CFC REFORMS IN THE UK – SOME EU LAW COMMENTS[1]

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In July 2011, the UK Treasury and Revenue issued a second consultation document on the reform of the UK's CFC rules.[3] In Annex I of the document, the UK Government set out its understanding of the relevant ECJ case law in this area. It highlighted the impact and relevance of the *Cadbury Schweppes* judgment of the ECJ [4] for these reforms and indicated the importance of the *SGI* [5] and *Thin Cap GLO*[6] judgments for understanding the concepts of justification and proportionality. In this article the author makes some comments on the EU law aspects of the proposed CFC reforms.

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1 Before articles have been accepted for publication in EC Tax Journal's peer-reviewed section, they have been subject to double-blind peer-review; that is, two academic reviewers who shall remain anonymous to the author and to each other and neither of whom are from the same country as the author have evaluated the article's academic merit. Only articles confirmed by the reviewers to show the highest standards of scholarship are accepted for publication in this section.

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3 Consultation on Controlled Foreign Companies (CFC) Reform, (Her Majesty's Treasury, London, June 2011). ISBN 978-1-84532-892-4. Available at http://www.hm-treasury.gov.uk/d/consult_cfc_detailed_proposals.pdf (last visited 10 Feb. 2012).

4 ECJ, 12 Sep. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* ("*Cadbury Schweppes*"), [2006] ECR I-7995.

5 ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle v Belgian State ("SGI*"), [2010] ECR I-487.

6 ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue ("Thin Cap GLO")*, [2007] ECR I-2107.

Introduction

The UK's CFC rules were challenged in *Cadbury Schweppes* and the ECJ held that it was a matter for the UK courts to determine whether the so-called "motive test" could be interpreted in such a way that the taxation provided under the UK's CFC regime could be restricted to "wholly artificial arrangement" situations. The judgment of the ECJ in *Cadbury Schweppes* was subsequently applied by the UK courts in *Vodaphone 2*,[7] where the Court of Appeal determined that the UK's CFC rules could be interpreted in a way which ensured EU law was respected by reading into the legislation an additional exception: "if the CFC is, in that accounting period, actually established in another member state of the EEA and carries on genuine economic activities there". Accordingly, the UK's rules could be interpreted in a way that ensured the freedom of establishment was guaranteed. This conforming interpretation approach adopted by the Court of Appeal appears to be correct. The UK legislation, therefore, needed to be amended and with the switch to a more territorial system for taxing foreign profits, the CFC rules were in need of reform. Hence, the current consultation process on the proposed reforms.

Annex I

Annex I of the consultation document sets out a brief, clear, statement of the UK Government's understanding of the relationship between EU law and CFC rules and of the jurisprudence of the ECJ in the area of anti-avoidance rules (CFC, thin capitalisation and transfer pricing).

The inclusion of Annex I in the consultation document is refreshing and to be welcomed. As is clear from *Cadbury Schweppes*, the UK CFC rules interact with the freedom of establishment. Therefore, it is important when designing new CFC rules to ensure that they comply with EU law, otherwise, problems are simply being stored-up for the future with further litigation being a distinct possibility. For instance, in May 2011, the European Commission issued a reasoned opinion[8] to the UK indicating that it considers that the UK's response to the *Cadbury Schweppes* judgment is inadequate and that further remedial measures are required.

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7 *Vodafone 2 v The Commissioners for her Majesty's Revenue and Customs ("Vodafone 2")*, [2010] 2 WLR 288, available at: URL: *http://www.bailii.org/ew/cases/EWCA/Civ/2009/446.html* (last visited 10 Feb.2012).

8 See Commission requests UK to further amend its treatment of controlled foreign corporations (CFCs), Case No 2009/4105, IP/11/606 of 19/05/2011. The Commission argues that the UK's post-*Cadbury Schweppes* rules continue to breach the freedom of establishment because they "fail to exclude from the CFC regime all subsidiaries established in EU/EEA Member States which are not purely artificial and are not involved in profit-shifting transactions".

Therefore, it is imperative to get the new CFC regime right and ensure that it is "EU-proof" and complies fully with EU law and the jurisprudence of the ECJ.

This article is divided into four parts. Part I looks at the improper use of EU law. Part II examines the concept of "wholly artificial arrangements". Part III analyses in some detail the approach of the Court of Appeal in *Thin Cap GLO CA* and Part IV offers some conclusions.

Part I - Improper use of EU law

The discussion of the judgment of the ECJ in *Cadbury Schweppes* is a useful starting point. Paragraph I.4 of the consultation document sets out the understanding of the UK Government on what *Cadbury Schweppes* established. However, it should be highlighted that this paragraph fails to mention a number of key findings of the ECJ that are important for understanding its jurisprudence concerning national anti-avoidance rules, such as CFC regimes.

In *Cadbury Schweppes*, the ECJ pointed out that "nationals of a Member State cannot attempt, under cover of the rights created by the Treaty, improperly to circumvent their national legislation. They must not improperly or fraudulently take advantage of provisions of Community law".[9] However, the Court explained that "the fact that a Community national, whether a natural or a legal person, sought to profit from tax advantages in force in a Member State other than his State of residence cannot in itself deprive him of the right to rely on the provisions of the Treaty"[10] and that "the fact that the company was established in a Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse of that freedom".[11] Therefore, there is a difference between a UK company setting up a subsidiary (CFC) in another Member State which conducts genuine economic activities and a UK company setting up a subsidiary (CFC) involving arrangements which artificially divert profits from the UK. In the former situation, the UK cannot tax the UK parent company on the profits of the CFC whereas in the latter situation it can.

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9 *Cadbury Schweppes* paragraph 35. For a detailed analysis of the *Cadbury Schweppes* judgment, see *"The UK's CFC rules and the freedom of establishment: Cadbury Schweppes plc and its IFSC subsidiaries – tax avoidance or tax mitigation?"* EC Tax Rev., 2007, 1, 13-33.

10 *Cadbury Schweppes* paragraph 36.

11 *Cadbury Schweppes* paragraph 37.

Thin Cap GLO

The ECJ repeated these important background comments in *Thin Cap GLO* (paragraph 73) where the Court highlighted that the mere fact that "a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty".

RBS Deutschland [12]

Similarly, in the sphere of VAT, in *RBS Deutschland*, the ECJ has accepted that "taxable persons are generally free to choose the organisational structures and the form of transactions which they consider to be most appropriate for their economic activities and for the purposes of limiting their tax burdens" [13] and that "a trader's choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations relating to the neutral system of VAT … [and that]… "where it is possible for the taxable person to choose from among a number of transactions, he may choose to structure his business in such a way as to limit his tax liability".[14]

Halifax

In *Halifax*,[15] the ECJ set out its test for abusive practices (in paragraphs 74 and 75), indicating that an abusive practice in the sphere of VAT can be found to exist only if, first, the transactions were contrary to the purpose of the VAT directive and the national legislation transposing it and second, that "it must be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage". The Court went on to stress that "the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages".

This approach was followed in *Cadbury Schweppes* where the Court noted that "the mere fact that a resident company establishes a secondary establishment, such

12 ECJ, 22 Dec. 2010, Case C-277/09, *The Commissioners for Her Majesty's Revenue & Customs v RBS Deutschland Holdings GmbH (RBS Deutschland),* [2010] ECR I-0000 (not yet reported).

13 *RBS Deutschland* paragraph 53.

14 *RBS Deutschland* paragraph 54.

15 ECJ, 21 Feb. 2006, Case C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd and County Wide Property Investments Ltd v Commissioners of Customs & Excise ("Halifax"),* [2006] ECR I-1609.

as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom".[16]

Some tax avoidance is acceptable to the ECJ

These background comments are important because they show that the ECJ does not outlaw cross-border tax avoidance entirely. Cross-border tax avoidance involving "tax mitigation" is clearly acceptable to the ECJ and forms part of the backdrop to understanding the limitations placed on the design of national anti-avoidance rules when national tax rules come into conflict with EU law, in particular the fundamental freedoms. However, genuine exercise of the freedoms is required.

"Visa planning"

By way of analogy, an example is seen in *Chen* [17] which involved "visa planning" rather than tax planning. This case involved Chinese nationals – a husband and wife - who worked for a business established in China. Mr Chen travelled regularly to the UK. In May 2000, Mrs Chen entered the UK when she was six months pregnant. She went to Belfast, Northern Ireland, in July 2000 where her child, Catherine, was born in September 2000. Claiming citizenship under the then Republic of Ireland nationality law, Catherine applied for an Irish passport because, at that time, anyone born on the island of Ireland was entitled to become an Irish citizen. Catherine was not entitled to British citizenship, even though she was born in Belfast. Consequently, Catherine was issued with an Irish passport. The ECJ noted that it was common ground that "Mrs Chen took up residence in the island of Ireland in order to enable the child she was expecting to acquire Irish nationality and, consequently, to enable her to acquire the right to reside, should the occasion arise, with her child in the United Kingdom".[18]

The ECJ then dealt with the abuse of the EU freedom of movement arguments put forward by the UK which referred to the "arrangements" put in place by Mrs Chen to secure Irish nationality for her child and, indirectly, a right of residence in the UK for herself as the child's primary carer. The ECJ examined the motives of the Chen family and noted that Mrs Chen admitted that the purpose of her stay in the UK was to create this situation so that she and her child could access EU law rights. However, as the acquisition and loss of nationality was a matter for each

16 *Cadbury Schweppes* paragraph 50.

17 ECJ, 19 Oct. 2004, Case C-200/02, *Kunqian Catherine Zhu and Man Lavette Chen v Secretary of State for the Home Department ("Chen")*, [2004] ECR I-9925.

18 *Chen* paragraph 11.

Member State, and as the legality of Catherine's Irish nationality had never been challenged, it was not "permissible for a Member State to restrict the effects of the grant of nationality of another Member State". Consequently, Catherine was entitled to reside in the UK as an EU national with sufficient resources to prevent her becoming a burden on the UK. Moreover, a refusal to allow the parent (whatever her nationality) and primary carer to reside with Catherine "would deprive the child's right of residence of any useful effect". Catherine was, accordingly, entitled to be accompanied by her primary carer who was also entitled to a right of residence in the UK for the duration of Catherine's residence.

Motive

The *Chen* case demonstrates that as long as there is a genuine exercise of the fundamental freedoms, the motives behind the exercise of those freedoms will not necessarily jeopardize their use in order to circumvent national rules. It seems clear that the arrangements put in place in the *Chen* case were a "pure" scheme (or a series of steps) to achieve residency in the UK for Mrs Chen. In other words, the exercise of the fundamental freedom or acquiring of a right of residency can be carried out for reasons which appear to be inappropriate to a Member State because the Member State's rules prevent the right of residency. However, all such rules of the EU Member States must be measured against the EU's internal market rules and the principle of proportionality.

In *Cadbury Schweppes*, the Court followed this thinking by rejecting the motives of the UK parent company as being abusive when it set up its subsidiaries in Ireland, even though the "arrangements" were put in place to obtain a tax advantage. The Court expressly indicated in *Cadbury Schweppes* [19] that in order for the legislation on CFCs to comply with EU law, "the taxation provided by that legislation must be excluded where, despite the existence of tax motives, the incorporation of the CFC reflects economic reality". Accordingly, "the extent to which the CFC exists in terms of premises, staff and equipment" [20] becomes important in determining whether the CFC is a real establishment as opposed to a "letterbox" or "front" subsidiary which are seen by the ECJ as wholly artificial arrangements.

19 *Cadbury Schweppes* paragraph 65.

20 *Cadbury Schweppes* paragraph 67.

Barbier

A similar approach can be seen in *Barbier*,[21] where the taxpayer took advantage of the favourable Dutch tax rules relating to splitting the legal and financial ownership of immovable property, for tax planning/ tax mitigation/ tax avoidance reasons. The motives behind the transactions and/or the use of the freedoms in both instances were to obtain tax advantages. Yet, the ECJ allowed such practices as long as the actual exercise of the fundamental freedom in question was properly exercised.

Genuine economic activity

These cases demonstrate that "tax planning" or "tax mitigation" can take place using EU law rights as long as the planning involved ensures that the objective of the rules in question are met and as long as there is genuine activity, establishment, capital movement, service, etc. carried out, and "wholly artificial arrangement" situations are avoided. It is also perfectly acceptable in the eyes of the ECJ for a taxpayer to arrange its affairs in such a way as to minimise taxation.

Part II - Wholly artificial arrangements

Paragraphs I.8 - I.14 of the consultation document contain an important discussion concerning the concept of "wholly artificial arrangements". The view of the UK Government is that the term "wholly artificial arrangements" refers to arrangements that do not relate to genuine economic activities pursued through an actual establishment in the host Member State; that a UK parent company will not have genuinely exercised its freedom of establishment if the CFC is itself a "wholly artificial arrangement" and that CFC rules constitute a justified restriction on the freedom of establishment so long as they only tax those profits that are attributable to "wholly artificial arrangements". In other words, the view of the UK Government is that the profits of the CFC can be apportioned, with the UK taxing the profits of the UK parent company on any CFC profits that are attributable to artificial diversion of profits from the UK. This appears to be a correct understanding of the jurisprudence.

Thin Cap GLO

Support for this thinking is found in *Thin Cap GLO* (paragraph 81), where the ECJ accepted that the fact that a resident company has been granted a loan by a non-

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21 ECJ, 11 Dec. 2003, Case C-364/01, *The heirs of H. Barbier v Inspecteur van de Belastingdienst Particulieren/ Ondernemingen buitenland te Heerlen ("Barbier")*, [2003] ECR I-15013.

resident associated company on terms which were not at arm's length constituted an objective element which can be independently verified in order to determine whether the transaction represented, *in whole or in part,* a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State. Moreover, in paragraph 83, the Court insisted that the re-characterisation of interest paid as a distribution must be limited to the proportion of that interest which exceeds what would have been agreed at arm's length.

SGI

Paragraph I.13 draws on the ECJ's judgment in *SGI* to find further support for the apportionment notion, highlighting that the ECJ held that transfer pricing rules tax profits that relate only to wholly artificial arrangements to the extent that they do not relate to arrangements that would have been made under "fully competitive conditions". Paragraph I.14 stresses that in both *SGI* and *Thin Cap GLO,* the ECJ explicitly noted that the independent enterprise approach to the arm's length principle as set out by the OECD in, for example, its Transfer Pricing Guidelines, constituted a suitable means of determining "wholly artificial arrangements". Given that paragraph 72 of *SGI* applies the same test as that seen in paragraph 81 of *Thin Cap GLO*, there can be no argument with this approach.

However, the problem arising from Annex I relates to the assumption that a "wholly artificial arrangement" equates simply to that beyond what would have been agreed between the parties acting at arm's length. This analysis fails to take into account the wording of the ECJ's judgments in *Thin Cap GLO* and *SGI,* in particular, the clear wording of the proportionality test. A comprehensive statement of the law appears to have been set out in point 67 of Advocate General Geelhoed's Opinion in *Thin Cap GLO*. His two prong proportionality test appears to have been applied by the ECJ in its judgment in *Thin Cap GLO* and in its subsequent *SGI* judgment. Significantly, the ECJ approved the comments of Advocate General Geelhoed in *Thin Cap GLO* (paragraph 82).

Two-prong proportionality test

The analysis adopted in paragraphs I.8 – I.14 of the consultation document focuses mainly on the second part of the two-prong proportionality test set out in paragraphs 71 and 72 of *SGI* and paragraphs 82 and 83 of *Thin Cap GLO* respectively. It fails to take into account the first part of that test. This appears to be a significant flaw in the understanding of the EU law in this area. This statement of EU law (and the interpretation of the jurisprudence of the ECJ in this area) seems to be based on the judgment of the English Court of Appeal in *Thin*

Cap GLO CA,[22] which represents the law of the UK at this moment in time.[23] A review of the *Thin Cap GLO CA* judgment is therefore necessary.

Acte clair

After the delivery of the judgment of the ECJ in *Thin Cap GLO*, the matter returned to the High Court and, subsequently, the Court of Appeal for judgment and review respectively. Whilst Henderson J. in the High Court in *Thin Cap GLO HC*,[24] decided the principal issue in favour of the claimants' interpretation, the Court of Appeal, by a 2-1 majority, decided in favour of the UK Revenue. Paragraphs I.8-I.14, therefore, express the interpretation of EU law as stated by the majority of the Court of Appeal in *Thin Cap GLO CA*.

Furthermore, an appeal by the claimants was refused by the Supreme Court in an order dated the 28 June 2011 on the grounds that the provision in question had already been interpreted by the ECJ in *SGI* and that "the correct application of Community law is obvious as to leave no scope for any reasonable doubt". In other words, the matter was acte clair so no further reference to the ECJ was required.

The majority of the Court of Appeal in *Thin Cap GLO CA* made it clear that the arm's length test was sufficient to determine the concept of wholly artificial arrangement and that no separate test of commercial justification was required by paragraph 71 of *SGI* and paragraph 82 of *Thin Cap GLO*. The decision of the Court of Appeal was by a 2-1 majority. The minority judgment delivered by Arden LJ agreed with the judgment of the High Court judge on the principal issue which concerned the interpretation of the proportionality test in *Thin Cap GLO* and whether a separate "commercial justification" assessment was required following a finding that the arm's length test had not been met.

It is highly arguable that the majority judgments in *Thin Cap GLO CA* misunderstood the case law of ECJ in this area. Accordingly, these issues are

22 *Test Claimants in the Thin Cap Group Litigation v Commissioners for Her Majesty's Revenue and Customs* ("*Thin Cap GLO CA*"), [2011] STC 738.

23 The Supreme Court denied the Claimants' application for permission to appeal the decision of the Court of Appeal to the Supreme Court.

24 *Test Claimants in the Thin Cap Group Litigation v Commissioners for Her Majesty's Customs and Excise* ("*Thin Cap GLO HC*"), [2010] STC 301.

discussed in some detail in the following sections because of the impact that this misunderstanding may have on the reform of the CFC rules.[25]

The Proportionality test in *Thin Cap GLO*

In paragraph 77 of *Thin Cap GLO*, the ECJ made it clear that the UK's thin capitalisation legislation was able to prevent practices "the *sole purpose* of which is to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory" (emphasis added). The Court went on to explain that the fact that the loan was not granted on arm's length terms constituted "an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State".[26] Thus, the arm's length test is an objective criterion against which to judge whether or not the transaction in question is a wholly artificial arrangement. However, it is the next paragraph of *Thin Cap GLO* (paragraph 82) that is important. Note the phrase "sole purpose", (highlighted above in paragraph 77). This is discussed in more detail below in Part III.

In paragraph 82 of *Thin Cap GLO*, the ECJ pointed out that "national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement, *entered into for tax reasons alone*, is to be considered as not going beyond what is necessary to prevent abusive practices where, in the first place, on each occasion on which such an arrangement cannot be ruled out the taxpayer *is given an opportunity... to provide evidence of any commercial justification* that there may have been for that arrangement" (emphasis added). Two particular phrases (highlighted) in this paragraph should be noted: the purely artificial arrangement must be entered into for tax reasons alone and whenever the existence of an artificial arrangement is demonstrated by the tax authorities, the taxpayer must be given an opportunity to provide evidence of any commercial justification for the arrangement.

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25 It has already been pointed out by this author that the UK's Supreme Court should have been more mindful of the Court's comments in *CILFIT* paragraph 16, where the ECJ pointed out that before it comes to the conclusion that the matter is acte clair "the national court or tribunal must be convinced that the matter is equally obvious to the courts of the other Member States and to the Court of Justice. Only if those conditions are satisfied, may the national court or tribunal refrain from submitting the question to the Court of Justice and take upon itself the responsibility for resolving it". The ECJ went on to highlight in *CILFIT* paragraph 20 that "every provision of Community law must be placed in its context and interpreted in the light of the provisions of Community law as a whole, regard being had to the objectives thereof and to its state of evolution at the date on which the provision in question is to be applied".

26 *Thin Cap GLO* paragraph 81.

In paragraph 83 of *Thin Cap GLO*, the Court moved on to the second aspect of the proportionality test, relating to the re-characterisation of the interest payments. The Court specifically referred to the situation where the consideration of the objective elements (referred to in the preceding paragraphs) led to the conclusion that the transaction in question represented a purely artificial arrangement *without any underlying commercial justification*. The highlighted phrase "without any commercial justification" refers back to what had to be shown by the taxpayer in the previous paragraph to rebut the presumption that a wholly artificial arrangement existed (because the arm's length test had been breached). It is this failure to demonstrate some commercial justification for the arrangements that triggers the second aspect of the proportionality assessment.

Paragraphs 86 and 87 of *Thin Cap GLO* also contain references to "entered into for tax reasons alone" and "evidence as to any commercial justification". Interestingly, the opportunity to provide commercial justification comes into play "if their transactions did not satisfy the conditions laid down under the DTC in order to assess their compatibility with the arm's-length criterion". In other words, it is clear from the wording of the judgment in *Thin Cap GLO,* that it was first a matter for the tax authorities to demonstrate that a purely artificial arrangement had taken place. This could be achieved through the use of an objective criterion such as the arm's length test. If the transaction in question did not comply with the arm's length principle, then that constituted evidence of a wholly artificial arrangement, entered into for tax reasons alone.

Jobra

Support for this reasoning is found in the Court's subsequent case law, such as *Jobra* [27] where the Court indicated that the burden of proof, in establishing a prima facie case that an artificial arrangement existed, rested with the tax authorities [28] and that the taxpayers had to be given the opportunity "to adduce evidence that no abuse is taking place". The same line of reasoning is adopted by the Court in *Tankreederei* [29](Case C-287/10), where the Court pointed out that as regards "the need to prevent abuse, it is true that it is apparent from settled case-law that a restriction on the freedom to provide services can be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and whose only purpose is to obtain a tax advantage". [30] The Court went on to point

27 ECJ, 4 Dec. 2008, Case C-330/07, *Jobra Vermögensverwaltungs-Gesellschaft mbH v Finanzamt Amstetten Melk Scheibbs ("Jobra"),* [2008] ECR I-9099.

28 See *Jobra* paragraph 38.

29 ECJ, 22 Dec. 2010, Case C-287/10*, Tankreederei I SA v Directeur de l'administration des contributions directes ("Tankreederei"),* [2010] ECR I-0000 (not yet reported).

30 *Tankreederei* paragraph 28.

out that “the national provision at issue … affects every undertaking which uses capital goods in the territory of a Member State other than … Luxembourg, and does so even where nothing … points towards the existence of such an artificial arrangement.[31]

Lammers and Van Cleeff

In *Lammers and Van Cleeff,* [32] a case involving German thin capitalisation rules decided after *Thin Cap GLO*, the ECJ recalled that the “mere fact that a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty”. [33] In dealing with the proportionality issue, the Court stressed that “it is apparent from the order for reference that the interest payments made by the Belgian subsidiary on a loan granted by a non-resident company which is a director were reclassified as dividends because the limit laid down in the second indent of Article 18(1), point 3, of the ITC 1992 had been exceeded, that is to say, at the beginning of the taxable period the total of the interest-bearing loans was higher than the paid-up capital plus taxed reserves”.[34] However, the Court pointed out that “even if the application of such a limit seeks to combat abusive practices, it goes in any event beyond what is necessary to attain that objective [35] … [because] Article 18(1), point 3, of the ITC 1992 also affects situations in which the transaction concerned cannot be regarded as a purely artificial arrangement. If interest payments made to non-resident companies are reclassified as dividends as soon as they exceed such a limit, it cannot be ruled out that that reclassification will also apply to interest paid on loans granted on an arm’s length basis”.[36] In other words, if the arrangements in question are not artificial in nature, then the thin cap rules cannot be used to justify the restriction on the freedom of establishment. It seems clear that if such loans are acceptable domestically, then they should also be acceptable cross-border in the absence of wholly artificial arrangements.

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31 *Tankreederei* paragraph 29.

32 ECJ, 17 Jan. 2008, Case C-107/07, *Lammers & van Cleeff NV v The Belgian State (“Lammers and van Cleeff”),* [2008] ECR I-173.

33 *Lammers and van Cleeff* paragraph 27. Interestingly, this case is not discussed in *Thin Cap GLO CA*.

34 *Lammers and van Cleeff* paragraph 31.

35 *Lammers and van Cleeff* paragraph 32.

36 *Lammers and van Cleeff* paragraph 33.

Commercial justification

In order for the UK rules in *Thin Cap GLO* to comply with EU law, however, they still had to comply with the principle of proportionality. According to the Advocate General and the ECJ in *Thin Cap GLO*, this meant that the taxpayer had to be given an opportunity to provide evidence of any commercial justification for the arrangement in question. Commercial justification for the arrangements would take the matter out of the realm of "wholly artificial arrangements", designed with the sole purpose to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory and would rebut the presumption that a wholly artificial arrangement existed. Such arrangements clearly would not be arrangements "entered into for tax reasons alone" because a commercial rationale for them beyond that of tax advantages would have been shown to exist. Moreover, the demonstration of some commercial justification for the arrangements in question would take such arrangements outside the scope of the justification for the national rules in combating abusive practices. This seems clear from the wording of paragraph 83 of *Thin Cap GLO*.

There is also support for this thinking in the *CFC and Dividend GLO,* [37] decided by the ECJ subsequent to *Thin Cap GLO* by way of a reasoned Order, where the Court highlighted that in relation to the UK's CFC rules that "a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements, which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory".[38] Here, again, the Court refers to artificial arrangements "which do not reflect economic reality", indicating that if they reflect economic reality then they are not wholly artificial arrangements and, as such, the national anti-abuse rules are incapable of justifying a restriction on a fundamental freedom in such circumstances. In paragraph 79 of *CFC and Dividend GLO*, this is confirmed by the Court when it states that "in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality. That finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment". This was the ECJ simply applying its *Cadbury Schweppes'* reasoning outlined above.

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37 ECJ, 23 Apr. 2008, Case C-201/05, *The Test Claimants in the CFC and Dividend Group Litigation v Commissioners of Inland Revenue ("CFC and Dividend GLO"),* [2008] ECR I-2875.

38 *CFC and Dividend GLO* paragraph 77.

The crux of the issue in these thin cap cases appears to be a failure to accept a genuine loan (or the establishment of a legitimate subsidiary in a CFC rule situation) in a cross-border situation, which is perfectly acceptable in a domestic environment. The jurisprudence of the ECJ indicates that a Member State is entitled to have national anti-avoidance rules that protect against tax avoidance involving wholly artificial arrangements or which involves some artificial diversion of profits / taxable income from that Member State which affect the balanced allocation of taxing rights between the Member States. But the national rules may not go beyond preventing such "wholly artificial arrangements". If such rules do not meet both prongs of the *Thin Cap GLO* proportionality test, then they cannot constitute a justification acceptable to the ECJ.

In *Thin Cap GLO*, the Court highlighted that "the fact that a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty" (paragraph 73 of *Thin Cap GLO*) but explained that in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, "the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory" (paragraph 74 of *Thin Cap GLO*). The fact that commercial justification has been shown takes the arrangements out of the "do not reflect economic reality" category and, therefore, outside the scope of the justification.

Transfer Pricing - *SGI*

The ECJ's decision in *SGI* does not appear to change matters.

SGI involved transfer pricing rather than thin capitalisation rules. The Court again noted that in relation to the prevention of tax avoidance, a national rule restricting the freedom of establishment may be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned (paragraph 65 of *SGI*). Further, the Court accepted that "to permit resident companies to transfer their profits in the form of unusual or gratuitous advantages to companies with which they have a relationship of interdependence that are established in other Member States may well undermine the balanced allocation of the power to impose taxes between the Member States" (paragraph 63 of *SGI*). The Court went on to explain that "national legislation which is not specifically designed to exclude from the tax advantage it confers such purely artificial arrangements – devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory – may nevertheless be regarded as justified by the objective of preventing tax avoidance, taken together with that of preserving the balanced allocation of the power to impose taxes between the Member States" (paragraph 66 of *SGI*).

The Court pointed out that these corrective tax measures were necessary because otherwise there was a risk that "*by means of artificial arrangements*, income transfers may be organised within companies having a relationship of interdependence towards those established in Member States applying the lowest rates of taxation or in Member States in which such income is not taxed" (paragraph 67 of *SGI*). By providing that the resident company is to be taxed in respect of any unusual or gratuitous advantages granted to an associated company established in another Member State, the Belgian rules at issue were able to combat such practices which the Court noted were "*designed only to avoid the tax normally due* in the Member State in which the company granting the advantage has its seat" (paragraph 68 of *SGI*). Note the focus of the Court is on "artificial arrangements" and the fact that granting of the unusual or gratuitous advantages to the connected company was "designed only to avoid the tax normally due". The Court concluded that such anti-avoidance rules were appropriate for achieving their objective. However, whether such rules were proportionate was the next matter to be decided.

Proportionality - *SGI*

The Court sets out its proportionality requirements in paragraphs 71 and 72 of *SGI*. Significantly, these paragraphs are worded in almost the same terms as paragraphs 82 and 83 of *Thin Cap GLO*.

In paragraph 71 of *SGI*, the Court applied the first prong of the *Thin Cap GLO* proportionality test, indicating that national legislation which provides for a consideration of "objective and verifiable elements *in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons,* is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance where, first, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide *evidence of any commercial justification* that there may have been for that transaction" (emphasis added). Again, the focus of the Court is on "artificial arrangement" and "entered into for tax reasons" and the provision of "evidence of any commercial justification" once the arm's length test has not been met.

The second prong of the proportionality test in paragraph 72 of *SGI* echoes paragraph 83 of *Thin Cap GLO* but differs to a certain extent. The Court points out that "where the consideration of such elements leads to the conclusion that the transaction in question goes beyond what the companies concerned would have agreed under fully competitive conditions, the corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence". In other words, where the transaction in question goes beyond what would have been agreed at arm's length, the corrective tax measure must be limited to what would have been agreed at arm's length.

In the following paragraph (73) of *SGI*, the Court sets out how the Belgian rules at issue are applied by the tax authorities and notes that the taxpayer is given a month to demonstrate that no unusual or gratuitous advantage is involved. If the tax authorities reject the taxpayer's arguments, the taxpayer can challenge the assessment before the national courts. The ECJ made it clear that it was a matter for the Belgian national court to verify whether the two legs of the proportionality principle were respected by the Belgian regime.

It seems clear from paragraphs 71 and 72 of *SGI* that the Court is applying the same proportionality test in *SGI* that it applied in *Thin Cap GLO*. Clearly, different national anti-avoidance rules are at stake. However, in both *SGI* and *Thin Cap GLO*, the Court insisted that "the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that arrangement" (paragraph 71 of *SGI* and paragraph 82 of *Thin Cap GLO*). Indeed, the same phrase is used in paragraph 84 of the *CFC and Dividend GLO* that was decided by way of a reasoned order.
Given that the majority judgments of the English Court of Appeal did not follow this line of reasoning, the next Part examines in detail the judgments in *Thin Cap GLO CA* in which the Court of Appeal applied the guidance given by the ECJ in *Thin Cap GLO* and interpreted, for the first time, the *SGI* decision.

Part III – The judgments in the *Thin Cap GLO CA* – an analysis

Lord Justice Stanley Burnton delivered the main judgment of the majority in the Court of Appeal. He pointed out that the ECJ had delivered two significant judgments since Henderson J. gave his judgment in the *Thin Cap GLO* (High Court) which would have affected his decision, namely, *Oy AA*[39] (this had not been cited) and *SGI*. An analysis of this judgment is, therefore, of the greatest importance.

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39 ECJ, 18 July 2007, Case C-231/05, *Oy AA,* [2007] ECR I-6373.

The judgment starts to unravel in paragraph 40 when Stanley Burnton LJ links "purely artificial arrangements" to "sham transactions" (in paragraph 42) because this led to a discussion that the UK's thin cap rules should be able to deal with a loan which does not involve an "artificial arrangement" in circumstances where "the corporation tax rate applicable to the profits of the parent is significantly lower than the rate applicable to the UK subsidiary's profits". This is a flaw in the understanding of the ECJ's case law concerning tax avoidance, in particular, the notion of "wholly artificial arrangements designed to circumvent the national tax system" which is the ECJ's understanding of the concept of "tax avoidance".[40]
Stanley Burnton LJ continued in paragraph 40: "The loan is not "a purely artificial arrangement", yet surely it is a legitimate, and should be a permissible, object of thin cap legislation?" The answer to this question is yes, if the UK is operating outside the constraints of EU law. However, the answer is no if EU law is applicable. This can be explained by the "migrant/non-migrant" (or national treatment) test applied by the ECJ which all EU Member States must respect.

National treatment test

The national treatment test is clearly set out in *De Groot* paragraph 94, where the ECJ highlighted that "as far as the exercise of the power of taxation so allocated is concerned, the Member States must comply with the Community rules ... and, more particularly, respect the principle of national treatment of nationals of other Member States and of their own nationals who exercise the freedoms guaranteed by the Treaty".[41]

The *Thin Cap GLO* case concerned the different treatment of two UK companies, one of which exercised the freedom of establishment and, as a consequence, suffered detrimental tax treatment amounting to a restriction on the freedom of establishment.[42] In other words, the UK's thin cap legislation breached the national treatment principle in respect of a UK company with an establishment in another

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40 See paragraph 26 of *ICI v Colmer* where the Court stated that "[a]s regards the justification based on the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment." The Court applies this understanding of "tax avoidance" in subsequent cases. ECJ, 16 Nov. 1998, Case C-264/96, *Imperial Chemical Industries (ICI) v Kenneth Hall Colmer (Inspector of Taxes),* [1998] ECR I-4695.

41 *De Groot* paragraph 94.

42 See *Thin Cap GLO* paragraph 63.

EU Member State. The ECJ explained that such a restriction was permissible if it was justified by overriding reasons of public interest. The UK argued that its thin cap rules were justified by the need to prevent tax avoidance, in particular, tax avoidance consisting of artificial arrangements designed to circumvent the UK's tax system.

Justification

Whilst the ECJ accepted in *Thin Cap GLO* that a restriction on the freedom of establishment could be justified where it specifically targeted wholly artificial arrangements designed to circumvent the legislation of the Member State concerned, it pointed out that the mere fact that a resident company was granted a loan by an associated company established in another Member State "cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty".[43] In other words, in an EU context, thin capitalisation rules amount to a restriction on the freedom of establishment in an EU context unless they fall within an acceptable justification.

Conduct

The ECJ went on to explain that in order for such a restriction to be justified on the ground of preventing abusive practices, "the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on the national territory".[44] This type of "conduct" was such as to undermine "the right of the Member States to exercise their tax jurisdiction in relation to activities carried out in their territory and thus jeopardise a balanced allocation between Member States of the power to impose taxes".[45] It is important to note that the conduct in question relates to "wholly artificial arrangements which do not reflect economic reality". This is highlighted again by the Court in the proportionality segment of the *Thin Cap GLO* judgment discussed above.

Balance in the allocation of taxing rights

Stanley Burnton LJ in *Thin Cap GLO CA*[46] focused on paragraph 62 of *Oy AA*, where the ECJ noted that "[c]onduct involving the creation of wholly artificial

43 *Thin Cap GLO* paragraph 73.

44 *Thin Cap GLO* paragraph 74.

45 *Thin Cap GLO* paragraph 75.

46 See paragraph 44 of *Thin Cap GLO CA*.

arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory is such as to undermine the right of the member states to exercise their tax jurisdiction in relation to those activities and jeopardise a balanced allocation between member states of the power to impose taxes." He argued that it was difficult to reconcile the judgment in *Oy AA* with that delivered in *Thin Cap GLO*. He commented that the Finnish legislation did not target purely artificial arrangements.

Stanley Burnton LJ then went on to analyse the *SGI* judgment of the ECJ and pointed out that the Belgian legislation was upheld even though it was not limited to purely artificial arrangements. In paragraph 57 of *Thin Cap GLO CA*, he concluded that "[l]egislation that involves the application of the arm's length test, as embodied in Article 9 of the OECD Model Convention, does not unlawfully interfere with Article 43 EC, provided the taxpayer is given an adequate opportunity to present his case to the tax authority that the transaction in question was on arm's length terms, and may challenge the decision of the tax authority before the national court, and, secondly, that the effect of the legislation is limited to those aspects of the advantage conferred by the taxpayer company that do not satisfy that test." This important finding ignored the clear language of the proportionality test in *Thin Cap GLO*, in particular the first prong of the test seen in paragraph 81 of the judgment. Moreover, it ignored the clear language set out in paragraph 71 of *SGI*.

Rimer LJ delivered the second judgment of the Court of Appeal and agreed with Stanley Burnton LJ. Arden LJ dissented.

Some general remarks on the *Thin Cap GLO CA* judgment

The interpretation of the jurisprudence of the ECJ by the majority in the *Thin Cap GLO CA* may be strongly criticised.

The majority judgments failed to correctly identify the process used by the ECJ in coming to its decisions in *Thin Cap GLO* and *SGI*. The starting point should have been the two-pronged "subjective" and "objective" tests seen in the *Halifax* judgment. This test for abuse was subsequently adopted by the ECJ in *Cadbury Schweppes* in the direct tax field. The *Thin Cap GLO* judgment was based on similar reasoning in relation to the test for abuse. Indeed, the main paragraphs of the *Thin Cap GLO* judgment concerning the justification of the thin cap rules on grounds based on the need to prevent abusive practices were in the main based on the reasoning of the ECJ in *Cadbury Schweppes*.[47]

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47 See *Thin Cap GLO* paragraphs 72-75.

The judgment in *Cadbury Schweppes* demonstrates that CFC rules are only compatible with the freedom of establishment in situations where they deal with the problem of wholly artificial arrangements designed to circumvent the national tax system in question. In paragraph 77 of *Thin Cap GLO*, the ECJ clearly states that "by providing that that interest is to be treated as a distribution, such legislation is able to prevent practices the sole purpose of which is to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory. It follows that such legislation is an appropriate means of attaining the objective underlying its adoption." Therefore, thin cap rules can be justified where they prevent practices "the sole purpose of which is to avoid tax" that would normally be payable in the national territory. In other words, they protect against artificial diversion of profits. However, it is important to note that this statement is clearly qualified by the principle of proportionality.

The ECJ goes on to explain in paragraph 81 of *Thin Cap GLO* that "[t]he fact that a resident company has been granted a loan by a non-resident company on terms which do not correspond to those which would have been agreed upon at arm's length constitutes, for the Member State in which the borrowing company is resident, an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State. In that regard, the question is whether, had there been an arm's-length relationship between the companies concerned, the loan would not have been granted or would have been granted for a different amount or at a different rate of interest." It continues in paragraph 82 by stating that "national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement, entered into for tax reasons alone, is to be considered as not going beyond what is necessary to prevent abusive practices where, in the first place, on each occasion on which the existence of such an arrangement cannot be ruled out, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that arrangement." If such evidence of commercial justification is produced then clearly the arrangement at hand is not a wholly artificial arrangement and the second leg of the proportionality test is unnecessary. The second leg of the proportionality test only kicks-in where the taxpayer does not demonstrate commercial justification for the arrangements in question.

It is argued that the majority judgments of the Court of Appeal in *Thin Cap GLO CA* misunderstood the importance and purpose of the proportionality test. The UK's thin cap rules amounted to a restriction on the freedom of establishment unless they were justified by a mandatory reason in the general interest. Therefore, it was not sufficient for the UK to simply demonstrate that a wholly artificial arrangement might have existed through the breach of the arm's length principle, it also had to meet the proportionality test which required the taxpayer to be given the opportunity to rebut that presumption that an artificial arrangement existed through the production of some evidence of commercial justification.

The High Court in *Thin Cap GLO HC* accepted that such evidence of commercial justification had been provided by the taxpayers. As such, the UK failed to demonstrate that a wholly artificial arrangement existed and, therefore, the loans in question were not artificial in nature. Consequently, the interest payments on such loans should be allowed in the same way as the interest payments on similar domestic loans.

It should be recalled that thin capitalisation rules are anti-avoidance rules that amount to a restriction on the freedom of establishment in the absence of justification. Controlled foreign company rules (CFC) (seen in *Cadbury Schweppes*) and transfer pricing rules (seen in *SGI*) are similar anti-avoidance rules. In the absence of a wholly artificial arrangement situation such rules cannot be justified in an internal market because they amount to a restriction on the freedom of establishment. In situations where domestic rules allow the establishment of a subsidiary where the CFC rules do not apply, similar situations must be allowed to occur cross-border when the freedom of establishment is involved. The same thinking applies when thin capitalisation rules are at play and when transfer-pricing rules are in operation. The proportionality test seen in *Cadbury Schweppes*, *Thin Cap GLO* and *SGI* is the same. It makes it clear that in the absence of a wholly artificial arrangement situation where the taxpayer has shown that the CFC reflects economic reality or that the loan was not entered into purely for tax reasons and that evidence of commercial justification has been produced or that there was some commercial reasons why the arm's length test was not met.

Strong support for this line of reasoning is found in the judgments of Henderson J. in his *Thin Cap GLO HC* decision and in the dissenting judgment of Arden LJ. In *Thin cap GLO CA*.

Henderson J. in *Thin Cap GLO HC*

Mr Justice Henderson stressed in paragraph 65 of his *Thin Cap GLO HC* decision that he was "unable to accept the Revenue's submission that the ECJ regarded the question of commercial justification as no more than an aspect of the arm's length test". He commented that it was "abundantly clear that the ECJ regarded them as separate tests, each of which had to be satisfied if the thin cap rules of the UK or any other member state were to meet the criterion of proportionality. The proposition that the ECJ regarded the arm's length test alone as sufficient for this purpose, or as a complete "proxy" for determining whether there was abusive tax avoidance, is in my opinion impossible to reconcile with the clear terms of the Court's judgment, in particular at paragraphs 82, 83, 86, 87 and 92." Henderson J. went on to point out that the ECJ "must be taken to have known that the UK thin cap rules contained no test apart from the arm's length test".[48] He concluded that "the only issue of fact which I strictly need to resolve is whether any of the relevant transactions entered into by the test claimants were, either wholly or in part, purely artificial arrangements devoid of any commercial justification. If that is the right question to ask, there can be no doubt about the answer. I am satisfied that none of the relevant transactions was, even remotely, of such a character, and to be fair the Revenue have never sought to argue that they were".[49]

Arden LJ in *Thin Cap GLO CA*

The dissenting judgment of Lady Justice Arden in *Thin Cap GLO CA* also provides strong support for the line of reasoning outlined above. In paragraph 104 she highlighted that an abusive transaction "is to be found by the tax authorities first asking, by reference to objective and verifiable elements, whether the transaction is on arm's length terms, or as it is from time to time put, on fully competitive terms. It follows that the Revenue does not have to go further at this stage than consider whether the loans were on a fully competitive basis. If it is not on such terms, the taxpayer must be given an opportunity to show that the terms were nonetheless commercial, as in *Lankhorst-Hohorst*, and for that reason not abusive. It is for the national court to determine whether the ground that the taxpayer asserts is sufficient commercial justification for this purpose". She went on to indicate that "the Revenue have accepted that, in the case of the claimants' test claims, there was some commercial reason for the non-resident parent company providing the money to its resident subsidiary, and that, if the judge was right on the test, it was satisfied in all these cases".[50]

In relation to *SGI*, Arden LJ pointed out that "[p]aragraph 82 of the judgment of the Court of Justice in [*Thin Cap GLO]* expressly refers to paragraph 67 of the Opinion of the Advocate General and would thus appear to be placing the same meaning on commercial justification as the Advocate General did in the first indent to that paragraph".[51] She noted that "it seems to me unlikely to be the correct interpretation of paragraph 72 of the judgment in *SGI* that it was intended to depart from the judgment of the Grand Chamber. Paragraph 72 of the judgment is only a

48 See *Thin Cap GLO HC* paragraph 70.

49 See *Thin Cap GLO HC* paragraph 100.

50 See *Thin Cap GLO CA* paragraph 108.

51 See *Thin Cap GLO CA* paragraph 99.

partial replication of paragraph 83 of the judgment in [*Thin Cap GLO*]. It can be seen from paragraph 79 of the Opinion of the Advocate General in *SGI* that the Court of Justice only had to deal with the corrective tax measure when a transaction was not at arm's length since it was not alleged that there was commercial justification in that case…" [52] She concluded that " in paragraphs 73 and 74 of its judgment in *SGI* … the Court of Justice noted the submission of the Belgian government that under Belgian law the national legislation permitted a taxpayer to resist its application if he could establish that the transaction had a commercial justification, and that the national legislation only led to disallowance of interest exceeding the commercial amount. The Court of Justice accordingly appear to have attached significance to the taxpayer having the ability to provide commercial justification and did not repeat the view, apparently taken by Advocate General Kokott in paragraph 78 of her Opinion [in *SGI*], that the taxpayer was required to show that the transaction was on arm's length terms".[53]

Part IV - Conclusion

In conclusion, perhaps three key points can be made. First, Her Majesty's Treasury and Her Majesty's Revenue and Customs are to be praised for producing Annex I of the CFC Reform Consultation Document. This, in itself, is a big step forward in the design and implementation of new tax rules in the UK because it recognises the supremacy of EU law even in the direct taxation area. By including such a clear statement of the law in Annex I the Consultation Document provides a snapshot of the EU law backdrop against which the UK's CFC reforms are taking place. The consultation process includes the possibility of analysing that understanding and this makes the whole consultation process more meaningful. This paper has endeavoured to challenge some of this understanding and hopefully contributes to the debate on this very important area of law reform.

Second, the author has been extremely critical of the judgments of the majority in the Court of Appeal in *Thin Cap GLO CA*. Clearly, there are significant questions concerning the proportionality test in *SGI* to be reconsidered, particularly because of the impact that the views of the majority in that case had on the drafting of Annex I. It seems clear to the author that the drafters of Annex I were entitled to base their understanding of the law of the UK as set out in the *Thin Cap GLO CA* judgment when they included the statement of EU law in Annex I. However, it is highly arguable that the interpretation of the jurisprudence of the ECJ adopted by the majority in the Court of Appeal in that case (in relation to anti-avoidance rules such as thin cap and transfer pricing) was defective. In any event, the issues in the

52 See *Thin Cap GLO CA* paragraph 100.

53 See *Thin Cap GLO CA* paragraph 101.

case were so novel in nature that a further reference to the ECJ would have been a more appropriate outcome. The judges in the Court of Appeal interpreted the *SGI* decision despite the fact that the ECJ has not done so to date. Clearly, the partnership between the national courts in the UK and the ECJ was weakened by this approach because there is a strong possibility that the majority judgments in the Court of Appeal misunderstood the jurisprudence of the ECJ.

Lastly, given the significance of getting the law in this crucial area of UK business law correct, it is extremely surprising that the UK's Supreme Court did not grant the Claimants an appeal and, consequently, make a further reference to the ECJ to determine the law in this area from an EU perspective. The fact that the Supreme Court declared that the matter was acte clair was even more surprising given the fact that two senior judges (Arden LJ and Henderson J) had held in favour of the taxpayers and delivered judgments on the EU law aspects more in keeping with the jurisprudence of the ECJ in this author's opinion. The 2-1 split in the Court of Appeal should have triggered an appeal to the Supreme Court and a further reference to the ECJ to determine this highly sensitive EU law issue. The consequence of getting it wrong simply stores up problems for the future and, of course, further ECJ litigation.

In 2011, the ECJ reminded the Member States that "[i]t should also be recalled that Article 267 TFEU, which is essential for the preservation of the Community character of the law established by the Treaties, aims to ensure that, in all circumstances, that law has the same effect in all Member States. The preliminary ruling mechanism thus established aims to avoid divergences in the interpretation of European Union law which the national courts have to apply and tends to ensure this application by making available to national judges a means of eliminating difficulties which may be occasioned by the requirement of giving European Union law its full effect within the framework of the judicial systems of the Member States. Further, the national courts have the most extensive power, or even the obligation, to make a reference to the Court if they consider that a case pending before them raises issues involving an interpretation or assessment of the validity of the provisions of European Union law and requiring a decision by them".[54]

The Court went on in paragraph 84 to state that "[t]he system set up by Article 267 TFEU therefore establishes between the Court of Justice and the national courts direct cooperation as part of which the latter are closely involved in the correct application and uniform interpretation of European Union law and also in the protection of individual rights conferred by that legal order."

54 See ECJ, 8 Mar. 2011, Opinion 1/09 of the Court (Full Court), [2011] ECR I-0000, paragraph 83 (not yet reported).

The Court concluded in paragraph 85 that "[i]t follows from all of the foregoing that the tasks attributed to the national courts and to the Court of Justice respectively are indispensable to the preservation of the very nature of the law established by the Treaties".

These statements should act as a reminder to national courts to use the preliminary ruling procedure when critical EU law issues appear in cases before them.