THE UK TAX GROUP LITIGATION ORDERS – THE CURRENT STATUS

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Introduction

The past few months have witnessed far reaching developments in the UK tax group litigation orders (GLOs). All the GLOs share the assertion that certain elements of the UK corporate tax regime breach the fundamental freedoms guaranteed by the EC Treaty and violate the non-discrimination provisions contained in double tax treaties to which the UK is a signatory. Indeed, the UK taxation system has been under scrutiny in virtually every legal forum, from the Special Commissioners to the European Court of Justice, as a result of challenges brought by numerous multi-national groups. Recently the ECJ has ruled in the Franked Investment Income (FII) GLO[3], The Thin Capitalisation (Thin Cap) GLO[4] and the ACT Class 4 GLO[5]. Various UK courts considered issues in the ACT 2[6]

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3 Judgment of the ECJ in case C-446/04: *Test Claimants in the FII Group Litigation*, dated 12th December 2006.

4 Judgment of the ECJ in case C-524/04: *Test Claimants in the Thin Cap Group Litigation*, dated 13th March 2007.

5 Judgment of the ECJ in case C-374/04: *Test Claimants in Class IV of the ACT Group Litigation*, dated 12th December 2006.

6 Judgment of the Chancery Division of the High Court in *Pirelli Cable Holding NV and others v Revenue and Customs Commissioners*, [2007] All ER (D) 408 (Mar), [2007] EWHC 583 (Ch), of 23rd March 2007.

and ACT 3[7] litigations and in the *Marks and Spencer* case[8] which is relevant to the Loss Relief GLO.

There are five main GLOs, each challenging a different aspect of the UK tax regime. They are:

- the Franked Investment Income (FII) group litigation;
- the Loss Relief group litigation;
- the Advanced Corporation Tax (ACT) group litigation;
- the Thin Capitalisation group litigation; and
- the Controlled Foreign Company (CFC) and Dividend group litigation.

The aim of this article is to summarise the issues raised through the GLOs and to provide an update on the current status of each.

The FII Group Litigation

The issues in the FII GLO relate to the tax treatment of dividends flowing to UK parented companies from their subsidiaries in the EU/EEA countries or in non-EU member states. In the UK, dividend income from foreign subsidiaries is taxed whereas dividend income from UK resident subsidiaries is not. Before 5th April 1999, a UK resident company was liable to pay Advance Corporation Tax (ACT) upon distribution of a dividend. It could set off the ACT in due course against its mainstream corporation tax for that period. In order to avoid or limit an ACT liability, a UK parent company could use dividends received by its UK subsidiaries (which was known as Franked Investment Income (FII)) to 'frank' the dividends it distributed to its ultimate shareholders. However, only dividends received from domestic subsidiaries could be used for franking purposes. As a result a UK parent could suffer ACT; and where it had no capacity to use it against its corporation tax, it remained surplus. Any surplus ACT could be surrendered only to UK group companies and not to foreign subsidiaries which resulted in surplus ACT becoming a permanent tax. During 1994 the UK permitted foreign dividends to be treated as Foreign Income Dividends (FIDs); upon the onward distribution of those to its

7 The Test case in *ACT 3* was heard in the House of Lords in late March 2007. Judgment is being reserved.

8 Judgment of the Court of Appeal in *Marks & Spencer plc v Halsey (Inspector of Taxes)*, [2007] All ER (D) 232 (Feb), [2007] EWCA Civ 117, of 20th February 2007

ultimate shareholders, the UK parent became liable to pay ACT but was permitted to claim back the ACT a few months later to the extent to which its dividend payments matched foreign dividends received. The FID regime resulted in the parent company being out of pocket for a period of time. That result did not follow the receipt and onward distribution of a domestic sourced dividend.

The claimants contend that these features breach Articles 43 and 56 of the EC Treaty because they had the effect of imposing a double tax charge on UK parent companies in respect of distributed profits from non-resident subsidiaries, whereas this was not the case with profits originating from UK resident subsidiaries. The provisions, so the Claimants argued, constituted a disincentive for UK companies to establish subsidiaries in other member states, discriminated against establishment there and constituted an impediment on the free flow of capital between member states and third countries.

The GLO was first heard by the UK High Court in 2004. That court referred various questions of community law to the ECJ for determination. The ECJ handed down its judgment on 12th September 2006. The judgment elicited comments including “not a clean kill”, “political”, and “unclear”, but on balance, was favourable to the claimants.

The Court essentially dealt with three questions. The first was whether the ACT regime (including the FID regime) which resulted in a UK parent being worse off where it received foreign sourced dividends (as opposed to domestic sourced dividends) breached the Treaty. The ECJ concluded that it did. The second issue concerned the taxation of foreign sourced dividends but the exemption of domestic dividends. The Court was careful to distinguish between portfolio holdings (holdings of less than 10%) and non-portfolio holdings (holdings of 10% and more). It held that even though it was permissible to operate an exemption system for domestic dividends alongside a credit system for foreign dividends, this was only the case as long as full relief was given, up to the level of UK tax, for the taxes on the underlying profits levied in the non UK resident’s home jurisdiction. If the rate of tax in the foreign jurisdiction was higher than the UK rate of tax, a credit for the excess would not be available and any additional administrative burden caused by compliance with the credit system would also not breach community law. However, in the case of portfolio holdings, a denial of full credit for the underlying tax on profits constituted a breach of community law.

Lastly, the court considered the issue of remedies. It restated the principle that domestic courts ought to afford claimants an effective remedy and recognised that remedies may exist for restitution and damages. The view of the court was that the claimants’ claims for repayment of ACT and corporation tax as well as the cash flow disadvantages suffered where “unlawful” ACT had been utilised were claims in restitution. However, it considered that some of the claims were for damages and restated the requirements to be met for such claims to succeed.

The judgment did leave important issues unresolved and these are for the UK courts to determine. Three issues require mention. The first is the engagement of articles 56 and 57 of the EC Treaty in relation to the FID regime, in so far as dividends were sourced from non-member states. Article 57 precludes reliance on article 56 where the restriction existed prior to 31st December 1993. The ECJ left it up to the domestic court to determine the extent to which it could be said that the FID regime, which was introduced with effect from 1994, was a new restriction which was introduced only after 31st December 1993, or whether it was merely an extension of the existing ACT regime. The second issue is of even greater significance. Regarding the taxation of non-portfolio holdings, the ECJ held that it was for the national court to determine whether the "tax rates are indeed the same and whether different levels of taxation occur only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs". This is confusing given the various reliefs which do exist and which do result in different rates of taxation. The last issue concerns the claim by some of the claimants for compensation in respect of enhanced dividends. By virtue of the FID regime, the ultimate shareholders of the parent company were not entitled to a tax credit as a result of which the parent paid enhanced dividends. The parent claimed for the value of these amounts. The ECJ held that it was for the national court to consider whether these payments constituted financial losses suffered by reason of a breach of community law.

The matter will now proceed to the UK domestic courts and is likely to be heard in the High Court at the end of 2007.

Loss Relief Group Litigation

In the Loss Relief group litigation the lawfulness of the UK group relief provisions is challenged. The UK rules did not permit EU resident companies to surrender their losses to a UK company within the same group, whereas surrender from UK group companies was permitted. This issue was originally raised in the *Marks & Spencer v Halsey* case which has since been considered by the ECJ, resulting in a landmark ruling[9]. The ECJ held the rules to be discriminatory but justifiable. However, it concluded that the rules would not be proportionate where it could be demonstrated that the subsidiary had exhausted the possibilities available in its state of residence of having the losses taken into account for the accounting period

9 Judgment of the ECJ in case C-446/03, *Marks & Spencer plc v Halsey (Inspector of Taxes)*.

concerned and for previous accounting periods and that there was no possibility of use of these losses in future years.

The matter was remitted back to the High Court and then moved on appeal to the Court of Appeal, which handed down its judgment on 20th February 2007[10]. In its decision, the Court of Appeal held that where the claimants had to show compliance with the ECJ test in respect of the use of losses in future years, they had to show that there was no "real" possibility of those losses being capable of utilisation. With that it meant that the possibility of future use must not be "fanciful". It also held that compliance with that test had to be shown at the time when the claim was made. That is still not the end of that case. It may or may not proceed on appeal to the House of Lords. Alternatively, the case will return to the Special Commissioners for final determination.

In the interim, the Loss Relief GLO had been stayed pending the outcome of the *Marks & Spencer* matter. There is at least one issue which remains alive in the GLO as a separate issue and which does not arise in the *Marks & Spencer* case. It concerns group companies parented in non-EU member states such as the US. The question arises whether the residency of the ultimate parent makes any difference to the outcome of the claim. In that regard, the claimants rely on the non-discrimination clause in the relevant UK double tax treaties. That issue will be determined in due course.

ACT Group Litigation

The ACT group litigation challenges the ACT regime, which was in force in the UK until April 1999. Under these rules whenever a UK company paid a dividend, it was required to pay ACT which it could off set against its mainstream corporation tax at a later stage in the relevant year. UK group companies were permitted to make a group income election and could postpone the payment of ACT until further distribution of the dividend by the parent. The election was not available to groups involving non-UK companies. That effectively meant that companies with a foreign parent remained liable at all times to pay ACT whenever they paid dividends and from a timing point of view, became liable to pay their corporation tax earlier than UK parented companies. In addition, upon the payment of ACT by UK companies, the recipient of the dividend became entitled to receive a tax credit, equivalent to the amount of the ACT. Where the recipient was a UK parent and it distributed the domestic sourced dividend to its ultimate shareholders, they also became entitled to a "domestic" credit. Where the recipient was a foreign parent, it could only in certain cases by virtue of a relevant Double

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10 Cf.: Footnote 5, supra.

Tax Treaty receive a “treaty” credit under the Treaty. For example, a Netherlands parent became entitled to a “treaty” credit which was equivalent to a “domestic” credit (or a percentage thereof depending on its shareholding) to which an individual UK shareholder would become entitled. In addition, to the extent that the foreign recipient received a “treaty” credit, the dividend, which would otherwise not be subject to UK tax, became taxable in the UK. The ultimate shareholder of the foreign parent would not receive any credit.

It is contended that those provisions breach Article 43 and 56 of the EC Treaty and the non-discrimination provisions of the relevant double taxation conventions. The ACT group litigation involves four different classes.

Class I

The claimants in this class have French and German parent companies. The claims essentially rely on the principles established in the cases of *Hoechst / Metallgesellschaft*[11]. The High Court has ordered the Revenue to pay damages for the periods of 6 years prior to the issue date of the claims. One important feature concerned the time period for which claims could be made and, in particular whether tax claims could be made on the basis of mistake of law, the mistake having been discovered only at the date of the ECJ judgment in *Hoechst*[12]. That issue was decided during 2006 by the House of Lords in the case of *Deutsche Morgan Grenfell*[13] in favour of the taxpayers, meaning that claims can now be brought for compensation going back as far as 1973. We note that the Government has since introduced legislation in Finance Act 2004 and proposes to introduce further legislation in Finance Bill 2007 to block these claims. It is likely that the legislation will result in further litigation.

11 Judgment of the ECJ in joined cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and others v Inland Revenue Commissioners and Attorney General* and *Hoechst AG and another v Inland Revenue Commissioners and Attorney General* of 8th March 2001.

12 Supra

13 Judgment of the House of Lords in *Deutsche Morgan Grenfell Group plc v Inland Revenue Commissioners and another* of 25th October 2006, [2006] All ER (D) 298 (Oct), [2006] UKHL 49.

Class II

Class II regroups all the claims made by companies with parent companies in EEA states other than France and Germany. This case is also known as *Pirelli*[14]. During 2006 the House of Lords was seized with the issue of compensation. It considered in particular whether in so far as the claimants claim compensation in respect of ACT suffered by UK subsidiaries which distributed dividends (as a result of a group income election not being available), the "treaty" credit received by foreign parent recipients, ought to be taken into account. The Lords held that the claim had to be seen in a group context and that the treaty credit had to be taken into account in determining the compensation. The manner in which it had to be done was referred back to the High Court. On 23rd March 2007 Rimer J entered judgment in favour of the Revenue[15]. This issue may or may not proceed back to the Lords.

Class III

The claimants in this class are UK companies with non EEA parents. The test case was heard by the House of Lords in March 2007. The issue concerns whether the non-discrimination clause in the double tax treaty is engaged and whether it had been incorporated as part of UK law.

On 23rd May 2007, the House of Lords handed down their judgment in this case. It was argued that the inability of a UK subsidiary to join a group income election with its non resident parent so that it could pay dividends free of ACT, discriminated against groups parented outside the UK. A UK subsidiary could pay a dividend to its UK parent within a group income election, thereby avoiding the need to pay ACT. The taxpayer claimed breach of the non discrimination article in the relevant double taxation conventions and secondly, breach of article 56 of the EC Treaty.

The Revenue argued that the non discrimination article was not engaged because a group income election merely shifted an ACT liability from a subsidiary to a parent. The fact that the non-resident parent could not be liable for ACT meant that there was a material difference which prevented a comparison being made with a purely UK group. The House of Lords has followed the Revenue's argument. Further, the House of Lords took the view that ACT is not corporation tax on income and chargeable gains, therefore it follows that the non discrimination article was not incorporated into UK law by way of section

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14 Cf. Footnote 4, supra.

15 Supra.

788(3)(a) of ICTA 1988 in a way which could impact provisions relating to ACT liabilities. The House of Lords also concluded that as there was no discrimination, article 56 EC could not be invoked.

Class IV

In this class the Claimants are companies within the EEA which have received dividends from UK companies. The claims are for compensation in so far as the non-resident recipients of the dividends did not receive “domestic” credits which they would have received had they been UK residents. Under the double tax conventions concluded by the United Kingdom with these countries, either no tax credit at all or merely a partial “treaty” credit, depending on the country of residence, was available to the claimant companies. Also, where a “treaty” credit was received, the dividend receipt could be subject to UK income tax.

The ECJ Judgment was handed down on 14th December 2006[16]. The judgment is confusing in many respects but the essence of the finding is that it is a breach of community law not to afford equivalent treatment in cases where the relevant dividend recipient falls within the UK tax net and would as such find itself in a position similar to a UK recipient. Accordingly, in respect of those counties where the double tax treaty provided for a treaty credit upon receipt of the dividend, and made the dividend subject to UK tax, the UK was obliged to provide equivalent treatment to the recipient of that dividend, and a recipient of a dividend in the UK in a similar position. This could mean that those parents who received a “treaty” credit (equivalent to half of the “domestic” credit received by a UK recipient) and who became liable to tax on the dividend received may be entitled to claim that they are to be placed in the same position as a UK recipient and therefore entitled to a credit equivalent to the “domestic” credit received by the UK recipient. This matter will proceed to the UK High court for further determination during 2007.

The Controlled Foreign Companies and Dividends GLO

This action challenges the UK law relating to the taxation of controlled foreign companies. Some similar issues arise here as in the *Cadbury Schweppes*[17] case, except that the GLO also includes claims relating to non-EU member states and asks a number of other questions on, for example, the treatment of life assurance. These issues were referred to the ECJ in 2005. A Court date can be expected in

16 CF.: Footnote 3, supra.

17 Judgment of the ECJ in case C-196/04, *Cadbury Schweppes plc and another v Inland Revenue Commissioners* of 12 September 2006.

the near future, if indeed the ECJ feels that one is still necessary in the light of the recent decisions in related cases such as *Cadbury Schweppes* and the *FII GLO*.

In *Cadbury Schweppes*[18] the ECJ concluded that in order for the UK legislation on CFCs to comply with community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality. Economic reality may be taken to mean that the CFC was an actual establishment intended to carry on genuine economic activities in the host member state. The Court considered that, just because activities which correspond to the profits of the CFC could as well have been carried out by a company established in the territory of the member state in which the parent company is established, this was insufficient to warrant the conclusion that the CFC is a wholly artificial arrangement. The resident company must therefore be given an "opportunity to produce evidence that the CFC is actually established and that its activities are genuine".

The essence of the ECJ finding is that even if tax motives existed, or a reduction in tax was occasioned thereby, the UK's CFC rules could not be applied where it was shown that the company was not wholly artificial and that it was actually established in the host member state and carried on genuine economic activities there.

Thin Capitalisation Group Litigation

Under the UK's Thin Capitalisation rules prior to Finance Act 2004 ("FA04") where interest was paid to a non-resident group entity, the Revenue could reclassify the interest payments as dividends, or simply disallow interest payments for tax computational purposes, on the grounds that the size of the loan or the interest rate thereon were greater than would be acceptable in an arm's length relationship. The rules did not provide for such recharacterisation or disallowance where the lending company was based in the UK. The Thin Capitalisation GLO argued that the pre-FA04 treatment was contrary to the freedom of establishment and the free movement of capital. As a result of the uncertainty created by this GLO, in FA04 the rules were subsumed into the transfer pricing rules and were amended so as to also apply to UK companies.

The ECJ gave its decision in this case, which was referred to them by the High Court in late 2004, on 13th March 2007[19]. The ECJ stated that the imposition of rules which re-characterised cross border interest payments but not domestic

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18 Supra.

19 Cf. Footnote 2, supra.

interest payments was discriminatory and in breach of the freedom of establishment. Such discriminatory treatment could be justified only where the legislation specifically targeted only wholly artificial arrangements, which were designed to circumvent the legislation of the member state concerned. The Court referred to the judgment in *Cadbury Schweppes*[20] for the definition of what constituted a wholly artificial arrangement. The provisions relying on the "arm's length test" would be consistent with the EC Treaty, so long as they did not go beyond the minimum necessary to achieve the justifiable objective of preventing the shifting of profits to low tax jurisdictions, and allowed for the arm's length measure to be exceeded where there is a commercial rationale for it. Whether the UK rules meet the Court's strictures has been left to the national court for determination. As a result this GLO will now proceed in the UK High Court during 2007.

Conclusion

All the GLOs raise significant UK corporate tax issues and have played a key role in the development of EU law. The next crucial stage is the interpretation by the UK courts of the guidance provided by the ECJ. The impact of these cases has been enormous. The Thin Cap Rules were amended. The Group Relief rules have been adjusted. New draft proposals regarding the CFC regime have been tabled and the Government has repeatedly sought to amend the law relating to limitation in cases of mistake. Only time will tell how fast the UK Government will move to make the UK tax regime compliant with community law.

20 CF Footnote 15, supra.