ICI v. COLMER

The recent decision of the European Court of Justice in ICI plc v. Colmer (Inspector of Taxes) (Case C-264/96, judgment delivered 16 July 1998) marks another major milestone in the development of EC tax law by the Court. Though the taxpayer enjoyed only a pyrhic victory, the decision has important implications for UK taxation and for taxation in other member states of the European Union.

The facts in ICI v. Colmer

The facts were, happily, quite straightforward. ICI was a member of a consortium. It held 49% of the shares in a UK-resident company, "Holdings"; the other 51% were held by Wellcome Foundation Limited. Holdings in turn owned 23 subsidiaries. Of those subsidiaries, 4 were resident in the United Kingdom, 6 in other member states of the European Union, and 13 in non-member states. One of the UK-resident subsidiaries incurred trading losses, and ICI sought to claim consortium relief for a proportion of the losses of that subsidiary under the provisions contained, at that time, in sections 258 to 264 ICTA 1970 (now sections 402 to 413 ICTA 1988).

In order to be able to claim consortium relief, it was necessary to show that Holdings was a holding company within the definition then contained in s.258(5)(b) ICTA 1970 (now s.413(3)(b) ICTA 1988). This defined a "holding company" as: "a company the business of which consists wholly or mainly in the holding of shares or

securities of companies which are its 90% subsidiaries, and which are trading companies …". The business of Holdings consisted entirely in the holding of shares or securities in other companies. However, s.258(7) ICTA 1970 (now s.413(5) ICTA 1988) provides as follows:

> "References in this and the following sections of this Chapter to a company apply only to bodies corporate resident in the United Kingdom …"

If the reference to companies in the definition of "holding company" was limited to companies resident in the United Kingdom, then only 4 out of the 23 subsidiaries of Holdings qualified. It could not be said that its business consisted wholly or mainly in the holding of shares or securities of [UK-resident] companies which are its 90% subsidiaries.

The Inland Revenue denied consortium relief to ICI on these grounds. ICI appealed against this decision and its appeal was rejected by the Special Commissioners. On further appeal, however, both the High Court and the Court of Appeal allowed ICI's claim. These courts adopted a different interpretation of the consortium relief provisions. They held that the requirement as to residence in the United Kingdom applied only to the company claiming consortium relief and to the company surrendering the relief. Here, both ICI - which was claiming the relief - and the subsidiary - which was surrendering its losses - were companies resident in the United Kingdom.

The Revenue appealed the case to the House of Lords. Before the House, ICI

argued that the consortium relief provisions, and the Revenue's interpretation of those provisions, infringed Community Law, specifically ICI's freedom of establishment under Article 52 of the Treaty of Rome (taken together with Article 58 which clarifies the application of Article 52 to companies).

The argument for ICI

The argument for ICI was quite simple. If the business of Holdings had consisted wholly or mainly of holding shares in UK-resident companies, the relief would have been available. If, however, the business of Holdings consisted wholly or mainly of holding shares in companies resident in other EU member states, then the relief would be denied. The operation of the relief was, therefore, a deterrent to the consortium establishing subsidiaries in other Member States. This was a restriction of the freedom that ICI enjoyed to establish subsidiaries in other Member States.

In order for ICI to succeed, however, there was a further element necessary to its argument. As readers will have appreciated, the business of Holdings did not consist wholly or mainly of holding shares in companies resident in EU member states. A majority of the subsidiary companies were resident outside the Union.

On this point, ICI put forward a secondary argument based on Article 5 of Treaty of Rome. This article, which is not often referred to in the tax context, imposes on institutions in Member States to cooperate in good faith to ensure the fulfilment of the obligations under the Treaty of Rome. The question was whether this duty of good faith

required the UK to accept an interpretation of the consortium relief provisions which was consistent with EU law. There was clearly two possible interpretations of the consortium relief provisions: there was the view taken by the Revenue, and Special Commissioners that the restriction to companies resident in the UK applied to all companies involved; and there was the interpretation adopted by the High Court and the Court of Appeal that this restriction applied only to the surrendering and claimant companies. The latter interpretation produced a result which would not infringe the right of establishment. Most important, if the United Kingdom was constrained by Article 5 to adopt the latter interpretation, then ICI would be successful since it had met the requirement that the surrendering and the claimant company were resident in the United Kingdom.

The House of Lords decided to refer two questions to the European Court of Justice for a preliminary ruling under Article 177. The first question raised the issue whether the consortium relief provisions contravened the freedom of establishment under Article 52. The second question asked whether Article 5 required the United Kingdom to adopt an interpretation consistent with Community law (even though a majority of the subsidiaries were resident outside the United Kingdom).

The taxpayer won on the first of these questions, but lost on the second. ICI would have needed to win on both of the questions to succeed.

<u>The first question: Art. 52 of the Treaty</u>

On the first question - raising the freedom of establishment - the Court restated some established points of Community law. Direct taxation remains a matter for the member states, but they must exercise their direct taxation powers consistently with the requirements of Community law. Article 52 prohibits member states from hindering the establishment of companies in other member states (referring to the Daily Mail case [1988] STC 787). Consortium relief was denied to consortia which established the majority of their subsidiaries outside the United Kingdom. On that basis, there was inequality of treatment according to whether subsidiaries were established in the United Kingdom or abroad. Such discriminatory treatment would be incompatible with Article 52 unless it could be justified by the Revenue.

It is the discussion of justification for unequal treatment which is perhaps the most interesting part of the case. The Revenue sought to justify the provisions on the grounds that they were designed to reduce the risk of tax avoidance by consortia arranging their affairs that losses accrued to UK resident subsidiaries whilst profits arose to non-resident subsidiaries (not taxable in the UK). The second justification was that there was, in effect, a balance in the provisions since the United Kingdom denied relief for the losses of a group with a majority of non-resident subsidiaries because the United Kingdom could not tax the profits of those non-resident subsidiaries.

The Court was unconvinced by either argument.

On tax avoidance, the Court took a very narrow view of what might constitute tax avoidance. They pointed out that the legislation did not have as a purpose the

prevention of wholly artificial arrangements set up to circumvent tax legislation. The mere establishment of a company outside the United Kingdom did not necessarily involve tax avoidance.

This is extremely interesting. If the Court continues to follow this decision, then member states will only be able to justify discriminatory legislation on grounds of combating tax avoidance if that avoidance consists of wholly artificial arrangements. One wonders whether other provisions of UK tax law would pass this test. For example, s.739 ICTA 1988 clearly discriminates against the establishment of, for example, overseas companies. However, it catches arrangements which cannot be regarded as wholly artificial.

The Court noted that the Revenue's argument on this first ground lacked conviction. If the restriction on consortium relief was intended to prevent tax avoidance, such avoidance could equally arise where there was only one overseas subsidiary (but a majority of UK-resident subsidiaries) in which event the legislation would have applied.

The second ground of justification was, in effect, an appeal to the need to maintain the "cohesion" of the tax system. The Court had established that discriminatory provisions could be justified on grounds of the cohesion of the tax system in cases such as Bachmann [1994] STC 855.

Again, one of the interesting aspects of the ICI case is that the Court limited the

argument based on cohesion. In Bachmann there had been a direct link between the deductibility of contributions to insurance policies and the taxation of the proceeds of those policies. There was no such direct link between granting consortium relief for the losses of resident subsidiaries and taxing the profits of non-resident subsidiaries. In so deciding, it appears that the Court was retreating somewhat from the concept of cohesion which has been criticised by commentators.

The overall conclusion was that legislation which applied differently to consortia according to whether a majority of their subsidiaries were established in the UK or in other member states was an infringement of Article 52 and could not be justified.

That, of course, did not take ICI home: they needed to win the argument on the second question as well.

The second question: Art. 5 of the Treaty

The Court pointed out that to require an extension of consortium relief to a consortium with a majority of subsidiaries outside the European Union raised an issue outside the scope of Community law. The Treaty of Rome did not preclude member states from adopting legislation which denied relief where the majority of subsidiaries were established outside the Union. Nor did Article 5 require a national court to interpret legislation so that it had that effect. Thus, in the circumstances, the United Kingdom was not required to adopt the interpretation accepted by the High Court and the Court of Appeal since to do so would benefit consortia with a majority of their

subsidiaries outside the Union.

Though the final decision may not have resulted in consortium relief for ICI, it is not so much the final result as the way in which the Court reached that result which is important.

The Court made it clear that provisions which deterred consortia or groups from establishing subsidiaries in other member states would infringe Article 52 and would need justification. The grounds of justification are limited and it is unlikely that such provisions would be justified on grounds of preventing tax avoidance or on grounds of cohesion.

This has major consequences for other provisions of UK tax law, as well as the laws of several other member states. Many people have considered for some time that the provisions for group relief - the surrender of trading losses within a group, for example - also fall foul of Article 52. Take, for example, the simple situation where a UK-resident holding company has a subsidiary in another member state which in turn has a sub-subsidiary resident in the United Kingdom. Under existing legislation, losses of the sub-subsidiary could not be surrendered to the holding company. It seems very hard to see how such a restriction on group relief can survive consistently with this decision.

At the time of writing, the Inland Revenue have not published any response to the decision in the ICI case. However, it seems that this decision makes more urgent a

review of a number of provisions of UK tax legislation to determine whether they are compatible with the provisions of the Treaty of Rome as interpreted by the European Court.