Taxation of Multinationals: Summer 2011
12th Edition

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Welcome to the twelfth edition of our bi-annual report on EU tax developments. This report covers the period from January to April 2011.

Over the last four months we have seen from Europe the attempted resurrection of the CCCTB project and a couple of interesting opinions from Advocates General on problems with imputation systems, but the most significant development in the case law over this period has to be the Haribo case.

The case concerned Austrian legislation which inserted a switchover mechanism moving from an exemption to a credit system for portfolio dividend income coming from low tax jurisdictions. The argument which appears to have led to the reference derives from the practicalities. A portfolio investor lacked the influence necessary to get from the company the type of information as to the underlying tax on the profits from which the dividends were distributed in order either to work out whether sufficient tax was paid to exercise the exemption, or what the underlying credit should have been otherwise. Austria had countered with an administrative circular which introduced a very simple system and which appears to have assumed that the rate of tax was the same as the national nominal rate if other information was not available.

Strictly speaking, then, the case did not really concern the dilemma which currently occupies the UK courts as to whether it is permissible to tax foreign sourced dividends but provide credit for any underlying tax paid up to the UK nominal rate, but exempt domestic sourced dividends. As readers will know, the issue with which the UK courts have been struggling is what the ECJ meant in its guidance on this topic in the FII group litigation. Did it mean such a system was permissible where the UK only had one nominal rate of corporation tax, save in highly exceptional circumstances? Or, did the Court mean in its ruling that such a system could only work permissibly where the rate of tax on domestic sourced profits could only be reduced below the nominal rate which would apply under the credit system for foreign sourced profits in highly exceptional circumstances?

While therefore the judgment dwells more on the practical issues arising under the Austrian system, it is interesting to see that the Advocate General and the Court had both assumed that the FII judgment should be read in the latter way, namely, in the way that would favour the tax payers. The Advocate General says so expressly. The Court does so in its usual implicit way by saying that the “tax burden” has to be the same and that the exemption system must produce an "equivalent result" to topping up to the nominal rate under the credit system.

This very issue was sent off to the ECJ in December as part of the next round of litigation in the FII case. Along with that question goes a question as to the extent to which third country rights can be invoked under the old article 56 EC and certain important specific questions in relation to the FII system. At the same time the Supreme Court in the FII case had reserved to itself a number of questions. These include whether the UK can permissibly reduce the limitation period applicable in restitution cases of this nature retrospectively so as to kill off claims which had already been brought as well as those which were pending. This is obviously an issue of very wide relevance.

The Supreme Court will also consider whether the Court of Appeal’s decision was right where it sought to extend and mould the error mistake provisions in section 33 TMA so as to make them retrospectively applicable to EU claims. As worded section 33 TMA had of course been entirely inapplicable to EU law claims which had been expressly excluded by the “prevailing practice” defence. The Court of Appeal's point is that while the claimants had properly exercised the claims that were applicable to them (i.e. common law restitution claims in mistake) and within time limit then available, what they should have done instead was to have brought statutory error or mistake claims under s33 TMA even though that remedy was inapplicable to them but then argued that the section 33 remedy should have been changed to make it applicable. The Supreme Court will be considering this year whether claimants should have engaged in those mental gymnastics.
Introduction

As a result the FII litigation has now been split in three with simultaneous hearings in the ECJ and Supreme Court with a rump of issues to remain to be considered once those stages are over. This would seem to be the first time that the Supreme Court has adopted such an inventive approach to case management as to have simultaneous references and appeals and which is no doubt a reflection of the extreme complexity of the litigation and its size.

The other main UK development in the first four months has been the Court of Appeal’s decision in the Thin Cap group litigation. By a majority the Court of Appeal reversed the High Court and concluded that the Thin Cap legislation prior to 2004 was lawful. To the majority, developments in the case law following the ECJ’s ruling in that case should be taken as informing us that when the ECJ said that the UK rules were precluded because of their failure to provide for a commercial justification defence, in addition to an arms length test, they should really be taken to have been saying that no commercial justification defence was needed beyond an arms length test. To the minority that view is unsustainable on the wording of the judgment and entirely incompatible with the Lankhorst-Hohorst judgment which the Thin Cap judgment was following, not reversing. It is hoped the Supreme Court will permit the tax payers the opportunity to revisit that conclusion.

As we move into 2011 the ECJ calendar seems to be filling up with cases from the UK. In addition to the FII case back before it, Philips and Littlewoods are already in the list. In addition the European Commission has applied for a hearing regarding its contention that the FA 2006 changes to the group relief rules (ostensibly to make them compatible with the Marks & Spencer case) offend community law. At least another two infringement actions against the UK in relation to its taxation of foreign profits and asset transfers are also pending.

For the Dorsey team 2011 will involve not just the Supreme Court and ECJ in FII and may be other cases, but also the Court of Appeal in Marks & Spencer and several other CFC and cross border group relief actions.

As usual, this booklet brings together articles the team have written over the first four months, plus our newsletters and bulletins on recent developments. I hope you will find this at least a useful compendium.

As we look forward to another active year, I thank the team for all their hard work and our clients for their continued support and loyalty.
Speed Read: The FII Group Litigation stands as the main arena to resolve many important issues of EU law and the available domestic remedies for the recovery of overpaid tax. The Supreme Court has employed an interesting approach to penetrate the complex labyrinth of issues it throws up. It has referred to the ECJ the remaining issues concerning the compatibility with EU law of the UK’s previous dividend taxation and ACT provisions where its previous guidance has given rise to dispute while at the same time agreeing to hear the parts of the appeals which raise fundamental issues of English law concerning the forum for claims and the time periods governing claims.

The FII Group Litigation is certainly a complicated piece of kit. Despite one trip already to Europe, the last Court challenged with deciphering the legal issues it raises, the Court of Appeal (The Test Claimants in the FII Group Litigation v CIR [2010] EWCA Civ 103), identified some 23 questions that still need to be answered to bring it to some kind of resolution. All are difficult with far-reaching relevance.

A reflection of that complexity is the unique approach now adopted for the next stage in the litigation. The case is now to be simultaneously the subject of an appeal to the Supreme Court and a second reference back to Luxembourg. While the combination of these stages will provide a hopefully speedier path through the highest appeal stage, it does add to the difficulty in tracking precisely what is being decided and where. This article will attempt to unpack the various issues which each of those Courts is now to consider and what will then remain.

The claims

UK-based company groups with global operations faced two particular differentials posed by the UK’s partial imputation system. The distribution of their profits to their public shareholders attracted an ACT charge. In this they were no different from any other UK corporate. The rub was in how that ACT was calculated and utilised. The liability for ACT was reduced by tax previously paid on those underlying profits. But the only tax considered was UK corporation tax, in the form of ACT. Tax that had been paid overseas was ignored. Further ACT was an advance payment of corporation tax. It could be utilised against the UK corporation tax liabilities of the group. But no equivalent existed to take account of tax liabilities of the group outside the UK. The result for multinational groups parented in the UK was that ACT was therefore generated on the distribution of their global profits without allowance for foreign tax paid and with only the profits from their UK operations available to recover it. Where most of the profits were earned, and taxed, overseas the result was both an additional layer of tax, in the form of ACT, and an insufficient profit pool against which then to off set it. Surplus ACT built up creating what became known by early 1990s as ‘the surplus ACT mountain’.

An alleviation of the problem was attempted in 1994 by the introduction of the concept of the foreign income dividend (or FID). This entitled taxpayers to a refund of ACT where the distribution to the public shareholders could be matched against profits which had been adequately taxed overseas. This did provide an equivalent mechanism to utilising ACT - by refunding it - but the ACT still had to be paid even where the underlying profits had already been taxed overseas. Thus an additional layer of tax was still imposed, albeit now a temporary not permanent charge.

However the more significant restriction was that the cash tax credit available to exempt shareholders until 1997 was not paid with a FID. For the company this made paying a FID a much more expensive means to distribute profits than ordinary dividends. A FID of £125 would provide to a pension fund the same net value as an ordinary dividend of £100. To keep this important and significant group of investors happy multinationals were therefore forced to enhance their FID dividends by 25% to make them of equivalent net value.

The second differential concerned the treatment of dividend income before it was distributed. Dividend income from UK subsidiaries was exempt from tax. That from non-residents was taxed with credit given for the tax paid on the underlying profits and any withholding tax. The claimants contend that it is too simplistic to regard those two approaches under the UK system as producing the same aggregate tax charge. The credit for overseas tax took account of the effective rate actually paid. If a domestic subsidiary could utilise relief to reduce its effective rate of tax below the nominal – and the evidence accepted by the Courts in this case is that
it was very common to do so – then topping up the rate paid on the cross-border dividend to the UK nominal rate would cause the profits distributed cross-border to be taxed in aggregate at a rate in excess of the rate commonly paid domestically.

In essence the claimants contend that by reason of these two differentials in the treatment of domestic and overseas profits within the partial imputation system, they have paid excess tax in breach of their EU rights. They want that excess back. Yet unravelling what that excess was poses some interesting questions. Tax on dividend income was a common source for the utilisation of ACT. If the underlying tax liability on dividend income was not lawfully due does this mean that the ACT utilised against it is also an unlawful charge even if the ACT was lawfully incurred in the first place? What of other reliefs such as brought forward losses or group relief applied against the tax liability on dividend income? Are they recoverable? Where those reliefs were expended against unlawful tax liabilities causing tax to be paid on other sources of income which could otherwise have been sheltered by those reliefs, will those payments amount to recoverable excess payments of tax? Other wrinkles of a similar nature also arise from managing these tax liabilities, thought at the time to be due, such as the enhancements made to FIDs mentioned earlier.

The division of the issues

At the first opportunity the case was referred to the ECJ with the agreement of both parties. The reference was long and complex in the hope of obtaining from that Court comprehensive guidance capable of answering all EU law questions needed to resolve these claims. That objective was not met. Disputes have arisen as to how the ECJ’s ruling is to be interpreted. Additional questions of English domestic law arise from its application. The consequence has been the categorisation by the Court of Appeal of no less than 23 legal issues which remain. Those issues, however, fall into three broad sets.

The first are what are described in the judgments as the corporate tree issues. These arise only in relation to the ACT claims. The ECJ was asked the fundamental question whether it was a breach of EU law to grant a tax credit to offset the recipient’s liability to ACT on its distributions for dividend income received from its UK subsidiaries on which ACT was paid but not for dividend income received from its non-resident subsidiaries on which corporation tax was paid in those jurisdictions. It is agreed that the answer favoured the taxpayers, but how far? HMRC’s interpretation of the answer restricts its application only to circumstances where the ACT was paid by the company which itself received dividend income from an EU company which itself paid tax on those profits. Where the ACT liability was paid higher up the chain in the UK (ie, in the branches of the corporate tree), or the corporation tax was paid on the underlying profits by a company lower down than the EU holding company (ie, in the roots), HMRC maintain that no breach of EU law has occurred or that the claim is not recoverable. Also within this set of issues is the claim for ‘equivalent relief’ to the surrender of ACT within a UK group where the ECJ’s first answer was not directly applicable to the case.

The second set of issues concerns the ECJ’s answer to the dividend taxation issue. The claimants interpret the Court’s answer as meaning that the tax on dividend income would be precluded if UK subsidiaries were commonly able to pay an effective rate of tax below the nominal on distributed income (the top-up tax meant that non-resident income was always taxed at least at the UK nominal rate). HMRC interpret the ECJ’s response as concluding that provided the UK charges the same nominal rate of corporation tax, save in exceptional circumstances, its system is not precluded. Also within this set of issues concerns the extent to which EU rights can extend to dividends received from beyond the EU or EEA. The High Court and Court of Appeal had concluded that the right to the free movement of capital (Article 56 EC now Article 63 TFEU) could in principle apply to protect dividends received from third countries after 1993, when that provision entered the treaty. HMRC argue that where a situation of control exists over the subsidiary, the circumstances are taken from the ambit of Article 56 altogether. However those Courts had then concluded that the amendments to the legislation after that date had not been sufficient to remove the protections for pre-existing legislation in Article 57(1) EC (Article 64(1) TFEU) so that HMRC prevailed on this point in any event.

The third set is the remedies issues. Here lie a broad grouping of both English law and EU law questions.
These questions ask what the circumstances are in which the types of tax payments and disadvantages mentioned above are recoverable and, crucially, over what period and in what forum. In particular, was it permissible for the UK to restrict the limitation period available for the recovery of claims retrospectively without notice in FA 2004 s 320 and FA 2007 s 107? When, if at all, can claimants be required to have employed the statutory error and mistake claim procedure (TMA 1970 s 33 and FA 1998 Sch 18 para 51) where that provision excluded the possibility of claims seeking to enforce EU rights by the effect of the ‘prevailing practice’ exclusion in para 2A?

The Supreme Court’s decision

Faced with this plethora of issues the Supreme Court has adopted a neat solution to handle these appeals. Although the reasoning is not expressed the result of its approach distinguishes the core issues from those which depend upon the outcome of those core issues. Where the core issue raises a question of EU law on which the Courts below have expressed doubt, or which is closely related to such an issue, the Supreme Court has concluded that the issue should now just be referred back to the ECJ for clarification. This covers the corporate tree issues, the dividend taxation issues and one of the remedies points.

Other core issues where a response to those referred questions is not an essential, will be heard by the Supreme Court now. These issues surround the question of whether the UK was able to restrict the limitation period for claims retrospectively, tied into which is the application of the statutory error or mistake procedure. The balance of the 23 issues are then on hold pending those stages. The TABLE below summarises what view each Court has held on each issue and where it is now going.

Table: Summary of outstanding issues

<table>
<thead>
<tr>
<th>No.</th>
<th>Issue</th>
<th>High Court</th>
<th>Court of Appeal</th>
<th>Supreme Court</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Did the dividend taxation provisions breach EU law?</td>
<td>Claimants succeed</td>
<td>Refer to ECJ</td>
<td>Refer to ECJ</td>
</tr>
<tr>
<td>2&amp;3</td>
<td>Is the answer to 1 the same for dividends received from 3rd countries?</td>
<td>EU rights engaged but legislation protected</td>
<td>Follows High Court</td>
<td>Refer to ECJ whether rights engaged. Whether legislation protected anyway is put on hold</td>
</tr>
<tr>
<td>4 &amp; 8</td>
<td>Corporate tree defence (‘the roots’): Is ACT unlawful where the CT was paid lower down the corporate tree than the non-resident distributing company?</td>
<td>Refer to ECJ</td>
<td>Refer to ECJ</td>
<td>Refer to ECJ</td>
</tr>
<tr>
<td>5, 8 &amp; 14</td>
<td>Corporate tree defence (‘the branches’): Is ACT unlawful where it was paid higher up the corporate tree than the water’s-edge recipient of the income</td>
<td>Refer to ECJ</td>
<td>Refer to ECJ</td>
<td>Refer to ECJ</td>
</tr>
<tr>
<td>6</td>
<td>Is EU income to be treated as FII?</td>
<td>Yes</td>
<td>No</td>
<td>On hold</td>
</tr>
<tr>
<td>7</td>
<td>Equivalent reliefs</td>
<td>Refer to ECJ</td>
<td>Refer to ECJ</td>
<td>Refer to ECJ</td>
</tr>
</tbody>
</table>
### Analysis - FII group litigation: outstanding issues

<table>
<thead>
<tr>
<th>No.</th>
<th>Issue</th>
<th>High Court</th>
<th>Court of Appeal</th>
<th>Supreme Court</th>
</tr>
</thead>
<tbody>
<tr>
<td>9 &amp; 10</td>
<td>Non EU FID claims</td>
<td>Claimants succeed</td>
<td>Claimants succeed</td>
<td>On hold</td>
</tr>
<tr>
<td>11 &amp; 13</td>
<td>Are reliefs (group relief, b/fwd losses, disclaiming cap. allowances) recoverable?</td>
<td>Claimants lose</td>
<td>Claimants lose</td>
<td>On hold</td>
</tr>
<tr>
<td>13</td>
<td>Lawful ACT set against unlawful dividend tax</td>
<td>Claimants lose</td>
<td>Claimants succeed</td>
<td>On hold</td>
</tr>
<tr>
<td>15-17</td>
<td>Can HMRC rely on a defence of 'change of position'?</td>
<td>Can arise in principle but doesn’t apply to EU claims</td>
<td>Doesn’t arise for decision</td>
<td>Nothing to appeal</td>
</tr>
<tr>
<td>18 &amp; 19</td>
<td>Damages claims (including FID enhancements)</td>
<td>Claimants lose</td>
<td>Claimants lose</td>
<td>On hold</td>
</tr>
<tr>
<td>12, 20-21</td>
<td>Limitation period (primary argument): That HMRC cannot rely on FA 2004 s 320 and FA 2001 s 107</td>
<td>Claims go back to 1973</td>
<td>Claims are limited to six years from issue of claim</td>
<td>Appeal to Supreme Court granted</td>
</tr>
<tr>
<td>22</td>
<td>Limitation period (alternative argument): that the extension of the limitation period by the Limitation Act 1980 s 32(1)(c) also applies to 'Woolwich' claims</td>
<td>Claimants lose</td>
<td>Claimants lose</td>
<td>On hold</td>
</tr>
<tr>
<td>23</td>
<td>Does TMA 1970 s 33 exclude tax paid on non-resident dividend income?</td>
<td>No</td>
<td>Yes</td>
<td>Appeal to Supreme Court granted</td>
</tr>
</tbody>
</table>

If all goes well the approach anticipated may well see the resolution of these core issues by the first half of 2012. In that event it may be that some of the remaining pending issues will fall away. Stock will need to be taken then. There is also a curly question remaining as to which Court next needs to consider the case. Most of the references to the ECJ technically come from the Court of Appeal as they form part of its order, one (Issue 2) was referred by the Supreme Court but all were remitted to Henderson J in the High Court to be drafted and sent. Which Court then is to deal with the answers? That is perhaps a problem which can wait for another day.
The Thin Cap GLO case challenges the UK’s thin capitalisation provisions as they existed prior to the amendments to the transfer pricing legislation that took effect from April 2004. Mr Justice Henderson had held in his judgment of November 17, 2009 in Test Claimants in the Thin Cap Group Litigation v Commissioners for Her Majesty’s Revenue and Customs [2009] EWHC 2908 (Ch) that the UK’s thin cap rules, prior to those 2004 changes, were incompatible with community law. His decision followed a reference to the ECJ and the basis for his judgment was to follow what he considered was the clear wording of the ECJ’s decision on that reference: the thin cap rules provided no exemption to protect genuine commercial transactions from thin cap adjustments, even if they fell beyond an arm’s-length test, and were therefore required to be disapplied in all circumstances where the relevant transaction was genuinely commercial.

HMRC had argued that the ECJ’s decision amounted to a finding that the UK’s thin cap provisions were compatible with community law and that the ECJ regarded the question of commercial justification as no more than an aspect of the arm’s-length test. The judge held that this view was “impossible to reconcile with the clear terms of the Court’s judgment” and referred to the “threadbare nature of the Revenue’s arguments on this part of the case”.

Despite this, in its recent judgment the Court of Appeal by majority decision has reversed Henderson J’s judgment in its entirety in Test Claimants in the Thin Cap Group Litigation v Commissioners for Her Majesty’s Revenue and Customs [2011] EWCA Civ 127. The result was a surprising one, not least for its interpretation of the ECJ judgment in the Thin Cap case, based predominantly on subsequent ECJ decisions.

Article 43

Lord Justices Stanley Burnton and Rimer held that the ECJ’s ruling concluded that the UK’s thin cap rules do not offend community law provided that

- the taxpayer is given an adequate opportunity to present his case to the tax authority that the transaction in question was on arm’s-length terms;
- the taxpayer may challenge the decision of the tax authority before the national court; and
- the effect of the legislation is limited to those aspects of the advantage conferred by the taxpayer company that do not satisfy that test, or, the legislation is permissible provided that it does not disallow any interest that would have been payable under a transaction on arm’s-length terms.

According to their lordships, as the UK’s legislation fulfilled these requirements, it was compatible with community law.

It follows that, in their lordships’ view, the ECJ in its Thin Cap judgment was not requiring there to be an additional exemption in the thin cap legislation to protect genuine commercial transactions from thin cap adjustments, in circumstances where they fell beyond an arm’s-length test.

The hurdle that the Court of Appeal had to clear to come to this conclusion was the ECJ’s characterisation of the need for a taxpayer to be able to show a commercial justification. The most pertinent example of this is at paragraph 86 of its judgment:

“Whilst a tax regime such as the regime which arises, in cases to which they apply, under the DTCs [double tax conventions] concluded by the United Kingdom appears initially to be based on a consideration of objective and verifiable elements which make it possible to determine whether a purely artificial arrangement, entered into for tax reasons alone, is involved, it is for the national court to determine, should it be established that the claimants in the main proceedings benefited from such a regime, whether that regime gave them an opportunity, if their transactions did not satisfy the conditions laid down under the DTC in order to assess their compatibility with the arm’s-length criterion, to provide evidence as to any commercial justification there may have been for the transactions, without being subject to any undue administrative constraints.” [emphasis added]

The Test Claimants’ argument based on this extract, and other similar comments in the ECJ’s judgment, was that ECJ has provided the clearest possible indication that there should be an additional commercial justification test in cases where the arm’s-length test was not met. In the above extract it seems particularly clear that...
on a plain reading of the paragraph community law requires an additional level when considering whether a transaction breaches this type of thin capitalisation rule, that is, whether despite breaching the arm’s-length test, a taxpaying company is entitled to show a genuine commercial purpose to the transaction, resulting in the rules not being applied to them. This also seems to be the clear result of the *Lankhorst-Hohorst* case, in which it was not in doubt that the loan was not on arm’s-length terms (because the company to which the loan was made was in such a parlous position that a third party bank would never have made the loan which was made) but in which, nevertheless, the ECJ held that the relevant national legislation was incompatible with community law.

The Court of Appeal, however, concluded that the “objective and verifiable elements” referred to by the ECJ should plainly cover the arm’s-length test but that, when referring additionally to commercial justification, it was unclear whether the ECJ were referring to something other than evidence demonstrating that the transaction and its terms would satisfy the arm’s-length test.

**Oy AA and SGI**

Lord Justice Stanley Burnton went on in his leading judgment to analyse the ECJ’s findings in the subsequent cases of *Oy AA* and *SGI*, which were both relied on by HMRC in support of their argument that the ECJ was using the term commercial justification interchangeably with arm’s-length terms.

The judgment in *SGI* was released by the ECJ after Mr Justice Henderson’s judgment and deals with anti-avoidance provisions not dissimilar to the UK’s thin cap legislation. The Test Claimants’ argument was that the judgment in *SGI* was on all fours with *Thin Cap*, if anything, simply applying the ECJ’s judgment in *Thin Cap*. Although the ECJ extends its explanation of, rather than simply repeats its reasoning in *Thin Cap*, it seems that the iteration in *SGI* is simply a clearer version of the *Thin Cap* reasoning, and if anything, on a plain reading, supports the ECJ’s judgment in *Thin Cap* rather than distinguishing from it. The clearest iteration of the reasoning in *SGI* is this:

*National legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the member states and to prevent tax avoidance where, first, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction...* [emphasis added]

Although on a plain reading of this passage the above quote might seem clearly to be on all fours with the ECJ’s findings in *Thin Cap* (that there should be an additional commercial justification test where the arm’s-length test is not met), Lord Justice Stanley Burnton nevertheless arrived at the conclusion that the application of an arm’s-length test is appropriate and sufficient to justify legislation which would otherwise be in breach of article 43, on the basis that, combined with the ECJ’s jurisprudence in *Oy AA*, the ECJ’s judgment in *SGI* made clear that ensuring the balanced allocation of taxing rights, together with the prevention of tax avoidance, “may justify legislation which would otherwise be an unlawful interference with the freedom of establishment guaranteed by article 43”, and that “the application of the arm’s-length test is appropriate and sufficient for this purpose”. Lord Justice Rimer focused on the reference to a “suspicion” that a transaction is not arm’s-length. In his view, this indicates that the ECJ in *SGI* must have meant that where there was doubt as to whether the arm’s-length test was satisfied, taxpayers should have the opportunity to provide evidence of commercial justification in order to prove that the relevant transaction was in fact on arm’s-length terms.

Lady Justice Arden, dissenting, supported the findings of Mr Justice Henderson.

She discusses at some length how the judgments in *Lankhorst-Hohorst, Thin Cap* and *SGI* fit together. Her view is that if the ECJ had intended for the *Thin Cap* and *SGI* judgments to bear the meaning attributed by Lord Justices Stanley Burnton and Rimer, then
**Thin Cap GLO case questions applicability of UK legislation**

(continued)

*Lankhorst-Hohorst* would no longer be good law. Therefore, in order for the Lord Justices to be correct, the ECJ must, in its *Thin Cap* judgment have been overruling its earlier decision in *Lankhorst-Hohorst*. There was, however, nothing in those later decisions to suggest that that was the ECJ’s intention. Lady Justice Arden therefore concludes that the ECJ has, in these cases, sought to provide a roadmap for determining what is or is not an abusive transaction. If the terms of a loan are on an arm’s-length basis, the Revenue does not have to go further. If the terms of a loan are not arm’s-length, the taxpayer must be given an opportunity to show that the terms were nonetheless commercial and for that reason not abusive.

*Oy AA* relates to the Finnish group contribution system and post-dates the ECJ’s *Thin Cap* judgment. It was however not relied on by HMRC in the High Court. Lord Justice Stanley Burnton finds that it is difficult to reconcile the ECJ’s judgment in *Oy AA* with that in *Thin Cap* on the basis that the Finnish legislation did not target and was not restricted in its application to purely artificial arrangements, yet it was upheld. The riposte is obvious: one concerns gifts and the other concerns loans. There is a world of difference between legislation which allows a payment essentially amounting to a form of relief (such as a group contribution payment) and anti-avoidance legislation. They have different aims and are driven by different purposes.

The second problem with the majority’s reasoning in this area picked up by Lady Justice Arden is the “*Lankhorst-Hohorst* question”, namely that if HMRC are right *Lankhorst-Hohorst* would have lost, not won. The majority simply do not address this issue in their judgments.

**Damages claims and sufficiently serious breach**

Although this issue was not one on which the Court of Appeal needed to give judgment, given the conclusions reached by the majority of the Court of Appeal, the Court nevertheless gave guidance as to whether the UK would have been in sufficiently serious breach if the Test Claimants had been right on their principal argument. The Court held unanimously that, even if the position had been made clear by the ECJ’s judgment in *Lankhorst-Hohorst* (which the majority do not accept), it would have been unreasonable not to allow the UK government time to consider the terms of remedial legislation, to enter into a consultation period and to bring new legislation before Parliament before it could fairly be held to be in sufficiently serious breach. Lord Justice Stanley Burnton does not say how long a period ought to be allowed and Lord Justice Rimer does not deal with the issue at all. Lady Justice Arden, however, took the view that the 15 months or so from the judgment in *Lankhorst-Hohorst* (December 12 2002) to the introduction of the new transfer pricing legislation (April 2004) was not excessive in the circumstances. Interestingly, there is no real authority referred to for this conclusion. While these comments are not part of the official decision, questions arise as to whether there really is a basis for this conclusion and, if so, what that basis might be.

**Effect for UK taxpayers and next steps**

Although at the time of writing there is no publicly available information as to whether the litigation will proceed beyond the Court of Appeal, one or two points are clear. If the Court of Appeal decision was to be appealed to the Supreme Court, the issue of the principles to be applied in interpreting a judgment of the ECJ is going to be a crucial one. The approach taken by the majority in the Court of Appeal raises important jurisprudential questions as to the ECJ’s approach to its own previous case law. Not only is this an issue of interpretation but an issue of the overlap between the various principles applied in this area (the balanced allocation of taxing rights, fiscal coherence and proportionality) and the application of these defences. This is clearly a case to watch for that reason. If, however, the Court of Appeal have had the final word on the matter, it would essentially have rendered toothless the ECJ’s assessment of the UK’s thin cap legislation and potentially leaves the UK’s legislation in this area at odds with the rest of Europe. ■
Challenges with compound interest in VAT claims

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VAT compound interest litigation is divided into three parts, each representing a separate legal line of argument to achieve essentially the same goal. That goal is the pursuit of the application of compound interest to repayments of VAT made by taxpayers in circumstances which have been found, following a judgment of the European Court of Justice (ECJ), to be unlawful.

For HM Revenue and Customs (HMRC), the outcome of these cases is significant, not only in terms of the immediate effect on revenue, but also the precedent effect on future claims as yet undecided (or even conceived of). For HMRC, to provide compensation on a compound interest basis would result in an unjustifiable windfall for the taxpayer. For the taxpayer, compound interest is a matter of commercial reality. The authorities have so far managed to see off one of the three tracts of litigation: the VIC GLO came to an end last year in the Court of Appeal. The remaining two continue.

The precise sums involved are not known and remain a matter of speculation. The only certainty is that if either of the remaining two cases is successful the cost to HM Treasury will be considerable.

The two most recent developments in the compound interest story are the settling of the order for reference to the ECJ in Littlewoods and the refusal of HMRC’s application for permission to appeal the decision of the Court of Appeal (that the claimants had brought their claims in time) in John Wilkins and others v Commissioners (The Compound Interest Project or CIP). The effect of the latter is to return the outstanding issues in that case back to the Court of Appeal for determination. It is unlikely, however, that those issues will be determined until the ECJ has delivered its judgment in Littlewoods.

Interest and VATA 1994

The traditional method for the recovery of overpaid VAT and interest is founded under the statutory regime within the VAT Act (VATA) of 1994. Almost all taxpayers who now have compound interest claims have already sought and recovered the principal VAT overpaid with simple interest. Interest, where awarded, was awarded by, and at the discretion of, the tax tribunals (formerly the VAT and Duties Tribunal). The relevant provisions are found in sections 80, 78 and 84(8) VATA 1994.

VIC High Court

The first case to go to trial in pursuit of compound interest on overpaid VAT was the VIC GLO ([F] Chalke Ltd and another v Revenue and Customs Commissioners [2009] EWHC 952). In it, a group of motor vehicle dealers made restitutionary claims for the recovery of compound interest pursuant to EU law. HMRC argued that such claims could not succeed because the UK had instituted a statutory scheme for the recovery of overpaid VAT and interest and, following the decision in Mono (Mono v HMRC [2008] EWCA Civ 306), in those circumstances, parliament had intended for that regime to be exclusive.

The claims concerned the repayment of VAT incurred on the onward sale of demonstrator vehicles and on manufacturers’ bonuses. VAT incurred in these circumstances became reclaimable following the ECJ judgments in Elida Gibbs ([C-317/94 [1996] ECR I-05339) and Italian Republic ([C-45/95 [1997] ECR I-3605).

In its judgment, delivered on May 8 2009, the High Court agreed with HMRC that the statutory method contained in VATA was exclusive for domestic UK claims. This however did not apply to claims which had their basis in European law. Following the ECJ decision in FII (Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue C-446/04) Justice Henderson ruled that, for restitution claims for overpaid VAT, EU law required that the full benefit of the monies wrongfully paid be disgorged from HMRC. That, in Henderson’s judgments, required full reimbursement of the tax with compound interest.

This proved to be a pyrrhic victory for the claimants however, who were ultimately unsuccessful because they were found to have brought their claims over six years after the date on which their right to claim arose and were therefore out of time.

John Wilkins Upper Tribunal

The next case to proceed was that of John Wilkins. This was the first case to be heard before the Upper Tribunal (Tax and Chancery) in June 2009. In it the taxpayers sought to use the statutory route to bring claims for compound interest under section 78 VATA. They argued that insofar as section 78 failed to provide
for the awarding of compound interest on refunds of unlawfully levied VAT, the tribunal should interpret the statute to give it that meaning in order to give full effect to EU law rights.

The president of the chamber, Mr Justice Warren, found against the taxpayer on section 78, ruling that the statutory provisions could not be interpreted to allow an award of compound interest in the Tax Tribunal. This was because an effective remedy existed through a High Court claim for restitution, as confirmed by Henderson in the VIC GLO. As a result it was not necessary to mould the provision of VATA to give effect to EU law rights.

In any case, Warren found that the taxpayers were out of time to make their claims. The claimants had argued that the three year time limit they had to bring their appeals ran from the point at which HMRC refused their request for compound interest. Warren, rejecting that submission, ruled that time had started to run for the claimants from the date of the original decisions of HMRC to pay simple interest.

VIC and Wilkins Court of Appeal

On appeal, the Court of Appeal in the VIC GLO (F J Chalke Ltd v Revenue and Customs Comrs [2010] EWCA Civ 313) upheld Henderson’s ruling on time barring but opined that the position with respect to an EU law entitlement to compound interest was not clear and should be the subject of a reference to the ECJ. Following the Court of Appeal’s judgment, the claimants did not seek to petition for leave to appeal to the Supreme Court and consequently the reference which the Court of Appeal wished for would have to wait for another case. The VIC GLO had reached the end of its journey.

The significant victory for the taxpayer in Wilkins in the Court of Appeal came in relation to time limitation. Many of the claimants (who, like those in the VIC GLO, were also motor dealers) had received repayments of the principal sums and simple interest some considerable time ago, and importantly, before the Court of Appeal decision in Sempra Metals (Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v Inland Revenue Commissioners and Another [2005] EWCA Civ 389. It was only following this decision, the claimants argued, that the pursuit of compound interest became a possibility in VAT cases. HMRC attempted to argue for a rigid interpretation of section 78 that would prevent second claims of interest. The majority of the Court of Appeal agreed with the claimants.

As noted above, HMRC sought leave to appeal this decision before the Supreme Court. Its application was refused in late November 2010 and the matter now reverts to the Court of Appeal to decide the substantive issue in relation to the entitlement to compound interest. This issue will not be decided, however, until the Court of Appeal has the benefit of the ECJ’s judgment in relation to the third tract of litigation: Littlewoods.

Littlewoods and effective remedy

The third case in the compound interest series is Littlewoods (Littlewoods Ltd and others v Revenue and Customs Commissioners [2010] EWHC 1071 (Ch)). The facts which form the background to the case relate to the VAT treatment of commissions awarded to Littlewoods’ agents and whether and how those commissions could be taken into account as a cost component of the supply of goods. It was common ground that HMRC’s treatment of the agents’ commissions had been defective.

In the VIC GLO the claimants had felt unable to use the statutory method found in section 78 and so made mistake-based restitutionary claims. In Wilkins (before the tribunal) the claimants argued that section 78 did apply, but had to be interpreted to give effect to EU law rights.

In Littlewoods, the claimant’s position does not rely on any interpretation of section 78. Instead, it goes straight to the issue of whether or not compound interest forms part of an effective remedy in EU law. If it is, then the statutory framework is largely irrelevant.

Mr Justice Vos, in his decision of May 19 2010 decided, (as parties had agreed), that a reference to the ECJ would be required to determine the issue of compound interest. In doing so, he set out a list of issues to be determined and, in accordance with the practice suggested by Justice Arden in FII (Test Claimants in the FII Group Litigation Revenue and Customs Commissioners [2010] EWCA Civ 103), gave his preliminary view on how each issue should be determined by the ECJ. Suffice it to say, Vos was against the claimants. Indeed, following FII in the Court of Appeal, the claimants in Littlewoods had decided not to seek leave to appeal to the Supreme Court.
of Appeal, and its effect on English restitution claims, he had little choice. This, however, represents only a preliminary view and on November 1 and 2 2010 the High Court convened again to consider the wording of the reference.

Looking back over the judgments delivered by the end of 2010, it would be fair to say that the position in the English courts on an EU law right to compound interest has shifted considerably away from the taxpayer: from the VIC GLO in the High Court, where the taxpayer won the point, but lost the procedure; to Wilkins in the Court of Appeal where the procedure has now been won, but the point has descended into limbo.

The pivotal case in the shift between these two positions was the judgment of the Court of Appeal in FII and its interpretation of the judgment of the ECJ in FII as well as its view of the law of restitution more generally.

In the context of European law, the right to a reimbursement of unlawfully levied tax comes from the ECJ decision in San Giorgio (Amministrazione delle Finanze dello Stato v SpA San Giorgio C-199/82). The question is: how far does this right go?

The first view is that EU law gives a taxpayer the right to recover the overpaid tax only. In other words, the principal sum. Anything else, including interest, is an ancillary and for national law to determine.

The second view arises out of the ECJ's decision in FII, and indicates that the obligation created by San Giorgio goes further and should prevent the member state from profiting from the money which was unlawfully extracted from the taxpayer by disgorging the full benefit obtained. This approach requires the English courts, as a matter of EU law, to provide compound interest as part of a remedy.

It was this second position which was adopted by Henderson in the VIC GLO (as well as in the High Court in FII and the Thin Cap GLO). However, since the Court of Appeal's judgment in FII, this position has been in doubt.

The main argument can be summarised as follows. In the VIC GLO before Henderson, he found that there was no material difference between the ECJ’s reasoning in paragraph 205 of the judgment in FII and that of the Advocate General in paragraph 132:

(Court) 205... where a resident company or its parent have suffered a financial loss from which the authorities of a Member State have benefited as the result of a payment of advance corporation tax... the Treaty provisions on freedom of movement require that resident subsidiaries and their non-resident parent companies should have an effective legal remedy in order to obtain reimbursement or reparation of the loss which they have sustained.

(AG) 132... The underlying principle should be that the UK should not profit and companies (or groups of companies) which have been required to pay the unlawful charge must not suffer loss as a result of the imposition of the charge. As such, in order that the remedy provided to the Test Claimants should be effective in obtaining reimbursement or reparation of the financial loss which they had sustained and from which the authorities of the Member State concerned had benefited, this relief should in my view extend to all direct consequences of the unlawful levying of tax. This includes to my mind: (1) repayment of unlawfully levied corporation tax... (4) loss of use of money insofar as corporation tax was, due to the breach of EU law, paid earlier than it would otherwise have been... In each case, it would be for the national court to satisfy itself that the relief claimed was a direct consequence of the unlawful levy charged.

The Court of Appeal, on the other hand, found in FII that the court was applying a much narrower test than the Advocate General. Following this, in the VIC GLO, the Court of Appeal found that the issue was far from clear and indicated the need for a reference.

The order for reference in Littlewoods was published on 4 November 2010 (Littlewoods Retail Ltd and others v Commissioners for HMRC [2010] EWHC 2771 (Ch)) and contains the following four questions:

**Question 1:**

Where a taxable person has overpaid VAT which was collected by the member state contrary to the requirements of EU VAT legislation, does the remedy provided by a member state accord with EU law if that
remedy provides only for (a) reimbursement of the principal sums overpaid, and (b) simple interest on those sums in accordance with national legislation, such as section 78 of the Value Added Tax Act 1994?

**Question 2:**
If not, does EU law require that the remedy provided by a member state should provide for (a) reimbursement of the principal sums overpaid, and (b) payment of compound interest as the measure of the use value of the sums overpaid in the hands of the member state and/or the loss of the use value of the money in the hands of the taxpayer?

**Question 3:**
If the answer to both questions 1 and 2 is in the negative, what must the remedy that EU law requires the member state to provide include, in addition to reimbursement of the principal sums overpaid, in respect of the use value of the overpayment and/or interest?

**Question 4:**
If the answer to question 1 is in the negative, does EU law principle of effectiveness require a member state to disapply national law restrictions (such as sections 78 and 80 of the Value Added Tax Act 1994) on any domestic claims or remedies that would otherwise be available to the taxpayer in order to vindicate the EU law right established in the Court of Justice’s answer to the first three questions, or can the principle of effectiveness be satisfied if the national court disappplies such restrictions only in respect of one of these domestic claims or remedies?

Ultimately, the question for Europe is what is an effective remedy so far as EU law is concerned? Put simply *Littlewoods* in Europe is really about whether member states can impose taxes which are contrary to European law; have those laws in force for considerable amounts of time (Littlewoods’ claims go back as far as 1973) and, following a judgment of the ECJ, simply return the tax to satisfy all their EU law obligations.

How can this, in any sense, represent an effective remedy? Interest levied in the commercial environment is almost always calculated at a compound rate. The House of Lords was satisfied in *Sempra* that an award of compound interest was necessary to achieve full restitution for the loss of the use of money. Clearly, the Advocate General in *FII* was satisfied that it was necessary to disgorge the benefit to HMRC to obtain an effective remedy for the taxpayer, yet this issue returns to Europe for yet further clarification.

**Significant implications**
Superficially it is difficult to see how the taxpayer can lose. However the headline compound interest may prove a cloud to the wider issue of effective remedy. This is, quite simply, a question of cost. If the ECJ finds in favour of the taxpayer, the implications for the governments of all member states will be very significant.

Procedurally speaking, the operation of a hearing at the ECJ will act against the taxpayer. It is inevitable that there will be a large number of interveners (non-party members states who wish to make submissions during the hearing). Each party has only 20 minutes to make submissions, with interveners getting 15 minutes each. This is the case regardless of how many are speaking for each side. Counsel for the taxpayer will have the right to reply to observations made during the hearing, however the overall effect is likely to give a great deal of the total air-time to the member states.

In the introduction to the Order for Reference, the ECJ is asked to decide whether EU law confers a right to recover the “full benefit which the member state has obtained”. This is the key issue. Further into the order however, the wording has the effect of shifting attention away from this issue of principle and on to the sums at stake. In paragraphs 10 and 11, for instance, reference is made to the amount of VAT and simple interest already repaid to Littlewoods. It is difficult to see why this is relevant to the ECJ when attempting to determine whether or not compound interest is required to give an effective remedy.

There will be pressure brought to bear on the court from the member states to find against the taxpayer, however, the ECJ has demonstrated itself more than capable of taking a principled stance in the face of strong opposition from the member states. It is hoped that the court will see through the sums at stake, which, after all, are a direct consequence of the sums unlawfully levied, and decide *Littlewoods* on a similar basis to the Advocate General in *FII*: that is to say, an effective remedy, on the basis of commercial reality.
The European Court of Justice handed down its judgment in the *Haribo* case on February 10 2011. The case was concerned with the way Austria taxed portfolio dividend income from EU/European Economic Area (EEA) and third country sources. Although domestic portfolio dividend income was automatically exempt from tax, EU/EEA income could only be exempted if the shareholder could show that the foreign income had been subject to a comparable tax at a comparable rate to that applying in Austria. If the taxpayer could not satisfy these requirements the income could still qualify for an imputation credit. However, the credit was also only granted subject to the taxpayer providing certain factual information. For EEA countries, a further condition to qualification for exemption was imposed, namely that Austria had concluded an agreement on exchange of information with the source state. No relief was given for third country (non-EU/EEA) portfolio income by way of exemption or by way of an imputation credit.

In *Haribo* the parent company received portfolio income from EU/EEA and third country sources and applied to the Austrian revenue authorities for an exemption. The Austrian tax authorities refused the taxpayer’s request.

In *Salinen*, the case joined with *Haribo* before the ECJ, a loss-making taxpayer had contended that a tax credit as granted by the Austrian authorities could never alleviate double taxation as the credit could not be carried forward into profit making years. The result was that though the portfolio income reduced the losses of the company which would lead to a higher tax charge in future years, no credit was available for the tax paid on these profits.

The court’s judgment

**Mutual assistance**

The court agreed with the Advocate General about the additional requirement in respect of EEA countries. It held that the Austrian system was unlawful in that it required the existence of a comprehensive agreement for mutual assistance with regard to administrative matters and enforcement to be in place with EEA states in order for distributions sourced there to qualify for an exemption. It held that administrative assistance provisions were sufficient to guarantee effective fiscal supervision.

**Exemption system v imputation system**

The court also asked whether it was contrary to community law for a member state to operate an exemption system domestically and a mixed exemption/imputation system for EU/EEA sourced dividends in situations where the exemption method was unavailable in the large majority of EU/EEA cases because the requirements to qualify for an exemption could not be fulfilled by the taxpayer.

The court held that in principle a member state was free to operate an exemption system domestically while operating an imputation system cross-border. This was subject to the condition that the tax rate applied to foreign-sourced dividends was not higher than the rate applied to nationally sourced dividends and that the tax credit was at least equal to the amount paid in the state of the company making the distribution up to the limit of the tax charged in the recipient company’s member state (a principle already established in case C-446/04 FII).

It also confirmed that a member state could impose a requirement to prove the underlying tax on the distribution as long as this did not place an excessively difficult or impossible burden on the taxpayer.

The court held that the requirements of the Austrian tax code to qualify for the exemption system were not contrary to community law as a taxpayer who did not qualify for an exemption could still qualify for the imputation system which in principle was equivalent to the exemption system.

The court took the view that the evidence required to qualify for an imputation credit required under the simplified Austrian procedure introduced on June 13 2008 did not make it impossible or excessively difficult for a taxpayer to qualify for a tax credit. The simplified procedure introduced a formula under which the tax credit was calculated simply by multiplying the profits of the distributing company by the nominal tax rate of corporate tax applicable in its state of residence and by the holding of the domestic recipient company in the capital of the distributing company. The information required from the distributing company or any investment fund through which the receiving company invested in the distributing company was therefore very limited.
In light of the simplified procedure, which the Advocate General did not consider in her opinion, the court did not need to debate whether a real relationship existed in domestic law between the payment of tax and the exemption granted. The simplified procedure does not look at tax actually paid but provides a credit for the nominal rate of underlying tax applying to the distribution. This procedure therefore addressed the taxpayer’s criticism that in domestic situations a dividend was exempt even if due to the use of reliefs no actual tax was paid at all, whereas in cross-border situations a tax credit was available only to the extent that payment of tax could be proved.

Importantly, the court also recognised that if it were to prove impossible for a taxpayer receiving dividends from outside Austria to benefit from the imputation method due to an excessive administrative burden, the legislation would not enable the economic double taxation of such dividends to be prevented, or even mitigated and would therefore be contrary to community law.

Third countries

The court agreed with the Advocate General that there was no possible justification for the fact that Austrian law extended neither a credit nor an exemption to portfolio income sourced in countries outside the EU/EEA. The main reason for this was that the measure went beyond what was necessary to justify the measure on any of the recognised justification grounds. It would seem that the court may have taken a different view if, in the same way as for EEA sourced portfolio income, any relief was linked to the existence of an agreement for mutual assistance with the relevant third country state.

The nature of the credit

The Salinen case asked two questions about the nature of the credit given under the imputation system.

The first question was whether it was contrary to community law to exempt domestic portfolio income but to give a credit for foreign portfolio income in situations where that credit could not be carried forward in loss making years.

The court considered that such a situation was contrary to community law because while in domestic situations double taxation was avoided through the exemption of the profits, the fact that in cross-border situations tax credits could not be carried forward despite the profits to which they attached being included in the tax base constituted an unjustifiable difference in treatment.

The second question asked whether a member state also needed to give relief for tax withheld by the state where the profits were made. The court confirmed that the levy of withholding tax by the source state which was not alleviated in the state of residence of the company receiving the dividend could only lead to juridical double taxation. The disadvantages which might arise from the parallel exercise of powers of taxation by different member states, in so far as such an exercise was not discriminatory, did not constitute restrictions prohibited by the treaty. This applied a fortiori if the juridical double taxation occurred as a result of the parallel exercise of taxing powers by a member state and a third country.

A helpful development

Despite the fact that the court found against the taxpayer on a number of questions the judgment should be considered as helpful to taxpayers in general.

In Haribo the simplified procedure which led to the court’s finding of compatibility had been introduced by the Ministry of Finance by way of a notice which did not have legislative force. This meant significant uncertainty for the taxpayer. The court has not only made clear that it has reached its conclusion in light of this simplified procedure but has also explained how it is understood to work. It said that should the conditions for the grant of a tax credit nevertheless be excessively difficult to fulfil the Austrian system would fall short of community law requirements.

Under these circumstances it will be very difficult for the national authorities to contend that the simplified procedure includes requirements other than the satisfaction of the seemingly simple three stage test. For countries like the UK where no such simple three stage test exists it will serve as an example of the sort of information that can lawfully be demanded.

The Salinen case also represents a major victory for the taxpayer and clarifies the limits of the principle that a tax credit only has to be granted up to the limit of the tax charged on those profits in the member state of the recipient. Here the court clearly held that the
ECJ rulings on Austrian law provide clarity for taxpayers

(continued)

fact that no tax was charged on the distributed profits themselves was not sufficient to deny a credit to be carried forward for use against tax liabilities which would not have arisen had those profits not reduced the companies loss carry forward.

Accor

Advocate General Mengozzi also handed down his opinion in the Accor case on December 22 2010. This case is concerned with the French prÈcompte, or advance payment system, which was very similar to the UK advance corporation tax system.

The Advocate General concluded that in situations where a French parent company could deduct from the advance payment the avoir fiscal, or tax credit, which attached to dividends received from domestic sources, such a credit should also be given for tax paid on the profits out of which foreign sourced dividends were paid. The tax authority could still refuse a tax credit in situations in which it could prove that this would lead to an unjust enrichment in the hands of the taxpayer.

The Advocate General also commented on the type of proof of underlying tax the revenue authorities could require the taxpayers to produce. While he agreed with the revenue authorities that it was in principle legitimate to ask the taxpayer for proof of the amount of underlying tax paid on the foreign distributed profits, this was only the case if in domestic situations the tax credit was also measured by the amount of tax actually paid and if to adduce such evidence would not be in practice impossible or excessively difficult.

Meilicke II

Advocate General Trstenjak handed down her opinion in the Meilicke case on January 13 2011. This case was concerned with the availability of tax credits for foreign tax. The Advocate General concluded that a tax credit needed to be given for the amount of tax actually paid up to the limit of the domestic corporate tax rate. To require a certificate for foreign corporate tax to be in the form prescribed by domestic law breached the principle of effectiveness if it was in fact impossible or excessively difficult to obtain such a certificate. Tax paid at a level lower than that of the foreign company making the distribution needs to be taken into account in so far as tax paid at a lower level in domestic situations also impacts on the level of credit extended to shareholders.

Like the court’s judgment in Haribo and the Advocate General’s opinion in Accor, Advocate General Trstenjak restated a number of well established community law principles but expands on them in a way that favours the taxpayer. More than anything all three cases share a common tenor that community law allows exemption and imposition methods to operate side by side but only if they are truly equivalent in their effect.
Prior to 1 April 2009, tax tribunals had discretion as to costs. For appeals commenced after this date, costs awards are usually limited to complex cases, and even then taxpayers can opt out of the costs shifting regime. Although the tribunal has the power to set aside the new rules in transitional cases and award costs under the old rules, complexity will not be relevant to this decision – to consider it would disregard the taxpayer’s right to opt out of the new regime.

Background
Reform of the tribunal system in 2009 brought with it a new, more restrictive, costs regime. Under the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 (“the 2009 rules”), unless a case is sufficiently complex, the First-tier Tribunal can only issue a wasted costs order, or allow recovery where a party has acted unreasonably (rules 10(1)(a) & (b)).

The old system was very different. The Value Added Tax Tribunals Rules 1986 (“the 1986 rules”) allowed the award of a sum ‘incidental to and consequent on the appeal’. Traditional costs shifting on appeal particularly benefited the taxpayer as HMRC by convention only sought costs against unsuccessful appellants if extensive work or some impropriety was involved.

Current proceedings
When the changes came into effect on 1 April 2009, any outstanding appeals became subject to the new rules. However, in these cases (known as “current proceedings”) the tribunal can disapply the 2009 rules in favour of 1986 ones, if necessary, to deal with proceedings “fairly and justly” (see para 7(3), Sch 3, Transfer of Tribunal Functions and Revenue and Customs Appeals Order 2009 (“the Transfer Order”)).

The reforms also introduced a multi-track allocation system. Appeals are now categorised according to their complexity, importance and value. Those requiring detailed examination at hearing are placed in either the Complex or Standard categories, useful guidance on which was provided in Capital Air Services v HMRC [2010] UKDTT 160 (TC) (see ‘Capital Air Services and “Complex” cases’ by David Ward and Matthew Hodkin, Tax Journal, 8 November 2010). The important difference is that costs orders in favour of the winning party are usually only made in complex cases.

Hawkeye Communications v Commissioners for HMRC [2010] UKFTT 636 (TC) was a current proceeding in which HMRC were successful and sought to obtain costs. Had Hawkeye been commenced under the 2009 rules, it would have been a complex case and costs would in principle have been allowed (rule 10(1)(c)). However, a current proceeding cannot be allocated to any category, regardless of its complexity (see Surestone Limited v Commissioners for HMRC [2009] UKFTT 352). Although tribunals can re-categorise, this also requires initial allocation. Since current proceedings were never allocated, they cannot be re-allocated either.

HMRC accepted this in its submissions and, unable to claim costs under the 2009 rules, it requested the tribunal use para 7(3) of the Transfer Order to apply the 1986 rules, in order to apply for costs under the old regime.

Which rules apply?
In its decision, the Tribunal cited Atec Associates Ltd v Commissioners for HMRC [2010] UKUT 176 TCC, stating that 2009 rules are prima facie applicable, subject only to the discretion under paragraph 7(3) to disapply them. The discretion must be used to dispose of proceedings “fairly and justly”. In Atec, the Tribunal had decided not to disapply the 2009 rules, as to do so there would have been a “retrograde step”.

The Tribunal in Hawkeye held that a balancing exercise of all relevant factors was required before discretion could be exercised under para 7(3). It clarified that there is neither a “retrograde step” nor a “compelling reason” test. Most surprising of all though, the hypothetical categorisation of a case is not necessarily relevant. Thus, although Hawkeye was complex by the standards of the decision in Capital Air, this was not a relevant factor.

The Tribunal refused to consider complexity, as to do so would disregard the taxpayer’s ability to opt out of the new costs-shifting regime. Under rule 10(1)(c)(ii) a taxpayer can opt out by written submission to the Tribunal within 28 days of notice of allocation. Consequently, HMRC only have a legitimate expectation of costs where the case has been categorised as complex and the taxpayer has not opted out.
Hawkeye Communications: costs in current cases before the FTT

There were several factors which could weigh in favour of applying the 1986 rules, for example, the division of work and time between the old and new rules – as up until the changes it could be assumed the old cost shifting regime applied. Furthermore, the circumstances of the application, particularly regarding its timing, will be relevant. In _Hawkeye_, HMRC had reinforced the Appellant’s expectation that the 2009 rules applied by failing to apply earlier under para 7(3). This was balanced against the division of work, and the taxpayer’s expectation of the new rules applying throughout outweighed any prejudice suffered by HMRC.

_The question of complexity is not relevant to deciding whether current or previous procedure governs the case._ Only once this is established can complexity be relevant. In addition though, whenever a taxpayer argues against the application of the old rules, it can be assumed that, given the option, he would opt out of the costs shifting regime under the new rules.

The end result in _Hawkeye_ should be of comfort to the taxpayer. Had the case been commenced and concluded under either the old or the new rules (assuming the opt-out was not exercised) HMRC could have claimed costs. Instead, being caught between the two, it could not. The judgment not only demonstrates the limits of the tribunal’s discretion under para 7(3) to award costs, but also shows that complexity will not always be relevant. In light of this, and the assumptions made when an application is opposed by the taxpayer, it will be extremely difficult for HMRC to recover costs in current proceedings before the tribunal.
Abuse of Law following HMRC v Weald Leasing Ltd and HMRC v RBS Deutschland Holdings GmbH

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The cases of HMRC v Weald Leasing Limited (Weald) and HMRC v RBS Deutschland Holdings GmbH (RBS) concern the concept of abuse of law in the VAT field. They are the latest in a line of cases following the landmark ruling of the European Court of Justice (ECJ) in Halifax Plc and others v HMRC (Halifax), in which the following test for establishing that a particular tax arrangement amounted to an abuse of Directive 77/388/EEC, the Sixth Directive, was established:

"...in the sphere of VAT, an abusive practice can be found to exist only if, first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage."

Weald

In Weald, the Churchill Group used a chain of companies to purchase goods which were needed by two companies, CML and CARC, for use in their exempt insurance businesses. Had CML and CARC purchased the goods directly they would have been able to recover only a small fraction of the VAT paid as input tax. Instead, the purchases were made, using interest-free loans from the Churchill Group, by Weald, a member of the Churchill group of companies but outside CML and CARC’s VAT group. Weald leased the goods to an interposed third party, Suas Ltd, which then subleased the goods to CARC and CML. Weald deducted the input VAT on the purchase of the goods on the basis that the goods were used for the taxable leasing transaction. As a result, instead of incurring an immediate irrecoverable VAT charge on the purchase price of the goods, CML and CARC paid VAT on the sublease rental payments, which were spread over 10 years. Suas Ltd, an unconnected company jointly owned by a VAT consultant and his wife, was interposed to prevent HMRC from making a direction under paragraph 1 of Schedule 6 to the Value Added Tax Act 1994 (VATA), which would have required VAT to be payable at the open market value of the rental. Such a direction could only be made on payments between connected persons.

HMRC decided that the scheme was artificial and outside normal commercial operations and disallowed the input VAT on the purchase of the goods by Weald. Weald appealed and was successful in the VAT and Duties Tribunal (as it then was) and the High Court. The Court of Appeal referred the matter to the ECJ, asking essentially three questions: whether this type of tax deferral leasing scheme was contrary to the purpose of the Sixth Directive; what “normal commercial operations” (a term taken from Halifax) meant; and, if there was abuse, how should the structure be redefined?

The arrangements illustrated in the following diagram:

RBS

RBS, a case referred by the Court of Session of Scotland, also concerned a leasing structure. The taxpayer, RBS Deutschland Holdings GmbH (RBSD), was a German subsidiary of the Royal Bank of Scotland Group and was registered in the UK as a non-established taxable person. It bought motorcars from Vinci Plc, an unconnected company incorporated in the UK. RBSD then leased the cars back to Vinci. RBSD also concluded a put option agreement with Vinci which required Vinci to buy back the cars at current market value when RBSD exercised the option.

The cars were duly leased between March 2001 and December 2004. During this period RBSD assigned the agreement it had with Vinci to another member of
Abuse of Law following HMRC v Weald Leasing Ltd and HMRC v RBS Deutschland Holdings GmbH

The leasing arrangements were entered into by RBSD rather than the UK group in order to exploit a hiatus between the UK and German rules. Owing to a discrepancy in the way in which the UK and Germany had implemented the provisions of the Sixth Directive, the UK viewed the leasing transaction as a supply of services and the place of supply to be Germany, where the supplier’s business was located. Conversely, Germany viewed the supply as a supply of goods and considered the supply to have occurred in the UK. Consequently no VAT was payable on the rental income either in the UK or in Germany. VAT was levied in the UK on the proceeds of the sale of the cars following exercise of the put option by the RBS German subsidiary but the output tax paid was roughly one third of that which would have been paid but for the arrangements.

RBS claimed a full deduction in respect of the input VAT paid on the purchase of the vehicles from Vinci. HMRC refused the deduction on the basis that the Directive did not permit deductions of input VAT for goods subsequently used for transactions to which output tax did not apply. They also argued that RBS had engaged in an abusive practice because the essential aim of the structure was to obtain a fiscal advantage contrary to the purposes of the Directive.

The ECJ was asked, in effect, to decide whether the UK could refuse the right to deduct input tax in these circumstances and, if not, whether the principle prohibiting abusive practices could, nevertheless, be applied since the purpose of the structure was to avoid paying VAT in either Member State.

The decisions

Unsurprisingly perhaps, in RBS, HMRC’s primary contention, namely that output tax must be paid in order for a right to deduction to arise, was supported by a number of Member States. It was, however, rejected by both the Advocate General and the Court. While recognising that the principle of fiscal neutrality linked the right to deduct input tax to the collection of output tax, it held that Article 17(2) and (3) of the Sixth Directive granted the taxable person the right to deduct input tax on goods and services used by them for the purposes of their taxable transactions. It then added:

“In so far as differences in the laws and regulations of the Member States continue to exist in this area, despite the establishment of the common system of VAT by the provisions of the directive, the fact that a Member State has not collected output VAT because of the manner in which it has categorised a commercial transaction cannot deny a taxable person the right to deduct input VAT paid in another Member State”.

Moving on to whether the arrangements were to be considered abusive, the Court noted that it was common ground that Vinci and RBSD were legally unconnected, the transactions were not artificial and were carried out in the context of normal commercial operations. There was therefore nothing to suggest that there was “an artificial arrangement that does not reflect economic reality and the sole aim of which is to obtain a tax advantage”.

Taxpayers were:

“generally free to choose the organisational structures and the form of transactions which they consider to be the most appropriate for their economic activities and for the purposes of limiting their tax burdens”.

The fact that services were supplied to a company established in one Member State by a company established in another Member State and that the terms of the transactions carried out were “chosen on the basis of factors specific to the economic operators concerned” was not an abuse of rights. The Court added that:

“The fact that a Member State has not collected output VAT because of the manner in which it has categorised a commercial transaction cannot deny a taxable person the right to deduct input VAT paid in another Member State”.

In Weald, HMRC, somewhat ambitiously, sought to attack the arrangements as a whole. Initially, they contended that no genuine economic activity was involved. However, following the ECJ’s decision in Halifax, that argument was no longer sustainable and was abandoned. They contended instead that the use of the lease-back scheme was designed artificially to
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(continued)

avoid the burden of the input tax which would have been payable if they had purchased the goods outright. The whole scheme was therefore abusive and should be redefined to prevent any input tax recovery.

This submission was rejected by the VAT & Duties Tribunal\(^\text{15}\) and the High Court.\(^\text{16}\) Both the Advocate General\(^\text{17}\) and the ECJ agreed:

“...the national court will have to determine, first, whether the contractual terms of the leasing transactions at issue in the main proceedings are contrary to the Sixth Directive and of the national legislation transposing it. That would particularly be the case if the rentals were set at levels which were unusually low or did not reflect any economic activity.

Secondly, the national court will also have to determine whether the involvement of an intermediate third party company, in this case, Suas, in those transactions is such as to preclude the application of those provisions.\(^*\)

The ECJ agreed that this was potentially a problem, observing:\(^\text{23}\)

“... the national court will have to determine, first, whether the contractual terms of the leasing transactions at issue in the main proceedings are contrary to the Sixth Directive and of the national legislation transposing it. That would particularly be the case if the rentals were set at levels which were unusually low or did not reflect any economic activity.

Thus, the leasing transaction was not of itself abusive because it was not contrary to the purpose of the Directive. Both the Tribunal and the High Court made the point that HMRC may have had a better case if they had attacked the lack of commerciality in the leasing structure itself. The only purpose behind what Mr. Justice Lindsay described as “the otherwise commercially pointless interposition of Suas”\(^\text{20}\) was to prevent HMRC from making a direction under Schedule 6 VATA. There hung a question mark over the terms of the rental agreement itself. In particular, was the amount of the rental payments too low?

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The Tribunal clearly thought that this was a key issue:

“any abuse arose not from the leases themselves but from the level of the rentals under the leases and from the arrangements to avoid directions under Schedule 6, paragraph 1.”\(^\text{21}\)

In the High Court, counsel for the taxpayer indicated that “if there was any abuse in the scheme it was only as to the over-low rentals paid”,\(^\text{22}\) a point with which the judge concurred.

The Court rejected the argument that the principle of prohibiting abusive practices did not apply to Paragraph 1 of Schedule 6 VATA because it was a purely national measure derogating from the Directive. The provision was adopted on the basis of Article 27 of the Directive and formed part of the national legislation implementing the Directive.

Turning to how the arrangements should be redefined if they were found to be abusive, it commented that, if the national court concluded that certain contractual terms of the leasing transactions and/or the intervention of SUAS constituted an abuse it would have to redefine those transactions disregarding the existence of SUAS and/or by varying or disapplying those contractual terms. The Court added, in line with what it had said in Halifax\(^\text{24}\) (and other cases), that the redefinition “should go no further than is necessary for the correct charging of the VAT and the prevention of tax evasion.”\(^\text{25}\) Thus, it would seem that any reconstruction would be limited to the lease and lease back transaction and would not extend to denial of the entirety of the input tax paid on the purchase of the goods, as the Revenue had contended.

Comment

Weald and RBS appear to strike a reasonable balance between the right of taxpayers to structure their business transactions in a way which minimises their tax liability and the right of tax authorities to challenge artificial arrangements or artificial aspects of otherwise commercial arrangements. In both cases it was clear
Abuse of Law following HMRC v Weald Leasing Ltd and HMRC v RBS Deutschland Holdings GmbH

(continued)

that the arrangements were set up to defer or avoid tax. The issue was whether they were contrary to the Directive. In Weald the use of leasing arrangements which had the effect of staggering the input tax charge was within the contemplation of the Directive and did not run counter to its purpose. In contrast, the introduction of non-commercial terms into the arrangements - facilitated by the interposition of an unconnected third party - had the potential artificially to reduce or stagger the input tax charge even further. This could not be said to be within the contemplation of the Directive and would run counter to its purpose.

The proportionate response to such abuse was not to disallow the input tax on the purchase by Weald, effectively redefining the transaction as an outright purchase, but rather to limit the reconstruction to the artificial element of the leasing arrangements.

In RBS the Court rightly held that this was not a case involving abuse. The transactions were perfectly genuine and commercial – it was just that, by using the group’s German subsidiaries, the group could exploit a hiatus between the UK and German rules. The real question, therefore, was the first one, namely whether Member States could make an input tax deduction conditional on output tax actually being paid. The Court refused to allow Member States to introduce, in effect, such a rule into the Directive. While the situation in RBS is plainly unsatisfactory from the viewpoint of the proper implementation of the EU VAT system, the answer, at least in this case, lies in proper implementation of the place of supply rules by Member States. The hiatus in the present case arose from the failure by either the UK or, more likely as the Commission said, by Germany to implement the Directive properly. It would be somewhat odd if the Directive were to be interpreted as containing provisions catering for its own inadequate implementation by Member States.

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1 HMRC v Weald Leasing Limited (C-103/09).
2 HMRC v RBS Deutschland Holdings GmbH (C-277/09).
3 Halifax Plc and others v Commissioners of Customs & Excise (C-255/02), [2006] STC 919.
5 Halifax, above fn. 3, [2006] STC 919, [74]-[75].
6 Weald Leasing Ltd v HMRC [2007] SWTI 1368.
7 Weald Leasing Ltd v HMRC [2008] EWHC 30 (Ch); [2008] STC 1601.
8 HMRC v RBS Deutschland Holdings GmbH [2008] CSIH 49; 2009 SC 35.
9 RBS, above fn. 2, (C-103/09), [42].
10 RBS, above fn. 2, (C-103/09), [51].
11 RBS, above fn. 2, (C-103/09), [53].
12 RBS, above fn. 2, (C-103/09), [52].
13 RBS, above fn. 2, (C-103/09), [42].
15 Weald, above fn. 6, [2007] SWTI 1368.
17 Advocate General Mazak.
18 Weald, above fn. 1, (C-103/09), [33].
19 Weald, above fn. 1, (C-103/09), [34].
20 Weald, above fn. 7, [2008] STC 1601, [14].
21 Weald, above fn. 6, [2007] SWTI 1368, [147].
22 Weald, above fn. 7, [2008] STC 1601, [39].
23 Weald, above fn. 1, (C-103/09), [39]-[40].
25 Weald, above fn. 1, (C-103/09) [52].
January 2011

Time Period Shortened for Claiming Stamp Duty Overpayments

Nathan Simmons

On 1 April 2011 the limitation period for the recovery of overpaid stamp duty reserve tax by way of a claim under Reg 14 of the 1986 SDRT Regulations will be reduced from 6 to 4 years. The period runs either from the date tax is paid or becomes accountable, whichever is later. To avoid time running out, claims more than 4 years old which have not yet been brought should be made before the change takes effect. Please contact Michael Anderson or Robert Waterson for further information on making claims.

C-310/09 Accor - Imputation Systems (avoir fiscal)

Philippe Freund

Advocate General Mengozzi handed down his opinion in the Accor case on 22 December 2010. This case is concerned with the French “précompte” (advance payment) system. The AG concluded that in situations where a French parent company can deduct from the advance payment the “avoir fiscal” (tax credit) which attached to dividends received from domestic sources, such a credit should also be given for tax paid on the profits out of which foreign sourced dividends were paid. The tax authority did however not need to grant such a credit in situations in which it could prove that this would lead to an unjust enrichment of the taxpayer. Finally, the Advocate General found that a Member State could ask the taxpayer for proof of the amount of underlying tax paid on the foreign distributed profits, but only if in domestic situations the tax credit was also measured by the amount of tax actually paid and if to adduce such evidence would not be in practice impossible or excessively difficult.

VAT: HMRC Guidance Following AXA UK Plc.

Robert Waterson

Following the decision in AXA (e-update Oct 2010), in which the ECJ ruled that processing payments through BACS was akin to a ‘debt collection’ rather than ‘financial service’, HMRC has released new guidance stating that all services concerned with collecting payments for the benefit of an entity to which those payments are owed, “regardless of whether those payments are received before, on, or after their due date” are akin to debt collection and liable to VAT at the standard rate. VAT must be accounted for on these services from 12 January 2011.

EU Commission Green Paper on VAT

Robert Waterson

The European Commission has issued a Green Paper on the future of VAT. The paper invites a public debate on the simplification of the VAT system across the EU and considers different methods for achieving this. The consultation is open to all interested parties and submissions are to be made by 31 May 2011 to taxud-vat-greenpaper@ec.europa.eu.
February 2011

C-436/08 and C-437/08 *Haribo* (tax on dividends from portfolio holdings)

*Philippe Freund*

This case concerns the Austrian system which exempted domestic portfolio dividend income from tax whilst granting a tax credit on dividends from an EU source or non-EU source if the relevant DTT contained exchange of information provisions. The credit for the underlying tax was calculated by reference to the local nominal rate.

The Court has confirmed that in principle it is possible to have an exemption system for domestic dividends and a credit system for non-resident income existing side by side, provided that the method for assessing the credit is not excessively difficult. The Austrian method of taking the nominal rate and assuming that the distributed profits were taxed at that rate did not pose an excessive difficulty.

Of course, under the UK system no credit for underlying tax was available where the holding was less than 10% and over that level the credit for underlying tax reflected the actual effective rate of tax paid. In this regard we commented in our November newsletter that the AG’s interpretation of the FII judgment supported our arguments that in those circumstances the UK system breached community law. The approach adopted in the judgment however, perhaps makes it less relevant than the AG’s opinion to the arguments regarding the lawfulness of the DV tax charge.

European Commission consults on cross-border dividend taxation

*Alison Last*

The European Commission has commenced a consultation to look into the withholding tax problems faced by portfolio and individual investors on cross-border dividend payments.

The consultation is aimed at stakeholders, including individuals and corporates, experienced in cross-border dividend tax issues with the objective of exploring possible solutions to the problems caused by the levying and crediting of withholding taxes on cross-border dividend payments, which can be discriminatory and may lead to double taxation.

Views are sought by the Commission on proposed solutions including:

- Abolition of withholding taxes on cross-border dividend payments to portfolio/individual investors
- The residence State grants full credit for the withholding taxes levied in the source State
- Net rather than gross taxation in the source Member State
- Limitation of both source and residence taxation of dividend income

The consultation period closes on 30 April 2011 and contributions may be submitted via the Commission’s website:


Thin Cap GLO - Court of Appeal Judgment Released

*Micahel Anderson*

In November 2009, Mr Justice Henderson held that the ECJ, in its *Thin Cap* judgment, had concluded that the UK’s Thin Cap rules would offend Community law unless they could be interpreted as applying only to wholly artificial arrangements designed to obtain a tax advantage and protected genuine commercial arrangements from any thin cap adjustments even if beyond arm’s length terms.

By a majority of 2 to 1 the Court of Appeal has today reversed the decision of Henderson J and concluded that the UK Thin Cap provisions were lawful. In doing so, the Court has accepted HMRC’s argument that the ECJ’s judgment in *Thin Cap* merely required the UK to apply an arm’s length test and not an additional “commercial justification” test. Henderson J had concluded that HMRC’s case on this point was “threadbare” for two reasons: (1) if HMRC were correct Lankhorst-Hohorst would have lost and (2) HMRC’s case contradicts the clear words of the ECJ’s judgment in *Thin Cap*. In reaching the contrary decision the majority conclude that judgments by the ECJ in other
areas lead to a different reading of the Thin Cap judgment than it appears to say.

Lady Justice Arden, dissenting, makes the same observations as Henderson J and criticises the majority for its failure to consider the Lankhorst-Hohorst point and for borrowing from inapplicable case law. She points out that for the majority's conclusion to be the correct one, the ECJ must have been intending to overrule Lankhorst-Hohorst in its Thin Cap judgment. There was however nothing in the Thin Cap judgment to suggest that this was their intention.

In consequence, the issue of whether the UK were in sufficiently serious breach did not arise. The Court however went on to say that if it had been clear that the UK’s legislation was incompatible with Community law as a result of the judgment in Lankhorst-Hohorst, the UK should have been given an extended period of time in which to make its legislation compatible. The period of 15 months from December 2002 to April 2004 would not have been excessive in the circumstances.

The next stage in proceedings would be for the claimants to seek leave to appeal to the Supreme Court.

Yet more UK anti abuse rules the subject of European Commission infringement procedure

Kelly Stricklin-Coutinho

The European Commission has taken the second step in its infringement procedure by issuing a Reasoned Opinion requesting that the UK amend two tax anti abuse regimes which it considers to be discriminatory.

The first discriminatory measure targeted by the Commission is the UK’s “transfer of assets abroad” legislation under which a UK investor who invests in a company incorporated and managed in another Member State is subject to tax on the income generated by that company (but had the investment been made in a UK company, only the company itself would be liable for tax). The second discriminatory measure targeted by the Commission is the UK’s rules on the attribution of capital gains. This legislation has the effect that where a UK resident company acquires more than a 10% share of a company in another Member State, and the non resident company makes a capital gain from the sale of an asset, that gain is attributed to the UK company and is taxed as a capital gain by the UK. Had both companies been UK companies, there would be no attribution of the gain.

The Commission considers that the freedom of establishment and free movement of capital are restricted by these measures because outside investments are taxed more heavily than domestic investments and that the measure is disproportionate. The UK now has two months to respond to the Reasoned Opinion.
March 2011

UK Budget 2011 - EU / Cross-Border Aspects
Nathan Simmons

No aspects of today’s budget announcement appear to impact upon EU or cross-border claims. The changes to the law with an EU dimension are consistent with previous announcements by the government. A short summary follows.

Interim CFC Reform
As previously proposed as part of a consultation document on CFC reform published on 29 November 2010, the government has announced interim CFC changes which:

• introduce an exemption for intra-group transactions where there is limited connection to the UK;
• introduce an exemption for CFCs holding IP where the IP and CFC have limited connection to the UK;
• introduce a 3 year exemption for foreign subsidiaries which, as a result of reorganisation or changes to UK ownership, come within the CFC charge;
• introduce an alternative de minimis exemption;
• extend the current transitional rules relating to superior and non-local holding companies to July 2012.

Foreign Branch Reform
Following the draft proposed legislation announced 9 December 2010 (with relatively minor changes), the Finance Bill 2011 will contain provisions allowing a UK company to irrevocably elect that all profits arising from foreign branches are exempt income for UK tax purposes. This includes any capital gains made by the foreign branches. Once the election is made, no relief is available for foreign branch losses.

Full CFC Reform (2012) - Finance Company Partial Exemption
In addition to the interim measures adopted, the government affirmed its intention to introduce fuller reforms to the CFC regime in the 2012 Finance Bill. As previously announced, the new regime will move to an entity-based system designed to operate in a more territorial way.

Amongst the proposals in the budget is a partial exemption for finance companies that would result in an effective tax rate of one-quarter on profits arising from overseas group financing activities.

A consultation document will follow in May 2011.

Amendments to Tax Treatment of Financing Costs and Income (2012)
Further consultation on the Debt Cap rules will be undertaken in 2011, with a view to publishing draft legislation in autumn 2011 for inclusion in the Finance Bill 2012.

The government has said this consultation is undertaken with an aim to allowing businesses to more easily apply the Debt Cap rules.

European Commission - proposed CCCTB Directive
Kelly Stricklin-Coutinho

The European Commission has released its proposed Directive on the CCCTB. The Commission proposes a common opt-in system for calculating the tax base of businesses operating in the EU. The Commission considers the aim of the CCCTB to be “to significantly reduce the administrative burden, compliance costs and legal uncertainties that businesses in the EU currently face in having to comply with up to 27 different national systems for determining their taxable profits.”

Key features of the CCCTB proposal are:

• An opt-in system for groups of companies who wish to fall within the CCCTB. Groups must opt-in for 5 years;
• Consolidation of the tax base, but not the tax rate;
• An apportionment formula which allocates the group’s tax base to the relevant Member State in which it operates.

The next step is for the EU Parliament to give its opinion and the Council to approve the proposal.
April 2011

Case C-94/10 Danfoss (AG Opinion): Extension to Rights to Recover Unlawful Taxes

Nathan Simmons

Advocate-General Kokott has concluded that where an unlawful excise duty has been passed on to a customer, the Member State should provide a mechanism by which the duty can be reclaimed from the State directly by the customer. The right to recover the unlawful tax is not to be limited just to the trader so that the customer could only recover the unlawful payment by suing the trader.

If the ECJ adopts the A-G's reasoning, it will potentially provide a helpful precedent for several categories of claims, particularly in circumstances where the company pursuing the claim (and on whom the tax burden has fallen) is not identical to the company on whom the charge or tax was levied. There may also be some procedural points in the opinion that are of assistance to taxpayers.

Rates of Compound interest for claims against HMRC now revealed

Philippe Freund

On 8 April 2011 the High Court handed down its judgment in the case of Amalgamated Metal Corporation Plc v Wragge & Co (a firm) and another ([2011] EWHC 887 (Comm)). The judgment concerns a claim by Amalgamated Metal Corporation Plc against its former solicitors arising from a settlement of a claim in the ACT Group Litigation.

The judgment is largely irrelevant to other claimants but for one point. The judgment goes through the correspondence surrounding the settlement and in doing so records HMRC’s position on interest rates for compounding. In all but the largest cases (£2 billion plus it looks like) HMRC accepted that the rate will be bank base on both utilised and unutilised ACT compounded monthly. In that biggest category the rate accepted was the treasury bill rate with quarterly compounding. The relevant paragraphs are paragraph 86 and 119ff.

This is the first publicly available confirmation of the compound interest terms HMRC have accepted in the past.

Compound Interest Project:
No Reference in Wilkins

Robert Waterson

The Court of Appeal has stayed Wilkins until 56 days after the ECJ gives Judgment in Littlewoods. Wilkins concerns the interpretation of s.78 VATA for the recovery of compound interest on VAT reclaims using the statutory appeals mechanism. Littlewoods, which also deals with the recovery of compound interest, is a mistake-based restitution claim, unconcerned with s.78. Wilkins applied for four questions to be referred to the ECJ which, it argued, were more pertinent to the issues in its cases.

Etherton LJ refused the application on the bases that the scope of the Littlewoods reference was sufficiently wide to enable the ECJ to state the extent of any entitlement to interest.
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