, 1998¹⁰. As. 37/1995 says, "it guarantees, therefore, the perfect neutrality with regard to the tax burden of all the economic activities, anyone that they are the purposes or the results of the same ones, providing that the above mentioned activities are, in turn, hold to VAT".

In the area of the European Union, the community regulation recognizes also this right to the deduction. And the ECJ has insisted on this nuclear aspect that has the right to the deduction in the common regime of the VAT. The decision *Schul*, C-15/81¹¹, arranges that: "one of the elements of base of the system of the VAT consists in the following; VAT is only required in every transaction as soon as there has been deduced the amount of the VAT that burdened directly the cost of the diverse elements of the price of the goods and of the services ... ", and the decisions *Ronpelman Aff.*, Of July 14, 1998 (Ass. 123 y 330/87)¹², *Oro* of

⁹A., SERRANO GUTIERREZ, "Régimen fiscal de las fusiones, escisiones, aportaciones de activos y canje de valores", *Manual del Impuesto sobre Sociedades*, IEF, Madrid, 2003, p. 899.

¹⁰Judgment of the European Court of Justice, 15 January 1998, *Belgische Staat v Ghent Coal Terminal NV*, case C-37/95.

¹¹Judgment of the European Court of Justice, 5 May 1982. *Gaston Schul Douane Expéditeur BV v Inspecteur der Invoerrechten en Accijnzen, Roosendaal*, case C-15/81.

¹² Judgment of the European Court of Justice, 14 July 1988, *Léa Jorion, née Jeunehomme, and Société anonyme d'étude et de gestion immobilière 'EGI' v Belgian State*, joined cases C-123/87 and C-330/87.

December 5, 1989 (As. 165/88)¹³ and *Genius Holding*, of December 13, 1989, As. 342/87¹⁴, insist of that “a basic element of the system of the value-added tax consists in that, in every transaction, the VAT only can have been required with deduction of the amount of the quota that has burdened directly the cost of the diverse constitutive elements of the price of the goods and of the services”.

3. Neutrality and the freedom of establishment in the European Union.

The requirements of neutrality turn out to be reinforced by the principle of freedom of establishment. The freedom of establishment has a direct effect, as says the decision *Klopp*, of July 12, 1984, As. C-107/83¹⁵. The ECJ, as the European Union judicial organ, introduced the principle of direct effect of community law in Member States.

The article 43, 2 of the EEC Treaty¹⁶ prohibits restrictions of the freedom of establishment, which applies to “restrictions on the setting-up of agencies, branches, or subsidiaries by nationals of any Member State established in the territory of any Member State”. This articles defines the freedom of establishment as “the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected”. For the EJC in the decision *Avoir Fiscal*, of January 28, 1986 (As. 270/83)¹⁷, this freedom consists in sharing, in a stable and continued way, in the economic life of a State different from the State of origin, in such a way that the corresponding freedom includes the effective exercise of an exploitation by means of a permanent installation in another Member State, with an indeterminate duration and without

¹³ Judgment of the European Court of Justice, 5 December 1989, *ORO Amsterdam Beheer BV and Concerto BV v Inspecteur der Omzetbelasting Amsterdam*, case C-165/88.

¹⁴ Judgment of the European Court of Justice, 13 December 1989, *Genius Holding BV v Staatssecretaris van Financiën*, case C-342/87.

¹⁵ Judgment of the European Court of Justice, 12 July 1984, *Ordre des avocats au Barreau de Paris v Onno Klopp*, case C-107/83.

¹⁶ EC Treaty.

¹⁷ Judgment of the European Court of Justice, 28 January 1986, *Commission of the European Communities v French Republic*, case C-270/83.

predictable limitation. And in particular, the freedom of establishment would include the right to fix the head office of the activity or to establish subsidiaries, branches or permanent establishments. And, as the EJC's decision *Centros* of March 9, 1999 (As. C-212/97)¹⁸ says, the freedom of establishment includes the right to administer and constitute companies in the same conditions that the ones defined by the legislation of the Member State of establishment for their nationals. The creation of a subsidiary integrates the right to the freedom of establishment of the article 43 to 48 of the EEC Treaty, since it has recognized the decision *Daily Mail* of September 27, 1988 (As. 81/87). It supposes not only the right to establish itself in other countries of the European Union and to create subsidiaries, but also includes the right to be treated in all the terms, even in the fiscal area, according to the regulation of the State in which the above mentioned subsidiary is located. This theory has been reaffirmed for the decision *Cadbury Schweppes*, September 12, 2006¹⁹.

The European Community law does not protect the abuse of the community freedoms. But, it is not possible to presume the abuse of the freedom of establishment for the mere fact that most of the economic activity of a company - or the whole activity- is located in the subsidiary and not in the parent company. Regarding to the use of the comparative advantages of taxation, in the decision *X and Y*, of November 21, 2002 (As. C-436-00), the EJC has affirmed that exists "an authentic right of the contributor to plan his tax operations bearing the normative differences that exist in the tax regulations of the Members States and exploiting the opportunities that the network of Double Taxation Conventions signed between them offer".

But tax avoidance and tax evasion are not protected by the EJC. The domestic anti-avoidance clauses (for example, the Controlled Foreign Corporations) are admissible. But, it is necessary that they are not discriminatory, and that respect

¹⁸ Judgment of the European Court of Justice, 9 March 1999, *Centros Ltd v Erhvervs- og Selskabsstyrelsen*, case C-212/97.

¹⁹In *Cadbury Schweppes plc v. Inland Revenue Commissioner*, case C-196/04, the ECJ decided that CFC legislation constitutes an unjustified restriction on the freedom of establishment when applied to genuine economic activity. Such legislation is acceptable only if designed to prevent those arrangements that are "wholly artificial." The taxpayer will now have the chance to put forth objective evidence to prove the genuineness of the establishment in the Member State and the taxpayer's intentions in setting up a subsidiary in a low-tax country are not dispositive of the validity of the establishment.

the principle of proportionality. They must not be applied to situations that are not fraudulent.

4. Neutrality and free movement of capital. The formula *import-export*. The internal and external tax neutrality.

In the European Community Law, therefore, the neutrality is, first, a consequence of the preeminence of the economic freedoms. And, secondly, a rule with very different applications, for example in restructuring operations or VAT.

But the fiscal neutrality has an important projection in the international plane. We can speak about neutrality between the different national tax systems at the moment of locating the investments or of placing the services in an environment of economic freedom. This neutrality operates on a few manifestations of wealth that take as the base the importation or exportation of goods with economic value.

The *import-export* model is characterized, fundamentally, because the economic relations between countries are orchestrated in imports and exports of goods and of services²⁰. From the tax point of view, this model has different implications in the direct taxation or in the indirect taxation. We are going to centre on the direct taxation and, especially, in the taxation that takes as an object the charge of the benefits obtained by the companies.

To this respect, it suits to remember that, at the international level, governs the principle of taxation of the societies in the country of residence, and that the residence of the societies is regulated for the domestic law. So that, it will depend on if the domestic regulation gathers the principle of worldwide income or the territorial taxation. Being the priority option the taxation for world revenue, this one ends in two conclusions: the first one, the world revenue supposes paying in the State of constitution of the society - State of the residence of the company

²⁰J.M., VALLEJO CHAMORRO-M., GUTIERREZ LOUSA., "Los Convenios para evitar la doble imposición: análisis de sus ventajas e inconvenientes", op. cit., p. 16.

taxpayer - for the whole revenue of the society, with independence where one finds the source from which this revenue comes.

Secondly, the worldwide revenue is determined by the principle of independence, essential element in the rule of the *separate enterprise*. According to this rule, a subsidiary constituted in another country is an independent subject that pays in the State of constitution. It is paid by the whole world revenue in the State where the society takes root but only for the world revenue attributable to the constituted in the country in question. The world revenue is not absolute and does not carry a fiscal world consolidation, so that the losses generated in the subsidiaries are not reflected in the tax base of the parent company except across the calculation as fiscally deductible loss of the deterioration of the participation in the subsidiary, deterioration that has to be generated by the above mentioned losses.

As DELGADO PACHECO says, the majority of the States agree that not resident entities of the group develop activities and obtain revenues, which only they must pay in residence when they are obtained a view to of remuneration of services given in these State or when there is produced the distribution of the dividends proceeding²¹ from these not resident entities²¹.

The taxation of the subsidiaries in the State in which they are constituted (principle of independence) supposes accepting the possibility to use *base companies*: legal entities that exist in one jurisdiction but are owned or controlled primarily by taxpayers of a different jurisdiction. Those are companies placed in territories of low taxation, destined for the *retention of income* the artificial diversion of profits. These profits are not taxed in the State of residence of his last beneficiary.

On the other hand, it is regulated the figure of *controlled foreign companies*. That is an anti-avoidance rule established for the suppositions where passive revenues are obtained (understood as pure revenues of the capital) across base companies placed in territories of low taxation. But besides an anti-avoidance rule it is a

²¹A., DELGADO PACHECO, "Las medidas antileusión en la fiscalidad internacional", *Nuevas tendencias en Economía y Fiscalidad Internacional*, ICE, septiembre-octubre 2005, nº 825, pp 105 and 106.

question of an instrument to protect the principle of neutrality in the capital exportation²².

Only some propositions like the ones that defend the model of Home State Taxation admit this tax consolidation, breaking the traditional rule of the principle of independence and of the *separate enterprise*, considering as a taxpayer the multinational group as well as the permanent establishments of the companies of the group, burdening it applying the procedure of the State of residence of the parent company. Therefore, the societies individually considered disappear, and join the group of societies as taxable persons. The Home State Taxation will be a modality rejected in Europe in favour of the modality of the Common Consolidated Corporate Tax Base, that presupposes a harmonious base and a few procedure dictated by the organs of the European Union²³.

Because of it, in case of exports, in all that the company is located and operates in fiscal certain sovereignty, from which it will realize the exports, the benefits of these operations pay in the State of residence of the society and, therefore, the fact that the sales are produced inside the above mentioned fiscal sovereignty or out, it is irrelevant at the moment of determining the tax to satisfy.

Nevertheless, the joint of the formula import-export has special relevance when the object of the import-exportation are the capitals.

The neutrality about the import or capital exportation has several manifestations that influence decisively the direct imposition of the companies and in the big categories that form the international tax system of the companies; specially in the relative thing like confronting the double juridical and economic imposition.

The fundamental idea is the following one: the tax regime cannot disturb the freedom of the investors at the moment of choosing the territory in which they are going to carry out the investment. This is, that the level of tax imposition does not concern the decision to invest in the own State of residence or abroad. Actually, to obtain an authentic neutrality depends on decisions that are not in the hand of the

²²E., SANZ GADEA, "El régimen especial de transparencia fiscal internacional", *Working Papers*, IEE, Banco Pastor-Fundación Barrié, A Coruña, 2000, p. 47.

²³The *Home State Taxation* system would be voluntary for both Member States and companies and would run for a five-year pilot phase. The Commission's 2004 European Tax Survey (see IP/04/1091 and European Tax Survey/Taxation Paper n° 3) showed that cross-border activity leads to higher company tax and VAT compliance costs for companies and that costs are proportionately higher for SMEs than for large companies.

legislative policy of an alone State. Because of it, it is easier to obtain conditions that facilitate the neutrality in the capital import and exportation in the area of the Supranational Law than across measures of domestic legislation.

This way, we must differ, on the one hand, the neutrality called *in the capital exportation* (the capital export neutrality) also so called *principle of internal neutrality*, according to which the subjects that produce revenues also abroad or only abroad, must receive the same tax treatment, neither more unfavourable nor more favourable, than the subjects that produce revenue exclusively inside the State of the residence.

It is very difficult to obtain this similar treatment for the domestic legislation. The element of comparison to appreciate if there is neutrality would depart from two resident subjects. The State of residence might grant a similar treatment to the resident who only obtains revenue in the country of residence and to the one that obtains total revenue or partially abroad. But in order that this legislative unilateral action guarantees the neutrality in the capital exportation there would be necessary an international model of taxation of the revenues based on the principle of residence according to which, the revenue, whatever the place of investment is, is taxed exclusively in the State of residence.

But the application of the principle of residence like the only criterion of international taxation (as it proposed the Report Neumark), is not possible nowadays, since the States where the investments are located do not give up to tax the revenue that is generated in their territory. And also is evident that the majority of the States apply simultaneously the principle of residence and the principle of source.

And this evidence is revealed clearly with regard to the international taxation of the groups of societies, so, as we said, the principle of worldwide income is determined by the rule of the independence and of the *separate enterprise*. The principle of taxation of the world income facilitates the neutrality in the capital exportation, on having claimed a taxation of income with independence of the location of his source. Nevertheless, this neutrality breaks in the measure in which there is not produced a global consolidation of the taxable base.

For it, the State of residence cannot eliminate the taxation, bigger or minor, in the State of the source because it is stranger to his sovereignty. And because of it, also, the principal threat to the neutrality in the capital exportation is the double juridical international imposition.

Because of it, only a real export neutrality will be achieved, eliminating the differences in the effective tax rate, or, which is the same thing, equalizing the effective tax rate in all the countries. And it only can achieve with legal solutions that they overcome the limits of the domestic legislation. It would demand, certainly, that all the countries were integrated to a harmonious space, which today is feasible neither in the direct taxation nor even in the European Union. Out of the supranational legal system, an equalization of tax rates is more difficult, because the tax power is something inherent in the sovereignty, and the current scene of economic globalization has caused the tax international competition. Being the fiscal undesirable, and like that competition the OECD proclaims it, his elimination or mitigation needs an international share. And a system based on the principle of neutrality in the exportation, in last instance, tries to eliminate the tax competition.

Therefore, on the one hand, the taxation in the country of residence coexists with the taxation in the country of the source, generating situations of double juridical international imposition, which are the principal obstacle to the neutrality in the capital exportation. Therefore, the State of residence will have to adopt mechanisms to mitigate this double imposition. The criterion of the exemption seems to be the most advisable, since the alternative method of deduction of the tax really satisfied (tax credit) is only a partial but not sufficient alteration. The tax credit method supposes that, in the country of residence, there is going to be supported the difference between the charge satisfied in origin and higher that it would correspond according to the internal legislation, but preventing that the revenues obtained in the same territory support a different charge depending on which the contributor is or not resident.

In addition, the adoption of the criterion of residence resident legitimizes a treatment differentiated between resident and not resident, except the requirements of the jurisprudence of the European Union with relation of not

discrimination principle. In the European jurisprudence, though a different treatment is admitted between residents and non residents, this one cannot hide a discrimination because of the nationality, line opened by the decision of the EJC *Commission vs. France* (known as *Avoir Fiscal*), of January 28, 1986²⁴, which supposes the exclusion in the tax area of the fiscal distortions that alter the competition of a market.

Besides the export neutrality, we must mention the neutrality in the capital import (import neutrality) or external neutrality (foreign neutrality). The neutrality in the exportation was a principle that was going to be applied preferably by the States of the residence of the taxpayers, who are exporting countries of the capital. On the contrary, the neutrality in the import or external neutrality has as addressees the so called *States of the source*. This neutrality supposes that these States must apply equal tax regime to whom obtain income in an exclusive way in the same one that to whom, for being resident in third countries, obtain part of their revenue in another country. That is to say, the State of the source must articulate the means in order that that all the investors who locate their investments in a certain jurisdiction have the same tax, with independence of their residence. But it is evident that the pursuit of this result cannot obtain only by means of the action of the State of the source.

Since we have said, the neutrality in the exportation only can be obtained fully across an impossible equalization of effective tax rates. But the neutrality in the capital import departs from a few much more realistic foundations, since capture like foundation a certain fiscal international competition. It recognizes, therefore, the freedom of the State of the source of demanding his withholding tax and his right to tax the income obtained in the territory, but guaranteeing a fiscal neutrality for the set of the investors who apply their capitals in a certain jurisdiction.

Regarding the taxation of the groups of societies, the neutrality in the capital import is the indispensable complement to the neutrality in the import. The neutrality in the exportation is not achieved in a full way because the principle of

²⁴ Judgment of the European Court of Justice, 28 January 1986, *Commission of the European Communities v French Republic*, case C-270/83.

taxation of the world revenue of a society in the place of residence is determined by the principle of independence. According to the principle of independence, the subsidiaries pay in the State where they are taken root, without *world consolidation*. The neutrality in the import acts directly on the taxation of the incomes in the country of the source (singularly, of the benefits of the subsidiaries by means of the Corporation Tax that demands the country of the source) guaranteeing the neutrality in this State. The income of the subsidiary is going to be taxed in the State of the source as social benefit. From the perspective of the parent company placed in the country of residence, it supposes that this benefit only is going to be taxed in the State of residence when the repatriation takes place like dividend paid for the subsidiary to the parent company. That will support a double economic international imposition that will to be corrected in the State of residence. The only exception will be the supposition of which in the State of residence exists a clause of controlled foreign companies because the subsidiary is a base company. But the controlled foreign clause would not be necessary if the dividends distributed by the base company were exempt in the country of residence would not make sense if the dividends distributed by the base company were exempt in the country of residence of the parent company. It would not be necessary if the method of exemption was generalized to correct the double international imposition of dividends.

5. The determining in the area of the European Community Law.

In the area of the Community Law, as he have said before, is not possible a neutrality in the exportation of the capitals *chemically pure*, since harmonization of tax rates does not exist -and not even of the tax base-, at least until the year 2001, when the European Commission dictated the Communication of October 23, 2001 *Towards a internal market without fiscal obstacles*²⁵, a strategy destined to endow to the companies of a consolidated tax base of the Corporation Tax, for

²⁵ Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee - Towards an Internal Market without tax obstacles - A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, COM/2001/0582.

their activities to communitarian scenario”, repeated in his later Communication of November, 2003²⁶.

The principle of worldwide income taxation in the State of residence and the operability of the principle of separation is reinforced by the fact that the creation of subsidiaries in another country of the European Union integrates the content of the freedom of establishment, from articles 43 to 48 EEC Treaty²⁷ (since EJC it has recognized in *Daily Mail* case, of September 27, 1988²⁸). And, for the resolution *Centros*, of March 9, 1999²⁹, this freedom includes the right to administer and constitute companies in the same conditions than the ones defined by the legislation of the Member State of establishment for his proper natives.

We have already said that the Community Law does not protect the abuse and the tax avoidance in the community. The resolution *X and Y*, of EJC, of November 21, 2002³⁰, has affirmed that it certainly exists “an authentic right of the contributor to plan his tax operations bearing the normative differences...”. But, it is not possible to presume the abuse of the freedom of establishment for the mere fact that most of the economic activity of a company or the whole activity is located in the subsidiary and not in the parent company.

Parallel to the harmonization process urged from the Commission, the case-law of EJC has put also brought out the aspect of the taxation of companies in a communitarian dimension. In the case *Marks and Spencer*³¹, there it was argued the compatibility of the English tax regime of the groups of societies (it was excluded the compensation of the losses foreseen for the resident subsidiaries for non residents) with the freedom of establishment recognized in the articles 43 and 48 of the EEC Treaty³². The resolution dictated on December 13, 2005 considered that the English tax regime of the groups concerns of valid the freedom of

²⁶ Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *An Internal Market without company tax obstacles: achievements, ongoing initiatives and remaining challenges*, COM/2003/0726.

²⁷ EC Treaty.

²⁸ Judgment of the Court of 27 September 1988, *The Queen v H. M. Treasury and Commissioners of Inland Revenue*, ex parte *Daily Mail and General Trust plc*, case C-81/87.

²⁹ Judgment of the European Court of Justice, 9 March 1999, *Centros Ltd v Erhvervs- og Selskabsstyrelsen*, case C-212/97.

³⁰ Judgment of the European Court of Justice, 21 November 2002, *X and Y case*, C-436/00.

³¹ Judgment of the European Court of Justice, 13 December 2005, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)*, case C-446/03.

³² EC Treaty.

establishment for diverse “imperious reasons of general interest”: the respect to the balance in the distribution of the distribution of the tax power between the Members States and the risk of tax evasion and double utilization of the losses.

With everything, the national measure object of the litigation was considered to be disproportionate and, in consequence, opposite, to the Community Law when they could not compensate the losses in any of two Members States, even if it is for depletion of the term of compensation without having obtained positive revenues in the State of residence of the subsidiary, the dissolution of the above mentioned entity, or any another reason.

With nuances, the mentioned jurisprudence has been repeated, on the other hand, in the resolution of May 15, 2008, *As. Lidl Belgium GmbH & Co. KG v. Finanzamt-Heilbronn*³³, relative to the compensation in the residence, not of negative bases of subsidiaries in the exterior, but of losses of the permanent establishments. This resolution declares compatible with the freedom of establishment gathered in the article 43 of the EEC Treaty³⁴, the German procedure that, in the frame of the German- Luxembourg Double Imposition Convention- to avoid the double imposition, were preventing the deduction in Germany of the losses obtained by a permanent establishment placed in Luxembourg. The restrictive measure is considered to be, on the other hand, provided by the purpose prosecuted.

In any case, the Court admits that a solution from the jurisprudence to this problem is insufficient. It will be necessary the adoption of positive measures of harmonization to allow the cross-border compensation of negative bases and losses of immediate form, beyond the cases limit solved by the Court.

6. The absence of neutrality in the form of financing of a company.

The operations between companies of the same group are fiscally relevant. When it does not exist a global tax consolidation and the groups of societies not to be formed as taxpayers, the taxpayers, from the principle of independence, are the

³³ Judgment of the European Court of Justice, 15 May , *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, case C-414/06.

³⁴ EC Treaty.

companies separated. Because of it the operations between the societies of the group have transcendence (what justifies the application of the arm's length rule). And, also are the operations of financing; the operations of indebtedness of a few societies of the group with others.

In international groups of societies, where the parent company is placed in a State and the subsidiary in other one, is possible the indebtedness of the parent with the subsidiary and vice versa. Supposing that it is the subsidiary the one who finances the not resident counterfoil, probably the subsidiary lender will be a base company placed in a State of privileged tax system or of low taxation, or a tax haven. The reduction of tax bases across the indebtedness with subsidiaries, are strategies of *stepping stone*. Opposite to these strategies, the fiscal systems foresee the formula of the *foreign controlled corporation*.

If it is the parent company the one that finances the subsidiary, the parent company will be placing the capitals in the shape of loan parallel to the funds invested with a view to the capital. The parent company (that is an owner of the participations of the subsidiary like shareholder) is, in addition, financial lender. And it raises an alternative for the subsidiary at the moment of obtaining funds. It can obtain them if the parent company increases his participation by means of a capital increase. And it can obtain it across funding, receiving loans of the parent company. In the first case the subsidiary will pay dividends and in second be interested.

In the first one of the cases, the effect will be that the benefit of the subsidiary only is going to be taxed in the State of residence when it is repatriated really with a view to dividend paid for the subsidiary to the parent company, which supposes a nuance of the principle of worldwide income. Only that portion of revenue generated by the subsidiary and that is a distribution object to the counterfoil with a view to dividend is taxed in the State of residence of the parent company. The payment of dividends is, simply, a distribution of taxable income that demurs the rule of worldwide income when a fiscal consolidation does not exist: the part of benefit of the subsidiary that is not distributed to the parent company with a view to dividend will not be taxed in the country of residence of the parent company, even if this State applies the worldwide income.

In the second case, the payment of the interests supposes the calculation of a financial deductible load to determine the net revenue. The generality of the classifications, and especially the Spanish one, consider the financial expenses to be tax deductible, included the interests earned by any loan to a society finance the development of his activities. Even the European Court of Justice has admitted a limitation to this possibility of deducing the interests, when the State of the source demands that the expenses are related directly to the activities that have generated the taxable income³⁵. It would be an expense for the subsidiary and a correlative income for the parent company: an integral element of the fiscal benefit, both in the State of the subsidiary and in the State of the counterfoil: in the first one like a negative component and in the second one like a positive component.

The business benefit, after the financial expenses, must be taxed in the State where this economic activity is being developed. The benefit will pay in the State of residence of the subsidiary, on condition of that it is a net income. Because of it, the benefit that it will pay in the State where the subsidiary develops the economic activity will be the benefit after deducing the financial expenses. On the other hand, the benefits of the credit that generates the indebtedness with which this activity is financed, is taxed principally in the State of residence of the lender. This scenario was completed by the taxation shared in the Double Taxation Conventions that are still the Model OECD, for dividends and interests. The justification of the shared taxation takes root more in a grant to the fiscal sovereignty of the State of the source, allowing him to tax, in a limited way, the income from resident investors, that in motivations of fiscal justice. But, it is true that the tax charge in the country of source of the paid interests, allows the State of residence of the payer company of interests to recover part of the tax theoretically lost on having accepted the deduction of those.

Nevertheless, this shared taxation was meeting attenuated by the taxation limited in the source of interests and dividends. And for the effective elimination of this taxation in the source in the Community law. This way, in the Community

³⁵ Judgment of the European Court of Justice, 3 October 2006, FKP Scorpio Konzertproduktionen GmbH v Finanzamt Hamburg-Eimsbüttel, case C-290/04.

European Area, the art. 5,1 of the Directive 90/435/EEC³⁶, in draft started to the same one by the Directive 2003/123/EC³⁷, of the Council, of December 22, 2003, it arranges that "the benefits distributed by an affiliated society to his society counterfoil will remain exempt from the retention in origin". Whereas for the case of associate societies of different Members States, the Directive 2003/49/EC³⁸ on the tax system of the interests and royalties, it suppresses any taxation (generally, withholding taxes) on the payments of interests and royalties. The interests and royalties will be exempt from any tax in the State of origin providing that, the effective beneficiary of the same ones, is a society of a Member State placed in another Member State or a permanent establishment placed in a Member State different from that of the society on whom it depends.

But in addition, the option for the capital increase or for the indebtedness, is an economic option of the first magnitude, since the subsidiary will decide if it increases his proper resources or increases his foreign resources, without existing procedure, mercantile or fiscal, that regulates the proportion that must observe the proper and foreign resources in the financing of a company. For it, the fiscal factor is very relevant. And also relevant is the existence of a fiscal neutrality.

The parent company can compete to finance to his subsidiary by means of a loan or increasing his share participation. In both cases, the perceived income will be taxed in the State of residence. The double juridical imposition provoked by the taxation in the source meets attenuated or mitigated by the taxation limited across the Conventions of Double Taxation or by the elimination of the above mentioned imposition in the source in the area of the Community law. In turn, the comparative aggravating factor that supposes the double economic imposition in the taxation of the dividends, also meets mitigated by the adoption of exemption methods for the countries of residence of the father companies.

For it, there is a trend to the location of the taxation of the business benefit in the State of the residence of the subsidiary. The tax charge in the source limits itself

³⁶ Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

³⁷ Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

³⁸ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

or eliminates, for the effect combined of the Conventions of Double Taxation, the Directives and the extension of the system of exemption as method to avoid the double imposition. It supposes, in the practice, limiting the charge of the business benefit to which there corresponds to the State of residence of the subsidiary. But the above mentioned tax charge will take place after the deduction of the financial expenses.

DELGADO PACHECO says "the system is neutral respect of the decision brings over of distributing or not dividends, but it is not neutral as for the form of financing of a company, since the location of the taxable benefit will depend on the financial expenses that are removed or deduce of the benefit of the activity"³⁹. In the case that debt financing comes from a company's owners, the interest payments can be seen as essentially veiled dividend payments. In the measure in which the financial expenses are always tax deductible, when a multinational group plans worldwide the total taxation, it will suit for him to articulate loans of his parent companies in countries of low taxation in favour of subsidiaries in countries of high taxation. Hereby, there will be achieved that the financial expenses reduce the tax base of jurisdictions of high taxation on the benefits of the companies. At the same time, the correlative financial income pay taxes in favourable jurisdictions. The multi-national companies from allocating excessive amounts of debt to their local operations for the purpose of claiming income tax deductions.

A tax jurisdiction can be *favourable* for having a minor taxation on this business benefit or for contemplating a good treatment for the interests.

It would be possible that the society lender was an authentic base company, formed as financial centre, with the purpose of granting funds to loan to the different subsidiaries placed in jurisdictions that contemplate a high taxation for the business benefits.

There is not neutrality in the form of funding of the societies placed in countries that contemplate an average or high taxation for the business benefits, because there are expectations of fiscal planning. The tax factor dissuades the

³⁹A., DELGADO PACHECO, "Las medidas antileusión en la fiscalidad internacional", op. cit., pp 105 and 106.

strengthening of the proper resources of companies, stimulating the leverage and favouring the increase of the foreign resources of societies placed in jurisdictions of high taxation for the business benefits. What has been gained in neutrality along the recent history of the international taxation (as for the taxation for world income in the country of residence of the parent companies and as for the decision to distribute or not dividends), it gets lost in the relative thing to the decision of how a company is financed by his parent. Especially, because the decision to do it increasing the debt it can be guided by the intention of the degradation of the tax base in the country of residence of the subsidiary, in favour of the country of location of the financial centre.

Depending on it, we might extract the following conclusions:

The taxation of the companies in the State of residence in application of the principle of worldwide income needs a context of neutrality, which will be reinforced by the direct application of economic freedoms as those who base the Community Law.

A company of multinational group pays taxes in the country in which it is constituted and of the parent company (centre of coordination, holding or financial centre) in the State where this one places. It does not exist a global fiscal consolidation. The country where the subsidiary places is formed as State of the source. This State will tax the flows of income that the subsidiary pays to the parent company. The tax charge in the source of these payments with a view to dividends or interests they limit themselves or eliminate. The only tax charge of the business benefit is that corresponds to the State of residence of the subsidiary, though with deduction of financial expenses.

The neutrality produces respect of the decision brings over of distributing or not dividends. But the possibility of deducing the financial expenses determines the neutrality in the relative thing to the decision of if the company is financed by proper or foreign funds. The right to deduce financial expenses disturbs the neutrality in the decision if the company is financed by proper or foreign funds. In conclusion: the choice of corporate finance is an important source of tax planning opportunities for multinational companies.

To avoid these situations, the countries of residence of the subsidiaries of a financial centre or parent companies lender protect their tax bases across a classic clause anti-tax avoidance special: the thin capitalisation.

7. Thin capitalisation as a mechanism of reaction against the abuse in the option of funding by means of loans.

Thin capitalisation is a situation in which the funds of a subsidiary have been contributed by the parent company in the shape of loan, not in the shape of capital contributions⁴⁰. At first, the fiscal system should not disturb on the decision to give funds to the subsidiary with a view to the capital or with a view to loan. The fiscal system should be neutral. But this neutrality has two exceptions.

The first exception is a consequence of the rule of the separate enterprise. According to the rule of the separate enterprise, the operations between the companies of a multinational group are relevant and must be valued applying the principle arm's length. They are operations between not independent parts, where it is required to value if this operation would be done in the same way between independent parts.

The second one, because the special relation between the lender and his subsidiary allows tax *improper conducts*. The operation of supply of funds by means of a loan can conceal a real contribution of the capital. And the payment of interests can conceal a distribution of benefits⁴¹.

If the payment of interests is an abusive conduct, it is necessary to fight applying the tax anti-avoidance clauses and, in last term, resorting the principle substance over forms. To know if the payment of interests is an abusive conduct of the tax payer, it will be necessary to analyze the previous indebtedness that justifies such a payment. And it will be necessary to determine in every concrete case if the

⁴⁰C., PALAO TABOADA, "Límites a la aplicación de la norma española contra la subcapitalización: estado de la cuestión", IEE de Galicia, Paper Works, Banco Pastor, Fundación Barrié de la Maza, A Coruña, 2000, p. 63; F.J., MAGRANER MORENO, *La coordinación del Impuesto sobre Sociedades en la Unión Europea*, Instituto de Estudios Fiscales, Madrid, 2009, p. 118.

⁴¹F.J., MAGRANER MORENO, *La coordinación del Impuesto sobre Sociedades en la Unión Europea*, Instituto de Estudios Fiscales, Madrid, 2009, p. 119.

activity has economic valid motive. In Spain, the Tribunal Económico-Administrativo Central, in its resolution on October 8, 2009, remembers that it is lawful for a company to get into debt to acquire something, but it is not admissible that the cause and effect relationship is inverted. The normal thing is that the purpose is to acquire something and for it the company to get into debt. The inadmissible thing is that the purpose is to get into debt to provoke the payment of a few interests an entity belonging to the same group, so that an acquisition is looked to feign the need of this indebtedness.

And from the second point of view, the relevant thing in the thin capitalisation is that the grant of the borrowing, normally for the parent company to the subsidiary, has been made in conditions different from those of the market, or to whom would meet in situation of independence. The principle of independence would be damaged, for what there would be necessary to confront the situations of undercapitalisation applying the arm's length principle.

The Spanish tax system includes the clause of thin capitalisation in the article 20 of the Consolidated Text of the Law on Corporation Tax (TLCT). Spanish tax law provides for a 3:1 debt-to-equity ratio for the net interest-bearing indebtedness of Spanish companies towards non-resident related parties. Interest accrued on any indebtedness that exceeds this ratio is considered as a dividend for tax purposes. The consequence is that these interests are not a tax deductible for the payer. The ratio does not apply to financial entities.

In Spain the thin capitalisation provokes several problems: the asymmetric qualification, the problem of the fixed ratio of indebtedness and especially, the limits derived from the Double Taxation Conventions and of the Community law.

7.1 System of the fixed ratio.

In Spain, the thin capitalisation does not apply when there is a contribution of the simulated capital, of a concealed distribution of benefits or of an operation of indebtedness that does not answer to normal conditions of market. The anti-avoidance clause in bears in mind, exclusively, where there is an excessively

disproportionate ratio between loan capital and equity capital. Spanish's thin capitalisation rules therefore apply a two-step test. First, they test whether the debt to equity ratio exceeds a certain prescribed ratio and, second, whether the interest levied on the loan exceeds a specified rate (fixed capital ratio of up to 3:1.). This fixed capital ratio has the condition of *safe harbour*, but it provokes some problems that impede his function anti-fraud: for example, that in groups of companies produce to themselves *chains of indebtednesses* that individually do not overcome the ratio of 3, but in his set they exceed it widely. And, in a more habitual way, that the not resident lender facilitates the financing to the resident, and this one distributes them between resident companies of the group.

In Spain, this problem was tried to solve by calculating the direct and the indirect indebtedness in the ratio. The legal provision refers to direct or indirect indebtedness. The concept of direct indebtedness is straightforward, however the definition of indirect is everything but clear in this context. While it is commonly accepted that back-to-back loans should fall under this definition, the Spanish tax authorities have taken an arguable stance in respect of guarantees granted by group companies (often requested by banks when financing companies of multinational groups). But the loans back to back must treat as simulations. Also, exists the doubt if it is possible to understand that there is indirect indebtedness in case of loans simply guaranteed by the group or even of credit lines jointly in favour of different companies of the group. In two tax rulings issued on March 24 1998 and on June 20 2001, the tax authorities stated that third party loans guaranteed by group companies are indirect indebtedness for the purposes of thin capitalisation rules. In two tax rulings issued on March 24 1998 and on June 20 2001, the tax authorities stated that third party loans guaranteed by group companies are indirect indebtedness for the purposes of thin capitalisation rules.

But the problem of the thin capitalisation rules with a method of the fixed ratio is his compatibility with the already mentioned principle of independence. And it because, if the application the clause of thin capitalisation limits itself to an automatic application of a *fixed ratio*, it seems that there is excluded the possibility of proving that it could have obtained the loan capital from a third party

on the same conditions. And therefore, it turns out to be incoherent with a conception of the thin capitalisation as a rule based on the arm's length principle.

7.2 The asymmetric qualification.

In Spain, when the indebtedness with the parent company is exceeded three times the company's share capital, the interest payment is not tax deductible. Overcome this percentage of indebtedness the full interest is catalogued by the norm as dividend. The Law forms a juridical fiction

If the society who perceives the excessive interest is the parent company of the one that pays them, the qualification of the received like dividend will only depend on that the country of residence of this company is ready to carry out this requalification. If the State of residence of the parent company does not re-qualify there will be an asymmetry in the qualification; the same income will be qualified as dividend in the country of the company payer and as interest in that of the company that receives this income.

This asymmetry in the qualification can frustrate the purpose of the thin capitalisation rules. This way, if the State of residence of the company lender does not proceed to a symmetrical requalification of the interest perceived by the resident, will be produced a double taxation. Since the State of residence will meet threatened, everything more, to eliminating the double juridical imposition but not the economic one, which never takes place (is never produced) with regard to a perception catalogued as interests⁴².

Nevertheless, this pretension to qualify as dividend the interests paid in excess is going to have a limited efficiency, since juridical instruments do not exist to force to the State of residence of the parent company to treat the revenue perceived as dividend. The only juridical possible frame would be that between the country of the company who pays the interests and that of the company who receives them,

⁴²J.M., CALDERON CARRERO, "Estudios de la normativa española sobre subcapitalización de sociedades a la luz del principio de no discriminación: análisis de su compatibilidad con los convenios de doble imposición y con el ordenamiento comunitario", *Crónica Tributaria*, nº 76, 1995, pp. 13 and 18.

there was a Double Taxation Treaty coordinated according to the Model OECD. In the Model OECD exists a rule, the article 11.6, according to which: where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Therefore, the Model would allow to the State of residence of the company lender to understand that the same one perceives a dividend and not interest only if his domestic legislation allows it to him. If the tax domestic norm of the country of residence of the company lender allows it, this classification will include a legal fiction that has to remove to his last consequences.

But in order that it was possible to apply this rule contained in a Double Taxation Treaty, it should admit the treatment of the thin capitalisation as a derivation of the principle arm's length. It is necessary to analyze the abstract compatibility of the figure of the thin capitalisation with the Model of the OECD.

7.3 Contradiction of the thin capitalisation rule with the Model OECD of Convention Double Taxation.

The Model Tax Convention OECD does not mention expressly the rule of thin capitalisation. It is necessary to wonder if the Model OECD allows to qualify a few interests as dividends. This possibility finds an obstacle: the paragraph 25 of the Commentary to the art. 10 of the Model OECD says that only it will be possible qualify as dividend the payment of a few interests when the lender "effectively shares the risks run by the company". It is something that does not happen always in all the suppositions of thin capitalisation.

The OECD has defended the compatibility of the thin capitalisation rule with the Double Taxation Convention. In the commentaries to the article 24 of the Model, the OECD says that the thin capitalisation rule is not opposite initially of not discrimination, in spite of the draft of the paragraph 5 of this article 24 of the Model OECD. In conformity with this rule, a resident entity in a State, controlled by resident entities in another State, may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

Nevertheless, the paragraph 58 of the commentaries to this article 24 indicates that this norm must be put in relation with the previous paragraph 4 and with the articles 9.1 and 11.6 of the proper Model of OECD. The thin capitalisation rule would form a part of the procedure relative to operations between associated enterprises. In this context, the paragraph 3 of the commentaries to the article 9 proclaims the compatibility between a Convention of Double Imposition and the thin capitalisation, if the arm's length principle is respected.

The thin capitalisation rule only will be compatible with the OECD Model if it is applied as a manifestation of the principle arm's length. In relation with the article 9 of the Model OECD, to admit that an excessive indebtedness is an operation that would not have reached agreement between independent companies, in such a way that the Administration would reject the financial expense corresponding to the excess of indebtedness as opposite of the principle arm's length⁴³. But, it will be necessary to admit that the borrowing company whom the Administration of his country tries to prevent the deduction of the interest paid, must be able to prove that his *ratio of indebtedness* is compatible with the arm's length rules.

The Spanish Law (art. 20,3 TLCT) allows the application of one ratio of indebtedness different. But it is not allowed that the debt society could justify that the ratio that it applies adjusts to the normal conditions of market. The Spanish Law establishes a system of *fixed ratio of indebtedness*.

⁴³A., DELGADO PACHECO, "Las medidas antileusión en la fiscalidad internacional", op.cit., p. 107.

The Model Tax Convention OECD does not exclude expressly the *fixed ratio of indebtedness*. But yes implicitly, because the *fixed ratio* excludes the proof that a different ratio adjusts to arm's length rule⁴⁴.

The OECD Report *Thin capitalisation*, adopted on 26 November 1986, related to the Model Tax Convention, establishes that the States must allow the proof of one different ratio, in agreement with the arm's length rule⁴⁵.

The compatibility of the thin capitalisation with the Model of the OECD needs a flexible thin capitalisation rule, instead of ratios or rigidly predetermined coefficients. The norm of thin capitalisation would not be opposite to an Double Imposition Treaty, providing that the affected companies could demonstrate that they would have obtained this funding of an independent entity in conditions of market of free competition.

7.4 Contradiction of the thin capitalisation rule with the Community law. The role of the freedom of establishment and the case Lankhorst.

The great controversy of the regime of the thin capitalisation in the last times is his possible incompatibility with the European Community Law.

From the European Community Law, the Member States can adopt internal measures against the tax avoidance and tax evasion, and when the same ones do not suppose denying the community freedoms basic freedoms. Over the past few years the European Court of Justice (ECJ) has handed down a number of important judgments in this area in which it has clarified the limitations on the lawful use of anti-avoidance rules. In case *Centros*, On March 9, 1999⁴⁶, the EJC

⁴⁴C. PALAO TABOADA, "Límites a la aplicación de la norma española contra la subcapitalización: estado de la cuestión", op. cit., pp. 70 and 71.

⁴⁵J.M., CALDERON CARRERO., "Estudio de la normativa española sobre supcapitalización de sociedades a la luz del principio de no discriminación: análisis de su compatibilidad con los convenios de doble imposición y con el ordenamiento comunitario", *Crónica Tributaria*, nº 76, 1995, pp 34 and 35; C., PALAO TABOADA, "Límites a la aplicación de la norma española contra la subcapitalización: Estado de la cuestión", *Revista de Técnica Tributaria*, nº 46, 1999, p. 54, C., GARCIA HERRERA, *Precios de transferencia y otras operaciones vinculadas en el Impuesto sobre Sociedades*, Madrid, IEF, 1991, pp. 238 y 239.

⁴⁶ Judgment of the European Court of Justice, 9 March 1999, *Centros Ltd v Erhvervs- og Selskabsstyrelsen*, case C-212/97.

said: the domestic anti-avoidance rules cannot be discriminatory, must apologize for pressing reasons of public interest and must be must be proportionate. The jurisprudence of EJC has insisted on the requirement of the proportionality – cases *Vestergaard*⁴⁷ and *Baxter*⁴⁸ -. and, lately, the *coherence principle* has discarded. Already, it is not necessary to justify fiscal disadvantages for not residents as requirement of the proper tax system⁴⁹.

EJC resolved expressly about the thin capitalisation rule in the *Lankhorst-Hohorst* case⁵⁰, the Court held that German System Tax ("§ 8a KStG), which applied the thin capitalisation rule only to non-resident companies, violated the freedom of establishment provision in Art. 43 of the EC Treaty⁵¹. The ECJ held that the difference in treatment between resident subsidiary companies according to the seat of their parent company constituted an obstacle to the freedom of establishment which was, in principle, prohibited by Article 43 EC. The ECJ noted that reduction in tax revenue did not constitute an overriding reason in the public interest which might justify a measure that was in principle contrary to a fundamental freedom. The German thin capitalisation rules were therefore contrary to article 43 EEC Treaty. The German clause establishes a fixed ratio of indebtedness⁵².

For the EJC, the risk of tax evasion does not justify a tax fiction. The EJC concludes in the mentioned resolution *Lankhorst-Hohorst*, that the thin capitalisation rule does not prosecute a legitimate purpose compatible with the EEC Treaty and does not justify itself for pressing reasons of public interest. It is settled law that reduction in tax revenue does not constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to

⁴⁷ Judgment of the European Court of Justice, 28 October 1999, Skatteministeriet and Bent Vestergaard, case C-55/98.

⁴⁸ Judgment of the European Court of Justice, 8 July 1999, Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA v Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Economie et des Finances and Ministère de l'Agriculture, de la Pêche et de l'Alimentation, case C-254/97.

⁴⁹ Judgment of the European Court of Justice, 6 June 2000, Staatssecretaris van Financiën and B.G.M. Verkooijen, case C-35/98.

⁵⁰ Judgment of the European Court of Justice, 12 December 2002, Lankhorst-Hohorst GmbH and Finanzamt Steinfurt, case C-324/00.

⁵¹ EC Treaty.

⁵²C., PALAO TABOADA, "Noemas antie-elusión en el Derecho interno español y en el Derecho Comunitario", *Asociación Argentina de Estudios Fiscales*, 2002, p. 8.

a fundamental freedom (see Case C-264/96, paragraph 28; Verkooijen, cited above, paragraph 59; Metallgesellschaft and Others, cited above, paragraph 59, and Case C-307/97 Saint-Gobain, paragraph 51⁵³).

EJC remembers that the anti-abuse measures must allow to judge the facts *in casu*. But thin capitalisation is a clause of automatic application to all the situations. The clauses anti-avoidance only can be accepted when they do not foresee a rule of general character, but his application needs an individual analysis of each one of the situations. As regards more specifically the justification based on the risk of tax evasion, it is important to note that the legislation at issue here does not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent German tax legislation, from attracting a tax benefit, but applies generally to any situation in which the parent company has its seat, for whatever reason, outside the Federal Republic of Germany. Neither the thin capitalisation is justified by the need to ensure the coherence of the applicable tax systems.

Therefore, the thin capitalisation is it contradicts to the community freedoms and, especially, to the freedom of establishment, in the measure in which his regulation provokes discriminatory effects.

Diverse Members States of the European Union have proceeded to modify their regulation as for thin capitalisation. The ECJ decision started a movement towards amendment of thin capitalisation rules, based in most cases on the extension also to resident companies. The Report *Structures of the Taxation Systems in the: 1995/2004*, elaborated by the European Commission⁵⁴, describes the reforms. From 1 April 2004, UK's thin capitalisation provisions apply to debt between two UK companies as well as in cross-border situation, and to each individual company on a stand-alone basis, rather than to a UK grouping. Of course, Germany has amended its rules to bring transactions between resident companies within their

⁵³ Judgment of the European Court of Justice, 16 July 1998, Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes, case C-264/96; Judgment of the European Court of Justice, 6 June 2000, Staatssecretaris van Financiën and B.G.M. Verkooijen, case C-35/98; Judgment of the European Court of Justice, 8 March 2001, Metallgesellschaft Ltd and Others (C-397/98), Hoechst AG and Hoechst (UK) Ltd (C-410/98) v Commissioners of Inland Revenue and HM Attorney General, joined cases C-397/98 and C-410/98; Judgment of the European Court of Justice, 21 September 1999, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt, case C-307/97.

⁵⁴ Doc. TAXUD E4/2006/DOC 3201.

scope. Spain amended its rules as from the beginning of 2004 to make the regime inapplicable in the case of loans from EU resident corporations that are related parties (unless the entity is resident in a territory included in a Spanish black list of tax havens). Denmark has presented a tax bill which, when enacted, will apply to loans between Danish companies. The French Courts ruled the incompatibility of thin capitalisation rules with tax treaties as well with freedom of establishment. Anyway, some problems of compatibility with the principle of non-discrimination still remain and it is not clear if these efforts will be sufficient to save their respective regimes.

First of all, the decision to remove thin capitalisation rules only in relation to shareholders resident in the EU (e.g. Spanish reform) leaves the new legislation conformed to the principle of freedom of establishment, but there could be a problem of compatibility with the principle of the free movement of capital, enshrined in Art.56 of the EC Treaty⁵⁵. In relation to third countries, the freedom of establishment principle is not applicable because its scope is limited to individuals and companies of EU Member States; on the contrary, Art. 56 prohibits all restrictions on the movement of capital and on payments between Member States and between Member States and third countries. To determine whether a parent company resident in a third country could claim protection under the free movement of capital, the applicable restrictions need to be analysed carefully: the crucial element could be the standard the ECJ would use to determine what constitute an arbitrary restriction.

Spain, has suppressed, by means of Ley de Medidas Administrativas y de Orden Social, 62/2003, of December 30, 2004, and with effects of January 1, 2004, when the company lender is in a Member state of the European Union. This situation is going to provoke problems in the future.

First, it can provoke problems of tax degradation. Fiscal degradation occurs through the erosion of the tax base resulting both from tax competition (the relocation of taxable bases to other countries). Not application of the thin capitalisation to companies located in countries of the European Union, will be stimulated the creation of financial centres in States like Ireland and the utilization

⁵⁵ EC Treaty.

to instruments like the loan back to back. In the latter case it appears if it would be necessary to apply the thin capitalisation like a clause anti-abuse or rule of transparency or look-through, because the lender company established in the country of the European Union would be a *formal lender* interposed between the borrowing company resident in Spain and the real lender established in a State not belonging to the European Union.

Secondly, Spain will continue applying the thin capitalisation when the company that receives the excessive interests, is established in a country that has the condition of tax haven. In Spain, the tax havens are defined from the existence of a *blacklist*, in the Real Decreto 1080/1991. In addition, Spanish legislation (Law 36/2006) provides that jurisdictions or territories that sign an exchange of information agreement or a double tax treaty with an exchange of information clause with Spain are automatically excluded from the Spanish tax haven *blacklist*. Spain is reducing its tax haven "blacklist" with the negotiation and signature of agreements of this type with territories that have historically been listed as tax havens.

The Spanish blacklist includes two countries that have joined the European Union on May 1, 2004; Malta and Cyprus. Of the two, Cyprus is the one that has raised a priori a few more attractive conditions on having had an aliquot reduced for enterprise benefits (10 for 100, opposite to 35 for 100 of Malta) and preferential tax regime very profitable across the IBCs (Business International Societies). The tax is 4,25 % for this type of juridical form. In addition, Cyprus has a sophisticated network of double taxation treaties available for use by non-resident companies and a very professional infrastructure.

Malta is not a tax haven since a Convention of Double Taxation with clause of exchange of information has signed of November 8, 2005. But Cyprus is still in the Spanish blacklist. But to Cyprus, it the Community law turns out to be applicable from May 1, 2004. And the Community Law includes the Directive on Mutual Assistance dates from 1977⁵⁶. It sets out the rules under which the Competent Authorities of Member States provide mutual assistance and exchange of

⁵⁶ Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation.

information in order that they may apply their tax laws effectively. The Directive makes provision for three types of information exchange - information on request, automatic exchange and spontaneous exchange. It also contains safeguards relating to secrecy so that any information exchanged is handled with proper respect and consideration for the rights of taxpayers. In addition, there are limits to the exchange of information in order to ensure that there is reciprocity in the types of information that can be exchanged. It is not possible for a Member State to seek information from another Member State if the state making the request would be precluded by its own laws, or administrative practices, from obtaining similar information.

The Council Directive 77/799/CEE includes the minimal standard of commitment of exchange of information. The Member States to which the Directive is applied, cannot have the condition of tax havens. Keeping Cyprus in the black Spanish list contradicts the primacy of the European Community law (cases *Simmenthal*⁵⁷ and *Marleasing*⁵⁸).

⁵⁷ Judgment of the European Court of Justice, 9 March 1978, Amministrazione delle Finanze dello Stato v Simmenthal SpA, case C-106/77.

⁵⁸ Judgment of the European Court of Justice, 13 November 1990, Marleasing SA v La Comercial Internacional de Alimentacion SA, case C-106/89.