THE TAXATION OF OUTBOUND DIVIDENDS IN THE EC: HAS AG GEELHOED GOT IT RIGHT?

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1. Introduction

The tax treatment of outbound dividends, i.e. the tax treatment of dividends paid by residents of one Member State to residents of other Member States, has been the subject of various direct tax cases placed before the European Court of Justice ("ECJ"). Indeed, *Avoir Fiscal*[1], widely regarded as the first direct tax case to be decided by the ECJ, concerned the denial of a French tax credit to non-resident insurance companies for dividends received through a branch situated in France. In spite of the long-known relevance of this issue to Community Law, case law involving the payment of dividends directly to non-residents has only recently started being referred to the ECJ. The first of these is the *ACT IV GLO*[2] case, upon which an opinion has recently been delivered by Advocate General Geelhoed ("the AG Opinion"). The scope of this article is to analyse critically the answer of AG Geelhoed in respect of the first part of the first question of the Reference for a Preliminary Ruling[3] submitted by the High Court to the ECJ.

2. Legislative Background and Issues

The legislation lying at the heart of this litigation relates to the old UK rules requiring the payment of advance corporation tax ("ACT") on dividends distributed by UK resident companies and the related tax credits that shareholders were entitled to receive therefrom. Indeed, this is not the first time that the

1 Case C-270/83 (*Commission v French Republic*) [1986] ECR 273 ("*Avoir Fiscal*").

2 Case 374/04 (*Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*), case pending.

3 Question 1(a) – O.J. C/273, 06.11.2004, p. 17.

compliance of this legislation with Community principles has been called into question. In *Metallgesellschaft*[4], the ECJ had already ruled that allowing UK resident subsidiaries to distribute dividends to their UK resident parents without having to pay ACT whilst denying them that possibility where their parent companies were resident in other Member States was contrary to the freedom of establishment enshrined in the EC Treaty[5].

Briefly, the legislation in question applied up until 1999. Through it, the UK operated a partial imputation system for avoiding economic double taxation upon a distribution of dividends from UK resident companies[6]. As a general rule, all UK resident companies were required to pay ACT whenever they made a distribution of profits. The ACT could then be set off against the mainstream tax liability of the distributing company once that became due[7]. UK residents in receipt of dividends upon which ACT had been paid were entitled to a tax credit equivalent to the amount of ACT paid. The possible uses of the tax credit differed according to whether the recipient was a company or an individual.

Where a UK resident company was involved, the dividend and tax credit were exempted from tax in the hands of the receiving company. If that company subsequently re-distributed that dividend to its own shareholders, the company was entitled to set off the tax credit against any ACT that it would have been required to pay upon the distribution. As a result, no further ACT would have generally been payable upon re-distributions of profit. Conversely, where the recipient happened to be a UK resident individual, the dividend and tax credit would have been taxable in the hands of the individual. However, in such a case, the individual was entitled to set off the tax credit against his or her own tax liability arising as a result of the dividend. Furthermore, the individual recipient would have also been entitled to a tax refund if the credit exceeded such liability.

Dividends paid out to non-resident shareholders, as a general rule, were not subject to any UK withholding tax. Nor, however were non-residents entitled to

4 Joined cases C-397/98 and C-410/98 (*Metallgesellschaft and Others*), [2001] ECR I-1727.

5 Arts. 43 – 48 ECT.

6 Economic double taxation in the case of dividends arises as a result of a state taxing the same income in the hands of two different taxpayers: the company earning profits pays corporation tax on the said profits; when it distributes those profits in the form of a dividend, such profits are taxed once again in the hands of the recipient.

7 Unrelieved ACT, or 'surplus' ACT, could be carried back or forward to be set off against mainstream corporation tax from other accounting periods. Alternatively, the company could surrender this ACT to its subsidiaries, which could in turn set it off against their own tax liability – para. 11 of the AG opinion.

receive the tax credit that the UK granted to its own residents. Certain exceptions to this general rule applied in cases where, as a result of a double tax convention ("DTC") entered into by the UK and another state, the UK imposed a withholding tax upon dividends received by companies resident in the other Contracting State. In these cases, the UK concurrently extended to such companies a partial tax credit equivalent to a proportion of the ACT paid by the UK resident distributing company[8].

The main issue before the Court, in fact relates to the difference in treatment outlined above. Basically, the Court is being asked to determine whether the UK is in breach of its Treaty obligations, and if so whether it is nonetheless justified, in granting tax credits to its residents whilst at the same time, in the absence of a DTC providing for the contrary, denying them to companies resident in other Member States[9].

3. Overview of the AG Opinion

AG Geelhoed delivered his opinion on the case on 23 February 2006. The AG begins by setting out the issues underlying dividend taxation in general and the systems adopted within the EU to deal with these issues[10]. Next he outlines the legislative background, the facts relevant to the case and the series of events leading to the request for the preliminary ruling by the High Court[11].

Having laid the foundations, the AG begins his analysis by identifying which of the two freedoms quoted in the first part of the first question, if any, is relevant to the case at hand – the freedom of establishment[12] or the free movement of capital[13].

8 See for example, Art. 10(3) of the UK-Netherlands Double Tax Convention.

9 The Court is also being asked to rule upon another two related issues: firstly, whether the UK is required under the Treaty to apply the same treatment that it applies to residents of a Member State (say, the Netherlands) which by virtue of DTC concluded between them, entitle certain Dutch residents to UK tax credits on dividends received from UK companies, to residents of other Member States; secondly, whether the UK is allowed to include limitation of benefit clauses in its DTCs that denies, in this case, Dutch residents controlled by residents of other Member States the benefits of the DTC. Owing to limitations of space, these two issues are not dealt with herein but are dealt with more generally in the other articles published as part of this special supplement.

10 AG Opinion, paras. 4 – 8.

11 *ibid*, paras. 9 – 24.

12 See n. 5 above.

13 Arts. 56 – 60 ECT.

The distinction is important because these freedoms differ from one another in two major respects. First, they possess a different geographical scope; whereas the freedom of establishment prohibits restrictions solely amongst Member States, the free movement of capital prohibits restrictions between both Member States and third countries. Secondly, and perhaps more importantly given the facts of the case [14], the freedoms apply to different periods; whereas the freedom of establishment has been included in the Treaty since its inception, the present provisions relating to the free movement of capital were introduced following the amendments of the Maastricht Treaty and became effective on 1 January 1994[15, 16]. Following the Court's reasoning in *Baars*[17], the AG concludes that since the non-resident parent companies have "definite influence over the...decisions" of the resident subsidiaries in the case at hand, such parents should be deemed to be exercising their right of establishment and that the exercise of the free movement of capital is a mere consequence of the exercise of the former[18]. As a result, the AG conducts the remaining part of his analysis on the basis of Arts. 43 to 48 ECT.

The next and lengthiest part of the Opinion sees the AG return to basics. The AG reviews the manner in which the principles of non-discrimination and prohibition of restriction, with particular reference to the freedom of establishment, are applied in the context of direct taxation. The AG draws an important distinction between two types of so-called "restrictions": first, restrictions which are a direct result of the co-existence of separate national tax systems[19], which he refers to as "quasi-restrictions" [20], and secondly, other restrictions that arise out of discriminatory practices of a Member State that dissuade nationals of other Member States from establishing themselves in its territory or hinders its own nationals from establishing themselves in another Member State. The AG refers to these latter restrictions as "true restrictions". As discussed in Section 4.1 below, the AG's use of some of the terminology in this area is somewhat confusing. The

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14 The case deals with dividends paid out as far back as January 1974, i.e. prior to the liberalization of capital, see AG Opinion para. 22.

15 However, as the AG rightly points out, in substance capital was already fully liberalized through the adoption of Council Directive 88/361 which came into effect on 1 July 1990.

16 AG Opinion, paras. 25 and 26.

17 Case C-251/98 (*Baars*) [2000] ECR I-2787.

18 AG Opinion, paras. 27 – 30.

19 Examples of such 'restrictions' include a company establishing itself in another Member State having to comply with the reporting requirements of its origin state and the host state, disparities between the general direct tax systems of the different Member States or the division of tax jurisdiction. *ibid*, paras. 42–54.

20 *ibid*, para. 38.

Opinion continues that only the latter type of restriction is prohibited by the ECT[21] and that the former although undesirable should be eliminated only through the intervention of the Community legislator[22].

The AG Opinion then goes on to outline the obligations of a Member State in eliminating "true restrictions" when acting in the capacity of an origin state and a host state, illustrating these obligations by reference to specific direct tax case law. In the case of the former, the AG cites the treatment of foreign and domestic income in accordance with the way in which it has divided its tax base as the origin state's central obligation[23] and, in this regard, questions the sagacity of the Court's decision in *Bosal*[24]. Turning his attention to the latter, the AG states that when acting as a host state, a Member State is subject to a 'more limited obligation' for ensuring equal treatment[25]. Indeed, a host state is required to grant equal treatment only if the non-resident is treated for tax purposes in the same way as a resident, citing as an example when a branch of a non-resident company is subject to corporation tax in the same way as resident companies[26]. The AG also makes reference to *Bouanich*[27] stating that a host state is free to choose the way in which it fulfils its Treaty obligations, whether through a DTC or otherwise. Consequently, the effects of a DTC must always be taken into account when determining the compliance of a Member State's legislation with the Treaty, since failing to do so would risk overlooking the economic reality of the situation at hand. By following this line of reasoning, the AG has effectively distanced himself from the approach adopted by the EFTA Court in *Fokus Bank*[28] which regarded the obligations of Contracting States under a DTC as having "no legal significance"[29].

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21 *ibid*, para. 55.

22 *ibid*, para. 39.

23 *ibid*, para. 58.

24 Case C-168/01 (*Bosal Holding BV*) [2003] ECR I-2479. The ECJ held that the Netherlands was in breach of its Treaty obligations by allowing a Dutch holding company to deduct expenses incurred in financing investments which generated income that was subject to Dutch tax but refused the deduction when the investment generated income that was exempt from Dutch tax as a consequence of it arising outside the Netherlands (despite it possibly being subject to tax in another Member State). *ibid*, paras. 62 – 64.

25 *ibid* para. 66.

26 *ibid*, para. 67.

27 Case C-265/04 (*Bouanich*) [2006] ECR I-0000.

28 Case E-1/04 (*Fokus Bank ASA v The Norwegian State*).

29 *ibid*, para. 38.

Having outlined the general framework, the AG applies the principles to the facts of the case. The AG rightly points out that the UK in this case is acting in the capacity of a host state. Having determined this, the AG focuses his attention on establishing whether the denial of the tax credit to the non-resident parent companies represents, in his own words, a 'true restriction' or a 'quasi-restriction' for the said non-resident parents. In other words, is the less favourable treatment accorded upon non-resident as opposed to resident parents companies a result of UK discriminatory treatment or simply due to a disparity in the taxation systems of the Member States? The AG concludes that the 'restriction' about which the Test Claimants are complaining is due to the latter[30].

The AG reasons that insofar as the UK does not impose any tax upon the dividends received by the non-resident parent companies (say, by obliging UK resident distributing companies to withhold tax), such non-resident companies fall outside the UK's tax jurisdiction. This is in direct contrast to the tax treatment of dividends received by UK residents, over whom the UK exercises jurisdiction and upon which the UK imposes tax. Therefore, according to the AG, the granting of the tax credit to a UK resident serves to extinguish economic double taxation that would arise as a result of taxing the dividends, whereas there being no UK tax imposed upon outbound dividends, there happens to be no UK economic double taxation to extinguish and, thus, no need to provide a tax credit[31]. If, on the other hand, the UK imposed a withholding tax on dividends, it would have been required to ensure that the non-resident parent company receives equivalent treatment to that of its residents. It may ensure equal treatment either by extending its tax credit to the non-resident parent or by looking to the provisions of a DTC concluded with the state of residence which obliges the said state to grant relief[32]. The AG admits that it is possible that UK profits, even in the absence of a UK withholding tax, may still be subject to economic double taxation in the state of residence. However, the AG excuses the UK from having to provide relief stating that "the rules of taxation priority accepted in international tax law hold that, in principle, the UK enjoys taxation priority over UK-source profits"[33] and that therefore the UK is not in breach of its Treaty obligations by not extending its tax credits to non-resident parents.

The AG then goes on to answer the remaining questions put before the ECJ, which however, owing to the narrow scope of this article are not dealt with here.

30 AG Opinion, para. 80.

31 *ibid*, para. 83.

32 *ibid*, paras. 88 and 89.

33 *ibid*, para. 85.

4. Analysis

In the main, the author agrees with most of the reasoning and conclusions of the AG. Yet, certain aspects of the Opinion seem somewhat confusing particularly when viewed in the light of the Court's thinking in previous case law. For example, some of the statements included in the Opinion such as equivalence of the terms "discrimination" and "restriction" seem to jar with the approach adopted by the Court in establishing whether a breach of the treaty exists. Furthermore, the AG, in attempting to determine whether the UK is in breach of its Treaty obligations, overlooks particular issues and circumstances whose existence may require a qualification of his conclusions. Each of these apparent shortcomings is dealt with separately in the sections below.

4.1 The use of terminology

At paragraph 36 of his Opinion, the AG categorically states that "in the direct taxation sphere, there is no practical difference between…'restriction' and 'discrimination'". At best, the AG's statement may be described as odd since he seems to imply that the terms may be used interchangeably. Although, arguably, this statement does not have a direct bearing upon the subsequent analysis, its inclusion is somewhat confusing. ECJ case law shows quite clearly that the two terms, although undoubtedly related, should not be construed as meaning the same thing. "Discrimination" as drafted within the Treaty[34] and when referred to by the Court does *not* encompass all types of discrimination. Rather, it only refers to discrimination which arises as a result of less favourable treatment accorded by a Member State upon a person simply because that person is not a national of that Member State. As expounded by the Court in *Sotgiu*[35], "discrimination" in a Community context refers to:

> " *… overt discrimination by reason of nationality [and] all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result…criteria such as place of origin or residence of a worker may, according to circumstances, be tantamount, as regards their practical effect, to discrimination on grounds of nationality.*"[36]

34 "…any discrimination on grounds of nationality shall be prohibited." – Art. 12 ECT.

35 Case C-152/73 (*Sotgiu*) [1974] ECR 153.

36 *ibid*, para 3.

In fact, as Farmer[37] explains, this principle cannot be applied without substantial difficulty in cases involving rules, which despite being clearly non-discriminatory, may restrict, dissuade or hinder a Member State's nationals from exercising their right to establish themselves in another Member State. In such cases the Court uses a more general restriction approach rather than attempting to pinpoint a specific instance of discrimination especially where, for example, in origin state cases the transgressing Member State is not discriminating against the nationals of other Member States (as in a host state situation) but is applying less favourable treatment upon its own nationals that choose to establish themselves abroad and its other nationals that choose to stay at home[38]. In these cases, it may be correct to say that the Member State is 'discriminating' since it is applying different rules to what essentially may be comparable situations. However, discrimination is not occurring on the grounds of nationality as prohibited by the Treaty but rather upon whether the Member State's national chooses to exercise his Treaty rights or not, which, in Community jargon, seems to fit more easily within the concept of 'restriction'.

Finally, the AG's statement is even more confusing when applied in the context of *Futura*[39]. In this case, the Court held that Luxembourg rules requiring the maintenance of a set of accounts for carrying losses forward by both Luxembourg resident companies and branches of non-resident companies established in Luxembourg as being non-discriminatory. However, even though Luxembourg, as a host state, was imposing the same obligations upon both residents and non-residents, the Court held that in the latter's case the measure was restrictive[40] and went beyond what was necessary to ensure the correct calculation of the losses to be carried forward[41]. Therefore, in spite of applying a non-discriminatory measure, Luxembourg was still regarded as being in breach of the Treaty. Following this reasoning, it might have been more precise for the AG to say that 'discrimination' rather than being equivalent to 'restriction' is actually just one type of 'restriction' and that not all restrictions are necessarily discriminatory in nature.

37 Farmer, P., "The Court's case law on taxation: a castle built on shifting sands?" (2003) *ECTR*, p. 77.

38 Referred to by O'Shea as the "migrant/non-migrant test". See O'Shea, T., "Marks and Spencer v Halsey (HM Inspector of Taxes): Restriction, Justification and Proportionality", (2006) *ECTR*, p.66-82.

39 Case C-250/95 (*Futura Participations*) [1997] ECR I-2471. See on this point O'Shea T., "Freedom of Establishment Tax Jurisprudence: Avoir Fiscal re-visited on its 20th Anniversary", [2006] YEL (forthcoming).

40 *Futura* judgement, para. 24.

41 *ibid*, para. 43.

4.2 Application of the principles

In host state cases such as this, the Court has arguably followed a consistent approach over the years. Ever since *Avoir Fiscal*, the Court has sought to determine in the first place whether the non-national (or non-resident) filing the complaint against the host state's tax measure was in a situation comparable to that of its own nationals (or residents). In this case the Court finds that since the French tax rules "place companies whose registered office is in France and branches and agencies situated in France of companies whose registered office is abroad *on the same footing* for the purposes of taxing their profits, those rules cannot, without giving rise to discrimination, treat them differently"[42]. The Court develops its reasoning in subsequent case law, but the basic principle remains the same.

In *Schumacker*[43], for example, the Court deals with the comparison of resident and non-resident individual and finds that "the situations of residents and non-residents are not, as a rule, comparable"[44]. However, in certain circumstances, residents and non-residents may be placed in objectively comparable situations such as, for example, when a non-resident obtains the major part[45] of his taxable income from an activity performed in the State of his employment but earns no significant income in his State of residence with the result that his State of residence is unable to grant benefits related to his personal and family circumstances. This thinking is taken one step forward in *Asscher*[46], where the Court requires the Netherlands to take into account Mr Asscher's situation in his state of residence (in this case, Belgium) in determining whether such a non-resident is in a situation that is comparable to that of its residents[47]. Although these cases apply to individuals, the same principles may also be applied to companies.

As outlined above, in *Futura*, for example, the Court views the Luxembourg rules as restrictive (albeit non-discriminatory) because the French company with the Luxembourg branch was required to keep two sets of accounts. This was found to be disproportionate to ensuring proper fiscal supervision of the branch as claimed

42 *Avoir Fiscal* judgement, para. 20.

43 Case C-279/93 (*Schumacker*) [1995] ECR I-0225.

44 *ibid*, para. 31.

45 In case C-391/97 (*Gschwind*) [1999] ECR I-5451, the Court quantifies 'major part' as having to constitute at least 90% of taxpayer's worldwide income.

46 Case C-107/94 (*Asscher*) [1996] ECR I-3089.

47 *ibid*, paras. 47 and 48.

by the Luxembourg tax authorities. In other words, like *Schumacker* and *Asscher*, the Court required Luxembourg to take account of the situation of the non-resident in its state of residence when applying its own rules.

This same principle has also been applied by the Court in its more recent case law involving host state situations and involving treaty freedoms other than establishment. In the *D Case*[48], involving the free movement of capital, the Court held that the Netherlands was not in breach of its Treaty obligations by disallowing Mr D – a resident of Germany – to benefit from a wealth tax allowance that Netherlands provided to its residents. Since only a minor part of Mr D's wealth was situated in the Netherlands and the major part of his wealth was situated in his state of residence, Mr D was not in a situation that was comparable to that of Dutch residents. In another recent ruling, *CLT-UFA*[49], the ECJ held as it did in its earlier cases that since a German branch of a company registered in Luxembourg and a German subsidiary are both subject to German income tax, both are in comparable situations[50].

In his Opinion, the AG tries to compare the situation of UK resident individual shareholders of a UK resident parent company holding a UK resident subsidiary ("the resident situation") with that of non-UK resident individual shareholders holding shares in a non-UK parent company which owns a UK resident subsidiary ("the non-resident situation"). The AG finds that since in the resident situation, the UK is exercising its jurisdiction at all three levels of the chain (i.e. at the level of the subsidiary, at the level of the parent and at the level of the individual shareholders) UK economic double taxation is bound to arise. On the other hand, in the non-resident situation, the UK exercises its jurisdiction at only the first level of the chain[51] (i.e. at the level of the subsidiary) because both the non-resident parent and its individual shareholders fall outside scope of the UK tax system. Hence, in the latter case no UK economic double taxation arises. On this basis, the AG concludes that the resident and non-resident situations are not comparable, and therefore their different treatment does not give rise to discrimination.

In the author's view, the AG fails to take sufficiently into account the situation of the non-resident in their own state of residence. What if the state of residence of the parent company taxes those dividends in the hands of the company? Admittedly, in most cases the AG's conclusion may in most cases be correct particularly since

48 Case C-376/03 (*D. v Inspecteur van de Belastingdienst*) [2005] ECR I-0000.

49 Case C-253/03 (*CLT UFA SA v Finanzamt Koln-West*) [2006] ECR I-0000.

50 *ibid*, para. 30.

51 Unless it imposes a withholding tax on the dividend payment.

Member States may probably provide economic double tax relief either under a DTC or under their own domestic provisions for UK corporation tax suffered on those dividends. Indeed, following *Manninen*[52], those Member States which, like Finland, provide economic double tax relief in respect of dividends received by resident shareholders holding shares in resident companies are required to extend such relief also when they receive dividends from shares held in companies resident in other Member States. As a result, such non-residents are being relieved from economic double taxation by their own country of residence and, as the AG concluded, are not in a similar situation to that of UK residents.

However, what if the state of residence never provides economic double tax relief since, for example, it employs a classical taxation system? In this case, the state of residence is under no obligation to provide relief since it applies the same system to both domestic and foreign source dividends. Arguably, therefore, the residents of such a State receiving dividends from UK resident companies are subject to economic double taxation just like a UK resident individual. As a result, the non-resident is now placed in a situation that is comparable to that of a UK resident individual and therefore since UK provides a tax credit to its own resident to relieve economic double taxation, it should probably be required to extend that credit to the non-resident.

As stated above, the AG recognizes this situation at paragraph 85 of his opinion and, rather oddly, cites accepted international tax principles as the reason why the UK should not be obliged to extend it tax credits. Odd because the Court has time and time again disregarded many dearly held ‘accepted international tax principles’ and jealously safeguarded the supremacy of Community law over such principles. It is therefore quite strange to suggest that the UK may apply different treatment to comparable situations due to the fact that as a source state it should have priority to tax.

5. Conclusion

The *ACT IV GLO* AG Opinion is not able to provide all the answers to the issues that might arise in situations involving outbound dividends. However, it should still be considered a significant case for at least two reasons: firstly, it sees the application of established Community Law principles in an as yet untested area of economic activity; secondly, and in relation to the first reason, it provides the ECJ with an indirect opportunity to stand by or distance itself from the decision of the EFTA Court in *Fokus Bank*. Considering the Court’s decision in *Bouanich* it seems likely that the Court will choose the latter course.

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52 Case C-319/02 (*Petri Manninen*) [2004] ECR I-0000.

Finally, it is also interesting to see the extent to which the Court will follow the reasoning of the AG Geelhoed in the issues discussed above as well as the other issues dealt with in the case, namely, the application of the most-favoured-nation principle and the legitimacy of limitation of benefit ("LoB") clauses. It is likely that with respect to the LoB issue the Court would have to choose between following the position it adopted in the non-tax *Open Skies* series of cases or the alternative approach propounded by the AG. Perhaps the only thing that is certain at this stage is the large bearing that the decision in this case will have on the outcome of other cases involving outbound dividends that are currently pending before the Court[53].

53 See for example cases C-175/05 (*Denkavit International BV*), pending (AG opinion issued on 27th April 2006) and C-379/05 (*Amurta*), pending.