IMPACT OF EU LAW ON THE UK DIRECT TAX SYSTEM

Grahame H J Turner[1]

I. Introduction

Just occasionally, one comes across a comment made by a legal authority that simply must be cited. In this particular instance, it is a comment made by Mr Justice Andrew Park in an article written after his retirement from the bench:

> I do not know everything that has been happening in this field over the last few years, but I probably know as much as anyone else…
>
> It took quite some time for the possible implications of Community law upon the direct tax systems of Member States to be appreciated…
>
> In the context of corporation tax a particularly important principle is the freedom of establishment…[2]

The author cannot, of course, claim to be as aware of developments in the interaction between EU law and UK Direct Taxation as was the learned judge, but the cited comment appears to the author to set the right tone for this discussion.

The interaction between EU law and national direct tax provisions might be said to be a relatively new and developing field. But is the law developing or are we seeing the principles expressed in different ways? After all, disregarding the few directives relevant to direct taxation, there is little in the Treaties applicable to taxation and the general principles of EU law were developed in the early years of the Court's case law.

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1 Grahame Turner is a research student at Institute of Advanced Legal Studies, University of London Grahame.Turner@postgrad.sas.ac.uk

2 Park A (2006) *A judge's tale: corporation tax and Community Law* British Tax Review Vol. 2006 Iss. 3 pages 322-344 at pages 322 & 323

It is the author's thesis that the law is not changing: it is just the application of the law to the intricate and complex tax laws of the Member States that is being clarified. In the author's view, the 'cardinal rule' might be stated to be that the person exercising the freedom must be treated *no less favourably* by his home state because he has exercised his Treaty rights and he should be treated *no less favourably* by the host state than it treats its own residents or nationals in comparable situations.

The purpose of this article is to review briefly some of the cases involving the UK's statutory provisions and to discuss the impact of these ECJ decisions on the UK's corporation tax[3] provisions, mostly relating to groups of companies. The difficulties involving the relieving provisions provided for groups were anticipated by Park J in a chapter in a book co-authored by him in 1996, which he cites in his article, *A judge's tale*:

> It is a cast-iron certainty that more cases along these lines will arise, and that rules of UK tax law will be challenged. The UK tax system provides reliefs of various sorts for intra-group transactions where the group members are UK-resident companies. (Transfers of assets without capital gains tax; dividends without paying advance corporation tax; group relief surrenders of tax losses; and many others.) In general these reliefs do not apply between a UK group-member and a non-resident member. If the non-resident is based in another member state the UK tax rule might be challenged by analogy with the *Halliburton*[4] decision[5]

Whilst the anticipated challenges did come to pass, the outcomes of those challenges have proved to be less disruptive to the UK system than possibly at first feared although many of these challenges are still before the UK courts.

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3 There have been changes required to other direct taxes such as Income Tax (Trading & Other Income) Act 2005 ("ITTOIA 2005"), s.397A enacted by Finance Act 2008 ("FA 2008"), which aligned the Income Tax treatment of foreign dividend income with that of UK dividend income in providing a 1/9th tax credit. This might have been a delayed response to ECJ 15 July 2004 C-315/02 *Anneliese Lenz and Finanzlandesdirektion für Tirol* ("*Lenz*") [2004] ECR I-7063 ; and the amendment to Inheritance Tax Act 1984 ("IHTA 1984"), Part 5 by FA 2009, s.122 extending agricultural land and woodlands relief beyond the shores of the UK to cover land in EU and EEA states: this was required by the EU Commission – see IP/09/170.

4 ECJ 4 January 1993 C-1/93 *Halliburton Services BV v Staatssecretaris van Financien* ("*Halliburton*") [1994] ECR I-1137 This case involved Dutch indirect tax provisions and an intra-group relief provision

5 Park [BTR 2006] *Ibid.* page 324

As Park J mentioned *Haliburton* as being of importance in alerting the UK judiciary to the potential problems with the UK's group provisions, brief mention will be made of that case. The UK cases decided by the ECJ[6] are:

Short Name	**Number**	**Date**	**EU Law**
Daily Mail	C-81/87	27 Sep 1988	Establishment
Commerzbank	C-330/91	13 July 1993	Establishment (inward) - branch
ICI	C-264/96	16 July 1998	Establishment (outward) – subs
Metallgesellschaft	C-397/98	8 March 2001	Establishment (inward) – subs
Oce van der Grinten	C-58/01	25 Sep 2003	Par/sub directive
Marks & Spencer	C-446/03	13 Dec 2005	Establishment (outward) – subs
Cadbury Schweppes	C-196/04	12 Sep 2006	Establishment (outward) – subs
ACT IV GLO	C-374/04	12 Dec 2006	Establishment & Capital (inward)
FII GLO7	C-446/04	12 Dec 2006	Establishment & Capital (outward)
Thin Cap GLO	C-524/04	13 March 2007	Establishment (inward) – subs
CFC & Dividend GLO	C-201/05	13 April 2008	Establishment (outward) – subs
HSBC Holdings	C-569/07	1 Oct 2009	Capital Duty

Park J was perfectly correct in identifying *establishment*[8] as being of primary relevance to UK corporation tax as many of the issues arise in relation to the complex group provisions.

Of the cases listed, *Daily Mail*, *Oce van der Grinten* and *HCBC Holdings* are of little relevance to the discussion in this article.

Daily Mail concerned an attempt by the taxpayer to move its tax residence from the UK without gaining the Treasury Consent required under Income and Corporation Taxes Act 1970 ("ICTA 1970"), s.482[9] and the ECJ decided that such an action did not appear to be within the scope of the freedom.

6 The listing has been extracted from *Materials on International and EU Tax Law* volume 2 (tenth edition) edited by Kees van Raad published by International Tax Center Leiden. The full citations for the cases will be given when next mentioned in subsequent sections of the article.

7 *FII GLO* has been referred back to the ECJ under the case number C-35/11

8 Article 49 TFEU

9 Re-enacted as Income and Corporation Taxes Act 1988 (" ICTA 1988"), s.765, which was repealed by FA 2009.

Oce van der Grinten concerned an interpretation of Council Directive 90/435/EEC and the ECJ determined that the income tax withheld by the UK from dividends was expressly permitted by Article 7(2) of the directive and that no infringement occurred.

HSBC Holdings concerned indirect taxation.

The remaining cases can be grouped under four categories:

Outbound Dividends

Metallgesellschaft and *ACT IV GLO* are closely linked, both being concerned with outbound dividends and the UK's (now repealed) ACT scheme, and will be considered together.

Anti-avoidance

Cadbury Schweppes and *CFC & Dividends GLO* were both concerned with the UK's CFC anti-avoidance provisions although the latter merely picked up on a few questions not answered by the Court in its earlier judgment in *Cadbury Schweppes*. Little will be said about that later case. They will be considered with *Thin Cap GLO* and other non-UK cases concerned with anti-avoidance provisions applicable to groups of companies.

Group Loss Relief Schemes

ICI and *Marks & Spencer* are both concerned with the UK's group relief provisions and will be considered together with reference to a relevant non-UK case concerned with group loss relief schemes. *Commerzbank* is a simple example of discrimination against a non-resident company and, though it did not concern the UK's group relief provisions, it will be referred to in the context of the changes enacted by the UK to extend group relief to UK branches of non-resident companies. Brief reference will be made to the more recent case, *Philips Electronics*[10], which involves a restriction to those provisions when the UK branch losses can be relieved in the non-resident's home state.

Inbound Dividends

FII GLO is concerned with taxation of inbound dividends (corporation tax). There has been no UK case involving taxation of inbound dividends under income tax rules but reference will be made to an Austrian case, *Lenz* (see FN 3). The principles

10 ECJ Pending C-18/11 *The Commissioners for Her Majesty's Revenue & Customs v Philips Electronics UK Ltd* ("*Philips Electronics (ECJ)*") and UK Lower Tier Tribunal [2009] UKFTT 226(TC) 18 August 2009

determined by the Court in *FII GLO* have been recently reviewed by the ECJ in another Austrian case, *Haribo*[11].

II. Preliminary Matters

It is necessary to briefly comment on two matters that have relevance to the scope of the amendments to the UK legislation required to make them compliant with EU law.

i. EEA Agreement

The Agreement on the European Economic Area ("EEA Agreement") is an agreement between the three remaining EEA members, Iceland, Liechtenstein and Norway, on the one hand and the European Union, and each of the Member States, on the other. Article 6 of the agreement provides:

> Without prejudice to future developments of case law, the provisions of this Agreement, in so far as they are identical in substance to corresponding rules of the Treaty establishing the European Economic Community and the Treaty establishing the European Coal and Steel Community and to acts adopted in application of these two Treaties, shall, in their implementation and application, be interpreted in conformity with the relevant rulings of the Court of Justice of the European Communities given prior to the date of signature of this Agreement.

The EEA Agreement contains provisions intended to reflect the TFEU freedoms of movement[12]. Accordingly, if a national provision infringes a TFEU freedom (and cannot be justified) it will infringe the corresponding freedom in the EEA Agreement. The UK is bound, therefore, to extend the scope of any amendment necessitated to make a provision compliant with EU law to the remaining EEA states. However, as the Member States are themselves signatories to the EEA Agreement, any reference to 'EEA states' will include reference to the Member States.[13]

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11 ECJ 10 February 2011 C-436/08 & C-437/08 *Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08) Österreichische Salinen AG (C-437/08)* ("*Haribo*") [2011] ECR I-0000

12 ECJ 23 October 2008 C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* ("*Krankenheim Ruhesitz*") [2008] ECR I-8061 paragraph 24

13 The Author has not researched whether similar obligations accrue under bilateral agreements between the EU and the Member States, on the one hand, and non-EEA states on the other, such as Switzerland.

ii. Establishment or Capital?

The author wrote a short analysis of this issue some three years ago[14] and his conclusions, on the basis of the Court's case law to that time, were:

> The freedoms that will be engaged in any situation will depend upon what is sought to be done by the claimant and by the purpose and scope of the national provisions obstructing him.
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> In the instance of investments in companies, the case-law of the Court reviewed above appears to provide the following guidance:
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> 1. The *Uberseering* case clarifies that the general rule is that investments made in companies come within the field of application of Article 56 EC but subject to the overriding application of Article 43 EC in the specific case of controlling investments and the *Lasertec* case makes it clear that such will be the case even if no relief can be obtained under Article 43 EC because of the involvement of a third country;
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> 2. If the national provision makes investment in a company unattractive to all persons regardless of nationality, Article 56 EC will be engaged and Article 43 EC will be infringed as an unavoidable consequence in relevant situations (*Dutch 'Golden Share'*);
>
> 3. If the national provision applies regardless of the size of the holding to disadvantage a person investing in a 'foreign' company, the provision may be examined under both Articles according to the circumstance of the claimant (*X and Y, FII GLO, Holbock*);
>
> 4. If the national provision is designed to apply only in the instance of a controlling investment and disadvantages the holder of that investment by reason of his exercise of establishment (*Marks & Spencer, ICI*) or by reference to the transactions, profits or activities of the establishment (*Cadbury Schweppes, Thin Cap GLO, Lasertec*), Article 43 EC will be engaged and will be exhaustive. Any infringement of Article 56 EC will be an unavoidable consequence of the infringement of that Article;
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> 5. If the national provision is designed to interfere in the business sought to be conducted by a company established in another

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14 Turner GHJ (2008) *Controlling Investments in Companies: Establishment or Movement of Capital* The EC Tax Journal Vol. 9 Iss. 3 pages 67 - 77

Member State, Article 43 EC is engaged and will be exhaustive even if the interference is triggered by the nature or structure of the share ownership of the company (*Dutch Shipping*).

This is by no means an exhaustive list but it is sufficient to answer the question posed in the introduction. This question was originally considered in the context of the UK's CFC legislation and the *Cadbury Schweppes* case, albeit that, like in the case of *Holbock*, Article 57(1) would apply.

The answer is that, where the national provision is designed or intended to apply only to controlling investments in companies, Article 43 EC is engaged and is exhaustive (*Marks & Spencer, Cadbury Schweppes, Thin Cap GLO*).

If, such as in the *Lasertec* case, Article 43 EC cannot have any application because of the involvement of a third country, the national provision does not infringe Community law.[15]

The author would add that it may be easier to see which of, or whether both, of the freedoms is/are engaged by the restrictive national provision by considering whether the provision in question is likely to deter the exercise of the right to establishment. So, for instance:

1. A national provision designed to have effect only in a situation where there is some form of relationship by which the acts of a company can be orchestrated by another person or by a group of persons acting together (whether through exercise of shareholder rights or acting in accordance with an understanding or the terms of an ancillary agreement; or through common management) is clearly designed to have an application in a situation within the concept of establishment: for instance, anti-avoidance legislation applicable to groups and targeting profits diversion;

2. A national provision that has effect in relation to dividends will impact on the investment return (Art 63 TFEU) and, similarly, on the repatriation of profits (Art 49 TFEU) of an economic activity conducted through a

15 Turner [ECTJ 2008] *Ibid.* pages 76 & 77 : citations as in the article. Art 43 EC is now Art. 49 TFEU and Art 56 EC is now Art 63 TFEU. The Art 49 TFEU override (over Art 63 TFEU) is provided by Art 65(2) TFEU: "*The provisions of this Chapter* ***shall be without prejudice*** *to the applicability of restrictions on the right of establishment which are compatible with the Treaties*" – refer to ECJ 13 April 2000 C-251/98 *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem* ("*Baars*") [2000] ECR I-2787 Advocate General Opinion paragraph 25: "…*Article [65(2) TFEU] demonstrates that any measure directly restricting the right of establishment must be judged by the criteria pertaining to that fundamental freedom; there is no scope for the alternative application of the rules relating to capital movements*…"

company, which would deter the exercise of establishment through the medium of a company;

3. A national provision that has effect in relation to the disposal of a shareholding would, likewise, engage both freedoms and the one applicable would be the one reflecting the behaviour of the person claiming protection under the freedoms; but

4. A national provision that has effect in relation to the trading of shares, but not for the purpose of making a disposal, will not deter a person from exercising the right of establishment.

   The provision causes no disadvantage to a person exercising that right construed as the right to engage in economic activities through the medium of a company set up in the other Member State:

   "…since the purpose of the [national] legislation…is to prevent non-resident shareholders from obtaining an undue tax advantage directly through the sale of shares with the sole objective of obtaining that advantage, and not with the objective of exercising the freedom of establishment or as a result of exercising that freedom, it must be held that the free movement of capital aspect of that legislation prevails over that of the freedom of establishment".[16]

There continues to be much discussion over the interpretation of the *Baars* formulation[17] and even attempts to formulate shareholding trigger levels. This is not helped by comments by the Court itself, such as:

> It is conceivable, in respect of companies having in general large numbers of smaller shareholdings, that the holders of shareholdings corresponding to those percentages [5% or greater or, if linked to participation in management, a lesser percentage] might have the power to influence in a definite manner the management of such a company and to determine its activities, which is covered by Article 43 EC…[18]

16 See ECJ 17 September 2009 C-182/08 *Glaxo Wellcome GmbH & Co KG v Finanzampt Munchen II* ("*Glaxo Wellcome*") [2009] ECR I-0000 paragraph 50

17 *Baars Ibid.* paragraph 22: "…*a national of a Member State who has a holding in the capital of a company established in another Member State which gives him definite influence over the company's decisions and allows him to determine its activities is exercising his right of establishment*".

18 ECJ 26 March 2009 C-326/07 *Commission of the European Communities v Italian Republic* ("*Commission v Italy (Golden share)*") [2009] ECR I-2291 paragraph 38

Conceptually, it is not easy to see how a person with that level of interest is conducting its business through the company in which it is invested unless it is as a member of a consortium or joint venture having a common economic objective. It is almost the case that the Court's *Baars* formulation has overridden the concept of establishment itself. That said, accounting convention certainly does reflect interests of significantly lower than 50%. For instance, Article 1 of Council Directive 83/349/EEC (Consolidated Accounts) contains definitions of circumstances in which a Member State might require consolidated accounts to be prepared, including where the parent company has exercised voting power of at least 20% of the votes to appoint the majority of the management.

For less technical situations, the trigger, in the view of the author, is qualitative and requires the answer to a simple question: *if the claimant has exercised or wishes to exercise his right of establishment, is the effect of the national provision such as to penalise him in some way for so doing or likely to deter him from exercising the freedom*? If the national provision is targeted at persons having a common economic interest and acting together to control a corporate vehicle through which they conduct their business, then only the freedom of establishment will be engaged.

III. Halliburton

Recalling the comment made by Park J:

> The UK tax system provides reliefs of various sorts for intra-group transactions where the group members are UK-resident companies…In general these reliefs do not apply between a UK group-member and a non-resident member…the UK tax rule might be challenged by analogy with the *Halliburton* decision[19]

So what was this case about?

The US company reorganised its activities in the Netherlands conducted through a branch of its wholly owned German subsidiary by obtaining the sale of that branch activity, including the assets and premises used by the branch, to a Dutch subsidiary directly owned by it from the US.

The US parent obtained no rights under the Treaty freedom of establishment: it was not a national of a Member State[20]. The Dutch subsidiary did not engage in any action that involved a 'movement': its investment by acquiring the branch activities as wholly 'internal'. Only the German subsidiary had exercised the right of establishment.

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19 See FN 5

20 See Article 54 TFEU

The transfer of ownership of the premises used by the branch to the Dutch subsidiary attracted transfer tax payable by the purchaser. Relief from transfer tax was available under Dutch national law for internal reorganisations: that is, transfers of chargeable assets between Dutch subsidiaries of a common Dutch parent.

The Dutch court held that the non-discrimination article in the US/Netherlands DTC extended the relief from transfer tax to Dutch subsidiaries of a US parent. That is a matter of national law and EU law has nothing to say on the matter.

Relief from transfer tax was denied in this case, however, because the vendor was a German company. The condition that both the vendor and the purchaser be Dutch incorporated companies was not satisfied. That does potentially engage EU law.
For EU law to engage, the person exercising the freedom must be treated *less favourably* than a national or resident of the host state or than he would be treated had he not exercised the freedom. The person who exercised the freedom was the German subsidiary but the person that was denied the relief from tax was the Dutch subsidiary. Had the common parent been a company treated as a national of a Member State, the denial of the relief would have been an obstruction to the exercise of the freedom by that EU parent. That was not the case here.

The Court observed, however, that:

> …payment of a tax on the sale of immovable property constitutes a burden which renders the conditions of sale of the property more onerous and thus has repercussions on the position of the transferor. In a case such as this, the vendor is in a distinctly less favourable position than if it had chosen the form of a public or private limited company instead of that of a permanent establishment for its business in the Netherlands[21]

Thus the potential disadvantage to the vendor was a price for the asset partially or wholly discounted for the tax burden incurred by the purchaser and the disadvantage arose because the German company chose to establish itself in the Netherlands through a branch rather than through a subsidiary.

The choice of form of establishment is protected by the Treaty freedom just as is the exercise of the freedom and this point was made by the Court in *Avoir Fiscal*[22]. The disadvantage, in that case, was the denial of a relief for tax credits attaching to French source dividend income taxable on a French branch of a foreign company that could be claimed by French resident companies. The foreign company was, thus, deterred from exercising the freedom of establishment through a branch, which is an infringement of the Treaty freedom.

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21 *Halliburton Ibid.* paragraph 19

22 ECJ 28 January 1986 C-270/83 *Commission of the European Communities v French Republic* ("*Avoir Fiscal*") [1986] ECR 273 at paragraph 22.

It is not clear to the author why it was *Halliburton* rather than *Avoir Fiscal*, decided 8 years earlier, that prompted the UK judiciary to realise that there were potentially inherent problems with the UK's corporation tax provisions, particularly those relating to groups, as suggested by Park J.

One reaction by the UK to remove unequal treatment of branches, whether in reaction to *Halliburton* or to *Commerzbank*[23], was to amend its group relief legislation in 2000[24] to enable non-resident companies within the charge to corporation tax by reason of trading in the UK through a branch to claim or surrender losses. This legislation, which contains a restriction designed to prevent "double-dipping" of losses, is due to be considered by the Court[25] as mentioned above. This is discussed at greater length in section VI below.

IV. Outbound Dividends

Whilst non-resident companies are within the scope of income tax[26], there is generally no withholding of income tax from distributions made by UK companies[27] although some Double Tax Conventions ("DTCs") retain income tax withholding rights linked to tax credits provided by the UK to non-residents.[28] Prior to the introduction of the UK's Advance Corporation Tax scheme, enacted in FA 1972, all UK company distributions were subject to withholding of income tax and these DTC provisions may be a legacy from that era.

23 ECJ 13 July 1993 C-330/91 *The Queen v Inland Revenue Commissioners, ex parte Commerzbank AG* ("*Commerzbank*") [1993] ECR I-4017

24 FA 2000, s.97 and Schedule 27effective from 1 April 2000, then re-enacted by FA 2006 incorporating further changes required following *Marks & Spencer* and now incorporated in Corporation Tax Act 2010 ("CTA 2010") sections 107 and 131. In a statement in Tax Bulletin Issue 60, page 961, HMRC revealed that they had decided not to contest taxpayer appeals relating to rejected claims made in respect of periods prior to April 2000.

25 *Philips Electronics (ECJ) Ibid.*

26 For instance, 'profits of a property business' – ITTOIA 2005, s.269(1).

27 There are always exceptions: one is in relation to distributions made by "Real Estate Investment Trusts" (REITS), which are specialised collective investment vehicles – see Income Tax Act 2007 ("ITA 2007"), s.973

28 See, for instance ECJ 25 September 2003 C-58/01 *Océ van der Grinten NV and Commissioners of Inland Revenue* ("*Océ van der Grinten*") [2003] ECR I-9809 A non-resident company is now treated as having paid income tax at the 'dividend ordinary rate' ITTOIA 2005 s.399(2)

The two cases to be considered in this section, *Metallgesellschaft*[29] and *ACT IV GLO*[30] both concerned the legislation enacted in FA 1972[31] applicable to distributions made on or after 6 April 1973. The pre-1972 legislation was in force for just over 3 months at the beginning of the UK's membership of the EU[32].

The UK's ACT scheme was simple in concept. The object of the scheme was to mitigate economic double taxation that arose from profits of a company being taxed, firstly, in the hands of the company and then, secondly, in the hands of shareholders when distributed in the form of dividends. Under the scheme, a shareholder received an imputed tax credit that he could set against his income tax liability, or which he could claim to be repaid to him should his income tax liability be insufficient.

However, the right to the tax credit was not conditional on the distributing company having paid corporation tax. Accordingly, the tax credits had to be funded and the mechanism used by the legislation was to oblige a company making a distribution to pay an amount termed Advance Corporation Tax corresponding to the tax credits attaching to the dividends paid.

The payment was so termed as the distributing company could treat that payment as a pre-payment of its corporation tax liability for the period up to a maximum amount[33] and would then have to pay over only the balance of its liability on the normal due date.

Where a company's dividend was partially or wholly funded by UK dividends received by it, its liability to account for ACT was reduced by the amounts of the tax credits received by it.

That is a broad description of the scheme and how it worked.

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29 ECJ 8 March 2001 C-397/98 & 410/98 *Metallgesellschaft Ltd and others (C-397/98) Hoechst AG, Hoechst UK Ltd (C-410/98) and Commissioners of Inland Revenue, H.M. Attorney General* ("*Metallgesellschaft*") [2001] ECR I-1727 decided 8 March 2001

30 ECJ 12 December 2006 C-374/04 *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* ("*ACT IV GLO*") [2006] ECR I-11673

31 The legislation was repealed by FA 1998, s.31 with effect from 6 April 1999

32 The UK's accession was on 1 January 1973 along with the Republic of Ireland and the Kingdom of Denmark.

33 The maximum amount was corporation tax chargeable on an amount equal to the net dividend and the tax credit added together (termed Franked Investment Income – "FII"). Income tax offset or Double Tax Relief could further reduce the payment due on the normal payment date. In cases where the small companies' rate was chargeable and that rate was aligned with the ACT fraction, there might have been no balance to pay where all of the taxable profits were distributed.

Because the ACT provisions applied to dividends paid by UK companies regardless of the shareholding relationship with the shareholder, it was considered that both the freedom of establishment and the free movement of capital were engaged.[34] *Metallgesellschaft*, however, was concerned with a provision that applied only to groups of companies and, thus, only the freedom of establishment was considered.[35]

i. Metallgesellschaft

In a sense, this was the first case involving group relieving provisions. Earlier cases such as *ICI*[36] and *X AB & Y AB*[37]concerned disqualification of entitlement to claim reliefs by one resident from another resident because of foreign investment or ownership.

At first sight, *Metallgesellschaft* is no different. The taxpayer was a UK subsidiary of a German company. It paid a dividend to its non-resident parent company and had to account for ACT. Had it been a subsidiary of a UK resident company, that parent would have been entitled to enter into a 'Group Income Election'[38], which would have entitled the subsidiary to pay its dividend without accounting for ACT. However, such a UK resident parent would have to pay the ACT when re-distributing its subsidiary's dividend whereas a non-resident parent company, being outside the scope of the ACT charging provisions, would not have that obligation. As Lord Hoffmann observed:

> An election is a joint decision by two entities paying and receiving dividends that one rather than the other will be liable for ACT. This is not a concept which can meaningfully be applied when one of the entities is not liable for ACT at all.[39]

The analysis by the ECJ proceeded on the basis that the objective of the UK provision was to provide the subsidiary with an opportunity to avoid the cost of funding the ACT payment, albeit that the parent company would thereby incur the

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34 *ACT IV GLO Ibid.* paragraphs 37 & 38

35 *Metallgesellschaft Ibid.* paragraph 40

36 ECJ 16 July 1998 C-264/96 *Imperial Chemical Industries plc and Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* ("*ICI*") [1998] ECR I-4695

37 ECJ 18 November 1999 C-200/98 *X AB, Y AB and Riksskatteverket* ("*X AB & Y AB*") [1999] ECR I-8261

38 Re-enacted as ICTA 1988, s.247

39 UK House of Lords 23 May 2007 *Boake Allen Limited and others v. Her Majesty's Revenue and Customs* ("*Boake Allen*") [2007] UKHL 25 paragraph 17: this was a summary of the excerpt from a speech made by Lord Nicholls, which he cites in paragraph 18

cost instead. The author construes the objective of the UK statute differently[40] and considers that the ECJ might have viewed the UK legislation differently had had the matter come before it after it had ruled on *Manninen*[41], a case involving the Finnish system of funded imputation credits.

The interpretation of the UK statute adopted by the ECJ is not binding on our national courts as the ECJ does not have jurisdiction to interpret national law.

> …the Court of Justice has no jurisdiction under Article [267 TFEU] to rule on the interpretation of provisions other than those of Community law[42]

However, the objective of this article is to consider the impact of decisions such as *Metallgesellschaft* on UK statute law not to discuss, in any depth, the cases themselves. The ECJ ruled that the UK provision, limiting eligibility to enter into an election ICTA 1988, s.247 to persons within the scope of the ACT charging provisions, that is, UK resident companies[43], was discriminatory.

It is unlikely that this decision had any impact on UK legislation as the changes to the dividend tax credit system had already been set in motion by F(No 2)A 1997, section 19, effective from 2 July 2007, repealing the legislation that entitled certain persons exempt from UK income tax (pension funds) from obtaining cash repayment of dividend tax credits.

Metallgesellschaft was referred to the ECJ in 1998. The ACT scheme may have been repealed because of the problems of surplus ACT[44]. To relieve that situation, the UK Parliament had enacted a special scheme, Foreign Income Dividends, that enabled companies to stream their foreign source income through as payments of 'FIDs' that carried a non-repayable tax credit. This scheme was unpopular with exempt funds and charities, which gained additional cash flow through recovery of the tax credits, and the first step taken in 1997 would have put shares paying

40 Draft article: "**An objective lost in translation – *Metallgesellschaft***". The analysis is too lengthy to replicate in this article.

41 ECJ 7 September 2004 C-319/02 *Petri Manninen* ("*Manninen*") [2004] ECR I-7477 decided 7 September 2004

42 ECJ 14 February 2000 C-141/99 *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) and Belgische Staat* ("*AMID*") [2000] ECR I-11619 paragraph 18

43 It should be noted that, whilst non-resident companies can be within the charge to Corporation Tax by reason of trading through a UK branch, they can never be within the ACT charging provisions.

44 Surplus ACT was ACT that could not be set against corporation tax liabilities and this was a particularly costly problem to international groups based in the UK whose profits were earned, and taxed, overseas for the most part.

ordinary dividends and shares paying FIDs to avoid surplus ACT on a level playing field: in neither case could a pension fund recover the attaching tax credit in cash. Charities were given a year's respite.

ii. ACT IV GLO

The first of the "GLOs", groups of litigants having similar claims arising in relation to a particular statutory provision, was the *ACT GLO* formed after the *Metallgesellschaft* judgment. Park J said:

> For the ACT GLO the Community law questions had been substantially determined already by the decision of the ECJ in the *Hoechst/ Metallgesellschaft* case, and the GLO was essentially a framework for the determination of questions of domestic law. (There is, in fact, an exception: one of the questions identified in the ACT GLO--described as the EU Liability Issue (IV)--had not been decided by the ECJ, and has been referred to the court by me in the meantime.)[45]

The case, as can be seen from the referring judge's comments, concerned the "EU Liability Issue" remaining to be considered by the ECJ. However, several other important points were answered in that case and it should be noted that it was considered side-by-side with the sister case, *FII GLO*[46], evidenced by the handing down of the two judgments on the same day.

The first point concerned the tax credits attaching to UK dividends. All UK residents within the scope of income tax were eligible to claim a credit to set against their liability or obtain repayment. Certain UK resident companies exempt from corporation tax on all income other than trading income (for instance, charities) were entitled to repayment. However, the position of non-residents depended on the relevant DTCs and entitlement was linked to a charge to income tax.

The Court said that a UK resident company receiving UK source dividends was entitled to a tax credit[47] distinguishing the situation of a non-resident company in receipt of UK source dividends but that was a case of comparing apples and pears.
It is true that a UK company with current year corporation tax losses could elect[48] to treat the surplus FII[49] received as taxable income offset by the losses, and thereby

45 Park [BTR 2006] *Ibid.* page 332

46 ECJ 12 December 2006 C-446/04 *Test Claimants in the FII Group Litigation* ("*FII GLO*") [2006] ECR I-11753

47 *ACT IV GLO Ibid.* paragraph 32

48 ICTA 1988 s.242

49 FII was Franked Investment Income and was the aggregate of the net dividend received and the tax credit attaching. It was surplus if it was not used to pay a dividend onwards.

obtain a repayment of the tax credit, but it was a temporary mortgage of the losses that unwound as soon as the company started paying dividends and paying ACT. Apart from that, the scheme was (loosely speaking) that a company paying dividends was treated as redistributing dividends received and was, thus, liable to pay ACT only to the extent that its dividends exceeded those received. The tax credits could not be used as an imputation credit to reduce a company's corporation tax liability.

Two issues were considered as regards the entitlements of non-resident companies: firstly, non-residents were not entitled to a tax credit unless they were within the scope of UK income tax; and, secondly, non-residents were treated differently as between each other under the DTCs concluded by the UK.

The Court had previously ruled on national schemes designed to mitigate economic double taxation suffered on 'inbound' dividends. In relation to schemes involving imputation credit relief, *Manninen* is possibly the most important and was cited by EFTA court in *Fokus Bank* in relation to the Norwegian imputation tax credit scheme. The EFTA court said:

> The Respondent's contention that taxation of outbound dividends is to be treated differently from taxation of inbound dividends must, however, be rejected. The purpose of the tax credit mechanism set up by Norwegian tax law is to avoid economic double taxation, i.e that profits that have already been taxed in the hand of the distributing company, are subsequently taxed as general income in the hands of the shareholders. That purpose can only be achieved if all the shareholders are given the benefit of an imputation credit, irrespective of their places of residence. Economic double taxation of the same assets will create the same undesirable effect, regardless of the shareholders' places of residence. In that respect, residents and non-residents are in a comparable situation.[50]

This is essentially the claim made by the litigants in *ACT IV GLO*.

It must be said that HMRC must have suffered a somewhat sinking feeling as they read through the first 56 paragraphs of the ECJ's judgment and may not have noticed in paragraph 46:

> …, it is, however, necessary to consider whether, having regard to the national measure at issue, the companies concerned are in an objectively comparable situation.

However, salvation was at hand and the Court, in paragraph 57, contradicted EFTA court and set the matter straight.

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50 EFTA 23 November 2004 E-1/04 *Fokus Bank ASA and The Norwegian State, represented by Skattedirektoratet (the Directorate of Taxes)* ("*Fokus Bank*") paragraph 30

Economic double taxation is not regarded as being caused by the tax charged on the profits by the source state. It is the tax charged on the shareholder in receipt of those taxed profits when distributed that is the cause of economic double taxation. Certainly, the source state may cause there to be economic double taxation where it subjects the dividends to a withholding tax: if it does, then it must ensure that it mitigates the charge to the extent that it does for its own residents.[51] But aside from the economic double taxation that it causes itself through the levy of a withholding tax, the source state is not in a position to mitigate economic double taxation that may arise and particularly that resulting from a levy of tax on the shareholder by his state of residence[52].

Accordingly, the UK had no obligation under EU law to treat foreign inward investors in the same way as UK resident investors and provide an imputed tax credit mitigating the corporation tax levied by the UK on the profits of resident companies. The ECJ added for clarity:

> …to require the Member State in which the company making the distribution is resident to ensure that profits distributed to a non-resident shareholder are not liable to…economic double taxation…by granting the shareholder a tax advantage equal to the tax paid on those profits by the company making the distribution, would mean in point of fact that that State would be obliged to abandon its right to tax a profit generated through an economic activity undertaken on its territory[53]

Implicit in this ruling is the acceptance that the source state has a priority right to levy tax on the profits. This applies also to withholding tax levied on shareholders in respect of their dividend income. However, as mentioned (FN 51) once the source state levies tax on the non-residents, it puts them in a situation comparable to its own residents as regards that tax and must provide comparable reliefs. This obligation may be partially or wholly discharged by provisions in a DTC entitling the shareholder to relief for the withholding tax against income tax in its state of residence[54] but this is subject to the *proviso* that the state of residence levies sufficient tax on the dividend income to give practical relief for the withholding tax levied by the source state[55].

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51 *ACT IV GLO Ibid.* paragraphs 68 & 70

52 *ACT IV GLO Ibid.* paragraph 58

53 *ACT IV GLO Ibid.* paragraph 59

54 *ACT IV GLO Ibid.* paragraph 71

55 ECJ 19 November 2009 C-540/07 *Commission of the European Communities v Italian Republic* ("*Commission v Italy (Outbound)*") [2009] ECR I-10983 paragraph 38

The other points considered in the case related to DTCs concluded by the UK. Some provided that a contracting state resident has rights to a tax credit but is subject to a charge to UK income tax; others concluded by the UK provided that a contracting state resident is exempted from UK income tax and has no right to a tax credit. As the UK mitigated the effect of economic double taxation in full where it reserved the right to tax (see FN 51) the provisions treated the relevant non-residents *no less favourably* than its own residents. Where the relevant non-residents were exempt from UK tax on the UK source dividend income, the UK provisions did not levy economic double taxation of the dividends.

A question was also raised in respect of a limitation of benefit provision in DTCs that provided for a reserved right to tax subject to the benefit of a tax credit, an anti-treaty shopping provision, but the question was misconceived. Any Member State is free to conclude DTCs with any other Member State specifying the connecting factors to be satisfied by residents of the contracting state before they can enjoy the benefits of any provision under the DTC. That has been clear since *Gilly*.[56]

iii. Outbound Dividends – concluding comments

The UK's system of ACT met with exhaustive challenge but it is not thought that the challenges under EU law led to the decision to repeal the legislation. It is clear that the system caused problems for international groups headquartered in the UK and the FID scheme designed to mitigate these problems left the shares of companies making use of the scheme less attractive to exempt funds and charities than the shares of companies that did not need to make use of the FID scheme.
Although the *Metallgesellschaft* decision has not been challenged to date, at least two UK Supreme Court judges have commented on the absurdities that would have resulted from allowing non-resident companies to join in a group income election and the perception of the objective of the legislation, upon which the ECJ based its analysis, appears to be equally absurd. There is an alternative construction of the objective of the legislation that does, indeed, result in resident and non-resident parent companies being in different situations under the law in question and that voids the discrimination analysis conducted. Restrictions may arise in certain situations. This will be analysed further in the draft article (see FN 40).
No consequence appeared to arise from *ACT IV GLO*.

V. Anti-avoidance

The UK anti-avoidance provisions considered by the Court are targeted at diversion of profits using artificial arrangements.

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56 ECJ 12 May 1998 C-336/96 *Mr & Mrs Robert Gilly v Directeur des Services Fiscal du Bas-Rhin* ("*Gilly*") [1998] ECR I-2793 paragraph 30

The UK's CFC rules[57] were considered in *Cadbury Schweppes*[58] and certain other residual issues in *CFC & Dividend GLO*[59].

These UK rules provide[60] that a subsidiary of a UK company established in a territory that levies tax on its income in any accounting period that does not at least equal 75% of the corporation tax that would be levied had the subsidiary been UK resident in that accounting period is within the scope of the legislation. There are then a series of exemptions. If a CFC fails to engage an exemption, the immediate UK parent could be charged corporation tax on an amount representing the CFC's income.

The UK's thin capitalisation rules were considered in *Thin Cap GLO*[61]. The provisions seek to disallow a tax deduction for interest expense on an intra-group loan that is of a kind, or has terms, that would not have been agreed by parties acting at arm's length. The objective of the legislation is to prevent UK profits from being diverted to another territory using debt arrangements.

The national provisions are aimed at neutralising artificial intra-group arrangements and the freedom of establishment alone was considered to have been engaged in these two cases.[62]

i. *Cadbury Schweppes*

It should be noted that the UK is still trying to formulate legislation that achieves both the prevention of diversion of profits away from the UK using artificial corporate structures and compliance with EU law.[63]

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57 ICTA 1988, sections 747 to 756 and Schedules 24 to 26

58 ECJ 17 September 2006 C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas Limited v Commissioners of the Inland Revenue* ("*Cadbury Schweppes*") [2006] ECR I-7995

59 ECJ 23 April 2008 C-201/05 *The Test Claimants in the CFC and Dividend Group Litigation v Commissioners of Inland Revenue* ("*CFC & Dividend GLO*") [2008] ECR I-2875 The residual issues largely concerned dividends. No comment is made on these issues here. There is little that could not be concluded from *Cadbury Schweppes* or from *FII GLO*

60 The legislation is still in force but has been subject to amendment from time to time.

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

62 *Cadbury Schweppes Ibid.* paragraph 32 *Thin Cap GLO Ibid.* paragraph 33

63 The latest consultation document was issued in November 2010. That document only contains one reference to EU law and that is in the summary of responses to the January 2010 consultation document: "*Some businesses considered that recent ECJ law means that all EU countries should be included on a white list*"

The scheme of the UK provisions was that a foreign subsidiary would fall within their scope simply by being assessed to foreign tax in its income (that is: profits excluding capital gains) in an amount that was at 25%[64] less than the amount of UK corporation tax that would be chargeable on the income. It was then necessary for the foreign subsidiary to fall within one of the exemptions in order that its UK parent could be spared a corporation tax assessment calculated by reference to the CFC's income. The situation was tested for each accounting period (UK corporation tax basis period) and it was quite possible for a foreign subsidiary to be within the provisions in one period but be outside their scope in another period.

HMRC produced a 'white list' of states of residence (sometimes specifying exclusions to the exemption) that could automatically exempt a foreign subsidiary from the regime and, thus, avoid significant, unnecessary compliance cost.

Other significant exemptions were provided for CFC's that made sufficient distributions to their UK parent[65] and those that conducted trading activities substantially with third parties.

The Irish subsidiary[66] set up by *Cadbury Schweppes* in a tax privileged area[67] had the business of raising finance and providing it to the group.[68] From information in the UK tribunal's decision to refer questions to the ECJ, it would seem that the profits for the period in question were in the order of £34.8 million. Few other details were available but a commercial assessment of that level of profit would suggest that the subsidiary would have required the full weight of the balance sheet of its ultimate parent behind it to enable it to handle the £billions that would have been necessary to generate profits of that order. In substance, it would not be reckless to suggest that the business that it was accounting for was, in fact, that of its ultimate parent.[69]

The restriction to the freedom was that the UK company exercising the freedom and establishing the subsidiary in another Member State could find itself assessed to UK tax by reference to the income received by its subsidiary, a separate legal person, whilst that would not be the case had it established the subsidiary in the UK.[70]

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64 The original rate was 50% and that applied in the assessments appealed by *Cadbury Schweppes*

65 Repealed by FA 2009.

66 Two were established but one had minimal activity.

67 The Irish International Financial Services Centre, which enjoyed a corporation tax rate of 10% at the time.

68 *Cadbury Schweppes Ibid.* paragraph 15

69 That is the view of the author

70 *Cadbury Schweppes Ibid.* paragraphs 45 & 46

Accordingly, the person exercising the freedom might incur a penalty for so doing and that might deter him from exercising the freedom.

The Court provided an extended analysis of ‘abuse’. There are many statements to choose from but the general rule appears to be:

> … 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[71]

To gauge whether a taxpayer is attempting to make improper use of a Treaty freedom it is necessary to examine the conduct of the taxpayer in the context of the objective of the freedom.[72] As can be verified from the wording of Article 49 TFEU, the freedom prohibits obstruction to movement of persons engaged in “*activities as self-employed persons*” or for the purpose of engaging in such activities. In the words of the Court:

> … it presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there[73]

Thus, if a person establishes a company simply to account for another company’s business, that person is either attempting to improperly use the freedom or, on another view, has not actually brought himself within the scope and objective of the freedom at all:

> In order to find that there is [a wholly artificial arrangement intended solely to escape…tax] there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that…the objective pursued by freedom of establishment…has not been achieved[74]

However, notwithstanding that the activity might, for the most part, not come within the scope or objective of the freedom, the freedom is engaged if the activity is to any extent within the scope or objective of the freedom.

This is where the ‘entity approach’ of the UK CFC legislation causes conflict with EU law. If the subsidiary does have an actual establishment and an actual economic

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71 *Cadbury Schweppes Ibid.* paragraph 35

72 *Cadbury Schweppes Ibid.* paragraph 52

73 *Cadbury Schweppes Ibid.* paragraph 54

74 *Cadbury Schweppes Ibid.* paragraph 64

activity, the provisions as originally enacted cannot be applied. The assessment on the UK parent must exclude the profits attributable to any genuine commercial activity.[75]

The UK's response was to enact certain amendments to the CFC legislation as an interim measure in FA 2007.[76]

A CFC comes within the scope of the relieving provision if it has a business establishment[77] in an EEA state[78] and employs individuals in that state[79]. The relief is that the UK parent can claim to have its assessment relating to the income of the CFC reduced (or voided) to the extent of the profits derived from the economic activity in the EEA state conducted by the individuals employed there.

The Court had held in *ICI*[80] that a national provision infringing a Treaty freedom needed to be amended or disapplied only to the extent that it had application to matters within the scope of the freedom. In this case, EU Law has nothing to say about provisions applicable to or in respect of persons established in non-Member States although the EEA agreement has comparable freedoms and the relief from the provisions must be extended to those states also.

Accordingly, the limitation of the 2007 relieving provisions to EEA states is permissible under EU law as extended by the EEA Agreement and taxpayers caught within the CFC provisions are given the opportunity to provide evidence and obtain relief in relation to profits derived from a genuine economic activity.[81]

ii. Thin Cap GLO

The ECJ had to consider a number of different UK regimes and they are summarised in *Thin Cap GLO*, paragraphs 3 to 15. The objective of this article is to identify changes made to the legislation to comply with EU law.

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75 *Cadbury Schweppes Ibid.* paragraph 75 & ruling

76 FA 2007, s.48 & Schedule 15, which introduced new sections 751A and 751B into ICTA 1988 effective from 6 December 2006 – although the ECJ judgment was handed down 17 September 2006.

77 See ICTA 1988, Schedule 25, paragraph 7: premises (including mines etc and construction sites) intended to be occupied and used more than just temporarily for the conduct of the activity.

78 The Member States were individually contracting parties to the EEA agreement as well as the European Union and the three non-Member States.

79 See the Court's comments in *Cadbury Schweppes Ibid.* at paragraph 67.

80 *ICI Ibid.* paragraph 34

81 *Cadbury Schweppes Ibid.* paragraph 70

It appears from the *Thin Cap GLO* judgment, at paragraph 16, that litigation in the UK was triggered following the judgment in *Lankhorst-Hohorst*[82], which was itself initiated by an order for reference from the German court on 21 August 2000. Accordingly, the changes made prior to and including those made in 1998[83] are unlikely to have been initiated by the need to comply with the Treaties. Indeed, it would appear that the legislation was introduced following consultation and an OECD report on transfer pricing and was intended to "…*reproduce into UK law the effect of Article 9(1) of the OECD Model Tax Convention*…"[84]. Only the legislation subsequent to the 1998 changes will be considered.

The 1998 legislation did not have provisions specifically applicable to thin capitalisation but provided a general scheme that applied to all transactions and arrangements between connected persons. Where such transactions or arrangements gave rise to a UK tax advantage that would not have arisen but for the fact of the relationship between the persons involved, the profits or losses of the UK resident person benefiting from the UK tax advantage were to be adjusted so as to reflect the situation that would be expected had the persons been independent enterprises. If it was considered that the transaction or arrangement would not have been effected between independent enterprises, then the profits or losses of the UK resident would be adjusted accordingly.

The legislation was disapplied where all the persons involved were UK residents and where certain other conditions were satisfied.

Importantly, there was no presumption of avoidance; there was no adjustment made if the transactions or arrangements satisfied the arms' length test; and, where they did not, the adjustment made was to substitute the arms' length situation.

The response in 2004 to *Lankhorst-Hohorst* was to remove the disapplication of the provisions where all persons involved were UK resident[85] and to insert specific provisions relating to thin capitalisation and guarantees.[86] The removal of the

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82 ECJ 12 December 2002 C-324/00 *Lankhorst-Hohorst GmbH v Finanzampt Steinfurt* ("*Lankhorst-Hohorst*") [2002] ECR I-11779

83 FA 1998, s.108 and Schedule 16 inserting new Schedule 28AA into ICTA 1988. The Transfer Pricing provisions have been re-enacted in Taxation (International and Other Provisions) Act 2010 ("TIOPA 2010)", Part 4 (sections 146 to 217). The ICTA 1988 provisions will be referred to to enable cross-reference to be made to the case law.

84 Chartered Institute of Taxation annotated copy of FA 1998 page 413

85 FA 2004, Schedule 42, Part 2 (1) which repealed ICTA 1988, Schedule 28AA, paragraph 5 (2) – (6)

86 FA 2004, sections 34 – 37 inserting new paragraphs 1A and 1B in ICTA 1988, Schedule 28AA as well as other provisions relieving double counting etc

‘discrimination’ against subsidiaries of non-resident parents did not impress the Advocate General. He said in his opinion delivered in June 2006:

> Nor am I of the view that, in order to conform with Article 43 EC, Member States should necessarily be obliged to extend thin cap legislation to purely domestic situations where no possible risk of abuse exists. I find it extremely regrettable that the lack of clarity as to the scope of the Article 43 EC justification on abuse grounds has led to a situation where Member States, unclear of the extent to which they may enact prima facie ‘discriminatory’ anti-abuse laws, have felt obliged to ‘play safe’ by extending the scope of their rules to purely domestic situations where no possible risk of abuse exists. Such an extension of legislation to situations falling wholly outwith its rationale, for purely formalistic ends and causing considerable extra administrative burden for domestic companies and tax authorities, is quite pointless and indeed counterproductive for economic efficiency. As such, it is anathema to the internal market.[87]

The post FA 2004 UK legislation enabled a corresponding adjustment to be made to the UK assessment of the lender[88] whilst the UK was not in a position to provide comparable relief for a non-resident lender.[89] It is possible that the rules would still constitute a restriction[90] unless justified as required of the pre-FA 2004 legislation.

It would seem that the UK is still unsure: the legislation is unchanged.

Lankhorst-Hohorst was the German trading subsidiary of a Dutch parent and the case concerned the German thin capitalisation provisions applied to loan interest paid by it to its Dutch parent. The loan from its parent enabled the German subsidiary to repay bank indebtedness at a time when trading losses had wiped out its equity capital. The ultimate Dutch parent provided a letter of comfort to external creditors in effect subordinating the intra-group loan below their claims against the German subsidiary.[91] This case involved a genuine commercial situation brought about by poor trading conditions experienced by the subsidiary.

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87 *Thin Cap GLO Ibid.* AG Opinion paragraph 68

88 ICTA 1988 Sched. 28AA, paragraphs 6 & 6C

89 This does not, of itself, give rise to an infringement: see *Thin Cap GLO Ibid.* paragraph 88

90 See, by analogy, ECJ 15 December 1995 C-415/93 *Union royale belge des sociétés de football association ASBL v Jean-Marc Bosman, Royal club liégeois SA v Jean-Marc Bosman and others and Union des associations européennes de football (UEFA) v Jean-Marc Bosman* (“*Bosman*”) [1995] ECR I-4921 paragraph 103

91 *Lankhorst-Hohorst Ibid.* paragraph 8

The German provisions were triggered where the loan was from a non-resident "substantial" shareholder[92] and the company's loan capital was more than three times shareholders' funds at any point in the year unless the loan was from a bank provided in the normal course of its trade or the loan could have been raised from an unconnected party on comparable terms. It seems that this exclusion did not extend to an inter-company loan made to enable such a permitted loan to be repaid.

The effect of the provision was to re-categorise the interest payments on the loan as distributions.

The German subsidiary was subject to a different, and disadvantageous, tax rule because of the residence status of its parent company. This automatically triggered an infringement of the freedom of establishment.[93]

The Court then considered whether the infringement could be justified. The Court observed that the German provisions did not have the specific purpose of preventing tax avoidance using artificial financial arrangements.[94] The Court also observed that the arrangements in point had no avoidance purpose.[95]

Thus, the German provisions could not be justified because they could apply in situations where there was no abuse of the national law. The provisions failed the third of the conditions stipulated by the Court in *Gebhard*:

> …they must be suitable for securing the attainment of the objective which they pursue…[96]

The UK legislation following the 1998 changes, however, had more limited effect. The UK rules provided for an adjustment of the interest payments for tax purposes down to the amount that would be payable on a loan provided by an unconnected lender.

Because the legislation only applied to subsidiaries of non-residents, and because it could result in a disadvantageous adjustment, the provisions automatically triggered

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92 More than 25%: this legislation was examined in ECJ 10 May 2007 C-492/04 *Lasertec Gesellschaft für Stanzformen mbH v Finanzamt Emmendingen* ("*Lasertec*") [2007] ECR I-3775 paragraph 4

93 *Lankhorst-Hohorst Ibid.* paragraph 32

94 *Lankhorst-Hohorst Ibid.* paragraph 37

95 It might be argued that the parent company should have re-capitalised its subsidiary to the extent of the deficiency on reserves.

96 ECJ 30 November 1995 C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* ("*Gebhard*") [1995] ECR I-4165 paragraph 37

an infringement.[97] Clearly, the extension of the provisions in 2004 to UK resident lenders eliminated the infringement[98] but it was unnecessary to do so:

> …legislation of a Member State may be justified by the need to combat abusive practices where it provides that interest paid by a resident subsidiary to a non-resident parent company is to be treated as a distribution only if, and in so far as, it exceeds what those companies would have agreed upon on an arm's-length basis, that is to say, the commercial terms which those parties would have accepted if they had not formed part of the same group of companies[99]

The provisions were considered "…*suitable for securing the attainment of the objective which they pursue*…", which was the prevention of tax avoidance by diversion of profits from the UK using artificial arrangements. That was necessary but not sufficient: the provisions had to satisfy also the principle of proportionality.

The Court stipulated two requirements.

The first was that the taxpayer should have the right to present evidence that the arrangement was commercially justified.[100] This requirement appears to be satisfied by the rights of appeal contained within the self-assessment provisions relating to enquiries[101] although the UK legislation is very prescriptive as to the matters that may be taken into account. For instance:

- The test is the transaction that would have been effected between 2independent enterprises"[102]

- In assessing the level of indebtedness of the borrower, whether a loan would have been granted in the whole amount or even part thereof and the rate of interest and other terms, no account is to be taken of any form of guarantee, surety, comfort or otherwise that might be provided by a connected person.[103]

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97 *Thin Cap GLO Ibid.* paragraph 63

98 See FN 90

99 *Thin Cap GLO Ibid.* paragraph 80

100 *Thin Cap GLO Ibid.* paragraph 82

101 FA 1998, Schedule 18, Part IV (paragraphs 24 to 35)

102 ICTA 1988, Sched. 28AA, para. 1(2)(a) re-enacted as TIOPA 2010 s.147(1)(d)

103 ICTA 1988, Sched 28AA, para. 1A(4) – (10) re-enacted as TIOPA 2010, s.152 & 154 and other definitional sections.

This latter point was considered in *Thin Cap GLO (CoA)*[104] and counsel for the taxpayers made the point that an arm's length lender acting in the real world would take account of the covenant and reputation of the parent company of the borrowing group but Stanley Burnton LJ dismissed the argument saying:

> There is nothing in the Thin Cap judgment to suggest that UK legislation might be incompatible because of its failure to take into account a subsidiary's membership of a non-UK group of companies[105]

The second requirement was that the legislation should make adjustment only to the extent that the interest paid exceeds the amount that would be paid in an arms' length situation. That is how the legislation is formulated but it is for the national court to determine the interpretation of national legislation.

The majority in *Thin Cap GLO (CoA)* took the narrow interpretation of the ECJ's requirements in effect treating them as one statement of the arm's length principle, felt to be fully expressed in the UK legislation. The conclusion was:

> The commercial justification that the taxpayer companies could have put forward for their transactions was that their terms were those which would have been agreed between unconnected parties. Since this was the test applied by the UK legislation, the fact that the taxpayer could not put forward some other commercial justification did not render the UK legislation incompatible with their or their parent companies' freedom of establishment. The taxpayers' transactions in issue did not satisfy the arm's length test, and the UK thin cap legislation was appropriately and lawfully applied to them[106]

The difference of opinion in the Court of Appeal appears to have revolved around the first requirement: what the Court meant by: "…*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*…".[107]

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104 Court of Appeal (England and Wales) 18 February 2011 *Test Claimants in the Thin Cap Group Litigation (Claimants) and Commissioners for Her Majesty's Revenue and Customs (Defendants)* ("*Thin Cap GLO (CoA)*") [2011] EWCA Civ 127

105 *Thin Cap GLO (CoA) Ibid.* paragraph 60

106 *Thin Cap GLO (CoA) Ibid.* paragraph 62: Stanley Burnton LJ, Rimer LJ assenting and Lady Justice Arden dissenting

107 *Thin Cap GLO Ibid.* paragraph 82

The author respectfully concurs with Lady Justice Arden (dissenting) and also considers that the ECJ had *Lankhorst-Hohorst* in mind when it prescribed the first of the requirements noted above.

The author considers that whilst taxpayers do have the opportunity under the UK provisions to provide the evidence that the ECJ spoke of, the Tribunal would need to disapply the prescriptive provisions that detach the arms' length test in the legislation from the real world and would need clear guidance on the meaning of :"*…commercial justification…*".

However, the author respectfully dissents from the view that the fact that the inter-company loan merely replaces an arm's length bank loan may be sufficient commercial justification. In her *obiter* Lady Justice Arden said:

> …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.[108]

As stated above (see FN 95), the author is not of the view that the *Lankhorst-Hohorst* loan was commercial because the capital of the subsidiary had not been restored to what it had been at the time that the bank finance was originally drawn down. To that extent, in the author's view, the inter-company loan could reasonably be considered to be capital, not debt.

It appears that we will possibly have to await the judgment of the UK Supreme Court on this.

iii. Anti-avoidance – concluding comments

It is inevitable that provisions aimed at prevention of cross-border diversion of profits within a group on companies will engage and infringe the freedom of establishment. They are special rules applicable only where one or more of the parties is non-resident and they will generally impose a UK tax charge to neutralise the benefit sought to be gained. To extend the rules to internal situations where, in the words of AG Geelhoed, "…*no possible risk of abuse exists*…" (see FN 87), is unnecessary.

Anti-avoidance measures can be justified provided that they are targeted at the abuse, go no further than neutralising the abuse and provide the taxpayer with an opportunity to provide evidence of the commerciality of the arrangement or transaction in question.

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108 *Thin Cap GLO (CoA) Ibid.* paragraph 104

VI. Group Loss Relief Schemes

Of primary interest in this section is *Marks & Spencer*. *ICI* concerned a provision in the loss relief scheme extension to consortiums that disqualified a UK resident company from eligibility because of the investments that it had made. This is discussed briefly below but it is to be distinguished from *Marks & Spencer*, which concerned a claim by a UK parent company to set the foreign operating losses of its foreign subsidiaries against the taxable UK profits of its UK group. The Court had encountered before legislation applicable to groups designed to prevent cross-border transfers or diversion of profits in *Lankhorst-Hohorst* but this was the first time that the Court was required to focus on the implications of ruling that the freedom of establishment required a Member State to extend its scheme for internal grouping of profits and losses to cross-border situations.

i. ICI

This case concerned a claim by ICI (UK resident) for relief in respect of the losses of Coopers Animal Health Ltd ("CAH" - UK resident) under the consortium relief provisions. CAH was owned by a consortium company of similar name (UK resident) and the consortium company was owned 49% by ICI and 51% by Wellcome Foundation Ltd (UK resident). The consortium company also owned 3 other UK resident subsidiaries, 6 subsidiaries resident in other member States and 13 subsidiaries resident in third countries.

The majority of the consortium company's subsidiaries were non-UK resident, and that disqualified the claim by ICI for relief in respect of 49% of CAH's losses, proportionate to its investment in the company. The technical reason for this was that the consortium company needed to satisfy the test that its business consisted 'wholly or mainly' in the holding of shares in trading subsidiaries[109] but shares held in non-resident companies (as well as shares held as trading stock) did not qualify as trading subsidiaries for the purpose of this test.[110]

As a side note, because the majority of the consortium company's subsidiaries were resident outside the EU, the UK rule disqualifying the claim was triggered in the case examined whether or not the UK rule was amended to treat investment in EU companies comparably with investment in UK companies. Accordingly, it was not the exercise of the freedom of establishment (investment in EU companies) that gave rise to the disqualification of ICI's claim under the UK provision.

Whilst, in principle, the UK provision could infringe the freedom of establishment by deterring a UK company from exercising the freedom, the freedom is not

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109 ICTA 1988 s.413(3)(b)

110 ICTA 1988 s.413(5): "*References in this Chapter to a company apply only to bodies corporate resident in the United Kingdom*…"

engaged where the disqualification has been triggered by setting up subsidiaries in third countries and there is no requirement to disapply the provision in such circumstances (although the legislation needed to be amended to remove "*legal uncertainty*")[111].

The UK was unable to offer any justification for the restriction. In response to the claim that the restriction prevented tax avoidance, the Court responded:

> …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[112]

Readers may recognise this type of formulation by the Court and might associate it with *Cadbury Schweppes*, though a later case.

The UK legislation was amended by FA 2000, Schedule 27, paragraph 2. New definitions for "company" were inserted in ICTA 1988, s.413(2)[113] and the words in ICTA 1988, s.413(5) cited in FN 110 were repealed.

ii. ***Commerzbank***[114]

As mentioned above, FA 2000 contained provisions extending group relief to UK branches of non-residents and provisions extending "*no gain / no loss*" transfers of chargeable assets to and from UK branches of non-resident group companies.

To qualify, the non-resident company had to be a member of the "75% group" and the profits or losses, or the chargeable assets, had to be within the scope of the charge to UK corporation tax. It is unclear why these modifications of the provisions were included in that Act but they would appear necessary following *Commerzbank* decided almost exactly five years before *ICI*.

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111 This can be construed from the answer to the second question put to the Court: *ICI Ibid.* paragraphs 33 & 34

112 *ICI Ibid.* paragraph 26. Readers may recognise this type of formulation by the Court and might associate it with *Cadbury Schweppes*. The Court did cite this formulation in part in paragraph 51 of that case.

113 "Company": *any body corporate*; and "non-resident company".

114 *Commerzbank Ibid.*

Commerzbank was a non-resident bank trading in the UK through a branch. The branch was within the charge to UK corporation tax.[115] The branch made loans in the course of its business including some substantial loans to US corporations. Commerzbank paid corporation tax on its trading profits but then claimed exemption from tax on the interest received from the US corporations pursuant to Article 15 of the UK/US DTC. That Article provided that interest paid by US corporations was taxable only in the UK if beneficially received by a UK resident company. Commerzbank was not resident in the UK.

The litigation arose in connection with its claim for '*repayment supplement*'[116] calculated on the corporation tax repaid to it after gaining agreement to its claim for exemption from UK tax on the US source interest income. Repayment supplement was only payable to UK resident companies under the provision as drafted at the time (see FN 116).

The Court ruled that the UK provision was discriminatory.[117] The Court did not elaborate further but it had already said in *Avoir Fiscal*:

> Since the rules at issue place companies whose registered office is in France and branches and agencies situated in France of companies whose registered office is abroad on the same footing for the purposes of taxing their profits, those rules, cannot, without giving rise to discrimination, treat them differently in regard to the grant of an advantage related to taxation, such as shareholders ' tax credits[118]

Whilst residents and non-residents are not necessarily in comparable situations as regards a Member State's legislation, where they are by reason of the Member State's legislation applying to a non-resident in a comparable manner, that non-resident is entitled to the same benefits and reliefs as are available to a resident under the provisions in question.

In Commerzbank the non-resident was entitled to repayment supplement on overpaid corporation tax because a resident would be entitled to that compensation in a similar circumstance.

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115 Corporation Tax Act 2009, s.5(3)

116 Then ICTA 1988, s.825: interest paid at a prescribed rate from the anniversary of the tax due date (generally). By s.825(7), repayment supplement was exempted from both income tax and corporation tax. From 1 October 1993, s.826 applied instead (enacted in F(No2)A 1987 s.87 in connection with the new 'pay & file' corporation tax scheme) and all non-resident companies qualified. There was a comparable exemption in s.826(5). FA 1998, s.34 amended s.826(5) repealing the exemption for persons within the charge to corporation tax.

117 *Commerzbank Ibid.* paragraph 19

118 *Avoir Fiscal Ibid.* paragraph 20

In the context of group relief, there is no logical reason for distinguishing the corporation tax profits or losses of a non-resident 75% group company from those of a resident 75% group company: both are within the charge to corporation tax as regards those profits or losses. That is not to say that the losses of a non-resident arising from an activity conducted outside the scope of corporation tax should be available for group relief: that was the issue considered in *Marks & Spencer*. The non-resident's foreign activities are *not* 'placed on the same footing' as they are not within the scope of the UK charging provisions.

iii. FA 2000 amendments

Separate comment on these provisions is made because they significantly extended the scope of the UK group relief scheme.

The amendments necessitated by *ICI* are noted in FNs 109, 110 and 113.

The Act made further amendments that extended the group relief provisions to UK branches of non-residents (discussed below in relation to *Philips Electronics*) and the amendments necessitated by *ICI* had the effect of repealing the requirement that a 75% group be comprised only of UK resident companies. The legislation defining a 75% group[119] stated:

> …two *companies* shall be deemed to be members of a group of *companies* if one is the 75 per cent. subsidiary of the other or both are 75 per cent. subsidiaries of a third *company*…

Thus, the UK residence requirement for companies in a 75% group was removed through the redefinition of "company"[120],. To maintain the restriction of group relief to companies within the charge to corporation tax, a requirement was inserted that such a company must be either UK resident or trading in the UK through a branch.[121]

This amendment meant not only that the chain of ownership would not be broken for group relief purposes by the interposition of a non-resident holding company[122] but also meant that UK subsidiaries of a non-resident parent could exchange group relief. in that, the amendment goes further than required by EU law. The Court

119 ICTA 1988, s.413(3)(a): emphasis added

120 See FN 113 and the repeal of the words in ICTA 1988, s.413(5) (FN 110)

121 New subsections ICTA 1988 s. 402(3A) & (3B) inserted by FA 2000, Sched.27, para. 1

122 This pre-empted the amendment that would have been required following the decision in ECJ 27 November 2008 C-418/07 *Société Papillon v Ministère du Budget, des Comptes publics et de la Fonction publique* ("*Papillon*") [2008] ECR I-8947 but may have been required by the earlier decision in *X AB & Y AB Ibid.*

confirmed that a situation involving a third country common parent cannot engage Article 49 TFEU in *Thin Cap GLO*:

> Article 43 EC has accordingly *no bearing on* the application of national legislation such as the legislation at issue in the main proceedings to a situation in which a resident company is granted a loan by a company which is resident in another Member State and which does not itself have a controlling shareholding in the borrowing company and where each of those companies is directly or indirectly controlled by a common parent company which is resident, for its part, in a non-member country[123]

In relation to losses available for surrender by UK branches of non-resident companies, however, a further provision was enacted[124] that reduced the eligible losses for any amount that could be deducted '*for the purposes of foreign tax*'. This is discussed in the next section in relation to *Philips Electronics*.

The 2000 Act similarly amended the provisions relating to intra-group transfers of chargeable assets and extended the relief to assets used by, or acquired to be used by, branches of non-resident group companies within the charge to corporation tax in relation to the relevant activities.[125]

iv. Philips Electronics[126]

Philips Electronics UK Ltd (" taxpayer") was a UK resident indirect subsidiary of Koninklijke Philips Electronics NV ("Philips"), a Dutch resident and registered company. The disputed claim for relief was for the losses of a UK branch of a Dutch subsidiary[127] of a Dutch joint venture company owned 50% by the Philips group and 50% by the LG Electronics group (the South Korean electronics giant).

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123 *Thin Cap GLO Ibid.* paragraph 98 Emphasis added

124 ICTA 1988, s.403D(1)(c) inserted by FA 2007, Sched. 27, para.4

125 FA 2000, Schedule 29 amending Taxation of Chargeable Gains Act 1992 ("TCGA 1992"), sections 170 – 179 and other relevant provisions.

126 First-Tier Tribunal 18 August 2009 *Philips Electronics UK Limited and The Commissioners for Her Majesty's Revenue & Customs* ("*Philips Electronics (LTT)*") [2009] UKFTT 226(TC) . The matter has been referred to the ECJ under the Article 267 TFEU procedure: *Philips Electronics (ECJ) Ibid.*

127 The name of the Dutch surrendering company was LG Philips Displays Netherlands BV ("LG.PD")

The provision in ICTA 1988 s.403D(1)(c) was triggered in relation to this claim because LG.PD was a member of a Dutch 'Fiscal Unity'.[128] The losses of LG.PD ("surrendering company") for some of the periods in question were used, in part, in the Fiscal Unity.[129]

(a) First Issue

The first issue considered by the Tribunal was whether the freedom of establishment was engaged.

The taxpayer was a subsidiary of Philips but the surrendering company was owned by the joint venture. Nevertheless, whilst Philips did not have independent control of the surrendering company, the essence of a joint venture is that the principals will:

> …pursue the same interests, take decisions concerning Columbus by agreement through the same representative at the general meeting of Columbus and decide on its activities.[130]

Accordingly, it is correct to regard the surrendering company as being an establishment of Philips for the purposes of Article 49 TFEU.

The conclusion of the Tribunal was:

> Here the person most affected by any restriction on the freedom of establishment is the Taxpayer which will have to pay more tax if it cannot use the losses because of a breach of the directly enforceable Community rights of another company established in the Community. Accordingly, the Taxpayer has standing to raise the issue in these proceedings[131]

The author would contend that UK provisions could only have obstructed the rights of Philips and those of the Dutch surrendering company rather than those of the taxpayer, the claimant of the losses, which does not appear to have exercised its rights under the freedom at all.

The taxpayer was the claimant and the view of the Tribunal does not appear to precisely accord with the view of the Court in *Marks & Spencer*, although the

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128 See the corporate structure diagram on page 4 of *Philips Electronics (LTT) Ibid.* See also ECJ 25 February 2010 C-337/08 *X Holding BV v Staatssecretaris van Financien* ("*X Holding*") [2010] ECR I-XXXX for the Court's review of the Dutch Fiscal Unity scheme.

129 See page 8 of *Philips Electronics (LTT) Ibid.*

130 ECJ 6 December 2007 C-298/05 *Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt* ("*Columbus Container*") [2007] ECR I-10451 paragraph 31

131 *Philips Electronics (LTT) Ibid.* paragraph 14 on page 13

identity of the person disadvantaged by the UK legislation makes little difference. The Court said in *Marks & Spencer*:

> Group relief such as that at issue in the main proceedings constitutes a tax advantage for the companies concerned. By speeding up the relief of the losses of the loss-making companies by allowing them to be set off immediately against the profits of other group companies, such relief confers a cash advantage *on the group*[132]

Apart from the fact that there is no evidence to suggest that the taxpayer had exercised the freedom of establishment, it might be contended also that the taxpayer did not suffer a disadvantage. The Tribunal may not have taken into consideration that a claimant company will generally make a payment for group relief reflecting the tax value of the losses claimed and this will be especially the case where the claimant is a trading company (its profits may be a basis of management remuneration) and where either company is partly owned by third parties. The UK legislation specifically exempts such a payment from tax.[133] Accordingly, it is generally the surrendering company, at the entity level, that obtains the cash advantage by monetising its losses and it is 'the group' at consolidated level that gains also.

Within the concept of establishment, however, it might be said that the parent company *is* the group: the concept of the freedom is that a parent is conducting its business through companies that are its "subsidiaries":

> …a parent company might be dissuaded from carrying on its activities through the intermediary of a subsidiary established in another Member State…[134]

Thus, the author would contend that the establishment rights infringed by the restriction in the UK legislation (if such is determined to be an infringement) are those of Philips, the relevant parts of the group being the taxpayer (wholly owned) and the surrendering company (50% owned). There is also a separate infringement of the rights of the surrendering company itself.

At the entity level, the surrendering company would be deterred from exercising its right of establishment and setting up a branch in the UK by a tax regime that would

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132 ECJ 13 December 2005 C-446/03 *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* ("*Marks & Spencer*") [2005] ECR I-10837 paragraph 32: emphasis added

133 ICTA 1988, s.402(6) re-enacted as CTA 2010 s.183 provided that the payment does not exceed 100% of the actual losses surrendered.

134 ECJ 18 September 2003 C-168/01 *Bosal Holding BV and Staatssecretaris van Financien* ("*Bosal*") [2003] ECR I-9409 paragraph 27

tax the profits of the branch as if it was constituted as a UK resident company[135] but would deny the benefits of the group relief scheme.

However, the action was not brought by the surrendering company.

Nevertheless, a restriction on the exercise of a freedom by a company that is regarded as a 'subsidiary' is also a restriction on the exercise of the freedom of the company regarded as being its 'parent' for the purposes of relief under Article 49 TFEU. By analogy, where a UK resident subsidiary borrows money from a sister subsidiary resident in a Member State and the interest on the loan is adjusted under thin capitalisation rules so as to tax disadvantage the UK resident borrower:

> …that measure [UK thin capitalisation provisions] affects freedom of establishment, not as regards the lending company, but only as regards the parent company which enjoys a level of control over each of the other companies concerned allowing it to influence the funding decisions of those companies…[136]

Thus, by two routes, it is possible to identify Philips, the parent company, as the person whose rights under Article 49 TFEU have been infringed if, that is, the UK provisions do cause a restriction.

That said, it is not thought that the identity of the disadvantaged person is material to the question of whether the UK provisions infringe the Treaty freedom.

(b) Second Issue

The second issue considered by the Tribunal was whether the UK law created a restriction. Two provisions were considered.

Firstly, there appears to have been a technical issue arising from the definition of "link company" in ICTA 1988 s.406(1)(a), which is probably unintended.

The *link company* is the company in the 75% group that owns the share in the consortium company and any member of the 75% group is entitled to step into the shoes of the *link company* and make a claim[137] for losses from a company owned by the consortium by reference to the *link company's* proportionate entitlement. It would seem that no amendment was made to this provision when the amendments to the definition of *company* were made in response to *ICI*. Because, following those

135 See CTA 2009, s.5(3)

136 *Thin Cap GLO Ibid.* paragraph 99

137 Note that the claim is not limited by the profits of the link company: ICTA 1988, s.406(2) states: "…*(disregarding any deficiency of profits)…*"

amendments, a non-resident company could be a 75% group company, the *link companies* in the case of this structure, being non-resident and conducting no trade in the UK themselves, could not actually make a claim. The taxpayer, in consequence, could not, technically, make a claim for the surrendering company's losses.

In the view of the Tribunal, ICTA 1988, s.406(2) creates a restriction[138].

The second provision considered was ICTA 1988, s.403D(1)(c) and the restriction to a claim in respect of the UK branch losses of a non-resident by reference to losses given relief against foreign tax.

The Tribunal appears to have gained inspiration from the Advocate General's Opinion in *ACT IV GLO*[139] recited in full to them by counsel for the taxpayer. The Tribunal observed that:

> We tax a UK branch in exactly the same way as a UK subsidiary (or a separate UK company) so far as the branch profits or losses made in the UK are concerned, except in relation to group relief under s 403D(1)(c)…the limitation on group relief is something that affects non-resident companies only and is therefore a restriction [140]

Whilst it is true that ICTA 1988, s.403D(1)(c) does not apply to UK resident companies, it should be noted that ICTA 1988 s.403E contains similar provisions applicable to the foreign branch losses of UK resident companies and ICTA 1988, s.404 ("dual resident investing companies") also applies to UK resident companies.
The Tribunal's comment suggests some form of discrimination but there appear to be restrictions of a similar nature applicable to resident companies. It is contended that a broader view of the UK provisions is necessary. Though concerning a different matter, a conforming interpretation of the UK's CFC legislation, the Chancellor in his judgment in *Vodafone2* said this:

> …the obligation of the national court is to examine the whole of the national law to consider how far it may be applied so as to conform to enforceable Community rights[141]

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138 *Philips Electronics (LTT) Ibid.* paragraph 17 on page 15

139 *ACT IV GLO Ibid.* paragraphs 48 to 69 and, particularly, paragraph 51 distinguishing between source states and states of residence.

140 *Philips Electronics (LTT) Ibid.* paragraph 21

141 Court of Appeal (England and Wales) 22 May 2009 *Vodafone 2 v The Commissioners for Her Majesty's Revenue & Customs* ("*Vodafone 2*") [2009] EWCA Civ 446 paragraph 34

Taking that broader view of the group relief provisions, there appears to be a general restriction aimed at preventing double dipping of losses.

The author does not mean to say that there is not a restriction.

The UK provision challenged appears to be flawed in concept. Where a state is exercising its taxing rights under a DTC and is taxing a non-resident, it is of no concern to it, as a general rule, what is happening in the state of residence of the non-resident[142]. Where the state is taxing a person as a resident, it is generally required by a DTC to provide relief to prevent double taxation of any income or profits falling to be taxed in the other contracting state.

Accordingly, following *Avoir Fiscal*[143], the branch must be treated in a manner that is equivalent to that afforded to a resident company. This is the same conclusion as the Tribunal's but it does not require the other provisions to be disregarded so that it can be said that the restriction applies only to non-resident companies.

Though the corresponding provision restricting the group relieving of losses of foreign branches of UK companies[144] was not in point, that, too, would appear to give rise to a restriction. The better adjustment, in the view of the author, is to restrict credit relief for foreign tax borne by the branch on subsequent profits to the extent that it would not have been levied had the foreign losses remained with the branch available for carry forward and set off against the subsequent profits instead of being used against the profits of another foreign person.

(c) Third and fourth Issues

The third issue was whether the restrictions could be justified and the Tribunal held that they could not. The Tribunal had no need to consider the fourth issue, whether the restrictions satisfied the principle of proportionality, but did so in relation to s.403D(1)(c) in case its conclusion that the restriction could not be justified was incorrect. The Tribunal concluded that the provision was disproportionate in a 'terminal loss' situation such as considered by the Court in *Marks & Spencer*, which is discussed below.

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142 Exceptionally, a source state may be required to have regard for the situation in the state of residence as the non-resident may be in a situation comparable to that of a resident when he/it has no source of income outside the source state: see ECJ 14 February 1995 C-279/93 *Finanzamt Koln-Altstadt v Roland Schumacker* ("*Schumacker*") [1995] ECR I-225 and ECJ 18 July 2007 C-182/06 *État du Grand-Duché de Luxembourg v Hans Ulrich Lakebrink, Katrin Peters-Lakebrink* ("*Lakebrink*") [2007] ECR I-6705 for instance.

143 *Avoir Fiscal Ibid.* paragraph 20

144 ICTA 1988, s.403E

(d) Conclusion

Both UK provisions challenged appear to cause an infringement of Article 49 TFEU although the infringement caused by ICTA 1988, s.406(1)(a) appears to have arisen inadvertently in consequence of the FA 2000 amendments and a failure of the Parliamentary Draftsman to follow through the consequences of the changes to the consortium relief provision.

The restrictive provision in ICTA 1988,s. 403D(1)(c) appears to be misconceived and unjustifiable. If the UK branch of a non-resident company is permitted to group relieve its losses, it will not have those losses to set against profits within the charge to corporation tax in a later period. The author cannot see how a double deduction can be obtained for UK tax purposes.

The restrictive provision in ICTA 1988, s.403E(2) was not in point. In the author's view, it is disproportionate. If the foreign branch of a UK company permits the use of its foreign losses against the profits of another person and, as a consequence, those losses are not then available to set off against subsequent foreign profits earned by the branch, a double benefit[145] will arise when the UK permits credit against UK tax levied on the branch profits for foreign tax levied on those subsequent profits. It appears to the author that a more appropriate counter to this double benefit would be to deny a DTR credit to the extent that the foreign tax would not have been assessed had the foreign branch retained its foreign losses for its own use.

v. *Marks & Spencer*

This case concerned the foreign losses of the UK company's foreign subsidiaries and a claim by the UK parent to offset those losses under the UK's group relief provisions against the UK corporation tax profits of the UK parent or its UK subsidiaries.

This is situation is different from that in *Avoir Fiscal* and *Commerzbank*.

The foreign subsidiaries were not in a situation comparable to that of the UK parent or its UK resident subsidiaries as regards entitlement to the benefits of the group relief legislation because the activities of the non-residents that gave rise to the losses were not within the scope of the UK charging provisions.

145 The double benefit is a double deduction for UK tax purposes. Firstly, a deduction for the branch losses adjusted for UK tax purposes as group relief; and, secondly, a deduction for foreign tax as credit relief from UK corporation tax. In the author's view, the extended source/residence argument conducted in the Tribunal hearing is irrelevant. The Advocate General was talking about allocations of taxing rights in a DTC and the responsibility of the state of residence under a DTC to provide a remedy for double taxation that would arise if it taxed foreign source income and profits.

However, the fact that the foreign subsidiaries were in a situation as regards the UK's corporation tax provisions that was different from the situation of the UK resident companies does not mean that the denial of relief for the foreign losses does not infringe the Treaty freedom.

The denial of the right to offset the foreign losses against UK profits, and thereby reduce the level of UK tax liability and cash outflow, is clearly a disadvantage to the group and is such as might deter the parent company from exercising the freedom of establishment and setting up subsidiaries abroad, which is a restriction.[146]

That is not the end of the matter, however. An infringement will be permitted if it can be justified.

Much has been written on this key case and the Court has cited its analysis in a number of later cases. There has been much discussion and questioning of what the Court actually meant by what it said in paragraphs 41 to 57 of its judgment, not least of all by an Advocate General and by the UK courts. The Court said in paragraph 41:

> …it is necessary to consider what the consequences would be if an advantage such as that at issue in the main proceedings were to be extended unconditionally

If the 'advantage', the group relief rules, was to be extended unconditionally:

> … the choice of the Member State of taxation would be a matter for the group of companies, which would have a wide discretion in that regard[147]
> …any extension of that advantage to cross-border situations would…have the effect of allowing parent companies to choose freely the Member State in which the losses of their non-resident subsidiary are to be taken into account…[148]

Or, in other words:

> …[the] State [in which the taxable profits have arisen] would be obliged to abandon its right to tax a profit generated through an economic activity undertaken on its territory[149]

146 *Marks & Spencer Ibid.* paragraphs 33 & 34

147 ECJ 18 July 2007 C-231/05 *Oy AA* ("*Oy AA*") [2007] ECR I-6373 paragraph 65

148 *X Holding Ibid.* paragraph 40

149 *ACT IV GLO Ibid.* paragraph 59

Whilst these judgments were handed down by the Court subsequent to *Marks & Spencer*, the Court had already stated its position more than seven years earlier:

> …if the State of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income, which would entail a loss of tax revenue for it and would thus be such as to encroach on its sovereignty in matters of direct taxation.[150]

The Court recognised that a group could shuffle profits and losses around the European Union using national grouping schemes and such behaviour is clearly not within the concept of the freedom. The concept involves the movement of persons conducting economic activities not the detachment of the results of those economic activities and their distribution elsewhere.[151]

Thus, whilst the restriction of the group relief provisions to profits and losses within the charge to UK corporation tax infringes the freedom of establishment, the Court recognised that:

> … in so far as it may be possible to identify other, less restrictive measures, such measures in any event require harmonisation rules adopted by the Community legislature[152]

The restriction was found to be disproportionate, however, in the situation where the losses of the foreign subsidiary could not be used, or expected to be used, in its state of residence. There has been considerable debate over what the Court may have meant by what it said in paragraph 55 but there is a general consensus that it is referring to 'terminal losses'.

The meaning of the ECJ's paragraph 55 conditions has received some consideration in the English courts and the interpretation endorsed by the Court of Appeal[153] was:

> Sub-paragraph 1: exhaustion of the possibilities available to the foreign subsidiary under local law to use the losses in the current period or previous periods; or to transfer them to another company for use.[154]

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150 *Gilly Ibid.* paragraph 48

151 The author's view and the subject of his research thesis.

152 *Marks & Spencer Ibid.* paragraph 58

153 Court of Appeal (England and Wales) 20 February 2007 *Marks & Spencer Plc v Halsey (HMIT)* ("*Marks & Spencer (CoA)*") [2007] EWCA Civ 117

154 *Marks & Spencer (CoA) Ibid.* paragraph 45

> Sub-paragraph 2: no real possibility of the foreign company being able to use the losses at a future time or transfer them to another person for use: future use of the losses should be regarded as 'possible' even if there is no real likelihood of them being used.[155]

It would be difficult for the claimant to argue that the condition in sub-paragraph 2 is satisfied at a time that the foreign subsidiary is still engaged in commercial activities as the claimant would then have to explain why the foreign subsidiary is continuing to operate without any prospect of making a profit.

There is logic to that ruling. In such a situation, unless the subsidiary is permitted by its parent to go into insolvent winding-up, the commercial loss is borne by the parent in its state of residence. It may be borne as a 'capital loss' but, where the national provisions would permit the parent both to book the capital loss and also relieve the operating loss of a resident subsidiary against operating profits, it would be a restriction if the national provisions did not permit comparable treatment of capital and operating losses deriving from a foreign subsidiary. That would be a different treatment of a cost suffered in relation to an investment dependent on where that investment was made.[156]

That does leave open the circumstance where, under local law, the losses that arose in previous periods are not for some reason usable against the profits of the continuing operations and it would not be permitted to use them even if, in future, the activities of the company were to be changed. *Krankenheim Ruhesitz* is considered below.

Krankenheim Ruhesitz

This case is mentioned because the Court did consider the obligations of a state of origin in relation to losses incurred by an establishment in another EEA state that could not be used in that state because of a restriction provided in the law of that state that was triggered by the circumstances of the principal company's business conducted outside that host state.

Krankenheim Ruhesitz was:

> …a limited liability company established in Germany which operated a permanent establishment situated in Austria from 1982 to 1994. Before the end of 1990, it made losses for that establishment totalling DEM 2 467 407, of which DEM 36 295 related to that year[157]

155 *Marks & Spencer (CoA) Ibid.* paragraph 49

156 See by analogy: *Bosal Ibid.*

157 *Krankenheim Ruhesitz Ibid.* paragraph 13

However, as regards those Austrian branch losses:

> Until 1988, Austrian tax law made no provision for the carrying forward of losses incurred by partially-taxable companies, i.e. by permanent establishments belonging to companies based in the territory of a State other than the Republic of Austria[158]

Although Austria changed its law in 1989, and allowed carry forward of losses incurred by branches of non-residents, the amount that could be recognised as carried forward as at 31 December 1988 was restricted to the losses incurred in the preceding 7 years; and, in the case of each year, restricted to the excess of the loss of the branch over the worldwide profits of the principal company. Accordingly, no loss could be carried forward for a particular period if the profits of the principal company earned outside Austria exceeded the loss of the Austrian branch.

Krankenheim Ruhesitz actually concerned a German tax scheme that permitted a German company to deduct foreign branch losses from its German tax profits on the basis that the relief would be reversed in later periods if the branch generated profits, in line with the profits made. The complaint of the taxpayer concerned this reversal of relief but the Court found the German tax rule to be justified.[159] It was then that the Court considered the "no possibility" relief provided for in the German provisions that would have resulted in the German relief becoming permanent had the situation of the Austrian branch satisfied the conditions in that German provision.[160]

The conditions in that relieving provision were:

- The German taxpayer had to provide evidence; and
- That the [Austrian] law did not permit losses to be carried forward [or back].

The fact that advantage could not be taken of a carry forward provided in the [Austrian] law [because of the restriction in the carry forward in the Austrian law by reference to the overall position of the German company in the period in which the branch loss occurred] was to be disregarded.

Thus, the German 'no possibility' relief looked only at whether there was a provision in the law of the other state permitting losses to be carried forward and was it was denied if there was such a provision even if that law restricted a carry forward in the circumstances of the claimant.

158 *Krankenheim Ruhesitz Ibid.* paragraph 11

159 *Krankenheim Ruhesitz Ibid.* paragraphs 43 to 45

160 *Krankenheim Ruhesitz Ibid.* paragraph 47 et sequa

The Court said:

> …a Member State cannot be required to take account…of the possible negative results arising from particularities of legislation of another Member State applicable to a permanent establishment situated in the territory of the said State which belongs to a company with a registered office in the first State[161]
>
> Nor can the assessment that the restriction arising from the said tax system is justified by the need to ensure the coherence of that system be called into question by the fact, referred to by the referring court in its third question, that the principal company disposed of its permanent establishment and that the profits and losses made by that establishment throughout its existence end with a negative result.[162]

The 'third question' referred to was:

> …must the State of residence refrain from retroactive recovery of tax on losses incurred by a permanent establishment situated in another Member State, to the extent to which those losses cannot otherwise be deducted in any Member State on the ground that the permanent establishment in that other Member State has been disposed of?[163]

The infringement, if any, results from the Austrian provision[164] in much the same way as it was concluded above that ICTA 1988, s.403D(1)(c) creates a restriction, as discussed in relation to *Philips Electronics*. But, though the Court did extend the *Marks & Spencer* 'paragraph 55' *proviso* to a situation involving a branch in *Lidl*[165], it nevertheless appears to have refused to extend relief to *Krankenheim Ruhesitz* in respect of the unrelieved losses that it incurred, possibly as a result of flawed Austrian legislation. The 'no possibilities' test was not satisfied because Austrian law provided for the carry forward of losses and because the branch continued its activities. Indeed, the Court observed in *Lidl*:

> …it must be pointed out that Luxembourg tax legislation provides for the possibility of deducting a taxpayer's losses in future tax years for the purposes of calculating the tax base[166]

161 *Krankenheim Ruhesitz Ibid.* paragraph 49

162 *Krankenheim Ruhesitz Ibid.* paragraph 53

163 *Krankenheim Ruhesitz Ibid.* paragraph 22

164 *Krankenheim Ruhesitz Ibid.* paragraph 51

165 ECJ 15 May 2008 C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzampt Heilbronn* ("*LidL*") [2008] ECR I-3601 paragraphs 46 to 48

166 *LidL Ibid.* paragraph 49

It would appear that the 'hard line' interpretation of the 'paragraph 55' *proviso* in *Marks & Spencer* by the Court of Appeal is consistent with both *Krankenheim Ruhesitz* and with *Lidl* and that the state of origin cannot be forced to provide relief for losses incurred in another state where there is a technical disallowance by the host state of losses incurred there by a branch or subsidiary established there.

Amendments made to the UK legislation

The UK's response was to amend the law and the new provisions were introduced by FA 2006, section 27 and Schedule 1. Non-resident companies qualifying under this legislation include third country resident companies that conduct trading activities through a PE or branch in an EEA state, so far as the claim would relate to the losses from those activities in the EEA territory, provided that the PE activities were not exempt from tax in the EEA territory under a provision in a DTC or otherwise.

The amendments, thus, reflected the extension of group relief to UK branches of non-resident companies: see VI iii above and the reference to FA 2000, Schedule 27. The 'terminal loss requirements' stipulated by the ECJ in paragraph 55 of the judgment are reflected in "*The qualifying loss condition*" set out in ICTA 1988, Schedule 18A, paragraphs 5 to 8.

vi. Group Loss Relief – concluding comments

ICI and *Commerzbank* re-affirm the principles, respectively, that a person should not be dispossessed of an entitlement merely because he has exercised a Treaty freedom of movement and that a non-resident should be treated under the law no less favourably than a resident if the law in question places the non-resident in a situation comparable to that of a resident. This latter rule re-iterates what the Court said in *Avoir Fiscal*.

The principle re-affirmed in *Commerzbank* necessitated the extension of the UK's group relief rules to UK branches of non-resident companies qualifying with the required shareholding relationships.

Philips Electronics has still to be considered by the ECJ but it is likely that it will strike down the restrictions in the UK legislation. The comment that it made in paragraph 51 of *Krankenheim Ruhesitz* is suggestive of that outcome.

Marks & Spencer, however, involved a taxpayer claim of a very different nature that would have run a coach and horses through the concept of direct tax sovereignty already upheld by the Court in *Gilly*. Whilst the Court had to find that the denial of loss relief in respect of foreign subsidiaries resulted in a disadvantage to a parent company exercising the freedom of establishment, the Court had to consider the implications of forcing the UK to extend the benefit unconditionally. The reserved competence to define the scope of its taxing powers would be devoid of meaning in the context of groups, which could shuffle profits and losses, detached from the underlying economic activities, around the Union to suit themselves. The Court declined to so hold that the restriction of group relief to UK resident companies (and now, to UK branches of non-resident companies) was an unjustifiable infringement except in the situation where, in cases of a disposal or a solvent winding up, the parent company would bear the cost of the subsidiary's operating losses itself.

The UK amended its legislation to conform with the ruling.

The Court has yet to consider a situation where a foreign subsidiary is allowed to go into insolvent winding-up with the consequence that creditors bear some of the cost of the operating losses. The author would speculate that the Court's answer would be that the parent's claim should be treated under national rules *no less favourably* because the subsidiary is a non-resident company. Whether relief can be claimed will depend upon the national rules dealing with claims for losses sustained by insolvent resident companies.

VII. Inbound Dividends

i. *FII GLO*[167]

The UK's dual system for relieving economic double taxation of company dividend income was considered by the Court in this case. These rules applied only for the purposes of corporation tax: the income tax rules for taxation of dividend income are different.

Dividends received from UK companies are exempt from corporation tax.[168] Dividends received from non-resident companies were subject to charge to corporation tax but with credit relief in all cases for any foreign withholding tax and, where the recipient group controls 10% or more of the voting shares of the non-resident company, credit relief for tax paid by that company on the profits distributed.[169]

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167 For a more detailed analysis of the case and the Court of appeal judgment Court of Appeal (England and Wales) 23 February 2010 *Test Claimants in the Franked Investment Group Litigation - and - (1) Commissioners of the Inland Revenue (2) Commissioners of Her Majesty's Revenue and Customs* ("*FII GLO (CoA)*") [2010] EWCA Civ 103 : see Turner GHJ (2010) *Taxation of Foreign Dividends - the permitted way to calculate credit relief for the purposes of UK corporation tax* The EC Tax Journal Vol. 11 Iss. pages 41-71

168 Formerly ICTA 1988, s.208 re-enacted as CTA 2009, s.1285. Exceptions to the rule are financial traders and Lloyds underwriters. This section was repealed by FA 2009, Schedule 14, paragraph 27. The corporation tax regime for both UK and foreign source dividends was revised by FA 2009 as explained in the text.

169 ICTA 1988 s.790 and sections 792 to 806M. The basic calculation rule for 'underlying tax' relief was in s.799.

The specific exemption of UK source dividends and the credit relief scheme for foreign source dividends were repealed by FA 2009 and a revised regime, basically an exemption regime, was substituted for both.[170]

The change from a credit relief scheme to an exemption scheme for foreign source dividend income appears to have been unnecessary:

> …Community law does not, in principle, prohibit a Member State from avoiding the imposition of a series of charges to tax on dividends received by a resident company by applying rules which exempt those dividends from tax when they are paid by a resident company, while preventing, through an imputation system, those dividends from being liable to a series of charges to tax when they are paid by a non-resident company[171]

However, that does not mean that the UK's credit relief scheme satisfied EU law:

> It is thus clear from case-law that, whatever the mechanism adopted for preventing or mitigating the imposition of a series of charges to tax or economic double taxation, the freedoms of movement guaranteed by the Treaty preclude a Member State from treating foreign-sourced dividends less favourably than nationally-sourced dividends, unless such a difference in treatment concerns situations which are not objectively comparable…[172]

Thus the Court has said that the UK may use different schemes for relieving economic double taxation of, respectively, domestic and foreign source dividend income but only provided that the treatment applied to foreign source dividend income is not 'less favourable' than that applied to domestic dividends.

The benchmark is set by the scheme for domestic dividends. The scheme applied to foreign dividends is compared to that and must not provide lower relief for economic double taxation.

To compare the scheme applied to foreign dividend income to the scheme applied to domestic dividends, it is necessary to define the UK exemption scheme in terms of an equivalent credit relief scheme.

The exemption for domestic dividend income is equivalent to levying corporation tax on the income when it becomes taxable in the hands of the shareholder[173] and

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170 FA 2009, s.34 and Schedule 14 introducing new Part 9A into CTA 2009 comprising new sections 931A to 931W.

171 *FII GLO Ibid.* paragraph 48

172 *FII GLO Ibid.* paragraph 46

173 The date on which the income arises is the date when the dividend is declared as payable.

providing a credit at the same rate of corporation tax. The tax paid, if any, by the company making the distribution is irrelevant.

It follows that the credit against corporation tax that should be permitted under a compliant scheme should be based on the nominal rate of foreign tax in force at the time that the foreign dividend becomes payable.

The exception to this noted by the author in his article on this case (see FN 167) is where the foreign company is streaming up dividends from a lower tier investment and the foreign company is an 'establishment' of the UK shareholder. In that case, if a higher level of credit would be granted against corporation tax if the UK shareholder held the investment in the lower tier company directly, the appropriate proportion of the foreign company dividend should attract that level of credit.[174]
It appears that the Austrian government adopted a simplified form of relief based on nominal rates of foreign corporation tax on 13 June 2008.[175]

There has been further reference to the Court for clarification on matters referred to in the judgment.[176]

ii. *Lenz*

The judgment was handed down on 15 July 2004.

Domestic source dividend income was taxable on residents at a rate calculated at 50% of the effective rate borne by a resident's income including, for the purpose of calculating the effective rate, the dividend income (or a flat rate of 25% if lower). Foreign source dividends were taxed at the flat rate of 25%. Thus, foreign dividend income might bear a higher rate of income tax than domestic source dividend income and this disadvantage might be such as to deter an Austrian resident from investing in foreign companies, which, as a corollary, would deny or impede to foreign companies access to the Austrian capital market.

The Austrian rules caused a restriction to the free movement of capital.[177]

It should be noted that the rate of income tax charged in the case of either source was not in any way linked to the tax paid by the distributing company.

174 By analogy with *X AB & Y AB Ibid.* A loss of credit relief would deter a UK company from holding its investment through its foreign subsidiary.

175 *Haribo Ibid.* paragraph 99

176 The case number C-35/11 has been allocated.

177 *Lenz Ibid.* paragraphs 20 - 22

Prior to the amendments made in 2008,[178] UK residents were granted a credit[179] against income tax chargeable on UK dividend income but not against income tax chargeable on foreign source dividend income. In substance, denying a tax credit against income tax chargeable on foreign source income is equivalent to charging income tax at a higher rate. See FN 179 to see the mechanism enacted to maintain the higher rate liability (40% - 20% charged on the grossed-up dividend) following the earlier change of the dividend tax credit system when the 1/9th tax credit was brought in.[180]

Following the amendments in 2008, UK residents were entitled to a credit that discharged the basic rate of income tax applicable to dividend income regardless of whether the source was a domestic company or a foreign company. Because Article 63 TFEU is engaged, the benefit of the tax credit must be extended to third country source dividend income.

There remained one restriction, however. The new relief only applied to 'minority' holdings in foreign companies, less than 10% of the issued share capital. This was amended in 2009[181] to enable relief to be claimed in respect of dividends derived from larger holdings provided that the distributing company resides (solely) in a territory that has concluded a DTC with the UK containing a 'non-discrimination article'.

iii. Inbound Dividends – concluding comments

The elimination of the restriction caused by the discriminatory tax credit system applicable to income tax was overlooked at the time that the legislature was preparing the ground for the repeal of the ACT system. It was subsequently resolved but a discriminatory system existed prior to April 2008.

The UK 'solved' the perceived problem for corporation tax by enacting a new scheme exempting foreign dividends. This may have been unnecessary although further clarification has been sought from the Court of Justice.

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178 FA 2008, s.34 and Schedule 12 amending ITTOIA 2005 s.397 and inserting in that Act new sections 397A to 397C effective from 6 April 2008.

179 The credit is equal to 1/9th of the cash dividend received or 10% of the grossed-up dividend (ITTOIA 2005, s.397(1)), which discharges the "dividend ordinary rate" of Income Tax (ITA 2007, s.8(1)). Higher rate taxpayers will be taxed at 32.5% of the grossed-up amount but can deduct the tax credit to reduce tax payable to 22.5% of the grossed-up amount, or 25% of the cash dividend.

180 The changes were enacted in F(No 2)A 1997, s.30 effective from 6 April 1999, to coincide with the repeal of ACT although pension funds (by s.19 of that Act) ceased to be entitled to repayment of tax credits attaching to UK dividends paid on or after 2 July 1997.

181 FA 2009, s.40 & Schedule 19

VIII. Barrier to entry

The author has considered the special legislation introduced in Finance Act 2006[182] determining special treatment of allowances claimable in respect of capital expenditure on 'plant & machinery' where the asset is leased under 'long funding lease'.[183] Whereas the general rule is that it is the legal owner of the asset who may claim the tax allowances, it is the lessee under a *long funding lease,* the 'economic owner' who has the right to claim the allowances under the special rules.

The view of the author was that these rules would put an inward investor at a commercial disadvantage to a domestic investor in circumstances where these rules are most likely to apply, in the case of substantial investment in plant & machinery, and that, following *Caixa-Bank*[184], the provisions would infringe the freedom of establishment.

The commercial disadvantage arises because an inward investor, who would most likely have insufficient or no tax base in the UK, would be reliant on a finance lease from a UK bank to gain benefit from the accelerated capital allowances claimable by reason of the capital investment. This might be particularly so because of the likely delay before the new enterprise started to make taxable profits in the UK. The provisions prevent the inward investor from using that means of finance to obtain that cash flow benefit.

A domestic investor would have an established tax base in the UK and would be likely to be able to gain immediate benefit from the capital allowances by way of set off against its other taxable income.
There does not appear to be any action pending.

IX. Recent EU Commission challenges

The EU Commission published a news release[185] on 16 February 2011 stating that it had:

> …formally requested the United Kingdom to amend two discriminatory

182 See Capital Allowances Act 2001 ("CAA 2001") as amended ss. 70A – 70YJ

183 Turner GHJ (2009) *Long funding leases and the EC Treaty (ECT)* International Tax Report Vol. 2009 Iss. February pages 1- 12

184 ECJ 5 October 2004 C-442/02 *Caixa-Bank France v Ministère de l'Économie, des Finances et de l'Industrie* ("*Caixa-Bank*") [2004] ECR I-8961

185 IP/11/158

anti-abuse tax regimes which concern the transfer of assets abroad[186] and attribution of gains to members of non-UK resident companies[187].

i. Transfer of Assets Abroad

The legislation is now included in ITA 2007 sections 714 – 751. It has been on the statute books for some time:

> It is notorious that before the passing of this legislation [i e the Finance Act 1936, s 18] individuals who were minded to enjoy their income without bearing any appropriate burden of British taxation were able to do so by transferring assets productive of income to a non-resident person or company by whom the income was retained abroad, so as not to incur taxation in England. The money representing the income was then by means of one or other of several well-known expedients, transferred to England as capital.[188]

The legislation is widely drawn. There must be a transfer of income producing assets to a person resident or domiciled abroad and a UK resident individual must have some power to enjoy that income, or part of it, in some manner (whether as income, or as capital appreciation or as a benefit or otherwise). It also includes a contingent right to enjoy the income in some manner.

One consequence of the charging provision is that an individual may become assessed to UK tax on the income (or part thereof by reason of HMRC practice) of a company resident outside the UK. In contrast, an individual investing in a UK resident company (that has no activity or investment outside the UK) is not assessed on that company's income. There is different treatment according to where the company '*has its seat*' or the other form of presence is established. This is similar to the consequences considered by the Court in *Cadbury Schweppes* and a restriction will be found as the tax disadvantage created is such as to deter UK individuals from investing outside the UK.[189]

There are exemptions. There is an exemption for arm's length transactions effected in the course of a trade or business, or for the purpose of setting up such.[190] And there is an exemption for transactions not related to a business where the taxpayer

186 Formerly ICTA 1988 s.739 re-enacted as ITA 2007, s.720

187 Taxation of Chargeable Gains Act 1992 ("TCGA 1992"), s.13

188 Lord Greene MR in *Inland Revenue Commissioners v Barclays Bank Ltd* 25 TC 107at page 115.

189 *Cadbury Schweppes Ibid.* paragraph 46

190 See ITA 2007, s.737(2)(b), (4) & s.738

can satisfy HMRC that none of the purposes of the transaction was to avoid 'taxation'.[191]

This exemption does not seem to satisfy the requirement of the Court that a provision infringing a Treaty freedom can be justified on the grounds of preventing tax avoidance only if it applies to *wholly artificial arrangements.*[192]

ii. Attribution of capital gains of non-resident companies

The legislation applies only to non-resident companies that would be '*close*'[193] if they were resident in the UK. A UK resident, or ordinarily resident, person (including a company) who, together with interests of connected persons[194], has an interest exceeding 10% of any chargeable gain realised by the company at the time that the gain was realised is assessed to UK tax on that interest in the gain as if that proportion of the gain had accrued directly to him/it.

The legislation provides exemptions in relation assets used by the non-resident company for the purposes of a trade carried on outside the UK and for chargeable gains on assets within the charge to Corporation Tax.[195]

One consequence of the charging provision is that a '*participator*' may become assessed to UK tax on his/its proportionate share of the gains of a separate legal person whereas he/it would not be assessed in that manner where the company is resident in the UK. There is different treatment according to where the company '*has its seat*'.

The analysis is as for the *Transfer of Assets Abroad* legislation.

iii. Investments engaging the free movement of capital

Both sets of provisions appear to have been in force on 31 December 1993 in materially the same form. This might limit the application of the freedom where the

191 See ITA 2007 s.737(2)(a) & (3). But 'taxation' is defined to include any taxes, duties or national insurance contributions.

192 See, for instance, *Lankhorst-Hohorst Ibid.* paragraph 37

193 See definition in CTA 2010 s.439 (by TCGA s.288(1)): such a company is controlled by 5 or fewer '*participators*' or by '*participators*' who are directors of the company. '*Participator*' has an extended meaning (see CTA 2010, s.441) to include loan creditors and persons having rights to acquire voting rights and rights to distributions or being able to secure that the income or assets of the company will be (wholly or partly) applied directly or indirectly for his benefit)

194 'C*onnected*': see TCGA s.286.

195 See subsection 5. Gains on assets used for the purpose of a UK trade will be within the charge to Corporation Tax.

investment is made in a state not party to the EEA Agreement.[196] This derogation will apply to 'direct investments' which are:

> Holdings in a company which are…acquired with a view to the establishment or maintenance of lasting and direct economic links between the shareholder and that company and… allow the shareholder to participate effectively in the management of that company or in its control…[197]

The derogation will apply also 'real estate': that is property that it owns "...*as part of the pursuit of its activities*…" or which "…*it itself manages*…".[198]

X. Concluding comments

This article commenced with a quote and a proposition. The quote was from Mr Justice Park (FN 2)

> It took quite some time for the possible implications of Community law upon the direct tax systems of Member States to be appreciated…

The proposition was:

> [a] person exercising the freedom must be treated *no less favourably* by his home state because he has exercised his Treaty rights and he should be treated *no less favourably* by the host state than it treats its own residents or nationals in comparable situations

A number of cases have been considered and mentioned. They span from January 1986 (*Avoir Fiscal*) to February 2011 (*Haribo*) and it is hoped that it has been demonstrated through cross-referencing that the fundamental rules, as summarised in the proposition, are consistently applied.

In sum total, the UK has not had to make swathes of amendments to its national legislation. The ACT scheme caused problems for international groups headquartered in the UK and the repeal process was under way long before the ECJ judgment in *Metallgesellschaft*. The changes to the rules for taxing foreign dividends (corporation tax) appear to have been unnecessary although the litigation process is still in progress. The constraint on anti-avoidance legislation to have

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196 See Article 64 TFEU.

197 *FII GLO Ibid.* paragraph 196

198 ECJ 11 October 2007 C-451/05 *Européenne et Luxembourgeoise d'investissements SA (ELISA) v Directeur général des impôts, Ministère public* ("*ELISA*") [2007] ECR I-8251 paragraph 65

application only to tainted profits can only be termed as reasonable. Most of the other changes were required to make the legislation even-handed: on what basis should a non-resident 75% group company be denied access to the Group Relief provisions in respect of its corporation tax profits or losses (relating to a UK branch)? If a UK company bearing the loss of an insolvent UK subsidiary can take relief for both the capital loss and the operating losses of that subsidiary, why should it not be entitled to do similarly in relation to a foreign subsidiary, established in the EEA? In both cases, it will be bearing the loss out of its own pockets unless creditors are left to bear the loss.

The impact of EU Law on the UK Direct Tax System has been to curb legislative excesses and to force removal of some distortions in the provisions, particularly those applying to groups of companies.

What is becoming apparent from the extensive post-ruling litigation in our courts is that insufficient investment is being made to understand EU Law and the decisions of the ECJ.

The Author pointed out in his article on *FII GLO*[199] that the English court appeared to ignore the two cases cited by the Court in paragraph 46 of its judgment.[200] And though the Tribunal that decided *Philips Electronics* was not required to look at the mirror provision applying to restrict surrender of losses incurred by a UK resident company in a foreign branch, the author considers that it should have done so before stating that: "…*limitation on group relief is something that affects non-resident companies only and is therefore a restriction*…", because the author considers that this is simply untrue. The group relief scheme applicable to branch losses (where there is a cross-border element) must be viewed as a whole. Both sister provisions were enacted at the same time.

The true constraints imposed by EU Law, to curb legislative excesses and to enforce even-handedness in the provisions, are to be welcomed.

The EU Commission has raised a challenge in respect of the UK's *Transfer of Assets Abroad* provisions. It is perhaps fitting to conclude this article with an extract from Lord Wilberforce's judgment in 1979 in *Vestey*, which was concerned with the application of these provisions in a previous enactment.

> In a case such as Lord Howard de Walden v Inland Revenue Comrs…The transferor…who derived a **comparatively small benefit** from the transferred assets, was taxed in respect of **the whole income**….It was an entirely valid argument…to say that the section was penal and meant to deter transfers abroad. In such a context his metaphor of burnt fingers is

199 See FN167

200 *Lenz* and *Manninen*

completely apposite. But the argument turns the other way when so Draconian a tax ('astonishingly severe' were leading counsel for the Crown's words) is sought to be imposed on **persons who had no hand in the transfer, who may never benefit from it, who cannot escape from it, who remain under liability so long as they live or the settlement lasts.** In relation to such persons equity and principle suggest that Parliament intended no such thing, or at least cannot be assumed from the veiled language used to have intended any such thing. To penalise is one thing, to visit the sins of the transferor on future generations is quite another…[201]

201 UK House of Lords 22 November 1979 *Vestey v Inland Revenue Commissioners (Nos 1 and 2)* ("*Vestey*") 54 Tax Cas 503 Emphasis added