New Developments in the Taxation of Multinationals

Winner: 2006 Editor’s Merit Award
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The already fast pace of developments in community tax law in 2005 has so accelerated that for 2006 we have converted our annual report into two half yearly ones. 2006 has already seen numerous significant milestones with the Dorsey tax team again at the forefront.

In addition to the Marks and Spencer case, during the first six months of 2006 the Group Litigation Orders (GLOs) in which Dorsey are the lead and test case solicitors continued to move through the national and European courts. The GLOs bring together a large number of claims brought by multinationals represented by Dorsey who contend that various UK corporation tax provisions are incompatible with provisions of European community law or the enforceable terms of double taxation conventions.

The year commenced with the Court of Appeal’s long awaited decision in the ACT Class 3 case in January. While following the trial judge in finding both that the ACT regime had discriminated against the UK subsidiaries of US and Japanese parent companies but that the breach was unenforceable at UK domestic law, the Court of Appeal however then concluded that issues of community law should be referred to the European Court. Currently we are awaiting the outcome of the petition for leave to appeal to the House of Lords to determine which of these two supreme courts will hear the next stage.

March also saw the return bout of the Marks and Spencer case in the High Court following the European Court’s encouraging judgment in December. That case now looks to be proceeding to the Court of Appeal while hearings occurred in the Loss Relief GLO in April. The ACT class 2 case returned, regrettably, to the High Court in March following the ruling of the House of Lords in February which reopens the issues surrounding the assessment of claims.

March also saw the release of the draft group relief changes motivated by the Marks and Spencer case. Dorsey cases also produced 3 Advocate General’s opinions in February to June commencing with the ACT Class IV case where the opinion was useful for some but not other taxpayers, continuing with the impressive and satisfying observations of Advocate General Geelhoed in the FII Case and ending with his views in the Thin Cap Case. It will be interesting to see how the rulings in these cases develop in upcoming months.

The whole Dorsey team have made us proud not only with their wins of prestigious awards from Legal Business and International Tax Review but also their high quality contributions to numerous well recognised publications including Taxation, BNA International and International Tax Review. We have included our contributions in the first half of the year in this booklet. In addition this year we have taken the opportunity of including an article by a very good friend of the team and firm, Peter Cussons, the eminent international tax partner of PricewaterhouseCoopers in London, which provides a thought provoking analysis of the interaction of some of our cases.

We expect the year to continue with more appearances before the European Court, in the CFC and Dividend GLO, as well as cases in the House of Lords and Court of Appeal.

The Dorsey tax team will continue to deliver outstanding services to our clients in corporate direct and indirect tax matters whether contentious or otherwise.
The EC Treaty lays down several freedoms. These are free movement of goods (Articles 23 to 28 EC); free movement of workers (Articles 39 to 42 EC); freedom of establishment (Articles 43 to 48 EC); freedom to provide services (Articles 49 to 55 EC); and free movement of capital (Articles 56 to 60 EC). The essential objective of Community law is the establishment of a single market, where nationals within the Community can trade and move without the impediment of national boundaries.

The classic mechanism of protection or impediment is tax and consequently an obvious area for conflict with Community law. Indirect tax has been confronted by legislating to transform it into a European tax. However, the vested interests of member states in their direct tax base have meant that with a few notable exceptions the collision of domestic tax regimes with the single market has been left to the European Court of Justice as arbiter.

Cross-border tax issues are of increasing importance to multinational corporate decision making in the developed world. Services, goods, and capital are increasingly fluid, allowing location to be driven by considerations other than where the market is. The marketplace is global, rather than national, so it’s necessary to have the ruthless paring of costs that global competition entails. Many more of us work for very large companies which operate in multiple jurisdictions, as opposed to the national giants of the past, so cross-border tax issues arise more commonly.

Multinational companies are now firmly wedded to viewing tax as a cost to be managed rather than a levy to be accepted. One of the ways to manage tax cost is to find parts of existing rules that may not be legal and to challenge them, either politically or in the courts.

Possibly the most important collision between domestic tax regimes and the single market is in regard to group relief. It is obvious that the risk of losses, especially in the start-up period, when this risk is highest, may compel enterprises to refrain from any activity in another member state. If a European group of companies has to pay corporate income tax in one of its E.U. subsidiaries in a particular year, even though the consolidated fiscal result of the group is zero or negative, the competitiveness of this group, compared to groups in the same position in the USA, China, India or Japan, will be weakened. So, what to do about it?

**Article 43 of the EC Treaty provides:**

“Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a member state in the territory of another member state shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any member state established in the territory of any member state.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms … under the conditions laid down for its nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital”.

There is a Loss Relief Group Litigation Order covering more than 70 company groups waiting in the wings for this decision in the Marks & Spencer case. Also under attack by Group Litigation in the United Kingdom are the U.K. thin capitalisation rules pre-2004, the controlled foreign companies and dividend rules, the franked investment income rules, the foreign income dividend rules and the U.K.’s ACT rules pre-1999. Similar cases are increasing being referred to the ECJ by courts in other member states. Sometimes the decisions are being made at national level.

Many E.U. governments anticipated that M&S would win. Some governments have already provided for cross border consolidation rules, most with significant restrictions. Today, Italy, Austria, Denmark and France allow for cross border consolidation: Italy and Austria under new rules, France under its longstanding option for worldwide taxation and Denmark under its recently amended system of cross border consolidation. However, we understand that in France only 13 (this is not a misprint) companies have opted for cross border consolidation. In Italy it seems that almost no one is willing to apply for cross border consolidation. We can reasonably expect that the new Danish cross border consolidation rules will also prove unpopular. This is
because these systems are “all in or all out” and have long minimum lock-in periods. The inflexibility of these systems may yet prove to be contrary to European law. The Austrian system is more flexible and is linked to a series of wider reforms of taxation of corporate income.

The Law and the Facts

The law and facts surrounding the Marks & Spencer case are well known and thus the briefest of recitals will suffice. The U.K.'s group relief provisions only allow for losses of a U.K. resident subsidiary (or U.K. permanent establishment of a non-U.K. resident subsidiary) to be surrendered to its U.K. parent and not losses incurred by a foreign subsidiary without a U.K. permanent establishment. This is as you would expect from the U.K.'s territorial-based system of taxation, under which U.K. residents are taxed on their worldwide profits, but non-U.K. residents are taxed only on U.K. source profits.

Marks & Spencer had subsidiary companies resident in Belgium, Germany and France that were loss making. It sought to surrender these losses by way of group relief to shelter U.K.-taxable profits of the U.K. parent. The retailer argued that the U.K.'s restrictions on group relief to U.K. resident companies were in contravention of paragraph two of Article 43 of the EC Treaty, in that by preventing the loss-surrender of a non-U.K. resident subsidiary, they constituted a barrier to the exercise of the freedom of establishment and made it less attractive to set up a subsidiary outside the United Kingdom.

History of the Litigation

In 2002 Marks and Spencer Plc appealed against the refusal of group relief, on the ground that the statutory limitations on the territorial scope of group relief were incompatible with, and overridden by, Community law. The U.K. Special Commissioners denied relief to Marks & Spencer, based on an extensive analysis of ECJ decisions. Remarkably, they found that it was “acte clair” that cross border group relief was not available.

Marks & Spencer appealed to the High Court. In that court, Park J. was of the opinion that the matter was not “acte clair” and made a preliminary reference to the European Court of Justice. The court asked two questions. The first deals with the general issue of Community law, namely, is it permissible to deny group relief for the losses of a non-resident subsidiary where group relief is permitted for the losses of a resident subsidiary? If not, can such a restriction be justified under community law? The second question only arises if the answer to the first is in favour of the taxpayer. In those circumstances, the second question raises the issue of whether the use of the losses in the foreign jurisdiction would make a difference and identifies a number of specific possibilities.

Advocate General Maduro delivered his opinion on April 7, 2005. The decision of the European Court of Justice was given on December 13, 2005.

The Advocate-General’s Opinion

As has been much reported in the press since April 7, 2005 the Advocate General concluded that denial of cross border group relief offended community law. The opinion is divided into two sections. The first is a determination of the substantive question: is the restriction of group relief to domestic company groups compatible with community law? The second question is a refutation of the two primary defences raised by member states: the principle of territoriality and the defence of fiscal cohesion.

Manninen and Lenz both concerned the different tax treatment of dividend income in the hands of a shareholder depending on whether the company paying the dividend was resident or non-resident. To the Advocate General there was no discernable difference between the circumstances of the resident and non-resident company. Both paid corporation tax on their profits somewhere in the community and a system that sought to alleviate economic double taxation in the hands of the shareholder and company but failed to take account of the cross border transaction did not achieve its objective and thus could not be justified.
In the instant case the Advocate General went further. To him arguments of discrimination on nationality grounds were old news. He invited the Court to conclude that community law had developed beyond that point. No longer was it necessary to make a comparison between the nationals of two different member states but rather it was necessary merely to ask whether the provision in question made more difficult the exercise of a freedom of movement within the community.

The result of this approach, to the Advocate General, was the establishment of a coherent E.U.-wide tax system, notwithstanding the individual member states’ taxing powers:

“... the principle of non-discrimination on the ground of nationality is not sufficient to safeguard all the objectives comprised in the establishment of an internal market. The latter seeks to secure for the citizens of the Union all the benefits inherent in the exercise of the freedoms of movement. It thus constitutes the trans-national dimension of European citizenship.

All these reasons explain the need to retain in tax matters the same concept of restriction on freedom of establishment which is applicable on other areas. Thus ‘all measures which prohibit, impede or render less attractive the exercise of that freedom’ must be regarded as restrictions ...”

The Advocate-General accepted that a system of group relief would not offend community law if it permitted the surrender of cross border losses from other community residents but subject to the condition that those losses could not be accorded “equivalent tax treatment” in their local jurisdiction ("double-dipping"). His comments on what this might mean in practice were imprecise.

The Advocate-General went even further than previous decisions in embracing the concept of community-wide-coherence in direct tax. To the Advocate General it was no longer necessary to find discrimination between a national and a non-national. One need look only at the cross-border transaction and ask if it was impeded. The result of this approach is that no comparator is required to decide whether national provisions breach community law: treating domestic transactions in the same way as cross-border transactions may well not protect legislation from offending community law. This has obvious and far-reaching implications particularly for attempts by member states to amend their legislation in response to the rulings in these cases.

The Judgment of the Court

The opinion of the Advocate-General is not of course binding on the Court, and in some notable tax cases it has not been followed, usually to the detriment of the corpus of European law. As the gap between the appearance of the opinion and the judgement grew longer speculation mounted that the opinion of April 7, 2005 was not going to be followed, at least in full. This speculation was wrong. The judgement of the Court follows the Advocate General quite closely.

The ECJ ruled that the U.K.’s group relief rules hinder the exercise by the parent company of its freedom of establishment in contravention of Articles 43 EC and 48 EC by deterring it from setting up subsidiaries in other member states.

The ECJ’s criticism of the U.K.'s rules is qualified. It stated that this restriction on the parent’s freedom of establishment is in principle justified since it pursued legitimate objectives compatible with the Treaty. These legitimate objectives were its attempts to preserve a balanced allocation of the power to impose taxes as between the member states; its attempts to prevent “double dipping”, that is, losses being used twice; and its attempts to prevent “jurisdiction shopping”— tax avoidance by allowing losses to be surrendered to companies established in states applying the highest rates of tax.

Notwithstanding these legitimate objectives, the ECJ concluded that the U.K.’s rules offend the principle of proportionality. In certain cases the U.K.’s restrictions on group relief go beyond what is necessary to attain the legitimate objectives referred to above. The U.K. rules are incompatible with the freedom of establishment in Article 43 in so far as they prevent losses being offset against the profits of the parent where the non-resident subsidiary has exhausted all possibilities of using the losses in its own state. The ECJ listed a number of these possibilities.
“... the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party or by offsetting the losses against the profits made by the subsidiary in previous periods, and there is no possibility for the foreign subsidiary’s losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party.”

The court comments that member states are free to adopt or maintain rules which preclude wholly artificial arrangements from achieving a tax benefit. This comment is less of a warning than it might seem: the ECJ has an extremely restricted view of what constitutes a “wholly artificial arrangement” with regard to the treatment of freedoms.

The Court has expressly avoided the question of whether losses should be computed on a U.K. or local basis, noting that the parties in this case had agreed for the losses to be computed on a U.K. basis.

**Legal implications for the United Kingdom**

The ECJ can impose temporal or other limitations on the rights of other claimants to bring similar claims. In the absence of any such restriction claims in similar cases will be subject to the usual domestic time limits for making claims and bringing appeals (although it would be open to a member state to introduce special rules). Since the ECJ made no mention of temporal restrictions on the implications of their judgment there is likely to be a period of time in which companies can bring claims if they have not already done so.

Nevertheless, the decision is unlikely to “open the floodgates” to other tax claims based on discrimination in the United Kingdom. We would of course recommend that specific advice be taken on whether High Court and/or protective statutory claims should be made in respect of these and other potentially discriminatory regimes. Most of the issues are already being litigated by means of Group Litigation in the United Kingdom so the possibilities are clear, although there are not as yet active GLOs based on exit charges, the pre-FA2004 transfer pricing rules, or pre FA-2006 U.K. foreign leasing rules. However, not all other E.U. countries where there is a difference in treatment based on tax residency have yet been called to account by their corporate sector on this point.

It must seem unlikely that the United Kingdom will now simply abolish group relief. Other countries have (as described above) introduced provisions allowing for cross border loss relief. As to possible U.K. legislative amendments perhaps deduction of the foreign losses in the United Kingdom, or of U.K. losses in another jurisdiction, could be restricted by being deductible once only; and for deductions to be recaptured when and if relief is also provided in the residence states of the subsidiaries.

For claimants in the Loss Relief Group Litigation, which awaits a reference to the ECJ, the judgment is qualified good news. A number of questions remain open. How should losses be computed? The U.K. system is incompatible with Community Law. Does this mean that claims can still be maintained where the conditions of paras 55 and 56 are not made out? The judgment does not deal with the timing differential point. Can a damages claim still be run where a group has suffered a timing disadvantage by the need to use the loss only in the source state? It is likely that a further reference to the ECJ will be necessary to resolve these issues.

For claimants in many of the other Group actions being brought in the United Kingdom the decision is unqualified good news. The insistence of the ECJ that restrictions which can be objectively justified should nevertheless be strictly proportionate will add weight to claims in the Thin Capitalisation, Franked Investment Income, and Controlled Foreign Companies GLOs.

**Practical Implications for Multinational Companies**

All of the above is very well but how does this judgment change decision making now in a practical business sense? Many businesses are interested not just in making money from their operations in their home state,
The Implications for Cross Border Loss Relief in the European Union

(continued)

but expanding market share and finding new markets. There are several direct results from the Marks & Spencer decision for companies in this position.

Freedom to offset losses cross border is not, at the moment, unrestricted. Domestic possibilities such as loss carry-back, group relief within the member state of the subsidiary and so on must be explored first. Nevertheless the decision is of immediate practical application where investments are not going well.

In the past, where a company based in one member state decided to expand into another member state and unfortunately made large losses, it might have been tempted to carry on trading there simply in the hope of one day making a profit and recapturing some of the losses it has made in the early years of the operation which would otherwise be lost. Those days are gone. If the parent is profitable, the subsidiary or group of subsidiaries can be liquidated and the losses set off against the parent's profits without further ado.

The decision also has the effect of setting a minimum sale price for loss making subsidiaries in other member states in circumstances where the subsidiary is the sole operation the parent has in that other member state. That minimum sale price is the corporate income tax rate of the member state of the parent multiplied by the accrued losses of the subsidiary. In circumstances where no one is prepared to offer that sum, parents will be better off liquidating the subsidiary.

Companies should take legal advice and review their operations outside their home state taking these factors into account.

Summary

The desire for Cross-Border Loss Relief within the European Union has been with us a long time. Article 7 of the draft parent-subsidiary directive read “a parent company established in the EC which holds a stake of at least 50 percent of the capital of a subsidiary in another EC member state may opt for a system of consolidated profits” ... and later “the country of the parent company will have to take into account tax paid by the subsidiaries in the other countries”. That was in 1969.

The case echoes the European Commission's attempt to introduce a system of cross-border loss relief in a Directive proposed in 1990. The ECJ makes it clear that the introduction of less restrictive measures is possible but that this will require harmonisation rules to be adopted by the Community legislature. Perhaps we will see new insights into the limitations of power of member states to tax and an impetus to the widely reported initiative to create a common consolidated corporate tax base within the European Union.

1 For example, the Parent-Subsidiary Directive
2 See in particular pending cases C-231/05 Oy Esab (Finnish group relief rules) and C-492/04 Lasertec (German thin capitalisation rules as regards third countries).
3 See the Coreal-Gestion and Andritz cases in France and the Lindex case in the Swedish Regional Administrative Court
4 Marks and Spencer Plc v Halsey (Inspector of Taxes) [2003] STC (SCD) 70.
5 Case C-319/02
6 Case C-315/02
7 Paragraph 26 of the Opinion
8 Paragraph 28 of the Opinion
9 Paragraph 32 of the Opinion
10 Paragraphs 34 and 35 of the Opinion
11 Case C-204/90 Bachmann and Case C-376/03 D are particularly in point.
12 Paragraphs 33 and 34 of the judgment
13 Paragraphs 53 to 56 of the judgment
14 Paragraph 55 of the judgment
15 See, for example, C-212/97 Centros & C-167/01 Inspire Art.
16 Paragraph 22 of the judgment
17 C-475/03 Banca Popolare di Cremona was, exceptionally, reheard on December 14, 2005 to address this and other issues.
18 These time limits are under attack in Deutsche Morgan Grenfell Group plc v Inland Revenue Commissioners and another [2005] EWCA Civ 78 which case goes to the House of Lords in 2006.
19 Paragraph 58 of the judgment
A Class Act

Simon Whitehead

The second round for the claims in the advance corporation tax (ACT) group litigation brought by non-European parented company groups (Class 3) has ended with a partial loss for the taxpayer. Yet the outcome of the European law element of the claims still remains outstanding and the Court of Appeal’s judgment, delivered on 31 January 2006 (Boake Allen Ltd v HMRC; NEC Semi-Condutors Ltd and Others v CIR [2006] EWCA Civ 25; see ‘Update’ in this issue and the case is also on the Internet at www.bailii.org/ew/cases/EWCA/Civ/2006/25.html), is not without a number of encouraging findings for taxpayers and leaves the group with a choice of possible avenues for the next stage in the litigation.

Origins

Much within the claims that are now collected within the ACT group litigation order (GLO) can be traced back to those brought by the Hoechst and Metallgesellschaft groups in 1995. The ACT regime restricted group income elections to subsidiaries and parents that were both resident in the UK. Famously, Hoechst brought a community law claim; the primary contention being that when it paid a dividend to its parent, it always paid corporation tax (in the form of ACT) earlier than a comparable subsidiary of a UK parent company. However, Hoechst also contended that, in any event, the non-discrimination article in the relevant double tax convention (all of which, like that in the UK/German convention engaged in the Hoechst case, follow the OECD model)? Park J concluded that they did.

That non-discrimination article claim, left on the bench in the Hoechst case, has now become Class 3 of the ACT group litigation, but with an added twist. In addition to relying on the non-discrimination article, the Class 3 claimants, although parented in the USA, Japan and Switzerland, nevertheless also contend that their community rights have been offended.

From 1 January 1994, the EC Treaty, Article 56, extends to third countries the right to the free movement of capital and payments with EU Member States.

The claimants contend that for ACT paid after that date, the inability to make a group income election offended those rights by placing an impediment on the payment of a dividend that was not encountered by a UK subsidiary of a UK parent.

The decision of the High Court

These claims raise a large number of novel points first addressed by Mr Justice Park in his judgment of November 2003. Leaving aside a point of procedure, the issues - and his conclusions - can be effectively categorised as five.

First, did these provisions offend the non-discrimination article in the relevant double tax convention (all of which, like that in the UK/German convention engaged in the Hoechst case, follow the OECD model)? Park J concluded that they did.

Second, were those provisions incorporated into UK law so that the taxpayers could enforce the breach? Park J concluded that they were not and that therefore that aspect of the claim concerned with double taxation conventions must fail notwithstanding the breach.

The third and fourth issues concern the available remedies. Even if there is discrimination and those treaty provisions have entered UK law in an enforceable way, HMRC contend that UK law offers no available remedy to these claimants. Park J concluded that it was not necessary for him to answer this question, given his answer to the second, but expressed reservations about the ability of UK law to compensate the claimants in any event.

As that litigation developed, the non-discrimination article claim was left behind in favour of the claims based on community law. This resulted in the groundbreaking decision of the European Court in March 2001 finding in favour of the taxpayers (Metalgesellschaft Ltd & Others v CIR and Hoechst AG v CIR [2001] STC 452).
The fourth question concerns a much criticised and venerable principle of English law (called the ‘Pintada principle’ in these judgments after the last House of Lords case which referred to it - President of India v La Pintada Companio Navigacion S.A. [1985] AC 104) - and by invoking it HMRC contended that, all else aside, the claimants could only ever recover compensation for ACT not utilised by the time their claims were commenced. Again, Park J did not need to address the point, but suggested that HMRC might be right.

The final issue concerned the claims under community law engaging EC Treaty, Art 56. Here, Park J emphatically concluded that the taxpayers must fail and refused their request for a reference of the question to Europe.

The Court of Appeal

On the primary issue of discrimination, argument centred on identifying what was ‘another similar enterprise’ with which to compare the test claimants (UK subsidiaries with parents in the US and Japan) in order to ascertain whether the ACT provisions gave rise to differential treatment. Everyone will remember that for over 20 years HMRC had contended that the comparison required under a nondiscrimination article was with a UK subsidiary parented in a third-party state. The article, in other words, was directed at preventing the UK subsidiaries from one country being treated worse than the subsidiaries of another, but said nothing of how the UK should treat its own.

That argument was abandoned at the High Court hearing in this case and has remained relegated to history. However, HMRC have now reinvented the same concept but in a more subtle way.

Their main contention is now that no comparison is possible. Where a UK subsidiary paid a dividend to its UK parent under a group income election, the liability to pay ACT did not disappear, but transferred to the parent who should then pay on the received dividend income to its own shareholders.

Thus, for HMRC, for the position of a UK subsidiary with a US parent to be comparable required the US parent to be liable to ACT upon the distribution of that receipt to its shareholders. As foreign residents are never liable to pay ACT, no comparison is therefore possible.

It follows from this argument that the nondiscrimination article can have no application unless the foreign resident parent is also liable to UK tax. Again, the effect of the argument is to remove the treatment of UK taxpayers with the capital owned in the UK from the ambit of the article.

To the Court of Appeal, like the High Court, this argument is wrong for it introduces an illegitimate element into the comparison, namely, the fiscal position of the parent which is not relevant to the non-discrimination article (see paragraph 42 of the judgment). The article concerns itself rather with the treatment of the subsidiary. The taxpayers therefore retain this critical finding of discrimination.

The second issue - whether the article is sufficiently incorporated into UK law to enable the taxpayers to seek to remedy its breach - centres on the wording of TA 1988, s 788(3)(a).

A double tax convention will have overriding effect at UK law to the extent that its provisions are incorporated into our law through the enabling provisions of s 788. Most relevantly, s 788(3)(a) enables those provisions of conventions concerning ‘corporation tax in respect of income and chargeable gains’ to enter UK law. However, like the High Court, the Court of Appeal has concluded that this does not cover ACT which, although unquestionably corporation tax, is better described as ‘corporation tax by reference to a dividend’ (see paragraph 61 of the judgment).

This leaves the unsatisfying result that the claimants who have been the subject of discrimination and who have brought claims in the correct manner and within necessary time limits, can still do nothing about it. Several commentators regarded the similar conclusion by Park J with some criticism and, if we return to the origins of this litigation, perhaps with reason.
Is ACT a Corporation Tax?
As its name describes, ACT was intended to act as an advance payment of corporation tax. That is how it was described to the ECJ in *Hoechst* and *Oce van der Grinten* [2003] STC 1248 and it was the essence of the Commission’s presentation to that Court at the hearing before it in the franked investment income (FII) group litigation order case in November 2005 (*Test Claimants in Franked Investment Income Group Litigation v CIR*, Case C-446/04). That was, fundamentally, how it was meant to work and indeed how it did work in the majority of the claims in Class 3 itself.

Why therefore is ‘an advance payment of corporation tax in respect of income and chargeable gains’ not itself ‘corporation tax in respect of income and chargeable gains’? To the Court of Appeal, relying on the mechanics of calculation and payment and the possibility of surplus ACT, it is not.

However, in dealing with the three remaining categories of issues, the Court of Appeal does go beyond the trial judge’s findings and - in some senses - more favourably for the taxpayer. They provide a more detailed consideration of the two issues concerning available remedies.

*Deutsche Morgan Grenfell Group plc v CIR* [2003] STC 1017 (at least at its current level) shuts the door on the argument that the claimants can seek recovery for the consequences of paying tax under the mistaken belief that it was lawfully payable.

Furthermore, other grounds of recovery are excluded by the fact that when the ACT was paid (no group income election of course being in place) it was lawfully demanded. However, the Court of Appeal do seem to hold that were that hurdle to be overcome then the Pintada principle would not be effective in limiting the remedy only to surplus ACT.

The conclusion on the final point is the most helpful to the taxpayers. Unlike the trial judge, the Court of Appeal has accepted that the claimant’s European law claims are worthy of reference to the ECJ.

What Next?
The Court of Appeal has left the test claimants in this litigation with a choice. Should they seek leave to appeal these findings to the House of Lords or should they seek a reference of the European claim to the ECJ? The suggestion that they could do both at the same time does not seem to find favour with at least one member of the Court. If the choice adopted was the ECJ route, the question would proceed to the European Court on the basis that under English law, while it was acknowledged that the taxpayers were the subject of discrimination, domestic law could offer them no comfort.

As a postscript, there is one aspect of the judgment that may appear unfamiliar to those not directly involved in this litigation. In 2003, the claims were the subject of group amendments which also set out the community law claim under Article 56. Park J had concluded that those amendments simply gave more details of claims already made and took effect from the dates the claims started in 2001.

The Court of Appeal has come to the contrary conclusion, dating those amendments to when they were introduced in 2003. If the taxpayer wins the *DMG* case in the House of Lords, this aspect will be academic. If not, and the finding remains and the taxpayers win upon the community law claim only, then recovery may be limited to ACT paid from 1997 (rather than 1995).
Introduction

More than 300 claims are currently pending against the UK tax authorities, Her Majesty’s Revenue and Customs (HMRC), on the basis that certain UK tax provisions violate the fundamental freedoms enshrined in the EC Treaty. The claimants also contend that the relevant provisions are prohibited by certain clauses in the tax treaties negotiated between the United Kingdom and other states. All the claims are being pursued through the UK High Court using Group Litigation Orders (GLOs), a mechanism under which the group litigation of common issues of fact or law is administered by the rules of court. Most of the Community law issues that arise in these claims have been referred to the European Court of Justice (ECJ) for consideration. The purpose of this note is to provide a summary of the issues that have been raised in each of the GLOs and their status at the time of writing.

The Background

The EC Treaty protects the fundamental freedoms, including the freedom not to be discriminated against on the basis of nationality, freedom of establishment and the free of movement of capital. The Member States are required to apply domestic legislation, including tax laws, in accordance with Community law and, therefore, cannot, without justification, impose rules that interfere with the exercise by commercial enterprises of these freedoms.

In addition, if bilateral tax treaties have been concluded between states and have effect in domestic law, these states may be bound in respect of their residents to act in accordance with the provisions contained in the tax treaties. Most of the tax treaties negotiated by the United Kingdom contain what is known as a "nondiscrimination provision", which prohibits the parties to the tax treaties from subjecting an enterprise to any taxation that is more burdensome than the taxation of similar enterprises in the other state. Accordingly, the United Kingdom is, in respect of the states with which a bilateral tax treaty contains such provisions, prohibited from imposing tax provisions in domestic law that may result in discrimination between enterprises in the United Kingdom and similar enterprises in the other state. The United Kingdom’s tax treaties also commonly contain a provision relating to the allocation of taxing rights that purports to prohibit the imposition of tax on profits earned in other states.

The claimants in the GLOs are relying on the fundamental freedoms in the EC Treaty and the tax treaty provisions. The claims have been brought under separate GLOs, each relating to different tax laws. These are:

- the loss relief group litigation;
- the advance corporation tax (ACT) group litigation;
- the franked investment income (FII) group litigation;
- the controlled foreign company (CFC) and dividend group litigation;
- the foreign income dividend (FID) group litigation; and
- the thin capitalization group litigation.

Each of these GLOs is discussed below.

Loss Relief Group Litigation

The claimants in this case are questioning the legality of the group relief provisions in the UK domestic legislation that prevent EU resident companies from surrendering losses to a UK company in the same group. The arguments are similar to those raised in the ECJ Marks & Spencer case. Some of the claimants contend that, for certain periods, different UK subsidiaries of a common non-EU parent company should have been able to benefit from group relief. The claims are made under Art. 56 of the EC Treaty and the non-discrimination provision of the relevant tax treaties. These issues have not yet been referred to the ECJ for consideration as part of a GLO.

As a preliminary step, HMRC sought to challenge the jurisdiction of the High Court to hear the claims. Specifically, HMRC contended that the claims should have been brought by way of appeal to the UK Special Commissioners. The UK House of Lords held that some elements of claims ought to proceed through the High Court and other elements through the statutory procedure via the Special Commissioners. Significantly, the House of Lords held that the statutory procedure had to comply with Community law principles of equivalence and effectiveness and failing this, the claims could proceed in the High Court.
Act Group Litigation

Under the UK group income election rules, an election was only permitted between UK resident companies. If a UK company paid dividends to a UK parent company, it did not have to account for ACT on the dividends where a group income election was in force. If, however, a UK company paid dividends to a non-UK parent company, it had to account for ACT in the quarter in which the dividends were paid and could not offset that ACT against any corporation tax due, or obtain a repayment, until nine months after the year end. Accordingly, companies with non-UK parent companies were disadvantaged by having effectively to pay their corporation tax bill earlier than companies with UK parent companies. The claimants contend that these rules contravene Art. 56 of the EC Treaty and tax treaty non-discrimination provisions. The claims are divided into the four categories summarized below.

Class I
The Class I claimants include French and German parented companies. Their right of action relies on the principles established in the Metallgesellschaft and Hoechst case. In this case, a number of the legal issues in question were decided in favour of the taxpayers, in particular that the UK’s domestic ACT rules were illegal insofar as a group income election was only available to UK companies and that companies which had suffered as a result were entitled to damages relating to the prior payment of ACT. The High Court has ordered that damages be paid for periods within each claim up to six years from the date the claim was issued.

Class II
The Class II claimants include all other European Economic Area (EEA) parented companies whose right of action relies on both the EC Treaty and the relevant tax treaties. This case differs from Class I only insofar as the parent companies in these countries have received a tax credit under the tax treaty in relation to the dividends paid. The High Court confirmed that the taxpayers are entitled to compensation, regardless of whether or not the recipient of the dividends received a tax credit under a tax treaty. This represented an extension of HMRC’s liability following from the Metallgesellschaft and Hoechst case. The judgment was upheld by the UK Court of Appeal and was referred to the House of Lords.

Class III
In the Class III claim, the claimants are non-EEA parented companies. It is contended that the incidence of ACT on the payment of dividends from a UK resident subsidiary to its parent company located in a non-Member State contravenes Art. 56 of the EC Treaty and the relevant tax treaty provisions. The High Court found that there had been a breach of the nondiscrimination articles in the tax treaties, but held that the relevant articles had not been incorporated into UK domestic law. Consequently, there was no basis for any claim under UK law.

The High Court was also asked by the claimants to refer the issue relating to Art. 56 of the EC Treaty to the ECJ for a determination. The judge in the case held that, even if there had been a restriction on the free movement of capital between Member States and third countries, there was an exception in Art. 57 of the EC Treaty, within which the claims fell, that permitted the ACT provisions. He also held that the issue was sufficiently clear to make it unnecessary for him to refer the question to the ECJ. The claimants appealed the decision to the Court of Appeal. At the time of writing, the decision of this Court was expected shortly.

Class IV
These claims are brought on behalf of companies in the EEA that have received dividends from a UK company. The claimants allege that the failure to provide for tax credits in the tax treaties concluded by the United Kingdom with France, Germany and Italy (for the relevant periods) on the payment of dividends is in breach of Art. 43 and Art. 56 of the EC Treaty. The claimants are predominantly resident in France, Germany and Italy where dividends were received from UK subsidiaries without any tax credit. Other EEA companies received a partial tax credit and a number of these companies are claiming that a full credit should have been paid. The High Court referred the questions to the ECJ for a preliminary ruling and the case was heard in the ECJ on 22 November 2005. At the time of writing, the Advocate General’s Opinion was expected on 23 February 2006.

This hearing took place on 23 and 24 November 2005 and, at the time of writing, a decision was expected in January or February 2006.
FII Group Litigation

A UK company paying dividends was liable to pay ACT. The ACT could be avoided if the company paying the dividends was a 51% subsidiary of another company and those companies made a group income election under the Income and Corporation Taxes Act 1988 (IOTA). The election could, however, not be made by the shareholders of the ultimate parent company. For the parent company to avoid ACT, it was permitted to use the dividends received by its UK subsidiaries to “frank” its own dividends. It could not, however, utilize the dividends received by its non-resident subsidiaries. If the parent company suffered surplus ACT, it could surrender this to its domestic subsidiaries, but not to those subsidiaries that were non-resident.

It is contended that these provisions breached Art. 12, Art. 43 and Art. 56 of the EC Treaty insofar as the provisions effectively imposed two UK tax charges on the UK holding company in respect of distributed profits from a non-resident subsidiary, which would not be the case had the subsidiary been a UK resident. Specifically, the tax provisions resulted in discrimination and were a disincentive for UK companies to establish subsidiaries in other Member States. With regard to both Member States and non-Member States, reliance is also placed on breach of the relevant tax treaties, in particular the allocation of taxing rights article.

The various questions of Community law that arise have been referred to the ECJ for consideration and include the questions of whether or not the taxing provisions offend Art. 56 of the EC Treaty and to what extent reliance can be placed on the limitations contained in Art. 57. The case was heard on 29 November 2005 and, at the time of writing, the Advocate General’s Opinion was expected in the first quarter of 2006.

CFCs

The relevant provisions deem a foreign company controlled by the UK company to be a CFC. In certain circumstances, the UK company has to pay tax (the “CFC charge”) on the apportioned profits of the CFC less any creditable tax. Tax is only payable if the company to which the apportionment is made owns more than 25% of the CFC. The legislation also provides for exemptions to the CFC charge on compliance with certain criteria, for example the pursuit of an acceptable dividend policy, i.e. distributions of profit by the CFC to the UK company, on which the UK company then pays tax.

Dividends

Foreign dividends are taxed in the hands of a UK company. The position is slightly different depending on the status of the distributor relative to the UK company. If the holding is more than 10%, the companies are, in appropriate circumstances, entitled to double taxation relief in relation to the underlying tax paid on the distribution by the distributor in its home country. The tax paid in the United Kingdom is, therefore, the differential between the UK tax payable and the relevant underlying foreign tax paid. Had the distributor been a UK company, no additional tax would have been payable. If the holding is less than 10%, dividends from these companies do not benefit from the offset of underlying foreign tax and are taxed in the ordinary way. Had the dividends been derived from UK companies, the claimants would not have been taxed on the dividends.

The claims relate to the recovery of taxes paid together with damages incurred as a result of compliance with the relevant legislation. The claimants contend that the provisions breach Community rights under Art. 43 and Art. 56 of the EC Treaty and the allocation of taxing rights article in the relevant tax treaties. These issues have been referred to the ECJ and, at the time of writing, a hearing was expected in mid 2006.

FID Group Litigation

The FID regime was designed to alleviate the tax burden on UK companies, which were unable to utilize surplus ACT. UK companies which received income in the form of dividends from non-resident companies, usually subsidiaries, and which subsequently paid dividends...
to their shareholders, were required to pay ACT by reference to their onwards dividends. These companies could not, however, set off as much of the ACT against their liability to mainstream corporation tax in the United Kingdom by virtue of double tax credits in respect of the tax suffered in the foreign jurisdictions from which the dividends flowed. By virtue of the FID regime, the UK dividend-paying company could make an election to have the onward dividends treated as FIDs. If it made that election, the paying company was not liable to ACT and the recipients of the dividends were not entitled to tax credits. The claimants, a substantial number of pension funds, argue that the FID regime was disadvantageous to them as recipients insofar as they would have received a tax credit if they had received a UK dividend and a cash sum, but, if the dividend was an FID, there was no credit and no cash payment.

The GLO essentially raises two questions. The first is whether or not the claims ought to be brought in the High Court as opposed to the statutory procedure by way of an appeal to the Special Commissioners. The second issue is whether or not the relevant FID provisions were contrary to Community law. The matter was heard by the High Court and on 18 November 2005 the Court held that a reference to the ECJ was unnecessary if the pension funds wished to claim tax credits contrary to domestic legislation, as domestic law provided an effective means to have such claims adjudicated within the existing statutory procedures.

It is contended that the provisions are contrary to Art. 12, Art. 43, Art. 49, Art. 56 and Art. 249 of the EC Treaty or the relevant tax treaties insofar as they:

- do not make provision for the consideration of consolidated borrowing from the UK resident group companies if their relevant parent companies are companies resident in the European Union or the EEA;
- disallow, as a deduction from the chargeable profits of subsidiaries in the United Kingdom, interest payments made to companies resident in the European Union or EEA that are members of the same company group; and/or require the maintenance of pre-defined debt: equity and interest cover ratios of the subsidiaries resident in the United Kingdom.

These questions have been referred to the ECJ for determination and, at the time of writing, the matter was due to be heard by the Court on 31 January 2006.

Conclusions

The GLO cases should provide the ECJ with an opportunity to consider the effect of the EC Treaty and the relevant tax treaties on important UK tax provisions. It should also be noted that these decisions will have significant implications not only for the United Kingdom, but also for other Member States.

Thin Capitalization Group Litigation

Sec. 209 and Sec. 212 of the ICTA are being challenged under the thin capitalization claim. Prior to Finance Act 2004, these provisions allowed HMRC to reclassify interest payments made to foreign parent companies as dividends. It is contended that foreign-parented groups have suffered losses as a consequence of these provisions. These losses include payments by UK subsidiaries of historic ACT on reclassified dividends, the denial of the right of the subsidiaries to offset interest payments against mainstream corporation tax and damages suffered by the parent company as a result of the requirement to maintain a subsidiary’s debt: equity ratio under agreements with HMRC.

These provisions were amended in Finance Act 2000 in respect of accounting periods ending after 1 April 2000.

1. Art. 12 EC Treaty.
3. Art. 56 EC Treaty. This is restricted by Art. 57 of the EC Treaty with regard to third countries, i.e. non-Member States of the European Union.
4. At the time of writing, there were 77 claimants.
5. These provisions were amended in Finance Act 2000 in respect of accounting periods ending after 1 April 2000.
6. ECJ, Case C-446/03, Marks & Spencer plc v. David Halsey (HM Inspector of Taxes). For more on this case, see G.T.K. Meussen, “The Marks & Spencer Case: The Final Countdown
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8. ACT was abolished with effect from 6 April 1999.
9. At the time of writing, there were a maximum of 215 claimants.
11. The issues of limitation (the Deutsche Morgan Grenfell case) and amount (the Sempa Metals case), however, remain undecided. At the time of writing, these cases were pending before the House of Lords.
12. At the time of writing, there were 64 claimants.
13. Claimants in Class 11 of the ACT Group Litigation v. CIR.
14. At the time of writing, there were 50 claimants.
17. At the time of writing, there were 40 claimants.
19. ECJ, Pending Case C 374/04, Test Claimants in Class IV of the ACT Group Litigation.
20. On or before 5 April 1999.
21. At the time of writing, there were 18 claimants.
22. ECJ, Pending Case C-446/04, Test Claimants in the FII Group Litigation.
23. At the time of writing, there were 18 claimants.
24. ECJ, Pending Case C-201/05, The Test Claimants in the CFC and Dividend Group Litigation.
25. ECJ, Pending Case C-196/04, Cadbury Schweppes and Cadbury Schweppes Overseas and ECJ, Pending Case C-203/05, Vodafone 2 have also been referred to the ECJ for consideration of aspects of the UK’s CFC rules, but these are separate and distinct cases.
26. The FID regime was enacted by Finance Act 1994 and is now regulated by Sec. 246A and Sec. 246Y of the ICTA.
27. The cash was payable until legislative changes were introduced in 1997.
28. BT Pensions Scheme and Others v. The Commissioners of HM Revenue & Customs (2005)
29. At the time of writing, there were 16 claimants.
30. ECJ, Pending Case C-524/04, Test Claimants in the Thin Cap Group Litigation. In connection with this, it should be noted that, on 12 December 2002, the ECJ held in the Lankhorst-Hohorst case (ECJ, 12 December 2002, Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt (2002) ECR 1-11779) that the German thin capitalization rules, which applied prior to the abolition of the German imputation system with effect from 1 January 2001, were in breach of Community law.
March 2006 marked another round of important municipal elections in a post-apartheid South Africa. The elections took place a few days after the announcement of the budget for the year by the Minister of Finance and in an economic atmosphere described by some as “extremely positive”, “the best in 40 years” and even “exploding”.

Many reforms have taken place over the past few years in South Africa. It seems, however, that reforms in the corporate environment, in particular in the field of corporate taxation, have been slow and have certainly not been in line with the current international trend of reduced or even flat corporate tax rates.

The purpose of this article is to highlight one aspect of South African corporate taxation which, remarkably, has remained unchanged. As a result the corporate tax rate has remained static despite the hopes of many corporations and experts in the field that it would be reduced in the budget especially given the current environment of global competitiveness.

This tax is Secondary Tax on Companies (“STC”), a tax which is foreign to most tax practitioners in other jurisdictions. This article will focus on the nature of STC and its impact on South African corporate taxation.

1. The Nature of STC

STC was introduced to the South African taxes regime in 1993. At that time the corporate tax rate in the country was 48 percent and it was subsequently reduced to 40 percent. Some years later in 1999, the rate was further reduced to 30 percent. In 2005 it was again reduced to 29 percent, which is the current level of corporate taxation.

STC is a tax on the distribution of dividends to shareholders. It is not a tax on dividends per se. In order to ensure that it is levied only once, it is levied on the net amount of dividends declared and dividends received that have been subject to STC. The STC liability is therefore determined on the difference between dividends accruing to the company and the dividends declared by it, with some exceptions and exemptions.

The rate of STC is 12.5 percent. The company itself is liable to pay the tax. It is payable at the end of the month following the month in which the dividend was declared and it is not deductible from the amount declared.

Some other distributions by companies are deemed to be dividends. As a result, STC is also payable on these amounts. These instances include the distribution of cash or assets, for example, where the company makes a loan to a shareholder. They also include cases such as waiver of debt or settlement of shareholder debt.

There are a number of exceptions or exemptions. In some cases, where a company has paid a dividend to a group company it could also elect not to pay STC on the distribution.

In other cases, no STC is levied at all. Regarding foreign companies in particular, the South African branch of a foreign company is exempt from STC. However, it is taxed on 35 percent of its taxable income derived from a source within the country. Double taxation is then avoided by the granting of a credit to foreign companies for dividends received from South African companies that have already been subject to STC.

II. The Impact and Effect of STC

STC does not target corporate income. It targets the distribution of income. It is a tax on the actual distribution of a dividend to a shareholder. It is effectively imposed on the distribution of operating profits. As a result, the company’s distributed earnings are taxed at a higher rate than its undistributed earnings.

Given these facts, what, could it be asked, is the rationale for maintaining STC? Why impose a higher corporation tax rate in circumstances where a country should be seeking corporate investment in a global environment where the trend is to reduce rates rather than to make it more burdensome for the company?
From a government fiscal perspective, it would certainly make sense to maintain STC given the fact that during 2005, the collection by the South African Revenue Services from STC has increased by 70 percent if compared to the previous year. It has also been stated officially that it is an incentive through which it is sought to facilitate reinvestment of the company’s earnings. As a result, it is contended, corporate investment in the South African economy is enhanced.

But where, it could be asked, is the attraction for a company? Viewed from a global perspective, it could be said that STC is tax which is used as a policy tool. Accepting that the tax rate for companies is 29 percent, the additional tax of 12.5 percent which is levied on the distribution of dividends, has the result that the company is effectively taxed at 37 percent. The average OECD corporate tax rate is 30 percent. The country’s rate is therefore at least 7 percent more than the global average corporate tax rate. It is certainly not in accordance with the current international trends having regard to the competitive environment created by other tax regimes, low tax rates and even flat rates.

Perhaps the answer lies in this. The corporation is effectively forced to reinvest and penalised should it elect to distribute its profits. As a result, corporate choice and freedom is limited to a large extent. But perhaps it could be said that this is a form of social responsibility. By reinvesting, the company may well make a substantial contribution to the well-being of the social environment in which it operates. This however comes at a great cost and has been seen by many as a disincentive. Perhaps more importantly, many companies regard themselves as socially responsible. They do not need that to be imposed on them in the form of a tax.

III. Conclusion

In a global investment arena which is offering increasingly attractive investment opportunities, many countries have sought to reduce their corporate tax rates. The South African Revenue have not followed this trend but have sought to impose a form of corporate social responsibility on companies by taxing them should they elect to distribute their profits rather than retaining and reinvesting those profits. This is a disincentive and it is believed that if STC is eventually abolished, it may go some way to make South Africa competitive in the international investment world from a corporate tax perspective.
The Benefits of Keeping Time Options
Open in Marks & Spencer Claims

Simon Whitehead

Taxpayers should be aware that time may still be on their side if they wish to make similar claims to Marks & Spencer. An analysis of other tax cases from the UK courts shows what is possible, explains Simon Whitehead of Dorsey & Whitney.

Corporate groups, particularly those parented in the UK, have no doubt been picking over the preliminary ruling in the Marks & Spencer group relief case and considering whether they can make similar claims. In this context it is important to keep in mind the interrelation between the numerous current community law cases proceeding through the UK courts relevant to tax. The options and opportunities for making claims may be much broader than they might first appear. Claims might well extend beyond what might be thought at the moment to be the maximum period of six years.

Marks & Spencer sets the scene

The first of four decisions to consider is the latest, Marks & Spencer (C-446/03 Marks & Spencer Plc v David Halsey (HMIT)), for it gives us the setting for the claim. Much has been and will be written on its interpretation and opinions differ. Distilled to the uncontestable, it surely concludes that there are circumstances where a national system of group relief must give relief for cross-border losses within the community. Losses must be capable of surrender where they cannot be used first in the source jurisdiction. This latter point creates a number of questions not dealt with by the judgement which concentrates purely on the issues of principle and the circumstances before the European Court of Justice (ECJ).

• Primarily, when can a loss no longer be capable of utilization in its source jurisdiction?
• Does it require losses to be terminal or there to be no theoretical possibility of local carryforward, as Treasury comment seems to suggest?
• Or is the court suggesting that a practical assessment needs to be made of the likelihood of future use locally? Furthermore when must the taxpayer reach the conclusion that the loss cannot be used locally?
• The UK group relief scheme envisages applications for group relief to be made within two years of the accounting period in which the corresponding profits and losses arose. Under the Dutch system a fiscal unity must be sought in the same year. Is the court therefore envisaging a practical assessment to be made by the taxpayer during this window as to whether the loss is likely to be used locally before electing to surrender it cross-border?

If so the Dutch taxpayer is left about a year less farsighted in conducting that assessment than its UK counterpart.

• There also remains the outstanding question of whether the loss should be computed on the basis of local rules or adjusted for the rules of the State to which it is to be surrendered.

These issues and others remain outstanding and are likely to produce yet further references to the ECJ. For present purposes let us assume that many potential claims will fall into the category where the loss is in practical terms unlikely to be used locally within the type of period which can be easily forecast without the assistance of a crystal ball. That is our setting.

Tribunal fixed by Autologic

In Autologic (Autologic Holdings plc & others v Commissioners of Inland Revenue [2005] 4 All 1 ER 1141), in July 2005 the House of Lords answered the question of which was the appropriate tribunal to determine claims brought under community law seeking remedies arising from the inability to make cross-border group relief claims. It divided the relevant claims into five categories. The first (within time Category I claims) were claims for the recovery of cash tax paid in the UK in circumstances where it would not have been paid had cross-border group relief been available and which claims had been made or could still be made within the available statutory period. These claims should in the ordinary course of events be made by statutory group relief applications to be appealed to the Commissioners of Income Tax upon their inevitable rejection.

The House of Lords concluded that all other categories of claim should be brought in the High Court. These include cash tax claims which are beyond the statutory period available for group relief applications (out of time Category I claims) and claims where tax was not actually
paid by the UK company concerned but was sheltered through the use of its own carried forward reliefs (Category 2 claims) or those of other UK companies in the group (Category 3 claims) which reliefs would have otherwise been available for carry forward or alternative use. The last category (Category 4) concerns claims by the non-resident companies who contend that had the UK system permitted cross-border surrenders then they could have monetized the loss through the receipt of a compensating payment from the UK recipient.

The critical distinction for present purposes behind the conclusion that cross-border group relief claims should be brought in the High Court (other than those simple within time claims just for cash tax paid) is that the time period for bringing those claims is regulated by the Limitation Act 1980 and rules governing the limitation periods for court, rather than tribunal, actions. So what is the period available for bringing High Court claims?

DMG discusses correct limitation

This brings us to the third case, DMG (Deutsche Morgan Grenfell Group plc v IRC [2005] STC 3290). The case is well known and asks the question as to what is the correct limitation period available where a claim is brought in the High Court (other than those simple within time claims just for cash tax paid) is that the time period for bringing those claims is regulated by the Limitation Act 1980 and rules governing the limitation periods for court, rather than tribunal, actions. So what is the period available for bringing High Court claims?

PPL claims directive breach

PPL was an industry body which collected licence fees for the copyright owners in sound recordings. Two sections of the Copyright, Designs and Patents Acts 1988 enabled sound recordings to be played without fee in certain circumstances. PPL contended that these provisions, which restricted their ability to obtain licence fees, breached an EU directive which was required to be brought into force by member states on July 1 1994. PPL issued a claim for damages for the fees that had not been able to collect in March 2003. They sought damages for the six-year period preceding the date of issue. The matter proceeded as a preliminary issue on the question of whether the claim was out of time and assumed that PPL was correct in its understanding of the substantive law.

The Crown argued that the claim was time barred. This was a claim in tort for breach of statutory duty. The statutory duty had been breached on January 1 1994 when the UK failed to bring the relevant directive into law by maintaining incompatible provisions in the 1988 Act. That date was more than six years before the date of issue of the claim form in 2003.

The High Court found for PPL. It held that a breach of statutory duty is an ongoing breach. Each time damage is sustained as a result a new claim arises. The UK was as much in breach in 1994 when it failed to introduce compliant legislation as it was when that legislation prevented the recovery of licence fees in, say, 2000.

What this might mean: longer claims

Now let us place these cases into the context of a concrete simplified example to illustrate how the High Court aspect of claims can have far reaching effects. Take a company group with a UK resident parent having two subsidiaries resident in the UK and the other in France. In Year 1 the parent makes a profit of 100 while the French subsidiary makes an identical loss. The
French subsidiary appears unlikely to return to profit. However the parent cannot receive the surrender of the cross-border loss so instead accepts the surrender of a relief of 50 from the UK subsidiary and pays tax on the balance. Assume in Year 4 the UK subsidiary returns to profit and pays tax which it could have prevented had it been able to carry forward the relief surrendered to the parent in Year 1. A claim is issued in the High Court by the group seeking relief from these adverse tax effects in Year 9.

If the taxpayer wins in the DMG case then, in practical terms, the entire claim would seem to be within time. The parent recovers relief for the tax paid on profits of 50 in Year 1, and the UK subsidiary is relieved for the effects of the use of its relief set against the other 50. But this might only occur if the claim is in the High Court. If the claim was brought in Year 9 as a statutory group-relief claim then (without years remaining open) perhaps the same result would not arise.

If the taxpayer loses in DMG then the limitation period for the High Court claim, it is generally thought, will be restricted to six years. But through this whole period the UK provisions were incompatible with community law. Applying PPL, the breach was a continuing one. While the loss may have been suffered in Year 1, it would seem the UK subsidiary also suffered another loss in Year 4 when it paid tax it might otherwise have sheltered. Year 4, being within six years of the issue of the claim in Year 9, the prospect arises that a claim can still be within the High Court limits for the tax on the 50 paid by the UK subsidiary. Again however this may only arise where the claim is brought in the Court.

In real life of course, the factual matrix will be more complex than this simple illustration. Yet now that the Marks & Spencer judgement is known and the ECJ are reviewing their case law on the imposition of temporal limitations to their judgments, when considering the availability of claims it is probably worthwhile to keep in mind that the guillotine may not fall after a simple six years if there is a High Court component to the claim.
Companies who find that they have overpaid tax as a result of UK tax law being in breach of EC law need to be prescribed the right remedy, says Liesl Fichardt.

Most tax practitioners and managers know what steps to take when a corporation, whether small or large, has mistakenly underpaid tax in any given year. The answer is less clear where, as a result of a provision which had been found to be in breach of community law, a company has overpaid tax or has suffered expenses which it would not have incurred otherwise.

The answers may lie with the European Court of Justice. In his opinion of 6 April 2006 in the Franked Investment Income Group Litigation Order, the Advocate General gave an important and detailed explanation of potential remedies which may be available to taxpayers where excessive tax had been paid or pecuniary loss suffered as a consequence of provisions which had been found to be in breach of the EC Treaty. Although the European Court of justice is not bound to follow the opinion of the Advocate General, his views are a useful guide to the court and the opinion is followed in about 80% of tax cases.

Dividends

The group litigation order concerns UK tax provisions relating to dividends received by UK resident companies. Some of the provisions formed part of the advance corporation tax regime, abolished in 1999; others are still relevant.

The provisions treat the taxation of domestic dividends and foreign dividends differently. In particular, a United Kingdom resident company faced no corporation tax liability in respect of domestic dividends, but was liable to UK corporation tax on foreign dividends, after deduction of a foreign tax credit. In addition, the regime dictated that a UK resident company, in so far as it received domestic dividends, was not liable to pay advance corporation tax when it paid dividends to its shareholders. However where it received foreign dividends it was liable to pay advance corporation tax.

The result was that companies often had to pay additional tax when they received dividends from subsidiaries in another Member State. A cash flow disadvantage also resulted due to companies having to pay advance corporation tax on distributions which were made from foreign dividends. In addition, the parent companies were not able to use the excess advance corporation tax payments by way of set off against mainstream corporation tax. In order to mitigate the impact of the regime on their shareholders, companies artificially increased the level of domestic dividends paid by them to their shareholders.

Thus the dividend regime had two important consequences.

The first was that companies were effectively out of pocket because of the different tax treatment of domestic and foreign dividends.

The second was that the companies incurred additional expenses in order to mitigate the impact of the relevant provisions.

The Advocate General considered that these tax provisions breached the EC Treaty without justification. The reason was that the provisions sought to restrict the freedom of a UK resident parent to establish a subsidiary or invest capital of a company in another Member State and violated Articles 45 and 56 of the EC Treaty.

Significantly, the Advocate General went on to consider the possible remedies for companies which took various steps to their detriment or paid excess tax pursuant to provisions which had been found to be contrary to community law. It is in that regard that his opinion becomes important for companies in general and taxpayers in the UK in particular.

The Advocate General acknowledged that under EC law national courts are obliged to ensure that taxpayers have an effective remedy in order to obtain reimbursement or reparation of a financial loss which they have sustained as a direct result of tax levied in breach of EC law. He noted the essential distinction between two different remedies. One remedy may be available where a taxpayer has overpaid tax. Another remedy may be available where the taxpayer is out of pocket, as a result of taking steps to mitigate the problem, perhaps the payment of dividends, which it would not have otherwise done. In the first instance, the
remedy is of a restitutionary nature. In the second, it is a claim for damages. The difference is significant and could have far-reaching consequences.

**Restitutionary**

A remedy is restitutionary in nature where it amounts to a repayment by the state of an amount unlawfully held by it.

The underlying principle, in the UK context, is that the UK should not profit, and companies which have been required to pay an unlawful tax should not suffer, as a result of the imposition of the tax. This remedy, in the opinion of the Advocate General, should be available to taxpayers who have paid excess corporation tax. It should also compensate a cash flow disadvantage, i.e. the loss of the use of money, which resulted from tax which was unlawfully levied in advance.

The same principle could also be applied to other circumstances. The taxpayer should be able to claim, as part of a restitutionary claim:

- the restoration of any relief which had been applied against the excess corporation tax unlawfully levied and paid;
- the restoration of reliefs foregone so as to set off unlawfully levied corporation tax;
- payment for the loss of use of money which was levied unlawfully and paid as advance tax.

The Advocate General’s view is that these claims should be allowed where the national court is satisfied that the relief claimed was a direct consequence of the unlawful tax charged.

**Damages**

A claim for damages is different in many respects. This remedy will not be available where the taxpayer has not made payment or where it has been denied a refund pursuant to an unlawful provision. But it may be available where the taxpayer has suffered loss or harm as a result of the failure by the state to comply with its obligations under EC law. However, a claim for damages must meet the following three conditions:

- the relevant rule of law must be intended to confer rights on individuals, i.e. would the claimant have a right to enforce, vis-a-vis the state, the particular obligation?
- the breach of community law must be sufficiently serious, e.g. where it is clear that the relevant national provision is inconsistent with EC law but that inconsistency was nevertheless disregarded by the state;
- there must be a direct causal link between the breach and the harm suffered.

**Implications for UK companies**

Could these principles be applied to other circumstances where excess tax had been paid pursuant to an unlawful provision or where the taxpayer has suffered a loss? The answer is yes. The taxpayer does have remedies available to it in EC and UK law. EC law recognises that the UK courts are required to ensure that the relevant remedy is effective so as to compensate the taxpayer for its loss.

The difficulty lies in choosing the appropriate remedy and being able to demonstrate the relevant requirements in each case. With regard to a restitutionary claim, the taxpayer would have to show that it was out of pocket due to excess or advance payments to the state. If it were unable to prove that the payments had been made pursuant to provisions which were unlawful, the claim would fail.

The other alternative is a claim for damages. Here, taxpayers who find themselves out of pocket as a result of having paid excess tax or because they have taken certain steps to mitigate any loss, would have to take care in assessing their particular circumstances so as to ensure that the relevant fact patterns match the legal requirements in respect of any (or both) of the available remedies offered to them under EC law. Failure to do that, may well result in them having no remedy at all.
Dividend Taxation in Non-E.U. Member Countries: Preventing Discrimination through Double Tax Conventions

Liesl Fichardt

Many tax authorities and courts in European Union Member States have considered the taxation of dividends in the recent past. One of the most contentious areas in this field concerns the tax treatment of dividends payable by a resident company to a resident shareholder where it differed from the tax treatment of dividends payable by a resident company cross border to a non-resident shareholder.

In those cases the relevant tax treatment has been viewed in the light of the EC Treaty which prevents, in the absence of justification, any restriction on the freedom of establishment and the free flow of capital. It has also been considered in the context of the provisions of the applicable Double Tax Conventions (DTC), where they contain a clause substantially similar to the non-discrimination clause of the OECD Model Convention.

In the European Union context, the European Court of Justice (ECJ) has upheld the important principle of equivalent tax treatment of a subsidiary which distributes dividends, whether it is owned by a resident or non-resident shareholder. The United Kingdom Court of Appeal recently confirmed that the tax treatment of dividends payable by a U.K. resident company to a non-U.K. resident corporate shareholder ought to be the same as that relating to the dividends payable by a U.K. resident company to a U.K. resident corporate shareholder. It held that differential treatment of companies in comparable situations is unlawful and contrary to the non-discrimination clause in the relevant U.K. DTC.

The tax treatment of dividends in certain non-E.U. member states have yet to be considered by the domestic courts in those countries. By way of example, in South Africa, a tax known as secondary tax on companies is payable upon the distribution of dividends. In some limited instances, an election to be exempt from STC is available, but only to a domestic corporate group. Can it be said that the provision contravenes the non-discrimination clause should it exist in a relevant DTC? What factors ought to be taken into account in order to rely on that clause successfully?

This article will examine some of the important factors which have crystallised in recent case law and which may provide guidance to determine whether a dividend tax regime violates such a non-discrimination clause.

Recent Case Law on Dividend Taxation

In some jurisdictions, tax authorities have sought to collect tax on the distribution by a corporation of its profits to shareholders. That tax is levied at different levels. It can be levied at the level of the source subsidiary company as a corporation tax on its profits. Tax can also be levied as a withholding tax when the dividend is paid, or as a tax on the shareholder recipient’s income, by regarding the receipt as part thereof. This may result in two forms of double taxation: economic double taxation (the levy of tax on the same amount in the hands of different entities) or juridical double taxation (the levy of tax on the same amount twice in the hands of the same entity). Double taxation, whether in the domestic context or in a cross-border context, has been alleviated in many different ways, for example, by way of exemption of tax at source, or by way of the granting of a credit at the level of the recipient.

In the United Kingdom, in particular, the dividend taxation regime which existed until April 1999 entailed a feature known as Advance Corporation Tax (ACT). A liability to pay ACT arose when a U.K. company paid a dividend. Where the company paying the dividend was a subsidiary of a U.K. resident company the two companies could make a group income election. In that case the subsidiary would not be liable to pay ACT. The group income election was, however, not available where the parent company was a non-U.K. resident. The result was that ACT remained payable by the U.K. subsidiary when it made a distribution to its foreign parent.
Various features of the ACT regime were challenged recently both in the context of the EC Treaty and in the context of DTCs. The ECJ has held that the ACT provisions relating to the group income election violated the right of freedom of establishment contained in Article 43 of the EC treaty, in so far as it operated to the disadvantage of parent companies based in other member states. Earlier this year, in the matter of Boake Allen Limited and Others v HMRC [2006] EWCA Civ 25, the U.K. Court of Appeal considered the non-availability of the group income election, in particular with regard to non-E.U. member shareholder recipients in the context of the relevant DTC. In that case, the shareholders receiving the dividends were residents in the United States and Japan. It was contended that the relevant taxation provisions were in breach of the non-discrimination clause in the DTCs concerned, which read as follows:

"Enterprises of a contracting state, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other contracting state shall not be subjected in the first-mentioned contracting state to any taxation which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned state are or may be subjected."

In another matter, UBS AG v HMRC [2006] EWCH 117 (Ch) the U.K. High Court had regard to a different feature of the ACT regime in the light of a similar non-discrimination clause in the U.K.-Switzerland Treaty. In both cases, the U.K. courts concluded that the ACT regime contravened the DTCs concerned.

Considering the judgments of the Court of Appeal in Boake Allen and the High Court in UBS, three important issues can be identified in relation to its approach to the non-discrimination clause and whether its provisions are violated by the dividend tax regime concerned. The first relates to the scope of the DTC, i.e whether it and the non-discrimination clause in particular, applied to the relevant tax concerned, so as to enable a taxpayer to rely thereon. The Appeal Court held that the DTC and the non-discrimination clause applied to corporation tax. The DTC provided for that in express terms.

The second issue concerned the comparator i.e., the enterprises which ought to be treated the same so as not to fall foul of the non-discrimination clause. In that regard both courts held that the comparable entities were U.K. resident subsidiaries paying dividends to U.K. resident parents and U.K. resident subsidiaries paying U.K. dividends to non-U.K. parents. The Court of Appeal concluded that the ACT provisions were inconsistent with the non-discrimination article because the U.K. subsidiary of a foreign company could not avoid having to pay ACT when it paid a dividend by entering into a group income election, unlike members of a U.K. group. The High Court concluded that the foreign parent was unable to invoke a provision, relating to credit payments following the payment of ACT by its U.K. subsidiary, whereas a U.K. parent could do so. In both cases the discrimination related to the place of residence of the shareholder.

A third issue that can be identified concerns the de facto fiscal situation of the foreign shareholder recipient. By way of background some, but not all, DTCs provide for a treaty credit payable to a foreign recipient, so as to avoid apparent double taxation, in a case where the tax is levied at the source level resulting in economic double taxation. In the context of the ACT regime, and depending on the terms of the U.K. DTC concerned, a treaty credit may or may not be available to the foreign recipient. Therefore, even where the domestic subsidiary is required to pay tax in some form when it makes a distribution, the parent will be entitled to claim a treaty credit, in an amount equivalent to or less than the tax paid by the subsidiary, in relation to the dividend. However, in the DTC non-discrimination article context, this is not a factor which the courts took into account in order to determine whether the dividend regime was discriminatory or not. This was not argued before the courts and the reason probably lies in the express words of the non-discrimination article, assuming it follows the OECD model. It requires that the subsidiary (when foreign owned) shall not be subject to taxation which is more burdensome than the taxation to which a subsidiary (when owned by a domestic parent) is subjected. The enquiry on the discrimination issue is therefore aimed at the taxation of the subsidiary itself. Any benefits to be received by the foreign parent by way of credits under the DTC are not relevant.
The availability of a treaty credit to the foreign parent could be of significance in another context. The credit could be taken into consideration when determining the compensation which may be claimed in a domestic court as a result of the payment of a tax by the subsidiary which had been found to be unlawful and contrary to the treaty non-discrimination clause. That was considered by the House of Lords in Pirelli Cable Holding NV and others V HMRC [2006] UKHL 4. The Lords were called upon, inter alia, to determine the compensation which a subsidiary was entitled to claim in circumstances where it was required to pay tax (in the form of ACT), and in fact paid it, when it distributed a dividend to its foreign parent. To the extent that the tax which it paid was unlawful, the subsidiary effectively claimed the value of the tax paid by it together with interest thereon. The Lords concluded that the treaty credit which was received by the parent in terms of a DTC provision so as to eliminate double taxation should be taken into account in determining the compensation claimed by the subsidiary. The rationale was based on the scheme inherent in the ACT regime. The Lords held that the payment of ACT was connected to the availability of the treaty credit and was a precondition for it. Therefore, where the subsidiary claimed the value of the tax paid by it (and which had been found to be unlawful) the compensation ought to be reduced by the value of the treaty credit received by the parent, in so far as the treaty credit would not have been available to the parent, if the subsidiary had not been liable to pay that tax in the first place.

How can these Principles be Applied to non-E.U. Member States?

Although each domestic situation will be determined in accordance with its own jurisprudence, useful criteria have crystallized from the recent U.K. court decisions in relation to the non-discrimination clause. The first is the scope of the DTC. It can state expressly that it applies to the particular tax or it can apply by implication. The second issue is the comparator entities. The third issue, the availability of treaty credits pursuant to another provision of the DTC, may however not be relevant in that enquiry.

How can this be Applied to the Issue of STC and other Similar taxes in Other Jurisdictions?

Regarding STC, it is a tax on the distribution of dividends to shareholders. STC is payable by the company making the distribution. The liability, at a rate of 12.5 percent, is determined on the difference between dividends accruing to the company and the dividends declared by it. There are a number of exceptions or exemptions. In one instance, where a company has paid a dividend to a group company which is also a S.A. resident, it could elect not to pay STC on the distribution. That election is not available if the parent is not a S.A. resident. Double taxation is then sought to be avoided by the granting of a treaty credit to the foreign parent for dividends received from South African companies that have already been subject to STC.

Both the S.A./U.K. and S.A./U.S. conventions follow the OECD model and contain a non-discrimination clause. In both, the scope of the treaty is clear. They expressly provide that they apply to STC. Regarding the comparator, in the context of the non-discrimination clause in both treaties, the entities that ought to be treated the same are a domestic company paying dividends to its domestic parent and a domestic company paying dividends to its foreign parent. Applying only these principles to the STC regime which limits the election not to pay STC to only a domestic group, the discrimination is clear.

The South African Revenue Services contend in a public announcement (August 26, 2004) that there is no discrimination. They also contend the situation is remedied in so far as the foreign parent is entitled to a credit under another provision of the treaty so as to avoid double taxation. Both the S.A./U.K. and S.A./U.S. treaties contain a clause to eliminate double taxation and provide, albeit in different forms, for a treaty credit to be payable to the foreign parent in respect of the tax paid by the subsidiary on its profits. It appears that the treaty credit is limited to tax on profits and not tax on the distribution of dividends. But even assuming that the foreign parent would be compensated to some extent by payment to it of a treaty credit, that does not do away with the discrimination inherent in the STC regime, which is prohibited by the non-discrimination clause. The value of the treaty credit received by the foreign parent may merely be a factor to be taken into consideration when
determining the value of compensation claimed by a subsidiary where it had paid STC, in circumstances where the election not to pay it was not available. However, the court may have to find that the payment of STC was a precondition for receipt of the treaty credit and that will depend on the terms of the relevant DTC.

Conclusion
International jurisprudence has developed in recent months which will entitle group companies with subsidiaries or parents in different states to tax treatment equivalent to domestic groups. The principle of non-discrimination is not reserved to E.U. member states by virtue of the EC treaty but can also be insisted upon by those who are based in non-member states where a non-discrimination article exists in the relevant DTC. Group companies who find themselves in these situations should therefore take steps to protect their positions in domestic law.
THE EC TREATY, in Articles 43 and 56, gives the right to the freedom of establishment and free movement of capital throughout Member States. Establishing exactly how those rights impinge on, for example, the payment of dividends across Member State borders and between companies and their subsidiaries and shareholders can be somewhat problematic. In an ideal world, the application of these Articles on paying companies and their states concerned would be clear. This article aims to establish what principles can be gleaned from recent decisions of the European Court of justice in such circumstances. Does one consider the substance of the transaction or is the form that it takes more important?

Within the space of a few months, opinions have now been delivered in some four dividend taxation cases before the European Court (ECJ). Interestingly, although honours are evenly shared, with two victories proposed for taxpayers (Test Claimants in the FII Group Litigation C-446104 and Denkavit International BV and Denkavit France SARL C-1 70/05) and two for Member States (Test Claimants in Class IV of the ACT Group Litigation C-374/04 and Kerckhaert and Morres C-513/04), the opinions have been the work of the same Advocate General, Advocate General Geelhoed. He advocates a clear and disarmingly simple mechanism for determining whether national provisions which tax dividends paid cross border differently from those paid internally offend community law.

Yet the differing results he reaches from the application of this simple test in two of these cases, ACT Class IV and Denkavit, show that this rigid approach can produce some somewhat incongruous results where what a Member State does becomes less significant than the way in which it does it.

Going against the tide

Before considering Advocate General Geelhoed’s approach in these two cases, an immediately arresting feature is that its mechanical approach seems contrary to what appears to be a developing theme in community law. We have seen an attitude recently among some of the Advocates General of the Court which seemed to be moving away from simple, formalistic tests like these in the application of community law. The clearest sign of this new attitude has been in proposals for the application of the defence deriving from Bachmann v Belgian State C-204/90; namely, the defence to a restriction on the exercise of a community freedom that it could be justified if it was necessary to maintain the cohesion of the national tax system in question. In other words, imposing a differential tax disadvantage on a cross-border transaction (as opposed to an internal one) could be justified where the disadvantage came with a corresponding tax benefit. In Bachmann, the disadvantage of not receiving a tax deduction for insurance or pension payments made to a non-resident fund corresponded with the advantage that the payout was not taxed where the fund was non-resident.

Despite that defence being invoked by Member States in probably every direct tax case since its inception in 1992, it has never again been successful. By 2002 - maybe even in response to the ubiquity of its appearance in these cases - the test for its successful application required the corresponding disadvantage and benefit not only to apply to the same taxpayer, but also the same tax; perhaps as best evidenced in Basal Holding BV v Staatssecretaris van Financiën C-168/01 at paragraph 29.

The focus of these cases where national direct tax provisions clash with fundamental community freedoms of movement usually falls on avoiding economic double taxation (taxation of the same earnings twice in the hands of two taxpayers - i.e. the company and its shareholders) as opposed to juridical double taxation (i.e. taxation twice of the same earnings in the hands of the same taxpayer). Often, national provisions have been found to pay more attention to correcting this acknowledged evil where the parties earning and receiving the income were both nationals of that Member State than when one was not, and indeed this is a feature of the four dividend taxation cases referred to above. It is difficult to then see how the Bachmann defence could ever bear any relevance to a context of economic double taxation if its application required a corresponding benefit and disadvantage to exist in the same taxpayer. For completeness, it should of course be remembered that Bachmann was not an economic double taxation case.
Yet in Manninen C-319/02 and Marks & Spencer v Halsey C-446/03 respectively, Advocates General Kokott and Maduro have recently questioned the application of this rigid and simple test. They both recommend that the ECJ loosen this requirement and take note of a company group as an economic entity. They raise the prospect that benefits to some companies within a group might be able to justify disadvantages to others. They propose a contextual analysis which seems rather out of step with the formal mechanical approach now advocated upon dividend taxation rules by Advocate General Geelhoed.

What then is this new test?

**The new test**

The first of these four recent dividend taxation cases was the **ACT Class IV** case where the test finds its genesis.

First, the Advocate General seeks to distinguish between differential taxing provisions which result from the arbitrary action of a single Member State and those resulting from the mere interaction of two different tax systems. The former he believes can cause discrimination, the latter only the dislocation naturally resulting from the lack of direct tax harmonisation across the community. It is questionable whether such a distinction currently exists in community law or indeed where the line between discrimination and dislocation could be drawn; however, we will not delve further into that abstract issue as the attention of this article is on the outcome he draws from this distinction.

The Advocate General then proposes a division between national provisions differentiating in their treatment of domestic and cross-border dividend payments depending on whether the Member State concerned is either the source state (i.e. the state of the dividend payer) or the home state (the state of the shareholder).

Where the Member State concerned is the source state the only obligation on the Member State arises when it also taxes the non-resident. In those circumstances the Member State must alleviate economic double taxation on the cross-border transaction to an equivalent extent to that alleviated domestically. Where it does not tax the non-resident the Member State can differentiate to its heart's content. If it wishes, it can provide full relief from economic double taxation internally while ignoring the same effect in a cross-border context and it will remain beyond the censure of community law.

While in formulating this critical distinction between the source and home state the Advocate General maintains that such a distinction exists already in the Court's case law, he does admit that it is challenged by three decisions.

First, it is directly challenged by the ruling in the Basal Holdings case. The Netherlands permitted a parent company to deduct the financing costs paid for its subsidiaries only where those subsidiaries' profits were subject to tax in the Netherlands. Advocate General Geelhoed's thesis would find nothing problematic in such a provision. The Netherlands, by definition, is not taxing the non resident subsidiaries for whose financing costs it refuses the deduction to the Dutch parent. What it does where the profits are made in the Netherlands is therefore, on his view, neither here nor there. Yet the ECJ ruled in favour of Basal Holdings. In **ACT Class IV** (see C-374/04, paragraph 63), the Advocate General's response to this decision contrary to his thesis is admirably candid: he regards the decision as wrong.

The second exception is **Marks & Spencer v Halsey**. On the Advocate General's view the UK in that case could employ group relief provisions (group relief can be seen as closely related to provisions alleviating economic double taxation) which prohibited the surrender of losses from non residents. The UK in this instance is the source state. Therefore, on his test, it need not take account of the losses of the non residents as it does not tax them even if it provides such an advantage where the resident loss maker is subject to UK tax. Yet again this is not what the Court concluded.

In **Marks & Spencer**, the Court concluded that there were circumstances in which the UK should recognise the surrender of the non-resident loss; namely, where it was stranded in a jurisdiction in which it could not be used. While in the general case the restriction of cross-border group relief might be permissible, this was (to the ECJ) not because the UK was the source state and did not
exercise taxing jurisdiction over the non resident, but
because otherwise unwelcome disruptive effects might
arise; for example that the loss might be used more than
once, or the balance of the allocation of taxing rights
between Member States might be disrupted, or company
groups might apply losses wherever the effective tax
rate would be the highest. The case therefore stands as
a challenge to Advocate General Geelhoed's test. In
ACT Class IV (paragraph 65), the Advocate General openly
admits this, advising the ECJ to apply the
Marks and Spencer ruling ‘extremely restrictively’ seeing it as the
introduction of an additional disparity in the interrelation
between national tax systems, thereby further distorting
the exercise of community freedoms.

The third exception is the Fokus Bank decision. Here
the EFTA Court, applying its understanding of European
Community law to the free movement of capital provision
of the European Economic Area Agreement, which
mirrors the like provision of the EC Treaty concluded
that Norway could not alleviate economic taxation on an
internal dividend without doing the same for outbound
crossborder distributions. Again in ACT Class IV (at
footnote 83), the Advocate General disagrees with that
Court.

However, there would seem to be a fourth exception
although it is not clear that this is acknowledged by the
Advocate General. In the Hoechst/Metallgesellschaft
cases ([2001] STC 452), the ECJ considered whether
the denial of a group income election to a UK subsidiary
of a nonresident parent was compatible with community
law. Again, the UK was the source state, a distinction
which in the thesis of Advocate General Geelhoed
should have been significant although it is nowhere
referred to in the opinion or judgment in that case. What
did a group income election do? It did not exonerate
a UK group from the payment of advance corporation
tax (ACT) on the eventual distribution of profits, but
rather prevented the multiple incidence of ACT as that
distribution moved through a company group toward
its eventual shareholders and permitted the UK group
to transfer the ACT to where it could be offset most
efficiently. It bears the hallmarks of provisions directed
against economic double taxation.

As the opinion and judgment in that case record, the
UK government had argued that, accordingly, the denial
of a group income election where the parent was non
resident was justified because the non-resident parent
was never liable to pay ACT and therefore there was
no need for a mechanism to alleviate the possibility of
multiple ACT liabilities or to introduce the foreign parent
into the net for offsetting it. Thus, if Advocate General
Geelhoed’s approach is consistent with the ECJ’s case
law, surely the UK government should have been right.
The UK was the source state. Group income elections
alleviated economic double taxation internally within the
UK group. The UK did not offer the same treatment cross
border, but equally - in the Hoechst/Metallgesellschaft
cases - did not tax the non resident. The Court’s contrary
conclusion therefore again stands as an inescapable
challenge to the existence of such a general principle
asserted by Advocate General Geelhoed in these
cases. (N.B. we are not dealing here, of course, with
the situation where equating domestic and cross border
treatment would in the latter case produce a result that
the income was not taxable anywhere, per Schempp
C-403/03, but rather with the alleviation of economic
double taxation.)

The existence of these four high profile challenges to
the Advocate General’s thesis leads to two possible
conclusions.

The first is that community law does not recognise this
fundamental distinction between source and home
state taxation which permits the source state to ignore
differential treatment provided it does not tax the non
resident. Otherwise these cases would not have been
decided as they were. None are particularly old (the
oldest being from 2001 and the most recent being only
seven months ago) and none are expressed as being
exceptions to a general rule which otherwise enables
the source state to ignore the cross-border situation. On
this basis, the Advocate General’s opinion is proposing
new law breaking from the past.
The second possible conclusion is that the Advocate General’s test is far too rigid and formalistic to be accommodated within community law as it currently stands whether or not it prefers the source state to the home state. Indeed, it is this conclusion which is supported by the contrasting results proposed by him in the ACT Class IV and Denkavit cases to which we now turn.

ACT Class IV and Denkavit
Both cases deal with dividend taxation provisions which seek to alleviate economic double taxation. There are two basic ways of doing this:

- a system which gives credit to the shareholder for the tax paid on the underlying profits which are the source of the distribution; or
- a system which exempts the dividend receipt from tax in the hands of the shareholder where the underlying profits are the subject of corporation tax.

The ACT Class IV case concerns a credit system and the Denkavit case an exemption. The ACT Class IV case is not concerned with group income elections, but with another feature of the UK’s imputation system which operated for dividends paid before 5 April 1999. The UK resident shareholder of a UK group would receive with its dividend a tax credit which partially alleviated economic double taxation for higher-rate taxpayers, entirely relieved it for lower-rate taxpayers and produced an additional cash payment for exempt taxpayers like pension funds. The credit was passed with the distribution from the UK subsidiary which earned the profit, through other UK resident companies in the chain to pass on to the ultimate public shareholders. However, where the UK subsidiary which earned the profit was parented by a German or French company, it was not given any credit to pass on. Accordingly, the shareholders (whether UK resident or not) of German or French parent companies of UK subsidiaries received no credit with the ultimate distribution of that source of profit.

The Denkavit case concerns dividends paid by French companies prior to the introduction of the Parent Subsidiary Directive. Internally, a dividend received by a French parent company from a French subsidiary would almost entirely be exempt from tax. When paid to a Dutch parent company it was subject to a 5% withholding tax and although credit could be given in the Netherlands, because the Dutch exempted dividend income received under the participation exemption, this tax was not relieved.

Reconciling these two cases
To Advocate General Geelhoed, the cases produce opposite results when viewed for compatibility with community law. In ACT Class IV he accepts that the shareholders of the German or French parent are worse off than shareholders of the UK parent. The former suffered unabated economic double taxation; the latter have it alleviated in whole or part or (in the case of pension funds prior to 1997) even where economic double taxation was not even at risk. Indeed, the effect of the cash credit for pension funds would seem to have amounted to economic non taxation. Yet, to the Advocate General, because the UK is the source state and does not collect tax from the German or French parent, this is not a disparity for which the UK can be criticised. In contrast, in Denkavit, the French do tax the non resident and therefore while France is the source state and does not collect tax from the German or French parent, this is not a disparity for which the UK can be criticised. In contrast, in Denkavit, the French do tax the non resident and therefore while France is the source state, nevertheless it must give equal treatment to that given to the French parent.

Yet why should the method used produce so fundamental a difference in outcome? Both sets of provisions were seeking to achieve the same result. Both sought to alleviate economic double taxation internally without addressing the circumstances of the cross-border movement. In ACT Class IV, the UK sought to do so by taxing both transactions in the same way, but then to give a credit internally not provided externally. The French achieved the same result by exempting internal dividends and not exempting external dividends. The objective and end result are identical yet the credit method gets to that outcome without offence; the exemption system does not.

Is this approach then not really the type of success of form over substance that Advocates General Kokott and Maduro were seeking to avoid in their criticism of the overly rigid approach adopted by the Court to the Bachmann defence? The UK, by giving the advantage of a tax credit internally which it denies externally, creates
Triumph of Form Over Substance?

(continued)

the same outcome as the French rules which only tax the external movement. In both, the internal movement is favoured. In both, the profits of the subsidiary are taxed more heavily in that jurisdiction simply because its capital is owned elsewhere. Yet because the UK gets to that end without actually taxing the non resident, it is permitted a result denied to the French. Is this not the type of outcome which might lead not to the neutral treatment of cross border and domestic transactions, but rather to more elaborate legislative means to produce the same differential result?

Conclusion

It is hoped that the Court might at least modify the rigidity of this proposed approach. Indeed the difficulties in its application are perhaps even evident in the Denkavit case itself. France did not in fact tax the non resident. The withholding tax was imposed on the French subsidiary. The logical response which those promoting Advocate General Geelhoed’s approach might give is that this is in effect the same thing. The tax is withheld from the dividend the parent would otherwise have received. Yet why is it not also the same thing to deny a credit? The value of the dividend received is equally diminished by the economic double taxation it carries with it. Surely mature community law should look to substance and outcome, not form?

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A recent Advocate General's Opinion has underlined the importance of making claims at an early stage for taxes overpaid contrary to European law. An Italian regional tax (IRAP) was held to be incompatible with European law which led prima facie to a repayment obligation of at least €120 billion for the Italian state.

Due to the sums involved, the European Court took the extraordinary step of reopening the oral procedure after the AG's Opinion was delivered in March 2005 to hear further arguments about a temporal limitation. A second AG's Opinion was delivered on March 14, 2006. It holds that IRAP was unlawful but recommends that, because Italy had acted in good faith and because of the serious difficulties that would be caused by repayment of such a large sum, there should be two limitations on the effect of this judgment:

- claims for repayment of sums paid in the past would only be accepted if made before March 2005 (the date of the first AG's Opinion holding IRAP to be unlawful);
- IRAP could continue in force from the date of the ECJ's judgment until the end of that accounting period in order to give Italy time to bring in an alternative method of raising revenue.

It remains to be seen whether the European Court itself will follow the AG's advice (or indeed go further in imposing a temporal limitation such as from the date the Banco Popolare case was referred to the ECJ). However, the lesson is clear: it is no longer safe to sit on the sidelines and await the outcome of challenges to the tax system of a member state on the basis of European law. Claims should be lodged as quickly as possible to minimize the risk of being unable to rely on a judgment of the ECJ.
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