GROUP LITIGATION AND THE EUROPEAN COURT OF JUSTICE

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Those who keep track of the diary of the European Court of Justice (ECJ) or the Commission's website will have noticed the entry over 2004 and 2005 of a number of pending cases identified only as the Claimants in certain group litigation v Commissioners of Inland Revenue. The United Kingdom national courts, specifically the High Court of England and Wales, have now referred questions in 4 such cases[2] to the ECJ with others possibly to follow. Two have been the subject of opinions with one awaited – all from Advocate General Geelhoed[3]. The fourth awaits hearing[4].

As the names suggest these cases are representative litigation where test cases have been selected by the national court through which answers are sought to questions relevant to the resolution of a number of other similar claims. In consequence the questions referred to the ECJ are longer and perhaps more elaborate than the norm. This article seeks to provide an overview and summary of the issues raised in this litigation and an update of their progress and the possible further references to the ECJ as part of this process.

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2 C-374/04 Test Claimants in class IV of the ACT Group Litigation v Commissioners of Inland Revenue; C-446/04 Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue; C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue; C-201/05 Test Claimants in the CFC and Dividend Group Litigation v Commissioners of Inland Revenue.

3 Opinions of Advocate General Geelhoed in C-374/04 (26th February 2006); C-446/04 (6 April 2006) and C-524/04 (18 May 2006).

4 C-201/05

What is Group Litigation?

The connecting feature of these group litigation actions, and there are now 7 proceeding through UK courts, is that they involve taxpayers seeking compensation from the effects of tax provisions or their application said to be contrary to community law or the terms of double taxation conventions. Their genesis lies in C-997/98 and C-410/98 *Hoechst* and *Metallgesellschaft*. UK subsidiaries of German parent companies faced with a liability to advance corporation tax (ACT) upon the payment of a dividend, in circumstances where the UK subsidiary of a UK parent company could have avoided that liability, sought to contest those provisions not by using the statutory system for appealing a relevant decision of their tax inspector but rather by seeking compensation for the imposition and payment of the ACT as a claim in restitution or damages through the civil courts.

Group litigation is a process in the UK only available in the context of court proceedings. It enables the court to manage multiple claims which raise similar issues of fact or law by drawing them together and selecting from them representative cases through which these common issues can be determined. Only in the context of social security is any similar procedure available under the statutory tribunal system for tax appeals[5] where the process of the assessment by inspectors of individual returns makes marshalling like claims difficult, although not impossible.[6]

The Common Issues

The first notable feature of the group litigation actions therefore is that although they have tax as their subject, they are in fact claims for restitution or damages seeking relief from the consequences of compliance with taxation provisions said to be incompatible with community law. As such they encounter similar defences from the Revenue reflected in virtually identical questions among those referred to the ECJ.

The taxpayers contend that they have suffered loss in a number of ways as the result of the allegedly unlawful provisions. The payment of the unlawful tax is only the most obvious. Where an unlawful tax liability was incurred the taxpayer may instead have utilised reliefs to shelter that liability which reliefs might otherwise have been carried forward or put to alternate use. Thus the taxpayer's

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5 viz reg 7A of the Special Commissioners (Jurisdiction and Procedure) Regulations 1994.

6 A similar approach was adopted by the Special Commissioners in Mars and William Grant using their general power to regulate their procedure.

complaint is not that it paid an unlawful tax but rather that it made other lawful tax payments in later years which it would not have incurred had it not been required to manage the unlawful imposts in earlier years.

Taken to another level of abstraction, the relief which sheltered the allegedly unlawful tax may have been surrendered to the taxpayer by another company in the group who would otherwise have been able to carry it forward. Here the claim becomes that not of the company which suffered the unlawful tax but of its sister: by using its relief in Year 1 to offset an unlawful tax liability of Company A, Company B paid a higher (lawful) tax bill in Year 2 against which that relief would have been available.

Another example appears in the context of the "Thin Cap" Group Litigation. Believing the thin capitalization rules of the UK to be lawful, companies may have taken measures which had the effect of increasing the corporation tax liability of the UK borrowing company in a cross border group such as converting some debt to equity or structuring a loan as interest free or not claiming interest as a deduction[7]. The FII group litigation offers another[8]. The ACT system permitted in certain circumstances, where what was known as a foreign income dividend or FID was paid, the recovery of ACT on the onward distribution of foreign sourced dividend income but without enabling the recipient shareholder to receive the same tax credit as would accompany a distribution of UK sourced income under the UK's imputation system. To maintain the attractiveness of their shares to UK resident investors, many UK public companies therefore enhanced the value of the dividend to its UK resident shareholders to compensate them in cash for the tax credit they would have received upon the distribution of UK income. That enhancement is claimed.

A careful reading of the referred questions reveals the response of the Revenue to these claims. It is common ground that if a claim is restitutionary then the conditions for recovery applicable to *Francovich* (damages) claims do not apply. The claim must simply be repaid. The Revenue however contend that this characterisation applies only to the repayment of cash tax paid where the tax itself is found to contravene community law. Where reliefs were used to shelter that liability or the tax impost which was paid was lawful even though more lawful tax was paid as a consequence of managing the unlawful tax, as in the circumstances above, the Revenue contend that the claim is only in damages. Likewise the other examples given above are, they contend, damages claims.

7 See questions 5 (b) to (d) in C-524/04: OJ C 57, 5.3.05 at p 20

8 See question in 6(ix) in C-446/04: OJ C 6, 8.1.05 at p26

Being damages claims they then maintain that two of the conditions for recovery are not met. The first is that the taxpayer's actions in managing the unlawful liability or in taking steps in reliance upon an expectation that the provisions were lawful, breaks the link between the unlawful provision and the loss. In consequence the breach of community law does not directly cause the loss. Secondly they contend that the breaches of community law occasioned by the UK's provisions, should the ECJ reach such a conclusion, are not sufficiently serious to entitle the claimants to compensation.

For good measure in one of the GLOs, but curiously not others to which the issue might be relevant[9], the Revenue raise the argument that the claimants have failed to mitigate their loss. In addition to claims under community law, the Claimants also claim that aspects of the subject provisions offend the enforceable terms of double taxation conventions (DTCs). Thus the imposition of thin cap restrictions only on cross border groups breaches the non discrimination article of DTCs which incorporate terms similar to article 24(5) of the OECD model as the Conseil d'État concluded in *Andritz SA* and *Coréal Gestion*[10]. They argue that controlled foreign company (CFC) rules offend the allocation of taxing powers article (similar to article 7(1) of the model) again as the same court found in *Schneider Electric*[11]. The Revenue contend in C-524/04 Thin Cap that taxpayers are obliged to complete any such challenges before they are entitled to pursue claims based on community rights.

The ACT Group Litigation

The earliest and largest of the group litigation orders (GLOs) is the ACT group litigation in which, at its height well over 200 company groups participated. Commenced in late 2001 on the application of the Revenue, the ACT GLO is divided into 4 classes. The feature common to the claims is that they are made by the UK subsidiaries of non resident parent companies who seek compensation for the imposition of ACT in circumstances where a UK subsidiary of a UK parent company could have avoided that liability.

9 It is raised in C-524/04 (question 10) but not others.

10 233894 Andritz SA (30th December 2003); 249047 SARL Coréal Gestion (30 December 2003)

11 No 232276 Schneider Electric (28th June 2002).

Although abolished in 1999, the ACT system has been so frequently the subject of references to the ECJ[12] that a description almost seems as redundant as the system itself. From 1972 until 1999 the UK operated a partial imputation system under which a UK resident shareholder received with a dividend from a UK resident company a tax credit equivalent to the basic rate of income tax. The company which paid the dividend was also liable to pay ACT at the same rate. It could then set the ACT against its subsequent corporation tax liability or, if insufficient, carry it forward, sometimes backward or surrender it to subsidiaries for application against their present or future corporation tax liabilities. The mischief with which the ACT GLO is concerned concentrates on the mechanism, known as a group income election, by which a company paying a dividend to a majority corporate shareholder might avoid an incidence of ACT, passing on the requirement to pay it should the recipient then distribute that income. This enabled company groups to incur the ACT liability where it was most tax efficient to do so but was a mechanism only available to UK resident company groups.

Although not specified in the GLO itself the distinctions drawn by the Revenue between claimants has in effect divided the claims into four classes. One distinction drawn is between cross border groups where the parent, resident in another EU Member State, received a tax credit under the terms of its double taxation convention with the UK upon the payment of dividends. Class 1 is claimants whose parents (mostly German or French resident) received no such credit. Although the Revenue accept that the *Hoechst* case is directly referable to such claimants, issues still remain to be resolved concerning the time period over which claims can be brought and the computation of interest. The test case for the former issue is of course the well known *Deutsche Morgan Grenfell* case which has had mixed results in the lower courts and was heard by the House of Lords in July 2006[13] and has been and is likely to be determined purely on the basis of national law uninfluenced by community law considerations.

The latter issue does raise community law arguments. The claimants, successful so far before the lower courts, argue that the principle of effectiveness requires full reparation, namely, compensation to reflect the commercial losses suffered. In other words they wish the damages for the period they were out of pocket for the tax imposed in breach of community law to be calculated at the actual borrowing rates of the claimant and compounded in common with any normal commercial debt. The test case, *Sempra Metals* (the renamed Metallgesellschaft group) whose

12 It has been the subject of 4 references so far: the combined references in C-997/98 and C-410/98 *Hoechst* and *Metallgesellschaft*; C-58/01 *Océ van der Grinten*; C-374/04 *Test Claimants in class IV of the ACT Group Litigation v Commissioners of Inland Revenue*; C-446/04 *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue*

13 [2006] 2 WLR 103 : [2005] 3 All ER 1025 : [2005] STC 329

claim commenced this litigation in 1995, is to be heard in the House of Lords in November 2006. A reference to the ECJ is possible although neither party appears to have requested one at earlier levels, content for the domestic courts to answer these questions from the guidance already supplied[14].

In contrast the claimants in class 2, for whom the Pirelli group is the test case, are the UK subsidiaries of parents resident in other Member States whose parents did receive credits under DTCs. This case asks, in effect, three questions. The first is whether the receipt of tax credits under DTCs was dependent upon the UK subsidiary paying ACT. No reference is made to ACT in the DTCs of course which entitle parent companies to credits on meeting various criteria associated only with the payment of a dividend. As DTCs deal with alleviating economic double taxation it might be logical therefore to associate the credit with the corporation tax on the underlying profits rather than with ACT which was intended only to operate as a temporary tax. Certainly the lower courts unanimously accepted that position but were reversed equally unanimously in February by the House of Lords[15]. To the Lords the UK system recognized only one tax credit which was a credit only available when the company had paid ACT.

This decision of the House of Lords now requires answers to the other two questions previously rendered irrelevant by the lower courts' views on the first. How is compensation to the subsidiary for having paid ACT to be calculated if the parent's credit must be brought into account, and, how does the subsidiary show that it would have exercised a group income election had one been available?

These questions have been remitted to the High Court and a hearing date is awaited. To the taxpayer the questions do raise important issues of community law which may produce a reference to the ECJ. In particular the claimants contend that the claims are restitutionary in nature and as such community law requires repayment without the precondition that the taxpayer show it would have acted differently had the legislation been compliant. To impose such an obligation to prove how taxpayers would have acted over 7 years ago in hypothetical circumstances, they argue, also breaches the principle of effectiveness.

Class 3 comprises company groups parented outside the EU/EEA. They raise two claims. First that the denial of a group income election to a UK subsidiary of a parent resident, relevantly, in the USA, Japan or Switzerland imposes on that subsidiary other or more burdensome tax or requirements than another similar enterprise solely because its capital is owned in that other state thus offending the non discrimination article in the DTC. Next, for ACT liabilities which fell to be

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14 [2006] QB 37 : [2005] 3 WLR 521 : [2005] STC 687

15 [2006] 1 WLR 400 : [2006] 2 All ER 81 : [2006] STC 548

paid after 31st December 1993, they contend that this differential system breaches article 56 EC. The first claim was unsuccessful before the High Court and the Court of Appeal[16]. As to the latter the Court of Appeal have proposed to refer it to the ECJ for a preliminary ruling but only if the House of Lords refuse leave for further appeal. The decision of the Lords on whether or not to permit a further appeal is pending.

Class 4 is of course the subject of the opinion of Advocate General Geelhoed of 26th February 2006 and judgment is awaited. Class 4, as the Advocate General's opinion makes clear, is not concerned with group income elections. The focus of the claim moves from the UK subsidiary to the parent. Where a subsidiary paid a dividend to its UK resident parent the parent received, in addition, a tax credit of – in the most relevant years – 25%. A Dutch resident parent received a 6.875% credit in like circumstances. A French parent received no credit at all. The reference asks whether a system producing those differential results offends community law.

The Loss Relief GLO

Around 70 company groups have brought claims within this GLO for compensation for the inability under the UK's group relief system to surrender the losses of non resident companies within the group to offset the profits of UK members. It has yet to be the subject of a reference to the ECJ for a predictable reason. It awaits further determination of the *Marks and Spencer* case. That case, a statutory tax appeal beyond the group litigation, has recommenced its process through the national courts following the ECJ's judgment last December. When the courts have resolved the issues deriving from that judgment it is likely that further issues of community law will arise in the claims within this GLO.

Some of those issues are likely to have a relevance only to interpreting the functioning of the UK's group relief system in a cross border context. One such issue is how to compute the loss for surrender purposes. Of more general relevance are issues deriving from differing group structures. The *Marks and Spencer* case of course concerned the surrender of the losses of non resident subsidiaries to offset the parent's profits and the ECJ's judgment addressed that circumstance. Should it matter however if the UK profit making company is the subsidiary and the loss maker is the parent or even another subsidiary of a common non-resident EU parent? The Revenue certainly maintain in the context of that litigation that it does indeed matter.

16 [2006] STC 606

An interesting interaction here between community law and double taxation conventions is engaged in this litigation. Assume the circumstance of French and UK resident subsidiaries of a common UK resident parent and the French company is in a position to surrender a loss to its UK sister under the terms of the *Marks and Spencer* ruling. Now assume the same circumstances but where the common parent is in the USA. If the UK then denied group relief would it be imposing other or more burdensome tax or requirements upon the UK subsidiary whose capital was owned in the USA than upon an identical subsidiary of a UK parent? This question is asked in this litigation.

The FII and FID GLOs

The ACT system produced anomalies not just for non resident companies trading through subsidiaries in the UK but also in the reverse circumstances. The UK employs a credit system for alleviating double taxation upon non resident sourced dividend receipts (but an exemption system internally). While ACT was intended only as a temporary tax, it could be used only as a relief against corporation tax liabilities within the UK group. Where therefore a UK parented group earned its profits in non resident subsidiaries which repatriated them to the UK, the onward distribution of those profits to the group's shareholders produced ACT but to the extent that they were taxed at source the credit system took from the scope of available profits against which it could be utilized, the very profits which were distributed. This produced large amounts of long term surplus ACT for groups which traded largely outside the UK and the strange anomaly that the ACT system could only begin to produce in a cross border context a result akin to the domestic, if the group concerned chose to invest only in tax havens. The FID system introduced in 1994 offered some limited mechanism for the recovery of ACT on the distribution of foreign source profits but at the expense of the shareholders' tax credit.

In the FII GLO about 20 UK parented company groups challenge both the UK's differential system for the taxation of dividend income and seek compensation for the incidence of surplus ACT together with other adverse tax effects (such as the example given above). Advocate General Geelhoed's opinion was delivered on 6th April and the Court's ruling is awaited. In the FID GLO over 30 institutional investors seek to reclaim the tax credit not received on the payment of dividends under the FID regime. They also seek for their dividend receipts from non resident companies credits equivalent to those which were available from UK companies in the absence of the FID system. That case currently remains with the UK courts and no doubt also awaits the ECJ's answer in the FII case.

Thin Cap GLO

Around 16 company groups have brought claims contending that they suffered a variety of tax disadvantages as the result of the operation of the UK's thin capitalisation rules on normal commercial transactions such as the provision of finance to make acquisitions or the investment of loans to shore up troubled businesses pending sale, and which were not motivated by the objective of profit stripping to which thin cap provisions are meant to be directed. For example, the main test cases involved loans from France and Sweden not usually recognized as low tax jurisdictions until the submissions of the Member States in this case. The same Advocate General, Geelhoed, delivered his opinion on 29th June 2006 and judgment is also pending.

CFC and Dividend GLO

Awaiting hearing before the ECJ is the reference in this GLO where a group of over 20 company groups challenge the compatibility with community law of the UK's CFC and dividend taxation systems. Much of this reference may be influenced by decisions in the FII and *Cadbury Schweppes* cases yet much will still remain, particularly concerning the compatibility of those regimes in third country contexts. No date for hearing has yet been given.

Finally

Although outside the context of corporate tax the ECJ's ruling in the *Bond House* case[17] has produced another GLO. While HM Revenue and Customs have refunded input VAT withheld pending that ruling on the grounds that the transactions were involved in a fraud to evade VAT, numerous mobile phone traders argue that that is not good enough. They seek *Francovich* damages on the grounds that withholding the VAT repayments caused them to suffer business losses which should be compensated. The case is in its infancy and it remains to be seen whether the UK courts believe it an issue they can answer themselves.

17 Optigen Ltd (C-354/03), Fulcrum Electronics Ltd (C-355/03), Bond House Systems Ltd (C-484/03) v Commissioners of Customs & Excise