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The Italian Supreme Court on October 4 issued order no. 21371, asking the European Court of Justice to clarify the abuse of law doctrine elaborated in its landmark decision in *Halifax plc et al. v. Commissioners of Customs and Excise* (C-255/02). (For the text of that judgment, see *2006 WTD 35-19* or *Doc 2006-3356*.)

Abuse of Law Doctrine

In *Halifax*, Halifax PLC, a financial institution that supplies mainly VAT-exempt financial services and therefore is limited in its ability to deduct a VAT on goods or services purchased, was engaged in a real estate development to build call centers and would have incurred a lot of input VAT, most of which would have been nondeductible.

To plan around that problem, Halifax PLC interposed some of its wholly owned subsidiaries between itself and its contractors. It then entered into a series of transactions so that the supplies of construction services were made to those subsidiaries, which were able to deduct the VAT on construction costs in full. If Halifax PLC had engaged the independent contractors directly, it would have been able to recover only 5 percent of the VAT charged on those construction costs.

The ECJ ruled that the plan was abusive and could not stand. It said that EU law (that is, the right to deduct input VAT) could not be extended to cover abusive practices or "transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by Community Law." In further qualifying the antiabuse test, the ECJ said it must be apparent from a number of objective factors that the essential aim of the transactions is to obtain a tax advantage. No abuse can be found to exist if a transaction has a motive other than the mere attainment of a tax advantage (the taxpayer being free to structure the transaction so as to pay the lowest tax possible).

A Similar Case in Italy

The case at issue in Italy concerns vehicle leases that are subject to a VAT in Italy. The transaction was carried out through separate but related arrangements aimed at reducing the VAT. The lessee entered into an insurance contract (covering the loss of or damages to the leased vehicles) and a guarantee contract (covering the lease payments owed to the lessor under the lease contracts) with an affiliate and member of the same group as the lessor. The payments due under the two contracts were exempt from a VAT.

The lease contract provided for lease payments that were artificially low, as they did not take into account the costs for the services provided by the affiliate under the separate guarantee and insurance contracts and corresponded only to the costs for the use of the vehicles.

The Italian Supreme Court wants to treat the separate arrangements as a single financial lease contract entered into directly between the lessor and the lessee and to subject the total amount of the payments made under the separate contracts to a VAT as a sole payment under the financial lease, on the theory that the principal purpose, or one of the principal purposes, of the separate arrangements was to avoid a VAT, as established in the ECJ judgment in *Halifax*.

Supreme Court Order

For the purpose of stringing together the various parts of the transaction and subjecting the entire amount of the payments to a VAT, the Supreme Court asked the ECJ to clarify whether the test used in *Halifax* would allow such treatment if the principal purpose or one of the principal purposes (but not the only purpose) of the transaction is tax avoidance.

The interpretative problem arises because the ECJ referred to the antiabuse test in different terms in the context of its judgment. It first referred to transactions entered into solely for the purpose of obtaining tax advantages. That test would seem to apply to transactions whose exclusive purpose is to avoid tax. It also referred to transactions for which the essential aim is to obtain tax advantages. That test would seem to extend to transactions in which one of the principal purposes or the principal (but not exclusive) purpose is to avoid tax.

In light of the variations in wording in the *Halifax* judgment, the Italian Supreme Court has asked for clarifications on the exact scope of the test, namely:

- whether, despite the different terminology, there is a single antiavoidance test or two different tests, depending on the specific facts of a case; and
- whether the abuse of law doctrine applies to transactions for which the principal purpose, or one of the principal purposes, is to avoid tax, or is more restrictive and applies only to transactions whose sole purpose is to avoid tax.

The ECJ's response will have a significant impact on Italian tax laws, considering that the Italian Supreme Court has held that the EU antiabuse doctrine has direct application at the level of domestic tax law and also in the area of direct (income) taxes.

Italy's National Income Tax

In two recent cases, the Italian Supreme Court held that the abuse of law doctrine elaborated at the EU level in the area of VAT law is generally applicable in all areas of Italian tax law to prevent tax avoidance. Further, the Court referred to that doctrine in support of its decision to consider null and void, and to deny the tax benefits of, transactions entered into for the sole purpose of avoiding income tax.

Both cases concerned dividend-washing transactions. In the first case (ruling 20398 (Oct. 21, 2005)), an investment fund sold stock of an Italian company to another Italian company after a dividend had been declared, but before the dividend was distributed, at a price equal to the value of the stock plus the amount of the dividend. The purchaser collected the dividend and immediately thereafter (in accordance with a prearranged plan), it sold the stock back to the fund, realizing a loss.

According to the law in effect at the time, the dividend, if paid to the fund, would have been subject to a gross-basis withholding tax, while any gain realized by the fund through the sale of the stock at a price that included the amount of the dividend was not taxable to the fund. The dividend collected by the purchasing company was taxable income for the purchaser, but the tax was eliminated by the imputation credit granted to the purchaser for an amount equal to the tax paid by the distributing company on the profits out of which the dividend had been distributed.

Therefore, the sole result of the transaction was to avoid the dividend withholding tax on the fund and to provide the purchaser with a loss that could offset other income. The transaction did not provide the opportunity for any economic profits or losses for the parties.

The ECJ's response will have a significant impact on Italian tax laws.

Tax law in effect at the time did not contain any antiavoidance provisions that could challenge that type of transaction. (Article 37 *bis* of Presidential Decree 600 (Sept. 29, 1973), which probably would have voided the transaction, was enacted later.)

The Supreme Court, reversing its earlier decisions on the issue, ruled that the case had to be tested under the abuse of law doctrine as elaborated by the ECJ in *Halifax*, which it said constitutes an underlying tax doctrine with effects at the national law level.

According to the Supreme Court, the abuse of law doctrine compelled it to find legal remedies within domestic law to nullify transactions aimed only at tax avoidance. The Court found those remedies in the general provisions of the Italian Civil Code, which establish that a contractual agreement is null and void if it lacks valid consideration (that is, it does not have economic substance) and is used to circumvent binding provisions of law.

In accordance with those provisions, the Italian Supreme Court held that the arrangement was abusive and should be disregarded, and it treated the purchaser as a mere agent of the fund for the purpose of collecting the dividend payment. The dividend income and capital loss realized by the purchaser of the stock were ignored, and the dividend was subjected to withholding tax as if it had been actually paid to the fund.

The second case (ruling 22932 (Nov. 14, 2005)) had a similar set of facts, except that the owner of the stock was a foreign person. He granted a usufruct right on the stock to an Italian company in exchange for a payment equal to the amount of the dividend declared on the stock. The Italian company collected the dividend and received a credit equal to the tax paid by the distributing company on the underlying profits that offset the tax on the dividend (under the old imputation system).

The foreign person was not subject to withholding tax on the dividend substitute payment received under the usufruct agreement (which was treated as purchase price of the stock).

In accordance with the abuse of law doctrine and domestic civil law provisions that disregard transactions lacking valid consideration and carried out in fraud of law, the Supreme Court disregarded the transaction as abusive and held that the dividend was subject to withholding tax as if it had been paid directly to the foreign person.

Conclusions

If the ECJ responds that the test applies to transactions for which one of the principal purposes (and not the sole purpose) is to avoid tax, the scope and impact of the antiabuse doctrine will be greatly enhanced, and it will add significantly to the array of antiavoidance provisions already available under Italian domestic tax law.

If that is the outcome, taxpayers engaged in tax planning in Italy will be under additional pressure to steer clear of the statutory antiavoidance provisions and the general antiabuse judicial doctrine originating from the ECJ and adopted by the Italian Supreme Court. ◆

♦ *Marco Rossi is a founding member of Marco Q. Rossi & Associati in Italy and New York.*