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# ECJ Recent Developments in Direct Taxation 2012

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# UK: The *FII GLO (II)* and *FII GLO (III)* Cases<sup>1</sup>

*Philip Baker*

## 1. Introduction

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<sup>1</sup> ECJ 13 November 2012, C-35/11, *Test Claimants in the FII Group Litigation*; ECJ, C-362/12, *Test Claimants in the FII Group Litigation*, pending.

## 1. Introduction

The reference back to the ECJ in the FII GLO (II) case, for clarification of the impact of the first FII GLO case, was discussed in the previous “Recent Developments” books for 2010 and again for 2011<sup>2</sup> and it is not intended to repeat what was said previously. Judgment was issued by the Court in FII GLO (II) on 13 November 2012. There has now also been a third reference to the Court arising out of the Frank Investment Income (“FII”) Group Litigation Order (“GLO”). This chapter discusses the judgment of 13 November 2012, with some brief comments, and then explains in outline the new reference.

To begin with some background on the judgment of 13 November 2012: the first *FII GLO* case (Case C-446/04) led to a judgment of 12 November 2006. There were nine questions posed to the Court in that case, the first one relating to the equivalence of the credit<sup>3</sup> and exemption methods for relief from international double taxation. On this point, the Court said as follows:

*“48 Thus, Community law does not, in principle, prohibit a Member State from avoiding the imposition of a series of charges to tax on dividends received by a resident company by applying rules which exempt those dividends from tax when they are paid by a resident company, while preventing, through an imputation system, those dividends from being liable to a series of charges to tax when they are paid by a non-resident company.*

*49 In order for the application of an imputation system to be compatible with Community law in such a situation, it is necessary, first of all, that the foreign-sourced dividends are not subject in that Member State to a higher rate of tax than the rate which applies to nationally-sourced dividends.*

...

*55 That point is not contested by the United Kingdom Government, which argues, however, that the application to the company making the distribution and to the company receiving it of different levels of taxation occurs only in highly exceptional circumstances, which do not arise in the main proceedings.*

*56 In that respect, it is for the national court to determine whether the tax rates are indeed the same and whether different levels of taxation occur only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs.” (emphasis added)*

<sup>2</sup> See Baker, in Lang (ed.), *ECJ – Recent Developments in Direct Taxation 2010*, p. 225–230 and Baker in Lang (ed.), *ECJ-Recent Developments in Direct Taxation 2011*, p. 265–270.

<sup>3</sup> The Court refers to the “imputation” method of relief. However, the more accepted terminology refers to the credit method, and this is consistent with Articles 23A and B of the OECD Model, for example. The term “imputation method” is reserved for the system of relieving economic double taxation by imputing to a shareholder some or all of the tax paid by a company on profits out of which a dividend is distributed. Examples of the imputation method are the former UK Advance Corporation Tax (ACT) system, and the French system of the *avoir fiscal*.

As explained in the volumes arising out of the earlier conferences cited in note 2, these paragraphs proved extremely difficult to interpret. The case returned initially to the English High Court<sup>4</sup>, and then led to a difference of opinion within the Court of Appeal<sup>5</sup>, and the case has finally proceeded on to the Supreme Court.<sup>6</sup> At these various hearings, it was decided that a further reference to the European Court should be made by the High Court, and this has led to the second case, *FII GLO (II)*,<sup>7</sup> and a further reference by the Supreme Court, which has led to the third case, *FII GLO (III)*.<sup>8</sup>

In *FII GLO (II)* the High Court posed five questions relating to the following issues:

1. clarification of the credit and exemption methods of relief from international double taxation;
2. clarification of the position where the foreign tax is paid by a sub-subsidary, or where Advanced Corporation Tax (“ACT”) is paid by a higher parent;
3. discussion whether the remedy is the repayment of tax (a *San Giorgio* claim) or for damages (in accordance with *Brasserie du Pêcheur/Factortame*);
4. whether Article 63 TFEU, the free movement of capital, applies to factual circumstances where there is a substantial shareholding in companies located in third states;
5. whether ACT can be credited against foreign taxes.

This chapter considers only the first and the fourth question as these are potentially the most significant.

### 1.1. The first question

The High Court posed the first question as follows:

*“Do the references to “tax rates” and “different levels of taxation” at paragraph 56 of the Court’s judgment of 12 December 2006 in Case C-446/04 Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue [2006] ECR I-11753:*

- (a) refer solely to statutory or nominal rates of tax; or
- (b) refer to the effective rates of tax paid as well as the statutory or nominal rates of tax; or
- (c) do the phrases referred to have some different meaning and, if so, what?”

This question raises directly the understanding of the Court in *FII GLO (I)* as to the comparability between the credit method and the exemption method of relief from international double taxation. This can be illustrated in the following example:

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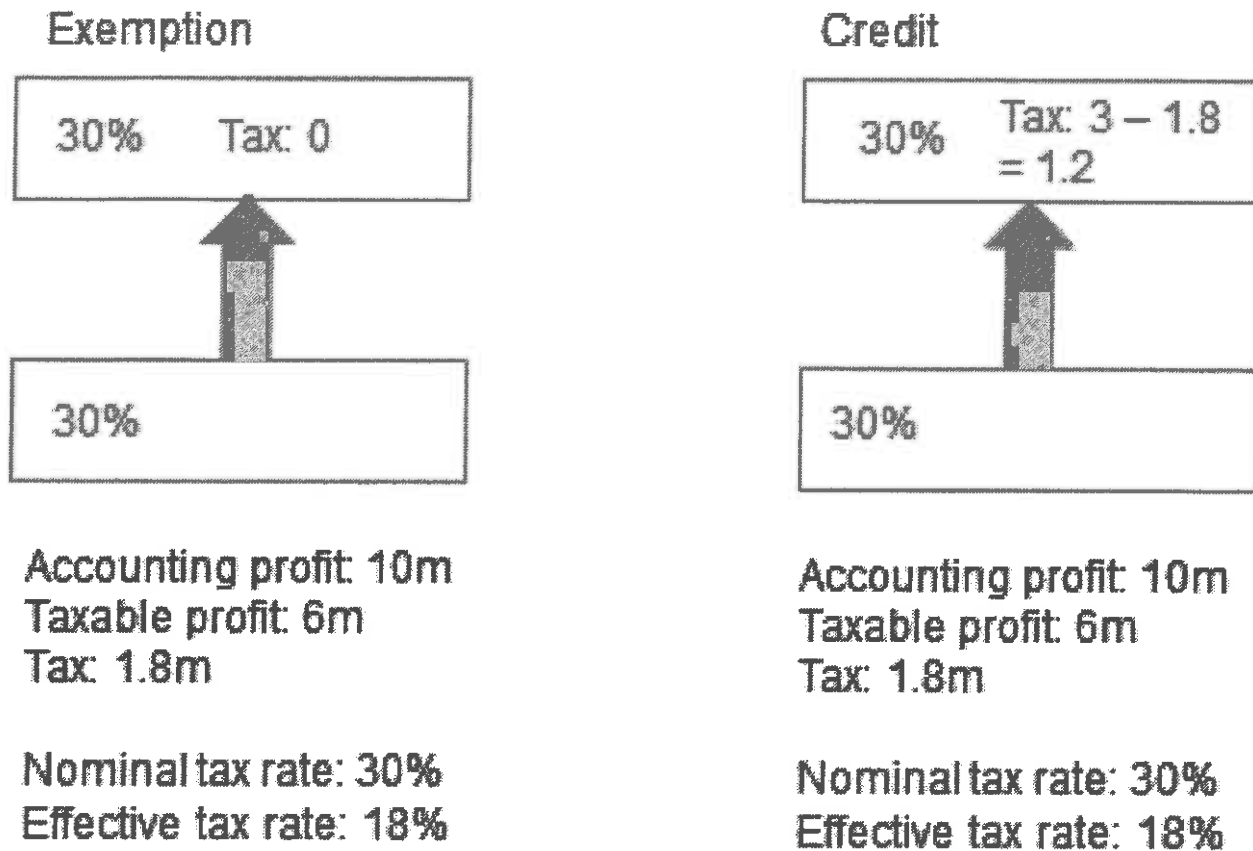
<sup>4</sup> See the judgment of Henderson J – [2008] EWHC 2893.

<sup>5</sup> The judgment of Arden, Burnton and Etherton LJ – see [2010] EWCA Civ 103.

<sup>6</sup> See [2012] UKFC 19.

<sup>7</sup> ECJ 13 November 2012, C-35/11, *Test Claimants in the FII Group Litigation*.

<sup>8</sup> ECJ, C-362/12, *Test Claimants in the FII Group Litigation*, pending.



The illustration on the left hand side shows a situation where dividends are exempt: that is the system that applied to dividends from a UK-resident company to its UK parent. This example assumes a nominal tax rate of 30% for all companies.

Assuming that the subsidiary had an accounting profit of 10m, but because of various reliefs its taxable profit was 6m, at 30% this would give rise to a tax charge of 1.8m. The nominal tax rate on the profits of the subsidiary was 30%, but if one takes the tax as a percentage of the accounting profit, the effective tax rate is only 18%. When the dividend is paid up to the parent it is exempt, so that overall the profits arising from the subsidiary and then paid up to the parent bear a total effective tax rate of 18%.

The argument before the Court compared this with the case of relief from double taxation by the credit method, which is illustrated on the right-hand side of this diagram. Again, there are accounting profits of 10m in the non-resident subsidiary but reliefs from tax give rise to a taxable profit of only 6m on which tax of 1.8m is paid. So far this is the same as the UK-resident subsidiary. There is, again, an effective tax rate in the subsidiary of 18%. However, unlike the situation with exemption, when the dividend is paid up to the parent, and assuming that the dividend is paid from the full accounting profit of 10m (one of a number of assumptions and simplifications made by the Court in this case), then the tax in the parent company would be 30% of 10. There would be a foreign tax credit of only 1.8 giving a residual tax liability in the parent of 1.2. The result is, as one would expect with the credit system, that the profit is subject to the higher tax rate in the country of the parent's residence of 30% so that the overall effective tax rate is 30%.

It should be emphasized that various assumptions are made in this type of comparison.

First, it is assumed that you can give a meaning to the term “effective tax rate”. Assuming that it means tax as a percentage of accounting profit, then clearly the effective tax rate depends upon how one computes that accounting profit. Different international accounting standards, for example, would give different measures of accounting profit; then clearly the effective tax rate depends upon how one computes that accounting profit.

It should be pointed out at this point that, when the first *FII GLO* case was referred back to the UK High Court, evidence was presented to the Court to show that the effective tax rate on subsidiary companies in the United Kingdom was generally lower than the nominal tax rate. This arises because of various tax reliefs such as depreciation allowances and the surrender of losses. It is a situation that is likely to arise in many countries.

A second assumption is that the only foreign tax that one is concerned with is the underlying tax on the profits out of which the dividend is paid. Of course, if there is a withholding tax on the gross amount of the dividend leaving the foreign subsidiary, that may have the effect of totally wiping out any tax liability on the dividend in the parent company.

Thirdly, this simple example assumes that the tax base in the foreign country is the same as the tax base on the subsidiary in the UK. Of course, that will never be true in practice. There may well be big differences between the tax base to which the foreign nominal rate is applied as compared with the tax base to which the UK nominal rate is applied. A lower foreign nominal rate, but applied to a wider tax base, may well result in a much higher effective rate than in the UK. Under UK law, an ordinary tax credit is granted for the lower of the actual foreign tax paid or the equivalent amount of UK tax computed on the foreign profits but applying the UK rules for the tax base (i.e. a normal tax credit). The amount of foreign tax actually paid is a function of both tax rate and tax base.

In its judgment of 13 November 2012, the Court responded on the first question as follows (and it bears quoting in full):

*“43 It must in fact be held that the tax rate applied to foreign-sourced dividends will be higher than the rate applied to nationally-sourced dividends within the meaning of the case-law cited in paragraph 39 of the present judgment, and therefore that the equivalence of the exemption and imputation methods will be compromised, in the following circumstances.*

*44 First, if the resident company which pays dividends is subject to a nominal rate of tax below the nominal rate of tax to which the resident company that receives the dividends is subject, the exemption of the nationally-sourced dividends from tax in the hands of the latter company will give rise to lower taxation of the distributed profits than that which results from application of the imputation method to foreign-sourced div-*

*idends received by the same resident company, but this time from a non-resident company also subject to low taxation of its profits, inter alia because of a lower nominal rate of tax.*

...

46 ***Second**, exemption from tax of dividends paid by a resident company and application to dividends paid by a non-resident company of an imputation method which, like that laid down in the rules at issue in the main proceedings, takes account of the effective level of taxation of the profits in the State of origin also cease to be equivalent if the profits of the resident company which pays dividends are subject in the Member State of residence to an effective level of taxation lower than the nominal rate of tax which is applicable there. ...*

49 *Accordingly, the determination which the referring court was called upon to make by the Court, in paragraph 56 of its judgment in Test Claimants in the FII Group Litigation, relates both to the applicable nominal rates of tax and to the effective levels of taxation. The ‘tax rates’ to which paragraph 56 refers relate to the nominal rate of tax and the ‘different levels of taxation ... by reason of a change to the tax base’ relate to the effective levels of taxation. The effective level of taxation may be lower than the nominal rate of tax by reason, in particular, of reliefs reducing the tax base.*

...

51 *It is apparent from the order of the referring court that the latter made the determination asked of it in paragraph 56 of the judgment in Test Claimants in the FII Group Litigation. It found that, in the main proceedings, the same nominal rate of tax applies both to the profits of the resident company paying dividends and to those of the resident company receiving them. On the other hand, it is apparent from the order for reference that the circumstance referred to in paragraph 46 of the present judgment is present, and not by way of exception: according to the referring court, **in the United Kingdom the effective level of taxation of the profits of resident companies is lower than the nominal rate of tax in the majority of cases.***

52 *It follows that application of the imputation method to foreign-sourced dividends as prescribed by the legislation at issue in the main proceedings does not ensure a tax treatment equivalent to that resulting from application of the exemption method to nationally-sourced dividends.”*

The UK High Court having received evidence that, in the United Kingdom, companies are generally subject to an effective level of taxation lower than the nominal rate of tax, it is not surprising that the Court concluded that the credit method does not ensure a tax treatment equivalent to that resulting from application of the exemption method.

Having concluded that the credit method did not ensure the same result as the exemption method, and consequently there was a restriction, the Court went on to consider whether there was a justification for the difference in treatment. At paragraphs 56 to 59, the Court concluded that the justification of cohesion of the national tax system was applicable. This topic, dealt with very briefly by the Court, seems to have been inserted only to allow the court to then discuss issues of proportionality. The justification of cohesion requires a direct link between the tax advantage granted and the offsetting of that advantage by a particular tax levy. The Court found this direct link – in paragraph 59 – in the link between the tax credit and the tax to which the distributed profits had already been subject. The Court seems entirely unconcerned that the tax had been paid by different taxpayers to different countries.

Proportionality is discussed at paragraphs 60 to 65 of the judgment, with the main conclusion being at paragraph 62, which provides as follows:

*“62. For the purposes of ensuring the cohesion of the tax system in question, national rules which took account in particular, also under the imputation method, of the nominal rate of tax to which the profits underlying the dividends paid have been subject would be appropriate for preventing the economic double taxation of the distributed profits and for ensuring the internal cohesion of the tax system while being less prejudicial to freedom of establishment and the free movement of capital”.*

In the subsequent paragraph, the Court states that such a foreign tax credit based upon the nominal rate of tax applied in the *Haribo* case<sup>9</sup>, though it is extremely difficult to see that was the position in that case. In effect, through proportionality the Court has tried to render compatible the statements it has made in its previous cases with the judgment here. It leaves open the possibility of a foreign tax credit being granted at the nominal rate of foreign tax. This is understood to be a form of “tax sparing” where credit is given not for the actual tax paid in the country of the subsidiary but for the tax that might have been paid at the nominal rate applied to a tax base (but there is no discussion whatsoever what that base may be).

Since the UK system of foreign tax credit gave a normal tax credit, limited to the lesser of the foreign tax actually suffered and the UK tax computed on the same profits, and did not grant a credit for foreign tax at the foreign nominal rate, the UK system of relief failed this test of proportionality.

## 1.2. Some comments on the answer to the first question

By its judgment in *Manninen*,<sup>10</sup> the European Court effectively killed the imputation system of relieving economic double taxation. By this judgment, the Court

<sup>9</sup> ECJ 10 February 2011, C-436/08 and C-437/08, *Haribo and Österreichische Salinen*, para. 99.

<sup>10</sup> ECJ 7 September 2004, C-319/02, *Manninen*.

has effectively killed the method of relief for international double taxation by the credit method. While the Court leaves open the possibility, in its discussion of proportionality, of a credit based upon the foreign nominal rates, it is extremely unlikely that any country would wish to adopt that approach.<sup>11</sup> In effect, the exemption of inter-company dividends is now the only practical system compatible with European Union law.

The Court reached this conclusion by asking whether the credit and the exemption method reached an equivalent result. It need not have bothered: of course they reach different results. They are intended to give effect to totally different policies. The credit system gives effect to Capital Export Neutrality, while the exemption system gives effect to Capital Import Neutrality. By rendering the credit system effectively impossible within the European Union, this policy choice is no longer available: all Member States are required to adopt a policy of Capital Import Neutrality with regard to foreign investment through subsidiaries. This will have a long-term fiscal impact on the Member States.

One issue which will no doubt be litigated at length in the United Kingdom courts is the actual result of the case. Does the judgment mean that the credit system previously operated in the United Kingdom, with taxation of overseas dividends and relief by a foreign tax credit, is incompatible with EU law and has to be dis-applied, or is it simply necessary that the foreign tax credit is recalculated to give a shadow credit based upon the nominal foreign tax rate? Put another way, can the UK's credit code be given a conforming interpretation such that it provides for a credit based on foreign nominal tax rates, or is the incompatibility with EU law simply impossible to remedy. That litigation will, no doubt, occupy the UK courts for some time and may eventually lead to a further reference to the European Court, perhaps for clarification of paragraph 62 of the judgment.

For over a hundred years countries have been offered the choice of relieving international double taxation by either the credit method or the exemption method. European countries no longer have the first option. This is the case even though

<sup>11</sup> Which would mean giving credit for tax which the foreign subsidiary has not fully paid, but which it might have paid if it had suffered tax at the foreign nominal rate. In theory, this could probably be done in simple cases. Take the example above, and assume that a dividend of 10 (the full accounting profit) was received by the parent from the foreign subsidiary. If the foreign nominal rate was 30%, the profits would have needed to be  $10 / 0.7 = 14.28$  so that tax of 30% (4.28) could be suffered to be left with 10. This gives rise to a form of deemed foreign tax credit of 4.28. This again assumes no withholding tax on the dividend. The calculation becomes more complex – if not virtually impossible – if the dividend derives from two or more foreign countries, each with a different nominal tax rate, possibly varying in different years. It would be necessary to identify the dividend received with the various underlying profits in different countries out of which the dividend would be treated as having been paid. Unless the parent's country had a relatively high nominal tax rate, and dividends were received from jurisdictions with significantly lower nominal tax rates, exemption would produce the same result in most cases, so states are likely to choose the exemption method.

the Parent-Subsidiary Directive, for example, provided for either method of relief. Was this result inevitable? For reasons given in the equivalent “Recent Developments” books in the previous two years, the author believes that this result was not inevitable but arose largely through the way in which this particular case was presented before the Court.

### 1.3. The fourth question

The fourth question posed by the High Court was as follows:

*“Where the national legislation in question does not apply exclusively to situations in which the parent company exercises decisive influence over the dividend paying company, can a resident company rely upon Article 63 TFEU ... in respect of dividends received from a subsidiary over which it exercises decisive influence and which is resident in a third country?”*

This question arose because of the possibility of applying the judgment to dividends from subsidiaries in third states. In some cases, the shareholding in the subsidiaries was high enough to give the parent decisive influence over the subsidiary – many were wholly-owned. This raised the issue whether such situations should fall exclusively within the scope of freedom of establishment – which does not apply to third states – or whether the free movement of capital might apply even where the shareholding in the third-state subsidiary was high enough to give decisive influence. Dicta from previous cases had led the UK Government to argue that the answer depended on the specific fact pattern. If, on the fact pattern, the parent did not have decisive influence, then free movement of capital applied and third-state shareholdings were covered. If, however, the parent factually had decisive influence, then free movement of capital did not apply, only freedom of establishment was relevant, and this does not apply to third states.

On this point, the explanation given by the Court for its answer is extremely clear, and one cannot improve upon quoting it extensively:

*“88 By its fourth question, the referring court asks, in essence, whether European Union law must be interpreted as meaning that a company that is resident in a Member State and has a shareholding in a company resident in a third country giving it definite influence over the decisions of the latter company and enabling it to determine its activities may rely upon Article 63 TFEU in order to call into question the consistency with European Union law of legislation of that Member State which relates to the tax treatment of foreign-sourced dividends and does not apply exclusively to situations in which the parent company exercises decisive influence over the company paying the dividends.*

*89 The tax treatment of dividends may fall within Article 49 TFEU on freedom of establishment and Article 63 TFEU on the free movement of cap-*

*ital (Haribo Lakritzen Hans Riegel and Österreichische Salinen, paragraph 33, and Accor, paragraph 30).*

- 90 *As regards the question whether national legislation falls within the scope of one or other of the freedoms of movement, it is clear from well established case-law that the purpose of the legislation concerned must be taken into consideration ...*
- 91 *National legislation intended to apply only to those shareholdings which enable the holder to exert a definite influence on a company's decisions and to determine its activities falls within the scope of Article 49 TFEU on freedom of establishment ...*
- 92 *On the other hand, national provisions which apply to shareholdings acquired solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking must be examined exclusively in light of the free movement of capital ...*
- 93 *The national rules at issue in the main proceedings apply **not only** to dividends received by a resident company on the basis of a shareholding that confers definite influence over the decisions of the company paying the dividends and enables its activities to be determined, **but also** to dividends received on the basis of a shareholding not conferring such influence. **In so far as the national legislation relates to dividends which originate in a Member State, it cannot therefore be determined from its purpose whether it falls predominantly within the scope of Article 49 TFEU or Article 63 TFEU.***
- 94 *In such circumstances, the Court takes account of the facts of the case in point in order to determine whether the situation to which the dispute in the main proceedings relates falls within the scope of one or other of those provisions ... 95 It was thus that, in paragraph 37 of its judgment in *Test Claimants in the FII Group Litigation*, the Court established that the cases chosen as test cases in the proceedings before the referring court concerned United Kingdom-resident companies which received dividends from companies established in other Member States that were wholly owned by them. As the nature of the interest in question would confer on the holder definite influence over the decisions of the company paying the dividends and allow it to determine the company's activities, the Court held that the Treaty provisions on freedom of establishment would apply in those test cases.*
- 96 *However, in a context such as that at issue in the main proceedings which relates to the tax treatment of dividends originating in a third country, it is sufficient to examine the purpose of national legislation in order to determine whether the tax treatment of such dividends falls within the scope of the Treaty provisions on the free movement of capital.*

- 97 *Since the chapter of the Treaty on freedom of establishment does not contain any provision which extends the application of its provisions to situations concerning the establishment of a company of a Member State in a third country or the establishment of a company of a third country in a Member State ..., legislation relating to the tax treatment of dividends originating in third countries is not capable of falling within the scope of Article 49 TFEU.*
- 98 *Where it is apparent from the purpose of such national legislation that it can only apply to those shareholdings which enable the holder to exert a definite influence on the decisions of the company concerned and to determine its activities, neither Article 49 TFEU nor Article 63 TFEU may be relied upon ...*
- 99 *On the other hand, national rules relating to the tax treatment of dividends from a third country which do not apply exclusively to situations in which the parent company exercises decisive influence over the company paying the dividends must be assessed in the light of Article 63 TFEU. A company resident in a Member State may therefore rely on that provision in order to call into question the legality of such rules, irrespective of the size of its shareholding in the company paying dividends established in a third country (see, to this effect, A, paragraphs 11 and 27)."* (emphasis added)

Having concluded that the free movement of capital could apply regardless of whether there was a portfolio holding in the third-state company or a much larger, direct holding, which gave definite influence over the company, provided that the legislation through its purpose applied to both situations, the Court then added a paragraph which is likely to be the focus of much litigation in the future:

*"100 Since the Treaty does not extend freedom of establishment to third countries, it is important to ensure that the interpretation of Article 63(1) TFEU as regards relations with third countries does not enable economic operators who do not fall within the limits of the territorial scope of freedom of establishment to profit from that freedom. Such a risk does not exist in a situation such as that at issue in the main proceedings. The legislation of the Member State in question does not relate to the conditions for access of a company from that Member State to the market in a third country or of a company from a third country to the market in that Member State. It concerns only the tax treatment of dividends which derive from investments which their recipient has made in a company established in a third country."*

One strongly suspects that this paragraph will feature repeatedly in later case law as it is likely that Member State governments will rely upon it to seek to limit the scope of free movement of capital.

That being said, the result is unquestionably desirable. A controlling shareholding can be seen as made up of several non-controlling holdings; or, if one likes, the greater shareholding includes the lesser. It would be surprising that the free movement of capital applied to a shareholding of, say, 5%, but did not apply to a shareholding of 50% in exactly the same circumstances where exactly the same legislation was at issue.

It now becomes important, therefore, to distinguish between legislation that applies only to cases where there is a definite influence over the subsidiary and situations where legislation applies more generally. This obviously touches upon the question of what percentage holding would be necessary to have definite influence – in some circumstances, a holding of 10% of the shares in a company (where the other 90% plus is widely held, for example) could give the 10% shareholder effectively complete control over the company. It is also not very helpful in these circumstances to ask about the *purpose* of the legislation. It is really a question of whether the legislation is limited in its scope only to cases where there is a substantial influence (for example, controlled foreign corporation legislation or legislation relating to corporate groups) and legislation which has a wider scope and applies to small and large shareholdings alike. Looking at the scope of the legislation, the answer will often be entirely clear. Legislation that applies regardless of the size of the shareholding will fall within free movement of capital where third states are concerned; legislation limited to substantial shareholdings giving decisive influence will fall exclusively within the freedom of establishment, and this freedom will not apply to third states.

## 2. The FII GLO (III) case

For the background to this case, the reader should look at the infringement action relating to the limitation period for actions for mistake of law, discussed elsewhere in this volume. The questions referred by the Supreme Court are as follows:

- “1. *Where under the law of a Member State a taxpayer can choose between two alternative causes of action in order to claim restitution of taxes levied contrary to Articles 49 and 63 TFEU and one of those causes of action benefits from a longer limitation period, is it compatible with the principles of effectiveness, legal certainty and legitimate expectations for that Member State to enact legislation curtailing that longer limitation period without notice and retrospectively to the date of the public announcement of the proposed new legislation?*
2. *Does it make any difference to the answer to Question 1 that, at the moment when the taxpayer issued its claim using the cause of action which benefited from the longer limitation period, the availability of the cause of action under national law had only been recognised (i) recently and (ii) by*

*a lower court and was not definitively confirmed by the highest judicial authority until later?”*

To understand this reference, it is necessary to read the Supreme Court’s judgment in the *FII GLO* case.<sup>12</sup> In essence, the question asks if the introduction of s. 320 of the Finance Act 2004, which removed the extended limitation period for actions to recover tax paid under a mistake, with immediate effect and without a period of grace, was contrary to EU law. The question posed emphasizes that there are two actions under UK law for recovering tax unlawfully extracted, and focuses on the principles of effectiveness, legal certainty and legitimate expectations. The second question asks whether the recent date of the identification of the cause of action, by a first-instance judgment, for tax paid under a mistake impacts on the legitimate expectation that the extended limitation period will not be curtailed. This concentrates on the differences of views that divided the judges in the Supreme Court and led to their decision to make a reference for a preliminary ruling.

After one decision in *FII GLO* this year, perhaps this new reference is one that is better discussed in future years.

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<sup>12</sup> [2012] UKSC 19.

# **United Kingdom – Infringement Actions**

*Philip Baker*

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- 3. The limitation period for actions arising from mistake of law**
- 4. Capital gains of controlled companies**
- 5. The transfer of assets abroad legislation**
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## 1. Introduction

There are currently four pending infringement actions against the UK relating to direct taxation which have been announced by the Commission and have reached the stage where the matter is being referred to the European Court. These four infringement actions are:

- IP/12/1017 – on cross-border loss relief.
- IP/12/64 – on limitation periods for actions arising from a mistake of law.
- IP/12/1146 – on capital gains of controlled companies.
- IP/12/1147 – on the transfer of assets abroad legislation.

These four infringement actions are discussed in that order below.

## 2. Cross-border loss relief

The European Court issued its judgment in the *Marks & Spencer* loss relief case<sup>1</sup> on 13 December 2005. At the time of writing, various issues relating to the implementation of that judgment are still being litigated in the United Kingdom.<sup>2</sup>

However, in Schedule 1 to the Finance Act 2006 the UK introduced a limited measure for cross-border loss relief under which losses arising in another Member State could be surrendered and used to offset profits in the United Kingdom if there was no possibility that the losses might be used outside the United Kingdom. The Commission took the view that this legislative response was inadequate in a number of respects, and did not properly implement the judgment in the *Marks & Spencer* case. Specifically, the requirement that there was no possibility that the losses might be used in any other Member State was far too restrictively drawn; the issue of “no possibility” of utilizing the losses in any other State had to be determined at the end of the accounting period in which the loss arose; and the amending legislation only applied to losses incurred after 1 April 2006. The second of these restrictive elements means that, in practice, it is virtually impossible to show that losses have no possibility of being used if one has to test that from the point of time at the end of the accounting period when the loss arose. Equally, the third element means that the infringement of EU law has been remedied only prospectively, and not with regard to the past.

The legislation in the Finance Act 2006 was rewritten under the Tax Law Rewrite process and became s.119 of the Corporation Tax Act 2010. The original request from the Commission to amend the 2006 legislation was made on 18 September 2008. Following the rewriting of the legislation, an amended request was made on 24 November 2010. The United Kingdom government has not responded to that request, and on 27 September 2012 the Commission referred the infringement to the European Court.

<sup>1</sup> ECJ 13 December 2005, C-446/03, *Marks & Spencer*.

<sup>2</sup> See *HMRC v Marks & Spencer plc* [2011] EWCA Civ 1156 for the latest judgment.

### 3. The limitation period for actions arising from mistake of law

In the United Kingdom the remedies of restitution or repayment where a tax has been unlawfully levied have only been developed by case law in the last few decades. This has much to do with the lack of a written constitution, which previously made it impossible to challenge a tax as being unlawful in the United Kingdom. For many years, it was the general view that there was no remedy for a payment made under a mistake of law, including a payment of taxes made under a mistake that the demand was lawful. That latter rule has been abandoned in recent years, and two remedies have developed in the United Kingdom through the case law: a remedy for the repayment of tax unlawfully demanded<sup>3</sup>, and a restitution remedy for tax paid under a mistake of law.<sup>4</sup>

With respect to the second of these remedies, the original limitation period contained in s.32(1)(c) of the Limitation Act 1980 provided that no period of limitation began to run until the mistake was discovered. For example, where the imposition of a tax was challenged as being contrary to European Community law, the fact that payment had been made under a mistake of law was not finally “discovered” until the judgment of the European Court which confirmed that the tax was unlawfully imposed. This gave rise to a very much extended limitation period, in that taxpayers who had paid tax under a rule found to be incompatible with EU law could commence their action generally within six years after the European Court judgment that struck down that taxation. Claims could then be brought going back as far as the entry of the United Kingdom into the European Economic Community in 1973.

In order to restrict the extended claims that were possible under this limitation period, the UK legislation was changed in stages.

First, in s.320 of the Finance Act 2004, the extended limitation period where a mistake was discovered was disapplied for claims brought after 8 September 2003. The consequence was that claims after that date could only be brought within six years after the tax in question was paid.

However, the second bite of the cherry then followed under s.107 of the Finance Act 2007 which disapplied the extended limitation period in s.32(1)(c) for tax claims brought before 8 September 2003. That second change was brought into operation with immediate effect and with no transitional period. As a consequence, taxpayers who had lodged claims before 8 September 2003 found that their claims were now barred by statute. It is this introduction of a bar to litigation with imme-

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<sup>3</sup> This remedy derives from *Woolwich Equitable Building Society v IRC* [1993] AC 70. In its recent judgment in *Test Claimants in the FII GLO v IRC* [2012] UKSC 19 the requirement for an unlawful demand was effectively reduced to a requirement that the tax was imposed unlawfully – there is no longer a requirement for a formal demand or assessment by the revenue authorities.

<sup>4</sup> This remedy derives from *Deutsche Morgan Grenfell Group plc v IRC* [2006] UKHL 49.

diate effect in s. 107 of the Finance Act 2007 that is the issue directly addressed in the infringement action.

Introducing a limitation period that bars claims, without giving a transitional period for those who have existing claims, raises issues as to its compatibility with the principle of effectiveness<sup>5</sup> and also the principle of legitimate expectations.

In this case, the request from the Commission to the UK to amend the law was made on 30 September 2010. The United Kingdom indicated that they did not intend to do so and so the matter was referred to the European Court on 26 January 2012.

Subsequent to the referral to the Court, on 23 May 2012 the UK Supreme Court in *Test Claimants in the FII GLO v IRC* ruled unanimously that s. 107 of the Finance Act 2007 was contrary to European law. So far, there does not appear to have been any reaction from the UK government. This raises an interesting issue as to whether the infringement action needs to proceed, given that the UK Supreme Court has already held that the legislation contravenes EU law. Meanwhile the Supreme Court has made a separate reference (the *FII GLO III* reference) to determine whether s. 320 Finance Act 2004 contravenes EU law, a point on which the seven judges of the Supreme Court could not agree (that new reference is discussed elsewhere in this volume).

#### 4. Capital gains of controlled companies

Since it was introduced in 1965, the United Kingdom capital gains tax has not applied to gains made by persons resident outside the United Kingdom (except in rather limited circumstances). It was theoretically possible, therefore, for a UK-resident individual or company to avoid capital gains tax by acquiring their investments through a non-resident company. To counter that, the original legislation (originally s.41 of the Finance Act 1965, then s.15 of the Capital Gains Tax Act 1979, and now s.13 of the Taxation of Chargeable Gains Act 1992) introduced something of a sledge-hammer provision. Under that provision any gains realized by a closely-held non-resident company (that is one under the control of five or fewer participators), would be attributed to any participator who held 10% or more of the interest in the company. Thus, a UK-resident individual or company who sought to avoid capital gains tax by setting up a non-resident company in which he, she or it held 10% or more of the interest would find the gains realized by the company were immediately attributed to him, her or it and taxed on that basis.

However, the legislation was never limited to avoidance circumstances only. It applied wherever there was a non-resident company which was closely held. There was no possibility of the taxpayer proving that the establishment of the company was bona fide and commercial or that it had no purpose of avoiding tax.

<sup>5</sup> See ECJ 11 July 2002, C-62/00, *Marks & Spencer v Commissioners of Customs & Excise* and ECJ 24 September 2002, C-255/00, *Grundig Italiana*.

The tax provision applied both to individual shareholders and also to corporate shareholders, so it was equivalent to CFC legislation for capital gains of corporates (and for individuals it was the capital gains equivalent to the transfer of assets abroad legislation, which applied to income).

The legislation is, as explained, applicable only to gains realized by non-resident companies. If a UK-resident company realized a chargeable gain, the company might be taxable on that gain, but there was no question of attributing the gain to its participators. Thus, the legislation operated in a discriminatory fashion, only applying to participators in non-resident companies and not to participators in resident companies.

The absence of any form of bona fide commercial defence or the ability to prove that tax avoidance was not a purpose of the structure is a particular factor that attracted the attention of the European Commission. In effect, underlying the legislation was a presumption that the use of a company resident outside the United Kingdom involved tax avoidance, and the taxpayer had no possibility of proving the contrary. The only limit on the operation of the legislation was that, if the non-resident company was resident in a jurisdiction with which the UK had a tax treaty with a suitable capital gains article, any gains which were taxable only in the other country would not be taxable in the UK in the hands of the participators. In effect, the UK recognized that the exemption from taxation of chargeable gains under the treaty flowed through and protected the participator as well.

Further comments about this legislation are added after the discussion of the next infringement action.

## **5. The transfer of assets abroad legislation**

The current legislation is found in ss.714 to 751 of the Income Tax Act 2007, but the basis is found in venerable, old legislation which was originally s.18 of the Finance Act 1936. That legislation, passed shortly before the Second World War, was designed to prevent UK-resident individuals from avoiding income tax by transferring assets to a person resident outside the United Kingdom in circumstances where the transferor retained the right to enjoy the income arising to the non-resident.

The legislation has been amended on a number of occasions since 1936. As a consequence of the amendments, it applies not only where the individual who transfers assets to the non-resident retains a power to enjoy the income of the non-resident but also where the transferor receives a capital payment and also where a non-transferor (a beneficiary of a trust, for example) receives a benefit provided out of income which has arisen from the asset transferred to the non-resident.

Unlike s.13 TCGA 1992 discussed above, the transfer of asset provisions have always been subject to a “bona fide commercial defence”, but the scope of that defence has been narrowed in recent years and the onus of proving the lack of any tax avoidance motive falls upon the taxpayer.

In effect, this legislation is the equivalent for individuals of CFC legislation for companies, except that it is not necessary that the UK-resident transferor or non-transferor has any control over the non-resident transferee.

## 6. The two infringement actions

The original request from the European Commission to the United Kingdom to amend both the transfer of assets abroad legislation and the provisions on capital gains of controlled companies was made on 16 February 2011. The United Kingdom did not respond to that until it published a consultative document including draft legislation on 30 July 2012. Many of those who responded to the consultation document considered that the draft proposals did not go far enough to comply with European Union law.<sup>6</sup> Clearly, the draft legislation – which had appeared almost a year and a half after the original request to amend the legislation – did not satisfy the Commission either: on 24 October 2012 the Commission referred both of these anti-avoidance measures to the European Court.

Subsequent to the referral, on 11 December 2012 the United Kingdom government unveiled amended proposals to revise both anti-avoidance measures. Initial reaction to those revised measure has been that, once again, they do not go far enough as to remedy the infringement of EU law in the original two sets of provisions.

Both of these anti-avoidance measures apply only to cross-border avoidance; they do not apply in an equivalent domestic situation. Established case law allows such legislation, which presents a restriction on the exercise of the freedom of establishment or the free movement of capital, to be justified provided it targets wholly artificial transactions and is not disproportionate. The issue for the Court is likely to be whether the UK legislation is restricted to wholly artificial arrangements and is not disproportionate.

Clearly, s. 13 TCGA 1992 was not restricted to artificial arrangements as it applied even to bona fide, non-avoidance situations. The proposed amendment to this section adds two defences, one a defence of no tax avoidance purpose. However, the legislation is still not restricted to **wholly artificial** arrangements. Also, the onus of proving the defence falls on the taxpayer – there is still something akin to a presumption of avoidance by the use of a non-resident company, which the taxpayer has to rebut.

The transfer of assets abroad provisions have always had a bona fide commercial defence, but it is doubtful if that is the same as a measure which targets only wholly artificial arrangements. Again, the onus is on the taxpayer to make out the defence. There is also an issue of proportionality here: if the legislation applies, **all** the income of the non-resident arising from the transfer can be attributed to the transferor,

<sup>6</sup> The fact that most respondents said this is clear from the Response Document published by HM Revenue & Customs on 11 December 2012.

even if the transferor has only retained a right to enjoy a fraction of the income. This is similar to the operation of some UK, domestic anti-avoidance legislation, but may still be disproportionate in a cross-border context.

This infringement action, assuming the UK does not bring forward EU-compliant legislation and the action proceeds, may give the Court an opportunity to elaborate on what is the acceptable scope of cross-border anti-avoidance legislation.