A MISUNDERSTANDING OF fACT-*METALLGESELLSCHAFT*

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Abstract:

The UK's ACT system was construed as a mechanism for prepaying corporation tax whereas, applying the Court's own criteria to the characteristics of the charging mechanism, it was a mechanism for taxing distributions. The Group Income Election can then be seen as a mechanism enabling distributions by UK companies to be taxed only when they emerge from the grouping. Following the Court's observations in relation to 'coherence', the UK had a defendable right to ensure that ACT was charged eventually. Extending the right to join in a GIE to non-resident parent companies would have prevented the UK from collecting tax on distributions made by UK subsidiaries. Accordingly, applying the Court's comparability test to determine whether there was discrimination, it is concluded that, in the context of a GIE and the ACT legislation, a non-resident parent company was not in a situation comparable to that of a UK resident parent company as it was outside the scope of that tax.

1. INTRODUCTION

There can be little doubt that the UK's scheme of Advance Corporation Tax ("ACT") introduced in 1972[2] deterred outward investment from the UK and made

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2 Finance Act 1972 ("FA 1972"), Part V and relevant schedules.

the UK less attractive to foreign groups as a state in which to site their headquarters. That was undoubtedly the reason for the repeal of the tax.[3]

However, the ACT scheme did not deter outbound investment simply because the payment of the tax gave rise to "cash flow disadvantages", a feature of the tax that appears to have caught the focus of the Court in *Metallgesellschaft*[4]. The feature of the ACT scheme that deterred outbound investment and led to the repeal of the tax was "*…the problem of surplus advance corporation tax (ACT) which arises where a company pays dividends out of foreign income.*"[5]

That, essentially, was the problem examined by the Court in *FII GLO*[6]. More precisely, the question examined was whether a UK resident company subject to the ACT regime might be deterred from investing in a non-resident company because dividends received from a non-resident company could not "frank" its distributions for ACT purposes to its own shareholders. That not only resulted in a cash flow disadvantage to the parent but, more importantly, often led to the parent company paying ACT that could not be utilised anywhere in the group. Accordingly, that question related to an obstruction to outbound investment, with the UK acting as a state of origin. A similar question arose in *Accor*[7] in relation to the French scheme.

In contrast, the question in *Metallgesellschaft* related to inbound investment with the UK acting as a host state. The question was whether the provision that restricted eligibility to join in making a Group Income Election[8] ("GIE") to UK resident companies discriminated against UK subsidiaries directly owned by non-

3 By FA 1998 s.31 with effect from 6 April 1999.

4 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 at paragraph 54, for instance

5 Cited from the note to the annotated Finance Act 1994, Schedule 16, as published by the Institute of Taxation. FA 1994, s.138 and Schedule 16 enacted the Foreign Income Dividends scheme, which attempted to address this problem. A brief summary of the scheme can be seen in *FII GLO*, paragraphs 23 – 25.

6 ECJ 12 December 2006 C-446/04 *Test Claimants in the FII Group Litigation* ("*FII GLO*") [2006] ECR I-11753 at paragraph 96, for instance

7 ECJ 15 September 2011 C-310/09 *Ministre du Budget, des Comptes publics et de la Fonction publique v Accor SA* ("*Accor*") [2011] ECR I-0000

8 The GIE was enacted in the Income and Corporation Taxes Act 1970 ("ICTA 1970"): 1970 Chapter 10: 12 March 1970, Section 256. Section 256(1) was amended by FA 1972, as explained later, to apply to ACT. Section 256(2) was unaffected. The revised election was re-enacted as Income and Corporation Taxes Act 1988: 1988 Chapter 1: 9 February 1988 ("ICTA 1988") section 247.

resident parents, which were barred by that provision from joining with their UK resident subsidiaries in an election.

The focus of this article will be the decision in *Metallgesellschaft* and consideration of the true 'objective pursued' by the GIE, which was an election that permitted a UK resident subsidiary to pay a dividend to its UK resident parent without having to account for ACT.

As the heading of this article suggests, it appears to the author that there was some misunderstanding by the Court of the ACT scheme and that its examination and analysis was based upon that misunderstanding. In particular, the Court's analysis proceeded on the basis that ACT was a mechanism of prepayment of corporation tax whereas, as will be strongly argued, it was a tax on distributions.

As the Court has stated itself on a number of occasions, the interpretation of a Member State's national legislation is a matter for the national court alone, not a matter for the Court of Justice:

> "In this case, <u>it is for the national court to determine</u> whether…the motive test, as defined by the legislation on CFCs, lends itself to an interpretation which enables the taxation provided for by that legislation to be restricted to wholly artificial arrangements…"[9]
>
> …it must be noted that <u>it is not for the Court</u>, in the context of a reference for a preliminary ruling, <u>to give a ruling on the interpretation of provisions of national law</u> or the definition of the factual context…"[10]
>
> The existence of legislation in Portugal providing for dividend tax withheld in the Netherlands to be taken into account, by way of granting a full tax credit, is precisely <u>a matter of fact which is not for the Court to determine</u>."[11]

The GIE, it will be explained, gave effect to a form of consolidation under which the parent company would become liable for the tax chargeable on distributions made by it out of profits generated by the group. Whilst it is true that the parent

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9 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 paragraph 72 emphasis added

10 ECJ 4 December 2008 C-330/07 *Jobra Vermögensverwaltungs-Gesellschaft mbH v Finanzamt Amstetten Melk Scheibbs* ("*Jobra*") [2008] ECR I-9099 paragraph 17 emphasis added

11 ECJ 8 November 2007 C-379/05 *Amurta SGPS v Inspecteur van de Belastingdienst/Amsterdam* ("*Amurta*") [2007] ECR I-9569 paragraphs 64 to 66 emphasis added

will pay dividends out of its own reserves, the level of dividend paid by a group parent will be determined by reference to the profits reported in the group's consolidated profit and loss account. To service this distribution burden, a group parent company will call up distributions from its subsidiaries.

The form of consolidation was special in that a subsidiary could decide on the occasion of each payment of a dividend whether to pay the dividend, or a specified part of it, under the election. Nevertheless, to the extent that a dividend was paid under election, it was disregarded for the purposes both of the charging provision and for that of the relieving provision applicable to the parent company.

This form of consolidation mechanism for charging a tax on distributions ceases to have any meaning when the parent company is non-resident and outside the scope of the charging provision. This clearly troubled Lord Hoffmann when he came to consider *Metallgesellschaft* when delivering his judgment in *Boake Allen*:

> "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."[12]

Lord Hoffmann did not make the point but, as dividends can only flow upwards to the parent, the result of all UK subsidiaries paying their dividends within the election would have been that the parent would have been accountable for the tax on distributions as if its subsidiaries were branches. It would be the parent that would have borne the full burden of the tax on distributions made outside the group to its own shareholders. The analysis conducted by the Court in subsequent tax consolidation cases will be considered.

Furthermore, the Court has recognised that where there is a link between a relieving provision and a charging provision, the coherence of the system cannot be assured unless the state can be certain of collecting the tax:

> "Cohesion of the tax system necessarily required that, if the Belgian tax authorities were to allow the deductibility of life assurance contributions from taxable income, they had to be certain that the capital paid by the assurance company at the expiry of the contract would in fact subsequently be taxed."[13]

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12 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

13 ECJ 7 September 2004 C-319/02 *Petri Manninen* ("*Manninen*") [2004] ECR I-7477 paragraph 47

Whilst the Court's case law relating to the coherence of the tax system stresses the importance of the relief and the charge applying to a single taxpayer, to the extent that the GIE applied to a distribution, it effectively treated the subsidiary and parent as such by disregarding the distribution until it emerged from the parent to the external shareholders of the group.

The discussion will proceed as follows:

- The nature of the tax: was ACT a 'prepayment of corporation tax' or was it a tax on distributions, as the author contends?
- In order to conduct the 'discrimination analysis', it is necessary to identify "*the objective pursued by the national provisions at issue*".[14] It will be necessary to discover from the Court's case law at what level the 'objective' is to be identified.

  As will be explained, the overall scheme had the objective of providing a means of mitigating economic double taxation; but the ACT charging provisions had the objective of ensuring that the imputed tax credit was funded.

  It is concluded that neither of these 'objectives pursued' is relevant to the analysis to be conducted in relation to the restrictive provision in the GIE.
- The underlying reasons for providing the GIE facility consisted of the reasons for providing it prior to the enactment of the ACT provisions and, additionally, to operate with a sister provision to enable efficient usage of ACT paid by a group within the group.

  The 'objective pursued' by the GIE, it is concluded, was to provide a consolidation mechanism for UK groups that enabled the ACT due on distributions outside of the group to be collected in a manner that enabled the group to optimise its ability to set the tax off against its corporation tax liabilities.
- Having determined the nature of the tax and the objective pursued by the GIE, it will be then necessary to apply the Court's analysis.

It is concluded that the situation of a non-resident parent seeking to elect with its UK subsidiary under a GIE was not comparable to that of a resident parent seeking to elect with its UK subsidiary. That is because the non-resident parent was outside the scope of the tax and ACT could then not be charged on a distribution out of UK source profits.

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14 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 paragraph 27

The conclusion reached is that the restriction in the GIE provisions that prevented a non-resident parent company from entering into an election with a resident subsidiary was not discriminatory.

2. THE NATURE, STRUCTURE AND 'OBJECTIVE PURSUED' BY THE ACT SCHEME

This section has a rather grand title but it is necessary to determine the purpose of a national provision as:

> "…the comparability of a Community situation with one which is purely domestic must be examined by taking into account the objective pursued by the national provisions at issue (see, to that effect, *Metallgesellschaft and Others*, paragraph 60…)"[15]

As the Court did conduct such an analysis of the UK ACT provisions including the GIE, in particular, in *Metallgesellschaft*, it is necessary to be clear on what their purpose was and which provisions are to be examined to determine the relevant "objective pursued".

For instance, should all of the provisions introduced in 1972 be examined? Or should those only relating to the charge on the company making the distribution (including the offsets and reliefs) be examined? Or should focus be restricted to the GIE only? These questions will be answered by reference to the examinations conducted by the Court in its case law starting, naturally, with *Papillon*.

As a preliminary, however, it is necessary to understand the nature and structure of the tax provisions.

The Court's perception of the tax (both in the negative sense and in the positive sense) was:

> "…ACT is in no sense a tax on dividends but rather an advance payment of corporation tax…" [16]

Such construction of the national provisions is a matter reserved to the national court. There are a number of features of the tax that do not sit comfortably with that perception and one such characteristic was noted by the Court subsequently in *FII GLO*:

15 *Papillon* paragraph 27: emphasis added

16 *Metallgesellschaft* paragraph 52

> "…The chargeable event for the ACT which a company receiving foreign-sourced dividends must pay is therefore not the receipt of those dividends but the payment of those dividends to its own shareholders."[17]

As a first step, the UK statutory provisions will be considered.

I. The Nature of ACT and the Structure of the Statutory Provisions

The Court does provide a summary of the UK legislation as re-enacted in ICTA 1988 in its judgment[18] but, whilst the relieving provisions of the 1972 legislation were in some cases amended subsequent to enactment to reduce the burden of the tax, the scheme of the tax was unchanged by those amendments and it is more easily understood from the provisions as originally enacted.

The principal provisions are to be found in FA 1972, Part V, sections 84 to 92 and, in relation to the GIE, Schedule 15, Part II.

The charging provisions are to be found in section 84, subsections (1) & (2). It is contended that the nature of the tax is to be determined from these provisions. The statute says:

> "(1) Where a company resident in the United Kingdom makes a qualifying distribution after 5th April 1973 it shall be liable to pay an amount of corporation tax (to be known as "advance corporation tax") in accordance with this section.
>
> (2) Subject to section 89 below, advance corporation tax shall be payable on an amount equal to the amount or value of the distribution, and shall be so payable at a rate (to be known as "the rate of advance corporation tax") which for the period beginning with 6th April 1973 and ending with 31st March 1974 shall be three-sevenths and thereafter such fraction as Parliament may from time to time determine." (emphasis added)

Section 89 referred to provides that the company making a distribution is liable to pay ACT only to the extent that the 'franked payment' (dividend plus ACT) exceeds its 'franked investment income' (dividends received from UK resident companies plus attaching tax credits – "FII"). This aspect of the scheme is not relevant here though it is relevant to *FII GLO*.

It is the wording of subsection (1) that may have caused the Court to misunderstand the nature of the tax.

17 *FII GLO* paragraph 110

18 *Metallgesellschaft* paragraphs 5 to 24

Despite the fact that the statute terms ACT "*an amount of corporation tax*", that does not actually make it "corporation tax", the legislation for which was enacted in 1965:

> "For the financial years 1964 and 1965 there shall be charged on profits of companies a tax, to be called corporation tax, at such rate as Parliament may hereafter determine; and corporation tax shall be charged also, and this Part of this Act shall apply, for any later financial year for which Parliament so determines."[19]

Corporation tax is a tax on profits. ACT was a tax payable on distributions by UK resident companies. They are different taxes having different bases of assessment. As can be seen from the charging provision for ACT, the liability for the tax is triggered by the making of a distribution and the amount of the tax payable is calculated as a fraction, then 3/7th, of the distribution made. There is no reference whatsoever to the chargeable profits of the company. Nor is there any provision enabling repayment of ACT except where FII is received later in the same accounting period and is not used to frank any further distributions. Not only was it possible that ACT paid in the accounting period would exceed the offset against corporation tax permitted, there were provisions[20] stipulating what could be done with that excess, referred to as 'surplus ACT'.

Indeed, the offset against the corporation tax liability specified in s.85(2) is most certainly not £1 for £1. In the first case, as originally enacted, the offset was restricted to corporation tax arising on income: that is, not including chargeable gains[21]. In the second place, the maximum offset was the amount of ACT that would be included in a hypothetical franked payment equal to the whole of the income (subsequently 'profits') charged to corporation tax.

Finally, s.85(1) provided:

> "…advance corporation tax paid by a company (and not repaid) in respect of any distribution made by it in an accounting period shall be set against its liability to corporation tax on any income charged to corporation tax for that accounting period and shall accordingly discharge a corresponding amount of that liability."

19 Finance Act 1965, Part IV, s.46(1) emphasis added

20 FA 1972, ss.85 & 92.

21 The restriction of offset against corporation tax to that chargeable on income was repealed by Finance (No 2) Act 1987, s.74(2) when the fractional reduction of companies' chargeable gains introduced in FA 1972, s.93 was repealed

The ACT paid could be used to discharge a corporation tax liability but that does not mean that it was, by reason of this, 'corporation tax'.

Income tax suffered by a UK resident company by withholding at source from income was also recovered by discharging a liability to corporation tax:

> "…where a company resident in the United Kingdom receives any payment on which it bears income tax by deduction (not being franked investment income), the income tax thereon shall be set off against any corporation tax assessable on the company by an assessment made for the accounting period in which that payment falls to be taken into account for corporation tax…"[22]

It cannot be argued that income tax is a prepayment of corporation tax merely because income tax suffered by a UK resident company in an accounting period can be set against and discharge a liability to corporation tax.

Note the exclusion of income tax suffered on FII before the introduction of ACT: this will be referred to later in the article when the pre-1972 enactment of the GIE is discussed.

If ACT truly was a "prepayment" of corporation tax, any surplus would have been repayable and there would have been no restriction on offset. In contrast, income tax suffered by deduction from source from income (other than FII) was repayable to the extent it was in excess of the corporation tax liability for the accounting period in which the income arose. If ACT is evaluated on the sole criterion that it could discharge (in part) a corporation tax liability, then income tax suffered by a company by deduction could be viewed as a prepayment of corporation tax also and a stronger case for that could be made out.

ACT was a separate tax levied on a different basis and such conclusion appears to be totally consistent with the Court's conclusion seven months later in *Athinaiki*:

> "It is apparent from the order for reference…<u>that the chargeable event for the taxation at issue in the main proceedings…is the payment of dividends. In addition, the amount of tax is directly related to the size of the distribution</u>…
>
> Contrary to the submissions of the Greek Government, <u>the taxation cannot be treated like an advance payment or prepayment (précompte) of corporation tax</u> to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company, within the meaning of Article 7(1) of the Directive. <u>The taxation relates to income</u>

22 ICTA 1970, s.240(5)

> which is taxed only in the event of a distribution of dividends and up to the limit of the dividends paid. That is shown by the fact (*inter alia*) that…the increase in the basic taxable amount generated…by the distribution of profits cannot be offset by the subsidiary using negative income from previous tax years, contrary to the fiscal principle enabling losses to be carried forward which is nevertheless laid down in Greek law."[23]

Thus, referring back to the Court's description of ACT in paragraph 52 of its judgment: "*…ACT is in no sense a tax on dividends but rather an advance payment of corporation tax…*", it can be said that is quite the contrary and that the Court has so held in relation to a Greek tax having similar characteristics.

Following the analysis in *Athinaiki*, ACT is a tax on distributions and, giving consideration to the statutory offset rules and to the fact that it is neither calculated by reference to profits nor repayable if found to be in excess of the corporation tax liability, it cannot be construed as a prepayment of corporation tax.

If a company makes a payment of corporation tax that is found to be excessive, that excess is repaid with the addition of 'repayment supplement' if eligible. That aspect of the UK system was examined in detail in *Commerzbank*[24].

The nature of the tax was that it was a tax on distributions made. The scheme of the tax was that, to the extent that the company was redistributing dividends received from other UK resident companies[25], it was liable to ACT only on the excess of its own distributions over such dividends received in the same or prior accounting periods and not previously redistributed. In that way, the UK Treasury could ensure that the repayable credit attaching to the distributions was fully funded. That scheme was no different in structure from that in existence before the enactment of the FA 1972 ACT provisions.

II. The objective pursued by the legislation

The overall objective of the UK legislation enacted in 1972 was stated by Lord Hoffmann in *Boake Allen*:

> "The economic purpose of this system was to ensure that a company's profits were not taxed twice: first as profits earned by the company and

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23 ECJ 4 October 2001 C-294/99 *Athinaiki Zithopiia AE and Elliniko Dimosio (Greek State)* ("*Athinaiki*") [2001] ECR I-6797 paragraphs 28 & 29 emphasis added

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

25 But not "group income": that is, dividends paid under the GIE.

> then again as dividends received by the shareholders…."[26]

The restrictive scheme examined in *Metallgesellschaft*, the GIE, however, was that enacted as a substitute for ICTA 1970, s.256(1)[27] by FA 1972 s.91 and Schedule 15, Part II:

> "Where a company receives dividends from another company (both being bodies corporate resident in the United Kingdom)… the company receiving the dividends and the company paying them may jointly elect that this subsection shall apply to the dividends received from the latter by the former… any such dividends shall be excluded from sections 84(1) and 86 of the Finance Act 1972 and are accordingly not included in references to franked payments made by the company paying the dividends or the franked investment income of the company receiving them…"

FA 1972, s.86 referred to provides the relief for the tax credit in the calculation of the ACT payable. If the subsidiary paid a dividend under election, its parent was denied the tax credit relief that it would otherwise have been able to claim against its own ACT liability when it paid out its own dividends. That disadvantage to the parent[28] was the reason why an election was necessary: the parent had to consent to the imposition of an increased ACT burden.

The restriction in the UK provisions was that only UK resident companies were eligible to join in an election and that there had to be a parent/subsidiary relationship between them. There was no requirement that the ultimate parent of the group had to be UK resident[29].

The action of the GIE was to disapply the ACT charging provision. The exclusion of a dividend paid under election from the classification of FII follows that. In *Metallgesellschaft*, the Court focussed on the relief from the obligation to pay ACT:

> "…it is contrary to Article 52 of the Treaty for the tax legislation of a Member State…to afford companies resident in that Member State the possibility of benefiting from a taxation regime allowing them to pay dividends to their parent company without having to pay advance

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26 *Boake Allen* paragraph 2

27 Re-enacted as ICTA 1988, s.247(1)

28 That disadvantage to the parent is comparable to the disadvantage litigated in *FII GLO*

29 If a non-resident company directly owned a UK resident company that owned one or more sub-subsidiaries, the UK subsidiary was fully entitled to enter into an election with its sub-subsidiaries. It was only the non-resident company that was not eligible.

> corporation tax where their parent company is also resident in that Member State but to deny them that possibility where their parent company has its seat in another Member State."[30]

The UK pointed out the coherence of the election to the Court[31] but its submission was dismissed by the Court citing in paragraph 52 its misunderstanding of the nature of the tax previously mentioned:

> "*...in so far as ACT is in no sense a tax on dividends but rather an advance payment of corporation tax...*".

That aside, it is necessary to determine whether the objective of the legislation is to be deduced at the level of the overall objective of the scheme (to mitigate economic double taxation) or whether it should be deduced at a lower level, being either at the level of the charging structure or at the level of the GIE itself.

As mentioned earlier, at the beginning of Section 2, the comparability test was defined by the Court in *Papillon*. The use of the test in that case will now be examined in order to see how it should be applied to the ACT legislation and the GIE. Two other cases will be examined, *X Holding BV*, which involved a claim to include a non-resident subsidiary in a tax consolidation and *Oy AA*, which involved a claim to make a financial transfer from a resident subsidiary to a non-resident parent, will then be examined briefly to make certain other points of distinction.

i. Papillon

The analysis in *Papillon* is particularly important to *Metallgesellschaft* because the Court made direct reference to *Metallgesellschaft* in paragraph 27 where it set out its definition of the test to be applied.

The matter in point was the French Tax Integration scheme, which enables a French resident parent company to form a single reporting entity with its 95% owned French resident subsidiaries for French company tax purposes. It would seem that the consolidation need not consist of all eligible companies as the subsidiaries have to give their consent to being included. The tax advantage is that profits and losses are automatically netted off.

However, only French resident subsidiaries owned by 'companies in the group' were eligible. In particular, as was the situation in point in the case, if a French resident subsidiary was owned directly by a non-resident[32] company, itself a

30 *Metallgesellschaft* paragraph 76

31 *Metallgesellschaft* paragraph 47

32 In *Papillon* the non-resident was a Dutch company

subsidiary of the French parent, that break in ownership by French companies included in the consolidation rendered the French subsidiary ineligible to be included in the Tax Integration.

That was the restriction.[33]

The stipulated test, as mentioned earlier, was:

> "…the comparability of a Community situation with one which is purely domestic must be examined by taking into account the objective pursued by the national provisions at issue…"[34]

The Court's analysis of the French scheme was as follows:

- The scheme aimed to treat the group as if it was the parent trading through branches, which are its consolidated subsidiaries (paragraph 28):

  The Court is not looking at the wider tax scheme but only at this special mechanism for assessing a parent and its 95% subsidiaries that have elected to be treated as a single reporting entity.

- The objective of the scheme can be achieved regardless of whether there is a non-resident company inserted in the ownership structure (paragraph 29):

  The Court is looking at the function of the restrictive provision and is concluding that the adjustments required to achieve the consolidation can be made just as well when there is a break in French ownership provided that the information required can be obtained.

- The situation where there is a non-resident company in the ownership structure is comparable to that where all companies in the ownership structure are French as the objective of the scheme is to consolidate only the profits and losses of the French companies as if they accrued directly to the French parent company (paragraph 30).

Applying this analysis to the GIE, which might be regarded as a mechanism for consolidating a parent and its elected subsidiaries for the purposes of charging ACT payable on distributions, the introduction of a non-resident parent in the structure will result in situations that are not comparable because the tax was levied only on UK resident companies.

The coherence of the election, under which the parent accepted a liability to ACT that was increased by the amount by which its subsidiary's liability was reduced,

33 Article 49 TFEU *Papillon* paragraph 32

34 *Papillon* paragraph 27

assuming that the parent paid a dividend at least equal to that paid to it by its subsidiary, could not have been achieved where the parent was a non-resident because that parent was not within the scope of the charge to ACT.

Pursuing this point on "coherence" a little further, although not attempting to do so to provide a "justification", where there is a linked relief and charge to tax, and where there is a single taxpayer, or two or more persons treated by the taxing provision effectively as such[35], the Court has said:

> "Cohesion of the tax system necessarily required that, if the Belgian tax authorities were to allow the deductibility of life assurance contributions from taxable income, they had to be certain that the capital paid by the assurance company at the expiry of the contract would in fact subsequently be taxed"[36]

The Court recognises that the relief may be denied if the linked tax charge cannot be levied. If a non-resident parent had been permitted to enter into a GIE with its UK resident subsidiaries, the linked tax charge could not have been levied. That was pointed out to the Court:

> "…if resident subsidiaries and their non-resident parent companies were able to benefit from the group election regime, no ACT at all would be paid in the United Kingdom."[37]

The Court's answer to this was, as noted before:

> "*…ACT is in no sense a tax on dividends but rather an advance payment of corporation tax…*"

The Court did not perceive ACT as a tax and therefore could not see the coherence.

Following the test prescribed, a group consisting of a non-resident parent company and its directly held resident subsidiary is not comparable, for the purposes of a GIE, to a group consisting only of UK resident companies. That is because the former could have avoided paying ACT on distributions if a GIE between them had been permitted.

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35 The Court appears to have accepted that the companies included in the French Tax Integration Scheme could be regarded as a single taxpayer: "*…the direct link which exists under the tax integration regime between the tax advantages and the neutralisation of intra-group transactions would thus be eliminated, thereby affecting the coherence of that regime*" (paragraph 50). The elimination of inter-company transactions is a key feature of any consolidation.

36 *Manninen* paragraph 47 emphasis added

37 *Metallgesellschaft* paragraph 48

ii. X Holding BV[38]

This case naturally follows on from *Papillon* in a sense because it concerned the Dutch tax integration scheme and a provision that restricted eligibility to be included to Dutch resident subsidiaries. The French Tax Integration Scheme similarly limited eligibility to French resident subsidiaries but that restriction was not subject to challenge in *Papillon*.

Whilst the Court did not cite *Papillon* in its statement of the test to be conducted, the test is the same, even if the description is slightly different:

> "…the comparability of a Community situation with an internal situation must be examined having regard to the aim pursued by the national provisions at issue…"[39]

The Court's analysis was:

> "…the situation of a resident parent company wishing to form a single tax entity with a resident subsidiary and the situation of a resident parent company wishing to form a single tax entity with a non-resident subsidiary are objectively comparable with regard to the objective of a tax scheme…which…allows the profits and losses of the companies constituting the single tax entity to be consolidated at the level of the parent company and the transactions carried out within the group to remain neutral for tax purposes…"[40]

The restriction was justified but, of concern here, is the Court's analysis and whether there are implications for the application of the test to the GIE provisions.

It must be noted that the Dutch national tax provision applied to the Dutch resident parent and that situation was unaffected whether it elected or not under the taxing provision to include one or more of its subsidiaries. The effect of the election to form a single tax entity was that the Dutch resident parent was accountable for tax on the profits of the subsidiary consolidated as if it was a branch of the parent and the losses of the subsidiary were dealt with in a similar manner. It could be of advantage or disadvantage to the Dutch parent depending on the results of its subsidiary and whether, if profitable, those results would be taxed at a lower rate in the state of residence only if no election was in place.

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38 ECJ 25 February 2010 C-337/08 *X Holding BV v Staatssecretaris van Financien* ("*X Holding*") [2010] ECR I-1215

39 *X Holding* paragraph 22 The case cited was ECJ 18 July 2007 C-231/05 *Oy AA* ("*Oy AA*") [2007] ECR I-6373 paragraph 38

40 *X Holding* paragraph 24

As was the case in *Papillon*, *X Holding* concerned an outbound investment situation whereas *Metallgesellschaft* concerned an inward investment situation. The reporting entity remained within the scope of the national taxation. It made no difference to the comparability test that *X Holding* sought to consolidate the results of a non-resident. The Court did agree that the Netherlands was justified in denying such a consolidation but that is a different matter.

In contrast, if a non-resident parent has been entitled to enter into a GIE with its UK resident subsidiary, the UK could not have levied ACT on the distributions made out of UK source profits.

Although not involving a review of a consolidation mechanism, the Court's examination in *Oy AA* of the Finnish system of intra-group financial transfers addressed an inward investment situation and, for that reason, it is considered next.

iii. Oy AA

The case concerned a claim by a Finnish subsidiary of a non-resident parent to make an intra-group financial transfer under the Finnish tax code to its parent and thereby transfer an amount of its taxable profits reflecting the value of the financial transfer to its parent. The Finnish provision did not permit this mechanism of providing group relief to be used to transfer profits to outside Finland's taxing jurisdiction.
The Court looked at the purpose of the financial transfer scheme:

> "…the purpose of the Finnish system of intra-group financial transfers is to remove tax disadvantages inherent in the structure of a group of companies by allowing a balancing out within a group that comprises both profit-making and loss-making companies."[41]

It should be noted that this was not a consolidation mechanism where the subject matter of the taxing charge is folded into the parent company's tax assessment. The fact that Finland would expect to tax the financial transfer in the hands of the parent in an internal situation does not change the fact that the Finnish legislation applied separately to the subsidiary and to the parent, if tax resident in Finland. The Court did observe that the coherence of the scheme could be preserved by making deductibility of the financial transfer conditional upon it being taxable in the hands of the parent.[42] However, that was of little comfort to Finland in a cross-border situation.

41 *Oy AA* paragraph 35

42 *Oy AA* paragraph 37

In this case, the treatment of the subsidiary under the Finnish provisions was different because of the residence status of its parent:

> "A difference in treatment between resident subsidiary companies according to the seat of their parent company constitutes an obstacle to the freedom of establishment if it makes it less attractive for companies established in other Member States to exercise that freedom…"[43]

This was the Court's finding also in *Metallgesellschaft* based on its concept of the ACT legislation and the effect of the GIE:

> "…the legislation in question creates a difference in treatment between subsidiaries resident in the United Kingdom depending on whether or not their parent company has its seat in the United Kingdom…"[44]

But the UK provision did not treat the UK subsidiaries of foreign parents differently. The restriction applied to the non-resident parent company, not to the subsidiary. The GIE consolidation was not permitted because the parent company was outside the scope of the tax.

Oy AA does not assist the analysis of the restrictive provision in the GIE but it does confirm that the analysis is to be conducted at the level of the special taxing scheme.

iv. Summary

In *Papillon*, the Court looked at the objective of the French Tax Integration scheme. That objective was to treat a resident parent and its elected subsidiaries as a single reporting entity, which would report only the net profit or loss of its dealings with the outside world.

The same objective is evident in the Dutch tax consolidation scheme examined in *X Holding* and that was what the Court based its analysis on.

Though the mechanism to obtain a netting-off of the results of a parent and a subsidiary was different in the Finnish system examined in *Oy AA*, the provisions were examined by reference to that same objective: the netting off of profits and losses within a group.

The UK's ACT scheme levied a tax on distributions made by UK resident companies.

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43 *Oy AA* paragraph 39

44 *Metallgesellschaft* paragraph 43

Viewing the GIE at the same level as that indicated in the three cases discussed, at the level of the special scheme, it was a consolidation mechanism and the effect of applying the election was that only distributions made to persons outside of that consolidation were subject to taxation.[45] Distributions, unlike transfers of losses or of profits, can move only in one direction: from subsidiary to parent. The objective of the GIE could not be achieved when the parent company was non-resident and outside of the scope of the charging provision.

Looking behind the objective at that level, it is possible to identify reasons for the provision of the GIE facility in the legislation that relate to the usage of the ACT generated by a group. As the 1972 Act provisions amended the GIE facility previously provided in the legislation, there would have been reasons for the provision of that facility in the previous statutory scheme for taxing company distributions.

These reasons for the provision of the GIE facility in the legislation will be considered below.

It might be argued that the reasons for the provision of the facility are not critical to determine the objective of the legislation for the purpose of the comparability test and the Court's discrimination analysis. It should be sufficient to make a finding that the objective of the provision was to provide a consolidation mechanism for the charging of ACT and the reasons for providing a consolidation mechanism should not really be relevant.

However, it can be demonstrated that the GIE consolidation mechanism was not provided solely, or mainly, for the purpose of providing the cash flow benefit that the Court based its analysis on.

Firstly, however, the pre-1972 scheme for taxing company distributions will be considered as the GIE facility was provided prior to the enactment of the ACT scheme.

III. The pre-1972 scheme for taxing company distributions

The charging provisions are to be found in 'Schedule F' set out in ICTA 1970, s.232.

Section 232(2) required UK companies to account for income tax at the basic rate on all distributions and section 232(3) empowered the distributing company to

45 It should be noted that where a subsidiary was only partly owned by the parent (directly and/or indirectly), the dividends paid to the minority shareholders were subject to the normal charging provisions.

withhold the income tax from the distribution paid.[46]

Accordingly, the income tax was levied on the beneficial owner of the distribution, the parent, and any cash flow disadvantage accrued to that person, not to the payer of the distribution, the subsidiary. This is the complete reverse of the situation following the enactment of the ACT scheme in FA 1972 and it will be recalled the importance placed by the Court on that cash flow benefit to subsidiaries under a GIE.

Section 238(2) exempted UK resident companies (and the trading UK branches of non-resident companies) from Income Tax on income and section 238(1) imposed the charge to corporation tax. Section 239 exempted distributions from UK companies from corporation tax.

Thus so far, a UK resident company was exempt from both income tax and corporation tax on UK source dividends but found itself bearing by deduction from dividends income tax to which it was not chargeable.

A UK company bearing such income tax to which it was not chargeable could not obtain repayment of it.[47] That income tax levy was ring-fenced. The basic scheme for the use of such income tax borne was set out in section 240 and Schedule 9. The dividend income subject to withholding of income tax under the legislation described was referred to as 'Franked Investment Income' ("FII"), a term used also in the FA 1972 ACT scheme.

The scheme in section 240 was that the excess of FII received over distributions made was to be carried forward to be treated as FII received in the following year. The ACT scheme had an identical provision.

Thus, it can be seen that, in the ordinary course, when a company paid its dividends to individual shareholders and to funds, the dividends would carry a tax credit fully funded (from the perspective of the state) by incremental withholdings made by companies paying dividends up the corporate chain.

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46 ICTA 1970, Schedule 9 contained the accounting provisions and income tax was only payable in respect of the excess of dividends paid over qualifying dividends received ('FII'). The amount that needed to be remitted could be further reduced for income tax suffered by deduction on, say, interest received.

47 ICTA 1970, s.240(1) - subject to the special scheme in ICTA 1970 s.254, which involved, very broadly speaking, a temporary mortgage of losses (widely defined) which was reversed when payments of dividends exceeded receipt of dividends in a later period

i. Groups – what may have been the objective of a group income election

What of a group situation? It is (hopefully) clear that the scheme described so far has, as its objectives, the taxation, by withholding, of shareholders in relation to the dividend income and the full funding of the tax credit attaching to dividends paid. Where a dividend is paid to a UK resident company, the intention is that that company acts as a conduit for the taxed income and it only has to make withholding from its own dividends to the extent that its own distributions exceed those received by it (after taking account of brought forward excess FII, as mentioned).

In a group situation, profits will be streamed up in the form of dividends to the parent and groups might be deterred from layering their structure by the increased compliance required in the absence of a group scheme and the cash flow consequences of pulling up dividends from subsidiaries in advance of paying dividends to external shareholders. As mentioned, the cash flow disadvantage accrued to the parent, not to its subsidiaries.

There could also be dividend traps in the group structure: intermediate holding companies with deficits on reserves that would have to be cleared before they could upstream FII received from trading subsidiaries. That could be costly to the group.

Furthermore, in that situation, the group will have then suffered and paid a tax from which the UK resident members are exempted (income tax) on income (UK source dividends) that is in any case exempt from any form of tax in the hands of those members of the group[48]. That would be an absurdity.

Another problem that might have been encountered in the absence of a GIE would have been the liquidation of unwanted subsidiaries that had material retained reserves. Unless the reserves are stripped out of such a company before liquidation, a chargeable gain will arise on its winding-up. That would generate a tax liability where none should arise. However, in the absence of a GIE, the stripping out of the reserves would give rise to an income tax withholding that might not be of immediate use to the parent.

Indeed, if the reserves of that subsidiary were pre-acquisition reserves to the immediate parent, the distribution from the subsidiary might not be available for onward distribution up the chain of ownership.

48 There is an exception for financial traders TA 1970, s.256(3)

Accordingly, the objective of the group income election in ICTA 1970, s.256, in so far as it applied to dividends, may have been to eliminate the disadvantages that might have arisen through multi-tiers of companies in the group structure and the costs of dividend trap companies leading to an absurdity of the group bearing a cost in relation to a tax from which it is exempt on income that is exempt from corporation tax.

The group income election was designed to eliminate the disadvantages of trading through a group of companies. Only UK resident companies were subject to the rules and only UK resident companies were exempted from income tax on their income.[49] Accordingly, it was natural for the election to be restricted to UK resident companies. The GIE is briefly described in the next section.

ii. The pre-FA 1972 group income election[50]

The election had two arms. The first, in subsection (1), dealt with dividends. The second, in subsection (2), dealt with other forms of payment, such as 'annual interest' or royalties, which were paid subject to deduction of income tax and which were received as taxable income in the grossed up amount.

The condition of UK residence of the payer and the recipient applied to both arms. The ownership requirement was that a company needed to be a 51% subsidiary (defined in the legislation) of its immediate parent or of a parent higher up the line. Indirect holdings could be aggregated with direct holdings.

The election did not prevent the payment of dividends subject to income tax withholding outside of the election. The purpose of this was to enable subsidiaries to upstream FII received by them.

The second arm of the election worked in a similar way except that payments could not be made outside of the election. However, those other payments must be distinguished as they were taxable in the hands of the recipients and the income tax deduction could be offset against corporation tax payable or repayment claimed if there was an insufficient corporation tax liability.[51]

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49 As previously stated, UK trading branches of non-resident companies fell within the scope of corporation tax and the exemption from income tax. If the dividend income related to the branch trade, it would be exempt from tax in the same way that a UK resident company would be exempted under the same rules. However, whilst branches might be treated as receiving dividend income, they cannot pay dividends.

50 ICTA 1970, s.256. The election was available for companies owned by a consortium also.

51 ICTA 1970, s.240(5)

iii. Points to be noted – comparison to the post FA 1972 scheme

- The ring-fencing of the income tax withheld from dividends was replicated in the ring-fencing of the ACT paid and the reason was the need to ensure that the repayable tax credits attached to UK dividends were fully funded.

  The Finnish scheme examined by the Court in *Manninen* was no different in this respect:

  "They point out that the tax credit is granted to the latter only on condition that that company has actually paid the tax on its profits. If that tax does not cover the minimum tax on the dividends to be distributed, that company is required to pay an additional tax"[52]

- The cash flow benefit arising from paying dividends under election accrued to the beneficial owner of the dividend pre FA 1972 but to the distributing company post FA 1972. There is no evidence of any policy to remove the cash flow benefit from the parent and to give it to the subsidiary.

  This is another indication that the election was viewed as a form of consolidation.

- The FA 1972 provisions amended the ICTA 1970 GIE provision and there is no reason to suppose that the reasons for providing the election facility in the pre-FA 1972 legislation were not equally valid after the introduction of the ACT scheme. The two problems identified above, in relation to dividend trap companies and liquidation of unwanted subsidiaries, would equally be problems under the post-FA 1972 scheme in the absence of a GIE.

IV. The Group Consolidation Mechanism for avoiding ACT surpluses

The ACT scheme introduced by FA 1972 gave rise to a problem that had not arisen in the pre-FA 1972 scheme for taxing distributions.

Under the pre-FA 1972 scheme, the income tax that had to be paid over to the tax authorities could be withheld from dividends paid, thus leaving the distributing company with no net cash outflow (provided that there were no obstructions trapping dividends within the group).

ACT, however, could only be "recovered" by offset against corporation tax payable and this gave rise to problems to some groups, particularly groups that had

52 *Manninen* paragraph 40

significant sources of foreign profit[53]. The problem for such groups was that the UK companies holding the investments in foreign subsidiaries might have little or no corporation tax liability on repatriated foreign profits because of double tax relief. If those companies paid ACT on their distributions made out of those foreign profits, most of that ACT would be carried forward as 'surplus ACT' and would be a burden to both the company and to the group.

It was necessary, therefore, to have a mechanism for transferring ACT to those companies in the group that had corporation tax liabilities against which the ACT payable by the group could be set off. The ACT surrender rule, enacted by FA 1972, s.92, enabled ACT to be surrendered downward to any subsidiary or sub-subsidiary but it did not accommodate sideways or upward surrender.

This deficiency in the legislation, which might have given rise to a restriction in a situation where a non-resident parent company was chargeable to corporation tax in respect of a UK trading branch and had a UK subsidiary having surplus ACT; or in a situation where a non-resident parent had two or more UK subsidiaries, one (or more) of which had surplus ACT and the other(s) had unused offset capacity; could be overcome through use of the GIE, or the surrender provision, or the two provisions together.

The GIE could be used to transfer the payment liability up the ownership chain and the surrender provision could be used to transfer the additional ACT paid by the parent down a different branch of the group family.

Thus, for a group headed by a UK resident parent, the surrender facility enacted in FA 1972 was all that was needed in order to enable sideways surrender of ACT. "Upwards transfer" of ACT could be achieved using the GIE alone.

V. Conclusion

ACT was a tax on distributions chargeable on the company making the distributions. The only connection that it had with corporation tax was that a company was entitled to set against the corporation tax payable for an accounting period ACT paid in that period up to the limit of a capped proportion. There were generous carry back rules and any surplus could be carried forward indefinitely but the surplus was not repayable.

The provisions enacted in FA 1972, sections 91 & 92, enabled a group headed by a UK resident parent to be consolidated for ACT payment and usage purposes.

53 Companies that had significant brought forward reliefs or significant current period tax depreciation or other accelerated tax write-offs also had insufficient corporation tax liability to absorb the ACT generated on distributions made out of current period profits.

The two provisions enabled internal transactions to be disregarded for the purposes of the charging provision but also enabled a group to retain the ability to access prior year capacity to use ACT under the generous carry back rules. Following amendment[54], ACT paid by a company could be carried back for up to 6 years to set against corporation tax paid in those earlier years, which would result in a repayment in cash. By restricting the carry back to ACT paid by the company concerned, it was unnecessary to distinguish between capacity to use the ACT generated at a time before it became owned by the group and that generated as a member of the group.[55]

Thus, like the UK's group relief scheme, which allows to groups the benefits of consolidation whilst preserving the rights of companies eligible to be included to retain the right to opt in for a particular accounting period in relation to all or any part of their losses, so the ACT consolidation enabled by those two provisions provided a comparably flexible scheme.

Unlike the UK's group relief scheme and the Finnish financial transfer scheme examined by the Court in *Oy AA*, the GIE, when applied, caused inter-company transactions to be disregarded and for the parent to become liable for the tax on distributions to the extent that the GIE was applied. The nature of the GIE was more in line with the tax integration schemes examined by the Court in *Papillon* and *X Holding BV*.

The objective pursued by those two provisions was to provide that scheme of consolidation.

3. *METALLGESELLSCHAFT*

It is now necessary to consider the analysis performed by the Court and to consider whether that analysis would have been performed differently had the nature of the tax and the objective of the GIE been viewed as described in the previous section.

54 The carry back period was increased to 6 years by FA 1984, s.52(1)

55 HMRC took exception to a transaction executed solely for the purpose of exploiting this, however. They lost the challenge in *Pigott v Staines Investments Ltd* 68 TC 342 and changed the law by FA 1993, s.81. After 16 March 1993, where there was both a change of ownership and, within a period of 3 years, a change in the nature of the trade or business of the company, a carry back of ACT paid after the change of ownership was restricted to accounting periods that commenced on or after the change of ownership (for this purpose, the accounting period in which the change of ownership occurred was split into two notional periods).

VI. The Analysis Conducted by the Court

The analysis of the effect of the GIE appears to be in paragraphs 43 and 44. The Court then considers two submissions made by the UK.

The first submission (paragraphs 46 to 60) argued the lack of comparability between a group headed by a resident subsidiary and a group headed by a non-resident subsidiary.

The second submission (paragraphs 61 to 73) argued coherence of the tax system as a justification. That argument sought to establish a link between ACT paid in respect of a distribution and the exemption from corporation tax granted to a company in receipt of the dividend.[56] As has already been stated in this article, the exemption from corporation tax for UK source dividends was in existence before FA 1972, by which ACT was introduced, was enacted. No attempt will be made to explain the UK Government's argument and there seems little point in reviewing the Court's rejection of the submission save to observe that the Court's statement in the first sentence of paragraph 70 and its statement in paragraph 71 both appear to be perfectly correct.

i. The Court's analysis of the GIE

- "*…the legislation in question creates a difference in treatment between subsidiaries resident in the United Kingdom depending on whether or not their parent company has its seat in the United Kingdom*".

  This is not technically correct. It was the non-resident parent companies that were ineligible and that was because of their residence status not because of their controlling interests in the UK resident subsidiaries.

- "*Resident subsidiaries of companies having their seat in the United Kingdom may…avail themselves of the group income election regime and thus be relieved of the obligation to pay ACT when distributing dividends to their parent companies.*"

  As observed previously, this involves a transfer of the obligation to pay tax to the parent as in the French Tax Integration Scheme, as in the Dutch equivalent and as in a VAT grouping, for that matter. But the election had no effect on the liability of the subsidiary to pay ACT to minority shareholders if it was less than 100% owned by the parent.

56 See paragraph 63

Furthermore, the disadvantage only accrued to direct subsidiaries of a non-resident company. Subsidiaries of UK subsidiaries could elect with their UK intermediate parents.

- "*It is not disputed that this gives the subsidiary of a parent company resident in the United Kingdom a cashflow advantage* <u>*inasmuch as it retains the sums which it would otherwise have had to pay by way of ACT until such time as MCT becomes payable*</u>*…*" (emphasis added)

  If the subsidiary is a trading company, the parent might charge it for the privilege of paying under election as, otherwise, the results will be distorted by the provision of interest-free funding by the parent.

It appears to be reasonably certain that the Court based its decision on the perception of a cash flow advantage to subsidiaries of UK parents that was denied to subsidiaries of non-resident parents on the presumption that the payment of ACT was a payment on account of its tax liability for the accounting period. As explained in the previous section, ACT was a tax on distributions.

ii. The UK's first submission (no comparability)

- "*…the United Kingdom Government claims that, even though making a group income election relieves the subsidiary of the obligation to pay ACT when paying dividends to its parent company, that payment is merely deferred, in that the parent company, being resident, is itself required to pay ACT when it makes distributions subject to that tax. The obligation to pay ACT when paying dividends is therefore transferred from the subsidiary to the parent company and the subsidiary's exemption from ACT is offset by the parent company's liability to ACT…By contrast…if resident subsidiaries and their non-resident parent companies were able to benefit from the group election regime, no ACT at all would be paid in the United Kingdom.*"

The Court responded with four observations:

- "*First, in so far as ACT is in no sense a tax on dividends but rather an advance payment of corporation tax, it is incorrect to suppose that affording resident subsidiaries of non-resident parent companies the possibility of making a group income election would allow the subsidiary to avoid paying any tax in the United Kingdom on profits distributed by way of dividends.*"

  As discussed above, this is incorrect. ACT was a tax on distributions. The analysis in the two following paragraphs is based on the view that ACT was a payment on account of corporation tax.

- "*The fact that a non-resident parent company is not liable to ACT is attributable to its not being liable to corporation tax in the United Kingdom, since it is subject to that tax in its State of establishment. Logic therefore requires that a company should not have to make advance payment of a tax to which it will never be liable*."

  This observation evidences the Court's perception of ACT. There is a technical error in that a non-resident company, such as *Commerzbank* was, can be within the scope of corporation tax (in relation to a trading UK branch) but could never have been within the scope of ACT.

- The third observation related to the risk of tax avoidance. That justification is not discussed in this article. This point seems to have been put up by the Dutch and Finnish governments in their interventions.

- The fourth observation related to loss of revenue and that, in terms of justification, is not discussed either.

The point that was made by the UK was that ACT was levied on all distributions made by UK companies at some stage and that permitting an exemption for UK subsidiaries of non-resident companies would, in fact, put them at an advantage.

The conclusion on comparability appears to be in paragraph 60:

> "…the difference in the tax treatment of parent companies depending on whether or not they are resident cannot justify denial of a tax advantage to subsidiaries, resident in the United Kingdom…since all those subsidiaries are liable to MCT on their profits irrespective of the place of residence of their parent companies."

This is a perfectly correct statement but relevant only if ACT was a payment on account of corporation tax.

VII. Amended analysis based on the true nature of the tax

ACT was a tax on distributions. In a group situation, the profits out of which the parent pays its dividend will often be primarily the dividends paid up to it by its subsidiaries. In some cases, the parent may have no independent activity and in many cases the parent's independent activity may be limited to debt funding of subsidiaries and associates and providing central services, such as company secretarial, tax, legal and accounting services to its subsidiaries. Distributions within a group are transfers of reserves up to the parent to fund dividends paid to the external equity providers to the group.

In some cases, equity may be provided directly into a subsidiary by an external provider but dividends to a minority interest, such as that, could not be paid under election. Where, however, the subsidiaries are wholly owned, there will be an internal streaming of dividends upwards to the parent and the distribution will only emerge from the group when the parent pays its dividends.

All that the GIE did, as pointed out by the Dutch government in paragraph 49 was:

> "…to put back the charging of ACT to another level within the same group of companies."

And the reason why a group needed this facility was to ensure that ACT was only paid by a company that could use the ACT paid, or could surrender it to a company that could use it, as, otherwise, there could be a cost, which might become a permanent and significant cost, to the group if ACT became stranded in a company that had no corporation tax to pay. Indeed, when originally enacted, that type of cost could accrue even if a company did have a corporation tax liability where that liability accrued only in respect of chargeable gains.

The way in which the GIE "*put back the charging of ACT to another level*" was to totally disregard distributions paid under election both as regards the liability for ACT and as regards tax credits normally attaching. A dividend paid under election was neither a franked payment nor was it franked investment income. That disregard of an inter-company transaction is what happens in a consolidation and that was the effect of the election to the extent that it was applied.

i. Coherence of the tax system

The concept is not deployed here as a justification but for the purpose of a comparability analysis. The analysis must be conducted at the parent company level. That is where the restrictive provision had application.

The situation of a UK resident company and that of a non-resident company in relation to the ACT provisions were not objectively comparable. A non-resident company could never be within the scope of the ACT provisions.

> "…the difference in treatment between companies…consisting in the application of different taxation arrangements to companies established in Belgium and to those established in another Member State, relates to situations which are not objectively comparable."[57]

57 ECJ 22 December 2008 C-282/07 *État belge - SPF Finances v Truck Center SA* ("*Truck Center*") [2008] ECR I-10767 paragraph 41

The Court was referring to the different taxing provisions applied by Belgium to levy tax on interest income arising in the state. Logically, the same view must be taken where only residents are within the scope of the state's taxing provisions.

A similar conclusion can be drawn from the Court's analysis of Question 1(a) in *ACT IV GLO*[58]. The Court observed:

> "…dividends paid by a company to its shareholders may be subject both to a series of charges to tax, since they are taxed, first, at distributing company level, as realised profits, and are then subject to corporation tax at parent company level, and to economic double taxation, since they are taxed, first, at the level of the company making the distribution and are then subject to income tax at ultimate shareholder level."[59]

Where a UK subsidiary paid a dividend (and accounted for ACT) to its UK parent, and the UK parent paid the dividend onwards to UK residents subject to UK income tax, the tax credit could be set against the shareholder's income tax liability and cash repayment would be made to the extent that the tax credit exceeded that liability.

Conversely, where a UK subsidiary paid its dividend to a non-resident parent and that parent paid the dividend onwards to its own shareholders, the UK tax credit was not passed on unless by reason of a specific DTA provision.

Where the distributing company and the ultimate shareholder were both UK resident, the UK could ensure that economic double taxation was mitigated by allowing the credit against the shareholder's income tax liability. Where, however, the ultimate shareholder is outside the scope of UK taxation:

> "…the [UK]…is not in the same position, as regards the prevention or mitigation of a series of charges to tax and of economic double taxation, as the Member State in which the shareholder receiving the distribution is resident."[60]

Simply put, if the UK did not tax the dividend as income in the hands of the foreign shareholder, it was not in a position to mitigate economic double taxation

58 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

59 *ACT IV GLO* paragraph 49

60 *ACT IV GLO* paragraph 58: [UK] substituted for "the Member State in which the profits are derived" to assist clarity.

suffered unless it waived the right to tax the profits of the distributing company. The Court considered and rejected that:

> "…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 a series of charges to tax or to economic double taxation, either by exempting those profits from tax at the level of the company making the distribution or 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"[61]

As regards the UK dividend tax credit relief, a shareholder within the scope of UK income tax was in a different situation from that of a shareholder not within the scope of UK income tax. The situations were not objectively comparable.

Thus, in the same way, the different treatment by the UK GIE provisions of resident companies and non-resident companies is of persons in situations that are not objectively comparable.

There is no discrimination of non-resident companies. The restriction of the ACT provisions to UK resident companies is an exercise of jurisdiction.

The corollary of that restriction of jurisdiction is that a distribution by a UK subsidiary could not have been taxed at the level of a non-resident parent when it re-distributed the dividend to external shareholders. There was no indirect discrimination of such subsidiaries. They were the last port of call before the dividend left the shores of the UK. They represented the highest level at which the distribution could be taxed. The coherence of the GIE was that ACT would be charged on distributions made by the group that were funnelled through the parent, but the individual members of the group could decide which of the members should pay the tax and on what proportion of their respective distributions. As explained, this mechanism was essential to enable most groups to avoid costly ACT surpluses accruing.

In the situation where a non-resident company directly holds a single UK subsidiary, that subsidiary either can use the ACT or it cannot. That was the situation of a sole UK company. The GIE (coupled with the sister ACT surrender provision) enabled a group to access offset against corporation tax liabilities as if the parent was trading through branches that were its subsidiaries. The

61 *ACT IV GLO* paragraph 59

disadvantage of trading through subsidiaries was largely mitigated by the two provisions.

ii. The Cash Flow disadvantage

The Court's analysis focussed solely on one side of the coin. The Court had no regard for the other side of the coin, which was the tax paid by the parent. If the subsidiaries paid dividends outside of the election, the parent might pay none itself if its dividends were fully funded out of dividends streamed up to it by UK subsidiaries. If all of its subsidiaries paid dividends within the election, it would bear the entire cost of ACT on its own shoulders. The respective liabilities of the parent and its UK subsidiaries were directly linked.

The same group cash flow benefits were obtained under the GIE as enacted prior to amendment by FA 1972 but the benefit accrued to the parent, not to the subsidiary. In the context of the pre-ACT legislation, the GIE enabled groups to avoid the commercial cost of stranded FII income tax credits. The same benefits arose after ACT was enacted except that the mechanism for recovery was a deduction of the ACT paid from corporation tax payable, not from dividends payable.

The analysis was incorrect because the nature of the tax was misunderstood. The wording of the UK statute possibly had a hand in this. The analysis proceeded on the assumption that ACT was a mechanism for pre-paying corporation tax and not a tax on distributions. By the Court's own case law, ACT was a tax on distributions and not a prepayment mechanism.

4. SUMMARY AND CONCLUSIONS

It is perhaps unfortunate that the Court did not have the benefit of its subsequent judgments in *Athinaiki* and *Manninen* at the time of its deliberations on the UK's

ACT provisions in *Metallgesellschaft*. It is quite possible that the Court would have perceived the true nature of the tax despite the wording in the UK statute and would have better understood the link between the charge to tax on the distributing company and the provision of an imputation tax credit.

Despite the description of ACT as "corporation tax" in the charging statute, it has been explained that it is not. That is because corporation tax is charged on profits earned by UK resident companies and ACT was charged on distributions made by such companies. The offset of ACT against corporation tax permitted by the statute was more restricted than the offset permitted for income tax borne by a UK company by deduction from certain sources of income and, whilst surplus income tax borne is repaid in cash, surplus ACT paid was not. For those reasons, ACT could not be termed a "prepayment of corporation tax". The sole criterion satisfied by ACT in that regard was its ability to discharge a liability to corporation tax up to specified limits. On the basis of that sole criterion, there is a far stronger case for terming UK income tax as a prepayment of corporation tax.

The author contends that ACT was a tax on distributions and that it satisfied the criteria for such stipulated by the Court in both *Athinaiki* and also *FII GLO*, which concerned the ACT provisions anyway:

> "…The chargeable event for the ACT which a company receiving foreign-sourced dividends must pay is therefore not the receipt of those dividends but the payment of those dividends to its own shareholders."[62]

The restriction examined in *Metallgesellschaft* was the eligibility to enter into a GIE. The restriction was that only UK resident companies (within the charge to ACT on distributions) were entitled to enter into such an election. In accordance with the Court's case law, it is necessary to consider the restriction in the context of the objective of the legislation.

The legislation may be considered at different levels: the overall purpose of the scheme; the narrower purpose of the charge; or the purpose of the GIE itself. The author concluded by reference to the Court's approach in other cases that it was the lowest of the levels that was appropriate.

However, a distinction must be made also between the objective of the legislation and the underlying reasons for the provision of that facility by that legislation. The objective was to provide a consolidation mechanism. The underlying reason for the provision of the facility was to mitigate disadvantages of trading using a multitier group of companies. The tax consolidation mechanisms examined by the Court in *Papillon* and in *X Holding BV* had a similar objective and underlying rationale. In effect, the consolidation provisions dis-incorporated the subsidiaries and treated them as branches of the parent, which became the reporting entity. The group relief system examined by the Court in *Marks & Spencer* and the financial transfer system examined in *Oy AA* provided different mechanisms to achieve a solution to the same underlying problem. But those mechanisms did not lead to a consolidation of two or more entities.

It has been observed that dividends flow through a group as the waters of a tributary flow to the main river and finally through the estuary to the sea. It is evident from the scheme of taxation of UK source dividends, which are and always

62 *FII GLO* paragraph 110

have been exempt from corporation tax, that the scheme sought to levy the relevant distribution tax once and once only as the dividend flowed from a UK resident company and successively through the accounts of UK resident parent companies. Both before and after the enactment of FA 1972, such dividend income was termed Franked Investment Income and, when redistributed, did not give rise to any further levy of distribution tax.

The statutory consequence of paying a distribution under a post 1972 GIE was that the ACT charging provision and the FII relieving provision were both disapplied to the distribution. The charging provision only applied when the dividend was redistributed by the parent to persons not entitled to enter into a GIE with it. If the parent was an intermediate holding company partially owned by minority interests, the part of the dividend paid to the minority interests would attract a charge to ACT regardless of whether the main part of the dividend was paid upwards to the ultimate parent under election.

The statutory consequence under the pre 1972 GIE was similar, although the distribution tax was in the form of an income tax withholding from the dividend.
The effect of the application of the GIE was to consolidate a parent and its subsidiaries, to disregard 'internal' distributions and to tax only what emerged from the grouping.

However, flexibility was required. If a subsidiary was in receipt of FII from UK companies outside the group, it needed to be funnelled up to the parent and, thus, the GIE permitted a company to determine on the occasion of each distribution the extent to which it would pay the distribution under election. This was particularly important in the post 1972 era when offset of ACT paid against corporation tax liabilities was on a company basis, not on a group basis. Only ACT paid by a company could be carried back to prior years and ACT could only be surrendered downwards: not sideways or upwards. It was therefore important to carefully manage which companies in a group paid the group's ACT bill as, otherwise, a group could be left with a surplus to carry forward and, more costly, that surplus might be carried forward in companies unlikely to be able to make use of it. This was possibly the principal underlying reason for the two group provisions in the 1972 Act.

As regards other underlying reasons for the provision of a GIE, it was suggested that, both before and after the enactment of the ACT scheme, deficiencies on reserves could cause dividend blockages in a group and FII could become stranded in an intermediate holding company until the deficiency was eliminated. And group reorganisations requiring stripping of reserves out of subsidiaries no longer needed would give rise payments of distribution tax in the absence of an election.

The objective of the GIE identified, both before and after the introduction of ACT, was to enable consolidation of a parent and its subsidiaries, albeit a very flexible arrangement, enabling groups to defer taxation of distributions until they emerged from the grouping.

The coherence of that mechanism for levying tax on distributions relied upon the UK being able to levy tax when they did so emerge. That would not have been possible where dividends were paid under election to a non-resident company outside the jurisdiction of the tax.

Following the Court's case law, having regard to the objective of the GIE, it was concluded that the restriction in the UK legislation, permitting groupings of UK resident companies only, did not give rise to discrimination either of the non-resident parent companies or, indirectly, their UK subsidiaries. As regards the ACT legislation, a non-resident company is not in a situation comparable with that of a resident company because it cannot be within the charge to that tax.

The much emphasised cash flow benefits arising under the GIE can only be seen if only one side of the coin is viewed. However, the Court did not base its determination on the cash flow benefits arising from a consolidation mechanism for taxing distributions. It based its determination on a hypothetical mechanism for making prepayments of corporation tax that was mysteriously linked to the payment of dividends.

As cited previously, the Court sees coherence in deferral of assessment of tax and acknowledges the necessity for the state to be able to levy it:

> "Cohesion of the tax system necessarily required that, if the Belgian tax authorities were to allow the deductibility of life assurance contributions from taxable income, <u>they had to be certain that the capital</u> paid by the assurance company at the expiry of the contract <u>would in fact subsequently be taxed</u>."[63]

On the basis of this analysis, the UK had no obligation to permit non-resident parent companies to join in a GIE with their UK resident subsidiaries.

As this involves a revised interpretation of the UK statute, it is a matter for the courts of the UK to re-determine the litigation.

63 *Manninen* paragraph 47 Emphasis added: the 'capital' referred to was constituted by the contributions made by the employee into his retirement fund.