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SOME AWFULLY BIG QUESTIONS ON TAX SOVEREIGNTY v LEVEL PLAYING FIELDS

Dr Sandra Eden[1]

Introduction

In the recent referrals from the UK in the cases of *Hoechst*[2] and *Metallgesellschaft,*[3] the European Court of Justice (ECJ) are given the opportunity to address some large and difficult questions, the answers to which may fundamentally affect the rights of member states to determine their tax relations with other member states. The referral will require the ECJ to consider both technical aspects of the UK imputation system, which was reformed with effect from 6th April 1999, and also the power of member states to enter into double taxation agreements which differentiate between non-residents on the basis of their state of residence. Although the questions asked relate to a system which is no longer in operation, the approach adopted by the ECJ in answering them cannot avoid addressing issues of much broader application.

The questions addressed to the ECJ

The facts of the cases are mercifully straightforward. In both cases, a UK subsidiary of a German parent company paid dividends to its parent, accounting for ACT on the payment. Separate legal issues raised by the referral address the position of both the subsidiaries and the parents.

The issue relating to the UK subsidiaries concerns the fact that they were not permitted to pay the dividends without payment of ACT under a group income

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1 Dr Sandra Eden, Senior Lecturer, Faculty of Law, University of Edinburgh, Old College, South Bridge, Edinburgh EH8 9YL
Tel: (0131) 650 2627, Fax: (0131) 662 0724. Email: sandra.eden@ed.ac.uk

2 Case C-410/98.

3 Case C-397/98.

election, an election which was only available in relation to dividend payments between UK resident companies.

The issue relating to the treatment of parent companies concerns the availability of the ACT as a tax credit. Their claim is, assuming that ACT was correctly accounted for by the subsidiary, that they should have received a tax credit either because a UK parent would receive the benefit of ACT, or, because under certain double taxation agreements companies resident in some other member states received a tax credit which was not available under the then current UK-Germany agreement.

The question of compatibility of UK law with Community law has been raised under articles 12 (formerly 6), 43(formerly 52), 48 (formerly 58) and 56 (formerly 73b). It appears nothing is being left to chance.

In approaching a reference from a national court which concerns one of the freedoms, the approach of the ECJ is to address three questions. First, which, if any, of the freedom articles applies to the issue under consideration? Second, has the right to the freedom in question been violated? This is sometimes a question of establishing discrimination, but has more recently often been expressed in terms of restrictions in general[4]. Third, is there a justification for the restriction in question? This paper seeks to unravel the issues which will be raised by these questions, and even, on occasion, tentatively suggests an answer or two. Some of the ground covered here has been considered in the context of an earlier brace of cases which covered similar, although not identical issues[5]. This paper seeks to add to that debate, raise issues which may have not been considered before, and take into account subsequent developments in the ECJ.

Which Article of the Treaty is likely to apply?

As mentioned above, the High Court has asked if there is a breach of one or more of three articles of the European Treaty: Art. 12, which concerns discrimination on

4 Case C-55/94 *Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165. Or indeed, use both approaches in one judgment: Case C-250/95 *Futura Participations SA and Singer v Administration des Contributions* [1997] ECR I-2471.

5 The cases of *Hoescht* and *Pirelli*. Whilst the facts were the same as here, the legal issues raised in the current reference are wider. In particular, the contributions by Gammie and Brannan "EC Law strikes at the UK Corporation Tax - The death knell of UK imputation" Intertax 1995/8-9 389 and Richardson "The Hoechst and Pirelli cases: the Adventures of an innocent abroad or the curious case of the foreign parents and the missing credit" 1998 BTR 283 are very helpful. Briefer discussion can be found in Oliver "The impact of EU non-discrimination provisions in UK corporate law" EC Tax Rev. 1998 p 170.

the ground of nationality in general, Art. 43, which provides for the freedom of establishment for individuals, which freedom is extended to enterprises by Art. 48, and Art. 56, which provides for the free movement of capital and, more relevantly for the cases under consideration, capital income.

One can briefly dismiss the application of Art. 12. The Court of Justice will dismiss the application of Art. 12 where there is another, more specific article prohibiting the discrimination[6]. Where it is a restriction or discrimination in relation to an economic activity which is being complained of, the ECJ has always judged that one or other of the freedom articles is more appropriately applied than Art. 12. So one can be reasonably confident that it will be Art. 43 or Art. 56, or indeed both, against which the UK legislation must be tested.

Whilst technically, the freedom of establishment might be exercised without the simultaneous exercise of the free movement of capital, current international practice on the taxation of the profits of international trade requires there to be at least a permanent establishment in a state in order for that state to exercise any jurisdiction over those profits. If the state of source exercises no tax jurisdiction over a non-resident, there can obviously be no discrimination against him. The setting up of a permanent establishment is one of the actions included within the meaning of the movement of capital, and so it is highly unlikely in practice that there will be the exercise of the freedom of establishment alone. In particular, where, as here, a parent is complaining of discrimination in relation to its overseas subsidiary, both freedoms appear to be violated. Indeed, both Art. 48 on establishment and Art. 56 on capital are capable of applying to restrictions placed on the setting up in a member state through a subsidiary. Article 48 expressly states that any restriction on "the setting up of agencies, branches or subsidiaries by nationals of any member state in the territory of any member state" is prohibited. In relation to the movement of capital, whilst there is no definition given of movement of capital in the Treaty itself, the Directives (superseded by the Treaty, but still a useful guide to the content of the term),[7] specifically included operating through a permanent establishment or a subsidiary as examples of movement of capital[8]. Finally, a Communication published by the Commission indicates both are to be treated as covered by both articles.[9]

6 E.g. *EC v Greece* [1989] ECR 1461 para 13, *Peralta* [1994] ECR I-3453 para 18.

7 Case C-222/97 *Trummer and Meyer* [1999] ECR I-1661.

8 Annex 1 of 1988 Council Directive 88/361 (OJ 1988 L 178/5).

9 Publication of the European Commission No C 220 19th July 1997.

So, if, as it seems, both articles *could* apply, how should the court proceed? Could both articles apply simultaneously? Both articles make express reference to the other and so contemplate an overlap in application[10]. Two approaches by the ECJ are discernible in cases where the national court has asked for guidance on more than one article. The first involves a preliminary analysis as to which article applies, after which the court goes on to consider that article only[11]. The second approach skips the first stage, and proceeds immediately with a consideration of one article mentioned by the application, which usually means the earliest article numerically[12]. The implication of this approach is that both articles apply. If, as is usually the case, a breach of the article to be considered is found, the court has decided that there is no need to consider the next article[13]. Perhaps it is not only because the freedom of movement of capital has relatively recently been given the status of a treaty freedom that it has rather rarely been considered: it may also have something to do with its position in the Treaty! On occasion, the Advocate General has adopted one approach, and the ECJ has adopted the other.[14]

AG Alber has recently suggested that where there is a *direct* infringement of the free movement of capital and only *indirect* infringement of the freedom of establishment, the provisions relating to capital apply, and vice versa. However, he suggests that where both the freedom of movement of capital and establishment are directly infringed, both articles apply.[15] Assuming that both the parents have at least a 51%

10 Art 43 and Art. 58.2 each refer to the other freedom. See Peters "Capital movements and taxation in the EC" EC Tax Review 1998 p 4.

11 *Bachmann* para 34. See also C-222/95 *Société Civile Immobilière Parodi and Banque H. Albert de Bary et Cie* [1999] ECR I-3899.

12 Although in C 302/97 *Konle v Austria,* judgment delivered 1sr June 1999 capital was considered before establishment.

13 An approach adopted in relation to services and capital in C 410/96 *Tribunal de Grande Instance, Metz v Ambry*, [1998] ECR I- 7875 and establishment and capital in C 302/97 *Konle v Austria*.

14 In C-118/96 *Safir v Skattemyndigheten I Dalarnas Lan*, [1998] ECR I-1897 the view was expressed by AG Tesauro, on the relationship between services and capital, that "combined application of these articles, without distinguishing whether the case involves freedom to provide services or free movement of capital, would not, to say the least, be a very rigorous approach ." Without making any comment on the relationship between the relevant articles, the Court simply decided that the restriction in *Safir* was a breach of the freedom of provision of services, and did not go on to consider Art. 56.

15 C - 251/98 *Baars v Inspecteur der Belastingdienst Particuliere/Ondernemingen Gorichem*, opinion delivered 14th October 1999.

stake in the UK subsidiaries (as otherwise they would be ineligible for the group relief they are claiming), it would seem likely that their primary objective in acquiring the UK holding was to engage in business in the UK rather than to move capital there.

Why it matters which freedom is infringed: Article 58.1

It can be a matter of importance as to which article applies as the rules attached to the individual articles are sometimes different, often in subtle respects. For example, the right of establishment is provided only to nationals of Member States but there is no nationality qualification in relation to free movement of capital. As the parties in the case under consideration are EU nationals, this is not an example of particular relevance here, but one which may be of fundamental importance is the extent to which the member state may be able to justify any restriction identified by the court, and in particular the application of Article 58.1.

One of the apparent differences between Art. 43 and Art. 56 lies in the extent to which the member state is given grounds to defend a restriction which impinges upon the respective freedoms. In relation to Art. 43, direct restrictions may be justified on the grounds of public policy, public security or health, and indirect restrictions may be justified by the wider ground of the public interest. These justifications are discussed later. In the context of capital, in addition to the justification of public policy and public security,[16] Art. 58.1 expressly reserves the right of member states to apply the relevant provisions of their tax law which distinguish between taxpayers "who are not in the same situation with regard to their place of residence". Article 58.3 adds that this "shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital or payments".

If the source state can use Art. 58.1 to tax more heavily the local permanent establishment of a foreign enterprise, or a local subsidiary with a foreign parent, or simply the return on investment to a non-resident, this would appear to conflict with the rights given under other treaty freedoms and at least some of the previous jurisprudence of the ECJ. The meaning of Art. 58.1 is still a mystery, partly because of the absence of consideration of Art. 56 in tax cases before the ECJ[16a]

16 Art. 58.2

16a In C-439/97 *Sandoz GmbH v Finanzlandesdirektion fur Wien, Niederosterreich und Burgenland*, judgment delivered 14th October 1999, the ECJ decided, without much in the way of discussion, that Art. 73d permitted a Member State to distinguish between loans from resident and non-resident lenders in order to prevent avoidance of stamp duty on loans from non-residents, but that this did not permit rules which had the effect of applying duty in cases where a loan from a resident lender would not have been dutiable.

but the obvious question is, to what extent does it provide a justification for treating non-residents less favourably which differs from the justifications permitted in the context of the other fundamental freedoms, and in particular Art.43?

If the ECJ adopts the first approach described above and addresses its mind to the preliminary issue of which article applies in the current cases, it is probable that it will conclude that it is Art. 43 which is most directly in question. In this event, of course Art. 58.1 has no relevance to the proceedings.

However, even if Art. 56, and by extension Art. 58.1 are not expressly excluded, there are three reasons why the apparently wide reaching effect of Art. 58.1 is not as dramatic as it first appears.

The first is that the court has often avoided consideration of the application of Art. 56 by finding that another freedom has been breached: the second approach described above. There is a question as to whether this is legitimate except in cases where the court has decided that it is *only* the other article which applies. If it does appear to be the case that both establishment and capital articles are relevant, then the case has not been fully addressed by a consideration of the rules relating to establishment only. The reason is this; Art. 43 is expressly stated to be *subject to* the articles on capital. This surely means that even if there is an infringement of the freedom of establishment, if the court then goes on to find that there is *no* infringement of the freedom of movement of capital, then the member state is not in breach of its treaty obligations. It is protected by the rules on capital. In other words, the right to freedom of establishment will be denied where the restriction complained of turns out to be a legitimate restriction on the freedom of movement of capital permitted by Art.58. This does suggest that cases which have adopted the second approach, such as *Safir*,[17] may have proceeded on dubious grounds.

The relationship between the articles is not new, and there is every likelihood that if the ECJ adopts the second approach, and find a breach of Art. 43, it will not go on to consider capital, and so the issue of Art. 58.1 will not arise.

This notwithstanding, there is a further argument which may perhaps be used to circumnavigate Art. 58.1, although at the same time acknowledging that Art. 56 applies[18]. Declaration No 7 attached to the Maastricht Treaty limits the application of Art. 58.1 to "relevant provisions" of their tax law which were already in effect

17 *Op cit* note 14. *Safir* concerned services, but there is no reason to doubt that the argument is equally valid in relation to establishment.

18 I am grateful to Professor Usher for this argument: see Usher *The Law of Money and Financial Services in the EC* 2nd ed (due January 2000) Ch 3.

at the end of 1993. In other words, member states entered into a political agreement that no new restrictions on the ground of residence would be introduced, but that restrictions at that date can be maintained. The rest of the argument turns on the meaning of "relevant provisions". Based on the primacy of EC law, the Declaration means that "relevant provisions" are only the *lawful* restrictions based on residence at the end of 1993 which gain the protection of Art. 58.1[19]. However, one is not limited to consideration of the case law at the date of the Declaration in determining whether a restriction of freedom of establishment was lawful or not because the ECJ declares law as it has always been. Therefore, discrimination on the ground of residence for the purposes of the freedom of movement of capital is tested by reference to whether the restriction *is* (rather than would have been at the end of 1993) permitted in the context of the other freedoms. If the restriction based on residence would not be lawful under the other freedoms, taking into account current case law, then it cannot be lawful in relation to capital. This provides an ingenious way of unifying the application of the respective freedoms, including the freedom of capital.

Alternatively, of course, the court may decide that "relevant provisions" means simply provisions in the legislation of the member states differentiating on the basis of residence, irrespective of whether they breached the other freedoms at the time. In this case one would appear to have different tests depending on which freedom is applied.

This brings us to the third argument which may avoid the application of different tests. This is not that Art. 58.1 does not apply, but that the scope of its application is not perhaps as radical as might first appear, and that on closer scrutiny, it might not be very much different from the rules established in relation to establishment and workers.

Article 58.1(a) is in the following terms,

"The provisions of Article 56 shall be without prejudice to the right of Member States:

(a) to apply the relevant provisions of their tax law which distinguish between tax payers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested."

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19 On the basis that provisions which are contrary to EC law are unenforceable.

The first point relates to the words "who are not in the same situation" with regard to their place of residence. One reading of these words is that they simply permit different treatment of residents and non-residents, as permitted by the OECD Model Treaty. However, they could be construed as meaning where residents and non residents are different they can be treated differently. By implication, where they are the same, they should be treated alike.

The second point relates to Art. 58.3, which provides,

> "The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments ..."

In other words, there must be good reason for treating residents and non-residents differently, and the good reason must presumably relate to other relevant differences from the tax point of view. The question of whether it is legitimate to treat a non-resident differently from a resident has been raised on a number of occasions in the context of the other freedoms,[20] and it is entirely possible that the ECJ will adopt the same approach in its construction of Art. 58.1. In other words, it will apply the same tests as to when a resident and a non-resident can be subjected to different tax rules irrespective of the freedom in question. The same view was expressed in the recent opinion of the Advocate General in *Baars,*[21] namely that the import of Art 58.3 is that it is only permissible to distinguish on the basis of residence to maintain the coherence of the national system.

There is an alternative view, namely that what is now Art. 58.1 was introduced post *Avoir Fiscal* [22] to protect the imputation system of taxation[23], and if this is the case, it may have significant bearing on the second question addressed to the Court if consideration of Art 58.1 becomes relevant.[24]

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20 See also Gammie and Brannan "EC Law strikes at the UK Corporation Tax - The death knell of UK imputation" Intertax 1995/8-9 389.

21 *Op cit* note 15 , para 58.

22 Case C-270/83 *Commission v France* [1986] ECR 273, hereinafter referred to as *Avoir Fiscal.*

23 Terra and Wattel *European Tax Law* 2nd ed (1997) p. 16.

24 Unfortunately, in its Communication referred to at note 9 above, the Commission did not clarify the position of Art. 58.1

As there is more than one way in the present cases in which the ECJ can avoid consideration of Art 58.1, it is suggested that it is unlikely that it will actively seek to do so, and one big question will remain unanswered. The most honourable way for it to do so is to decide that it is only Art. 43 which applies.
In view of the above conclusion, the rest of the article considers the merits of the case from the perspective of Art.43 only, and it is to the meat of the case that we now turn.

The making and receiving of UK company distributions prior to 6th April 1999

The making of a distribution by a UK company

Until the reform in the UK with effect from 6th April 1999, where a UK resident company made a distribution to its shareholders, it was required to make payment of advance corporation tax (ACT), expressed as a proportion of the distribution. Any ACT paid by a company in an accounting period would, subject to certain restrictions, reduce the amount of any corporation tax due by the company on its UK profits in that period, or, if it had insufficient UK profits in that period, against tax on UK profits in subsequent periods. In effect, the distributing company made an interest free loan for what might be a considerable period to the Inland Revenue. Distributions between UK companies who were members of a group could be made, on election, free of ACT.[25] Income under a group income election had certain disadvantages for the receiving company if the receiving company was itself making payment of dividends,[26] but it relieved the paying company of the cash flow disadvantages of paying ACT.

The receipt of a distribution from a UK company

Turning to the position of the recipient, dividends received from a UK company were, in the hands of another UK company, grossed up to reflect the ACT paid and treated as franked investment income (FII). FII was not taxed in the hands of that company, but it is important to note that except in limited circumstances, the tax credit representing the ACT could not be repaid. The advantage of being in receipt of FII from the recipient's point of view was that the distribution could be passed on by the recipient company without further payment of ACT. In effect, the first time

25 TA 1988 s.247. There are various tax reliefs available to groups, and the definition of group can vary according to relief claimed. Here it broadly means a parent and its 51% subsidiaries.

26 For the treatment of distributions in the hands of the receiving company, see the next section.

profits leave the UK company, ACT is accounted for, and these profits can subsequently be circulated within the corporate sector without any further liability to account either for tax on those profits, or for ACT when the profits are eventually passed on to the investor.

Now, as noted above, any ACT which was actually paid by the company could, subject to restrictions, be set off against the company's corporation tax liability at the end of the day. If the company distributed "franked" income, it had no ACT to pay on that distribution (it had already been paid by the company who originally distributed the profits), but neither would there be any reduction in the final corporation tax bill. In other words, the receipt of FII had no effect on the overall tax bill and only provided a cash flow advantage.

In contrast, in relation to dividends received by non-corporate UK resident shareholders, including pension funds, a distribution from a UK company, except a foreign income distribution (FID), came with a fully fledged tax credit, and could be in appropriate circumstances repaid to shareholders. The tax credit attached to the distribution was not explicitly linked to the amount of ACT paid on the distribution, but was set at a rate which reflected the rate of ACT.

There is a further, less obvious feature of FII which is relevant to the case in hand. Where a UK resident company's FII exceeded franked payments (distributions plus the tax credit) in its accounting period, there came into existence something known as surplus FII. Generally this was used to make ACT free distributions in subsequent accounting periods, but where the company had certain losses, these could be set against surplus FII and the tax credit in the FII paid out to the company. This was reversed in subsequent accounting periods when dividends and ACT were paid, and the losses revived.[27] The concept of FII was limited to UK resident companies.[28]

Where a non-resident company receives a distribution from a UK company, the effect of FA 1995 s.128 is that the only tax on the distribution is that deducted at source. Except as provided for under a double taxation treaty, the tax credit available to resident shareholders was not repayable to a corporate non resident, and no withholding tax was imposed.

27 In effect, the ACT paid to the company was treated as "repaid" when the company paid the ACT on its next distributions instead of using the surplus FII to frank them.

28 TA 1988 s.238(1).

The restriction of the group income election to resident companies

We are now in a position to consider the first question addressed to the ECJ, which is whether the restriction of a group income election to income payable to another UK company constituted a breach of the Treaty. As it is considered that the only relevant point of distinction between the articles on the freedom of movement of capital and that of establishment in this context is that provided by Art. 58.1, discussed earlier, the restriction is discussed in relation to Art. 43 rather than Art. 56.

As a preliminary point, one must consider whether there is a treaty freedom at issue here. In order to show that there has been a restriction imposed on a treaty freedom, the taxpayer must show that it has in fact exercised a treaty freedom. Discriminatory treatment of its own nationals by a state, whilst undesirable, is not prohibited under the Treaty freedoms[29]. On the face of it, here we have a UK company complaining of discrimination under UK legislation, and so the matter is entirely internal[30]. It was however made clear in *Halliburton*[31] that it is not just the position of the legal entity which actually pays the tax which has to be considered. *Halliburton* concerned a group type relief from property transfer tax in relation to transactions between group members. Property in the Netherlands was transferred from one group member (non-resident) to another (resident in the Netherlands). Had both companies been resident in the Netherlands, relief on transfer tax on the property would have been available under domestic law. The fact that such relief was denied under Dutch law because of the non-residence of the transferor was held to be a restriction of the freedom of establishment. In that case it was unsuccessfully argued by the member state that as it was the resident purchaser who accounted for the tax on the transfer, the matter was entirely internal. However, the fact that tax had to be paid was regarded as likely to affect the non-resident's decision to acquire property in the state. It was suggested that the tax to be paid by the purchaser could have had an effect on the price received by the non-resident, and as such is reflected in the cost of disposal, and obstacles to disposal fall within the scope of what is now Art. 43.

By analogy, if greater ongoing tax costs are faced by a subsidiary in the present case just because the subsidiary has a non-resident parent, this affects the competitiveness of the subsidiary and this constitutes an obstacle to establishment in that state by a

29 Case C-112/91 *Werner v Finanzamt Aachen-Innenstadt* [1993] ECR I-449.

30 This argument was raised by the member state in Case C-1/93 *Halliburton Services BV v Staatssecretaris van Financien* [1994] ECR I-1137, but not by the UK in Case C-264/96 *ICI v Colmer* [1998] ECR I-4695.

31 *Op cit.*

non-resident parent. So the ECJ are unlikely to find that this question relates to a purely internal matter.

If one stops simply at the effect of the denial of the group income election on the paying company, then it is clear that it has been disadvantaged in comparison to a UK subsidiary of a UK parent. It is useful to be clear on the type of disadvantage claimed here. Broadly, cases involving freedom of establishment fall into one of two groups. The first, and more common to date, is where a non-resident can point enviously to a resident's tax reliefs and claims discrimination[32]. The other, and the one into which the current cases fall, is where a resident has been disadvantaged in comparison to another resident simply because it has a non-resident connection[33]. The resident/resident comparison has arisen rather less frequently in the case law of the ECJ than the resident/non-resident comparison, and where it has, the decisions tended to be framed in the language of *restriction* rather than discrimination[34]. This is probably because in order to come within the scope of the Treaty freedoms, it has to be shown that these freedoms are being exercised. So, in order for a resident to show that there has been a restriction on the freedom of establishment, a further factor must be brought into account, and this will usually be the existence of a non-resident whose freedom is being restricted in some way. The fact that the argument must be based on restriction rather than discrimination makes the argument less defined. Discrimination under Community law involves the application of different rules to comparable situations or the application of the same rule to differing situations[35]. So in cases of discrimination, the issue is one of identifying the comparable situation. Although this is a troublesome task, as the discussion in the next section shows, at least the question is clear. In relation to restrictions, virtually any tax difference between two member states (the fact that it is written in another language?) can be regarded as a restriction to trade, and the case law is relatively undeveloped on how one is to identify a *relevant* restriction.

The restriction which can be claimed by the subsidiaries is similar to that identified by the Advocate General in *ICI v Colmer*, namely that "the legislation at issue limits,

32 As was the case in *Avoir Fiscal*, Case C-330/91, *R v IRC ex p Commerzbank* [1993] ECR I-4017, Case C-311/97 *Royal Bank of Scotland plc v Ellinko Dimosio* judgment delivered 29th April 1999, Case C-307/97 *Compagnie de Saint-Gobain v Finanzamt Aachen-Innenstadt,* [1999] ECR-I 2651.

33 E.g, *Halliburton, Colmer.*

34 Farmer expands on the development of the "restriction" based approach in "EC law and double taxation agreements" ECTJ 3/3 [1999] 137.

35 Case C-279/93 *Finanzamt Koln-Altstadt v Schumacker* [1995] ECR I-225.

or at least discourages, the exercise by British companies of the right to create corporate structures in other member states".[36] Turn this round slightly by substituting "non-UK" for "British", and "UK" for "other member states" and, without leaving the scope of the freedom granted by Art. 43, the restriction in this case has been hit on the head.

However, the finding of a restriction in *Colmer*, where a group election was again at issue,[37] was made easier by the fact that the relief was denied in relation to two UK members of a consortium, whose only sin was to have a holding company whose business may not have consisted wholly or mainly of companies established in the UK. There is a difference here, and that is the activity in relation to which relief is claimed is one between a resident subsidiary and its non-resident parent. In this respect, the case of *Halliburton*, discussed above, may cast some light.

However, there is also an important distinction between the taxable event in *Halliburton* and those in *Hoechst* and *Metallgesellschaft*. The tax in *Halliburton* was a property tax and was levied once. In the present case, the question of tax arises twice in respect of the same transaction: the treatment in the hands of the payer, and the treatment in the hands of the recipient, and the extent to which the *overall* tax treatment can be taken into account which is the most difficult question to address.

The focus of recent case law has been relatively narrow, dealing rather with the particular tax disadvantage alleged rather than the global picture[38], and if this is continued, it would appear that there is a restriction on the freedom of establishment in the *Hoechst* and *Metallgesellschaft* cases[39]. As noted at the beginning of this section, looking only at the UK subsidiary, it is clear that it has been denied access to relief to which a similar company with a UK parent would have been entitled.

Even taking into account the wider picture,[40] whilst the conclusion becomes less clear cut, taking the view of ACT as a prepayment of corporation tax which will, in the normal run of things normally be payable eventually by the company making a

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36 *Op cit* n. 30 at para 16.

37 Although in this case concerning intra-group transfer of losses under TA 1988 ss.402, 413.

38 The distinction between a resident and a non-resident for tax purposes is considered in more detail at pp 31-37.

39 See Oliver *op cit*.

40 See the next section for a discussion of the justifications.

distribution,[41] it is suggested that the conclusion of the Court would still be that the restriction is a breach of Art. 43.

EC jurisprudence on justifications for a breach of Article 43

In the event that the ECJ does find that the denial of group relief is a breach of the freedom articles, the question arises as to whether the discrimination can be justified. Before turning to a consideration of potential justifications in this particular case, it is useful to briefly rehearse the law in this area.

Although the treaty article on the freedom of establishment permits special treatment of foreign nationals only on grounds of public policy, public security or public health, it has been established that these narrow restrictions only apply where the discrimination is directly on the ground of nationality. Discrimination on the ground of residence is indirect discrimination,[42] and in cases of indirect discrimination, the ECJ appears to have accepted that the state should be given a wider range of justifications for restrictions on the freedoms, based on arguments of public interest[43]. Before proceeding to consider the extended justifications, it is interesting to pause for a moment and consider whether the discriminatory treatment of companies is direct or indirect. In cases concerning individuals, it appears to have been decided that the discrimination on the basis of residence was indirect, which is appropriate given the clear distinction between residence and nationality in relation to individuals.[44] However, it was assumed in *Avoir Fiscal* that the discrimination in the treatment of a company's permanent establishment was direct, and this might be justified by reference to the fact that companies do not have nationality,[45] except in so far as this is given for particular purposes, and by the clear association in Art. 43 between nationality and residence in relation to companies.[46] This would however mean that any justifications would be limited to the narrow range listed above, and

41 The nature of ACT is ambiguous - it shares characteristics of a prepayment of corporation tax, but also is in other ways like a prepayment of personal tax.

42 Case C-152/73 *Sotgiu v Deutsche Bundepost* [1974] ECR 153, Case C-175-88 *Biehl v Administration des contributions* [1990] ECR I-1779, *Commerzbank*.

43 Case C-120/79 *Cassis de Dijon* [1979] ECR 649.

44 *Biehl*.

45 They do however have a domicile.

46 This argument is pursued more fully in Richardson op cit n.5 at 304 et seq.

would exclude the arguments based on public interest. In subsequent cases[47] the court has been prepared to at least give consideration to justifications based on public interest, and so to afford the member states the same range of justifications in relation to companies as to individuals, which seems only sensible. Given this subsequent string of cases, it would be unlikely that the court would now adopt a more restrictive approach.

The range of justifications which can be made is not closed, but broadly the restriction must be in the public interest, which must outweigh the treaty freedom, and must be proportional to the effect which it is attempted to achieve.

Arguments which have failed as justifications for tax restrictions are legion, as economic justifications for the breach of treaty freedoms are in general not acceptable.[48] One argument which will not justify the breach of Art. 43 is the suggestion that had the foreign parent set up in the UK through a permanent establishment it could have avoided the problem of ACT. A company has the right to choose the form in which it exercises its right of establishment.[49]

The only argument which has met with any success in the past has been the cohesion argument, namely that the discrimination is necessary for the cohesion (or coherence) of the tax system. It is not intended to rehearse this argument in detail as this has been done elsewhere.[50] In brief, in *Bachmann*, the restriction of insurance deductions to a resident insurance company was held to be justifiable because of the existence of a close relationship between the deduction of the pension contribution, and the taxation of the eventual pension. In subsequent cases, general arguments based on loss of tax revenue, or other advantages given to the taxpayer

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47 *Commerzbank*, *Halliburton*, *Colmer*, *Saint Gobain.*

48 Arguments which have failed include administrative difficulties cause by the involvement with other tax jurisdictions *(Bachmann*, *Halliburton*), that double taxation agreements fix the discrimination *(Avoir Fiscal)*, the need to prevent tax loss: (*Avoir Fiscal, Biehl, Denkavit)*; to prevent tax avoidance (*Colmer*), the fact that the entity discriminated against gained other tax benefits by virtue of its non-resident status (*Avoir Fiscal, Commerzbank*).

49 *Avoir Fiscal.*

50 Quaghebeur " A bridge over muddled waters - coherence in the case law of the Court of Justice of the European Communities relating to discrimination against non-resident taxpayers" ECTJ 1/2 [1995/96]109, Hinnekens "Non-discrimination in EC Income Tax Law: Painting in the colours of a chameleon like principle" European Taxation 1996 p 286, Wattel "The EC Court's attempts to reconcile the Treaty Freedoms with International Tax Law", CML Rev 1996 p 223, Vanistendael "The consequences of *Schumacker* and *Wielockx*: two steps forward in the tax procession of Echternach" CML Rev 1996 p 255.

which offset the disadvantages have failed[51]. Moreover, in *Wielockx*[52], a subsequent case with marked similarities to *Bachmann*, the coherence argument was significantly restricted as the Court looked not only at the state's domestic tax law, but also took into account its double tax treaties, and found that by seeking to achieve coherence through its treaties, it could no longer seek to justify restrictive provisions in its domestic law.

As well as coherence, the Court has also held that "the effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying a restriction on the exercise of fundamental freedoms"[53], although this has had little impact in tax cases. The view of the Court has been that effective fiscal supervision is generally attainable by other more proportionate means. For example, if a member state wants information from other member states on the tax position of a taxpayer, the use of the Mutual Assistance Directive[54] is the appropriate means[55]. In *Futura*, the requirement of effective fiscal supervision was considered in the context of identification of the losses of a permanent establishment located there. Whilst accepting the justification, the court found that the account keeping requirements imposed by Luxembourg were excessive.[56] So, the principle of effectiveness of fiscal supervision would not appear to be a justification which would feature in the cases under consideration.

Accordingly, the current position on justifications is that it appears that it is only the coherence of the tax system which can be argued in this case, and then only to the extent that coherence has not been achieved through the treaty system.

Is restriction of the group income election necessary for the coherence of UK law?

Turning to the relief under consideration, what justification can be made for denying the group election where the payment is to a non-resident company? Bearing in mind the nature of ACT as a prepayment of corporation tax, the difference is more

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51 E.g. *Commerzbank*.

52 Case C-80/94 *Wielockx v Inspecteur der directe belastingen* [1995] ECR I-2493.

53 *Futura* op cit n 4. See also *Cassis de Dijon*, *Bachmann*.

54 Council Directive 77/799/EEC (OJ 1977 L 336 p 15).

55 E.g *Bachmann*.

56 It was also held that the Luxembourg Government did not have to accept an apportionment of the parent's total losses, neither did they have to apply the same basis as the resident state for the calculation of the loss.

one of timing than amount of tax collected. Without the election, the UK collects tax at the time of payment of the dividend. With the election, the UK collects it with the rest of the tax on the paying company's profits (there is no ACT to reduce the corporation tax bill of the paying company). This is not to say the Government is indifferent to the fact of payment of ACT (it is paid earlier, and surplus ACT *does* arise), but rather that it would be surprising if, from the point of view of the paying company, it was regarded as necessary for the coherence of the UK tax system.

Following the payment through to the recipient, in the absence of a group income election a UK company (1) may distribute the payment without further ACT and (2) may not in general reclaim the ACT. With a group income election in effect, the UK recipient must account for any ACT when it passes on the distribution it received to its own shareholders. The foreign company on the other hand (1) may not be able to distribute without further tax, and (2) may under a double taxation agreement be able to reclaim at least some UK tax.

So, one argument for restricting the election to payments between UK companies is that if the recipient is non-UK resident, the UK will neither collect ACT when the distribution is made, neither will it be able to collect it when the distribution is passed out of the recipient company. Again, however, this is only a timing issue. If ACT is collected from the UK recipient on subsequent distribution, a matching amount of UK corporation tax will be, at the end of the day, foregone: the UK recipient company's tax bill is reduced by the ACT. The fact of ACT does not in theory increase or decrease government revenue and so it is not a matter of particular importance that the UK cannot collect ACT on distributions from the non-UK resident recipient.

Given the demise of the ACT system in the UK, it is perhaps indulgent to speculate as to how the international group income election might have worked, but it is likely that an attempt would have been made to remove the right of repayment of the ACT credit normally available to certain foreign shareholders under double taxation agreements in relation to dividends paid under such an election. If this were the case, ironically the extension of the election in relation to transfers to a non -resident would have the effect of *increasing* UK tax in relation to dividends payable under the election, as the ACT would not be repayable.

So, it appears that no justification of the restriction of availability of the group income election on the grounds of cohesion can be made.

What if the ECJ finds against the UK in the first question?

So, if the ECJ shares the view reached here that the restriction of the group income election to distributions between resident companies is an unjustified breach of the freedom of establishment, where does it leave the questions raised by the parents concerning the denial of the ACT credit? The first argument, based on the denial of the ACT credit in comparison with other UK parents, relies on ACT having been paid, and this would not have been the case had the group income election been available and made. This does not render the parents' case irrelevant as the companies could have chosen *not* to pay dividends under the election. The answer is also important, although not directly in point in this case, in the case where payments were made between companies who did not satisfy the definition of a group for the purposes of the election.

The second argument of the parents, based on denial of the tax credit under treaty, also has continued relevance. First, as pointed out above, the companies could have chosen not to have taken advantage of the election. However there is also an argument that even if no ACT was paid, the recipient company would, without adjustment to the UK's tax treaties, still be able to reclaim the credit. This is because a tax credit available under treaty is not linked to the underlying payment of ACT, but is stated as being the tax credit which would have been available had a resident individual received the dividend. The argument becomes a little sticky here because individuals could not receive distributions under a group income election, and so there was no provision in UK tax law governing the tax credit in that event.

Under the post 1999 regime, tax credits continue to be available under treaty despite the abolition of ACT, but this is because they are equally available to UK resident individuals.

It is hoped that the ECJ does not decline to deal with the other issues raised on the basis of the answer to the first question, as an opportunity for much needed clarification of the law will have been missed.

The denial of the tax credit to non-resident parents in comparison with resident companies

Is there a breach of Art. 43?

The claim of the parent companies is that it is a breach of the freedom of establishment for a tax credit to be given under UK national law to residents which was not available to non-residents. In order to establish such a breach, it must be shown that the treatment was discriminatory or in other ways provided a restriction on the freedom of establishment. It would seem from the framing of the questions to the ECJ that the arguments in this case will proceed on the basis of discrimination, rather than on any more general restriction on the freedom of establishment. Discrimination under Community law involves the application of different rules to comparable situations or the application of the same rule to differing situations[57]. So, for discrimination to be established here, the parent companies must show that they were subject to different rules in comparison with resident parents, and in a comparable situation.

Does the denial of the credit disadvantage the non-resident parent?

Before we turn to the question of comparability, we have to consider whether the rules were in fact different in a significant way. Section 231(1) TA 1988 was, and still is, on the face of it, discriminatory as it provides that UK residents only will receive a tax credit on a distribution from a UK company[58]. It was noted earlier that this credit can be used by a company in only two ways: to facilitate the payment of distributions without paying ACT, and to be temporarily released against certain UK losses.

In relation to the first of these, to frank the payment of UK dividends, because a non-resident parent is not required to account for UK ACT on its distributions, it is suggested that it is not being put in a worse (different) position in comparison to its UK counterpart on this account.

Although the question put to the ECJ by the Chancery Division does not raise the issue, could the parents have claimed discrimination in comparison with a UK resident individual who *would* have been able to claim a tax credit? The answer is almost certainly no as it is an accepted principle of tax law that companies are subject to separate tax rules, in general being charged at different rates of tax and being eligible for different reliefs. To equate a non-resident company with an individual would at the extreme lead to the bizarre situation whereby non-resident companies could claim personal allowances and be taxed at income tax rates[59]. In passing, it could be added that there could be no claim of discrimination by a non-

57 *Schumacker*.

58 Section 231(1) is subject to various exceptions, including double taxation agreements (s. 788(3)) and non-resident individuals entitled to personal allowances (s. 232)

59 Richardson *op cit* n. 5.

resident individual, as EEA nationals are treated as UK residents for the purposes of claiming a tax credit.[60]

Although the question formulated by the Chancery Division relates to tax credits rather than the use of surplus FII, this issue is brought in indirectly as it is the tax credit element of FII which is repaid in the event of surplus FII being set against losses. As pointed out above, in limited situations the existence of surplus FII could temporarily be used to a cash flow advantage. The temporary nature of the advantage is not the issue as denial of even a temporary advantage could constitute discrimination. More relevant is the limited use to which a non-resident company could put any FII. A UK company could elect to set surplus FII only against losses generated within the UK tax system[61], and as a non-resident parent can have no such losses (unless it operates within the UK through a permanent establishment) denying this use of surplus FII to non-residents does not appear to be a disadvantage.

What if the parent had been operating in the UK through a permanent establishment?

There is no suggestion in the case under consideration that the parent operated in the UK through a permanent establishment, as well as through the subsidiary, but it is interesting to consider what arguments might have been raised in that event as this would potentially allow the non-resident to utilise the FII. The ECJ has consistently held that where a permanent establishment and the resident are otherwise in a comparable tax position, to deprive a permanent establishment of benefits which would be available to the resident is in contravention of the freedom of establishment[62]. A technical difficulty might be in identifying *surplus* FII, although as a non-resident company cannot make franked payments, all FII would presumably be surplus. The real difficulty arises when one compares the position of the non-resident and the resident in the next accounting period. As indicated above, eventually the ACT released by the claim is functionally clawed back when the resident company makes future distributions. This cannot happen in relation to a non-resident, and might well lead to the finding that the inability of the permanent establishment to make distributions is a relevant distinction between it and a resident company, which would permit the different treatment in relation to FII. The Inland

60 TA 1988 s.232

61 Such a restriction appears to be legitimate under EC law: *Ventura*.

62 *Avoir Fiscal, Royal Bank of Scotland plc, Saint Gobain*.

Revenue's view is that it is not discriminatory to refuse the surplus FII claim to non-residents.[63]

In all the cases so far considered by the ECJ on permanent establishment, the permanent establishment has been taxed on the income in question, in common with resident companies, but then has been denied relief, or been subjected to higher tax rates in respect of that income. There is a direct link between the taxation of the particular income and the discrimination. There is no similar relationship between the availability of surplus FII and the existence of a loss - they inevitably arise separately. Whether this would constitute a relevant difference would have to be tested, but it would seem that if the ECJ is genuinely seeking to put the permanent establishment in the same position as the resident, the permanent establishment should be entitled to the relief.

Returning to the case under consideration, if the company seeks to argue that it is put in a worse position than the UK company because, when it makes its own distributions, it has to account for some equivalent of ACT with no allowance for ACT paid, then this would represent a very significant extension of the argument. It is at this point that the issue of identifying whether there is different treatment shades into the issue of comparable situations, or when is it legitimate to treat a resident differently from a non-resident, and it is to this question we now turn.

When is it legitimate to differentiate between residents and non-residents for tax purposes?

There is a ritual incantation by member states in most of the cases on freedom of establishment and freedom of movement of workers that non-residents are different from residents and therefore it is legitimate to treat them differently. Although this incantation is also frequently intoned by the ECJ, in practice this principle has been accepted more clearly in relation to the tax treatment of individuals[64] than in relation to companies, and it is important to attempt to work out why.

63 SP 2/95. This appears to be on the basis that it doesn't fit: the relief is "part of the way in which UK companies and their shareholders are taxed, including the obligation to pay ACT in respect of distributions made by a UK company and the treatment of franked payments, neither of which extends to non-resident companies."

64 Although this has been accepted as a principle, in the case law on the freedom of movement of workers and the self employed, the non-resident has so far managed to establish that he is in fact in a comparable position to the resident, and has been entitled to resident's reliefs: *Schumacker*, *Wielockz* and Case C-107/94 *Asscher v Staatssecretaris van Financien* [1996] ECR I-3089.

The question appears to hinge on the extent to which one is entitled to take into account the treatment of the taxpayer in a third country, usually his country of residence, when determining whether a member state has acted in a discriminatory fashion. On the face of it, this seems an odd question. It is the tax law of a particular member state which is under review. How can the same tax law be discriminatory or not depending on the treatment of the taxpayer by another member state? Is this not giving the foreign legislator power to establish or eliminate conformity of a member state's national law with EC law?[65] This is only partially answered by the response that the issue is not whether the tax law of a member state is discriminatory in general, but whether it discriminates against a particular taxpayer. The question is one of focus. When assessing discrimination, how many characteristics of a non-resident and a resident have to match before one has a "comparable situation"? The main issue is whether one compares taxpayers simply from the point of view of the tax system of the member state in question, or whether one can take into account the global tax picture.

The main point of alleged difference between a resident and a non-resident is the so-called universal tax principle that a state taxes its residents on their world-wide income whereas non-residents are taxed only on income from a source in that state. In all but one of the cases concerning companies where the argument has been put forward by the member state that it is entitled to treat the non-resident differently from a resident because it is different, the ECJ has adopted a narrow focus, and has asked, is there a relevant difference in relation to the *particular tax rule*.[66] All that had to match was that both the non-resident and the resident were liable for tax on that income, and then the non-resident faced discrimination either through being denied a relief, or being subjected to a higher rate of tax. The fact that the permanent establishment received different (usually advantageous) treatment in other areas was not regarded as relevant. In its most recent judgment however, *Saint Gobain*,[67] the ECJ ventured into new territory by evaluating the assertion that residents are different because they face unlimited tax liability whilst non-residents are subject to limited liability. The case concerned the taxation of a permanent establishment of a French company in Germany, and whether it was entitled to certain reliefs which a domestic company would have received in respect of holdings of shares in third countries, and the receipt of income therefrom. Using first the narrow approach, the ECJ decided that in relation to the taxation of foreign share-

65 As pointed out by Lang "The Binding Effect of the EC Fundamental Freedoms on Tax Treaties" in Gassner et al (eds) Tax Treaties and EC Law" at p 27.

66 *Avoir Fiscal, Commerzbank, Royal Bank of Scotland plc.*

67 *Op cit* n 32.

holdings and foreign dividends, a permanent establishment and a resident company were in objectively comparable situations. Accordingly they should be treated the same. The ECJ might have stopped there, but it then proceeded to address the argument on world-wide/source liability, and revealed that like many principles, it was evident more in its breach than its observance. In fact, it was demonstrated that in Germany, where the permanent establishment was situated, certain treaties provided that distributions from overseas companies received by resident companies were exempt from tax whilst permanent establishments were taxed on similar income. In other words, non-residents were being taxed on a wider range of income than residents! As a result, the court was not persuaded that the two entities should receive different tax treatment in respect of the shareholdings and foreign income, the same conclusion as was reached adopting the narrow approach. What is significant is the fact that this question was addressed at all, as it widens the object of enquiry beyond the taxation by *one* state of *one* particular slice of income for the first time in the context of companies. The wider focus has already been adopted in the context of individuals, to which we now turn.

In the context of individuals, the ECJ appears to have accepted that it is legitimate in certain respects to afford different tax treatment to residents and non-residents where they are different, but the matching of characteristics has extended beyond merely asking whether both are liable to tax on that income in the state of source. It has been held that it is not legitimate for a state to deny personal reliefs to a non-resident where that person has insufficient income in the state of residence to gain the advantage of the reliefs there. It is by implication legitimate generally to deny non-residents such reliefs as they are normally granted by the state of residence, being the best jurisdiction to assess entitlement.[68] The justification was expressed in the following terms by the Court in *Schumacker:*

> "Income received in the territory of a member state by a non-resident is in most cases only a part of his total income, which is concentrated at his place of residence. Moreover, a non-resident's personal ability to pay tax, determined by reference to his aggregate income and his personal and family circumstances, is more easy to assess at the place where his personal and financial interests are centred. In general, that is the place where he had his usual abode. Accordingly, international tax law, and in particular the model double taxation treaty of the OECD, recognises that in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the state of residence.

68 *Schumacker, Wielockx, Asscher.*

> The situation of a resident is different in so far as the major part of his income is normally concentrated in the state of residence, Moreover, that state generally has available all the information needed to assess the taxpayer's overall ability to pay, taking account of his personal and family circumstances."[69]

Subsequently, in *Wielockx*, the ECJ observed

> "If a non-resident taxpayer is not given the same tax treatment as regards deductions from his taxable income as a resident, his personal situation will be taken into account neither by the tax authorities of the State where he works - because he is not resident there- nor by the State of residence - because he receives no income there. Consequently, his overall tax burden will be greater and he will be at a disadvantage compared to a resident".[70]

These two extracts seem to approach the issue from slightly different angles. The first, by making reference to the ability to pay and family circumstances, seems to be concerned with issues of equity and progressivity. To this extent, it does not obviously transmit to the taxation of companies. Whilst the second extract contains an echo of this, it is also concerned with the question of discrimination by over-taxation. This obviously does transmit to companies. What is especially important in the latter quote is the reference to the overall tax burden which, by bringing into account the amount of tax paid in *another* state, here the state of residence, opens up considerably the object of enquiry.

Why the difference in approach? Two possibilities are suggested here, and neither turn on the fact that in one case the taxpayer is a company and in the other an individual. The first possible reason is that in general, the rule that residents get personal allowances and reliefs in the state of residence is much more reliably observed than the world-wide/source tax liability, and so account must be taken of it. However, the fact that the taxing state must also take account of the level of the particular taxpayer's income in his state of residence, suggests that it is not observance of a general principle which justifies the distinction. The rule is not just that the state of source is not required to give personal reliefs. There is a qualification to be added, which is "except where the individual has insufficient income in the state of residence." This requires the tailoring of the tax system to the precise requirements of the taxpayer, which is exactly the opposite of the observance of a general principle.

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69 At paras 31 - 33.

70 At para 20.

Perhaps a better explanation for the difference in approach can be found in the nature of the tax treatment which is alleged to be discriminatory, rather than in the characteristics of the taxpayer. In relation to companies, the reliefs wrongfully denied to non-residents have been specific to particular sources of income, capital or transaction: tax credits attached to dividends,[71] exemption of overseas dividends or share capital[72], a repayment supplement on overpaid tax,[73] relief from property transfer tax[74], group relief.[75] Such reliefs have been described as "income related tax benefits" (obviously, in light of the list above, extending beyond income but still specific to transactions) in contrast to "person related benefits".[76] Non-resident individuals have been given the same advantages as residents where the tax benefit in question is limited rather than global,[77] thus confirming that it is not the difference between companies and individuals per se which forms the dividing line.

The difference between reliefs which apply to particular sources of income or transactions, and personal reliefs is that the latter are related to the personal characteristics of the taxpayer, including levels of world-wide income.[78] It is therefore entirely appropriate to take a wider range of factors into account. There is however a further factor which would justify taking into account the position in the state of residence in relation to such reliefs: this is that the taxpayer by virtue of *an absence of income* would not have been able to get relief. This is an important point: the relief is denied not because the state of residence rules prevent it but because the taxpayer's situation is such as to deny relief. So, the rule has been

71 *Avoir Fiscal, Saint Gobain.*

72 *Saint Gobain.*

73 *Commerzbank.*

74 *Halliburton.*

75 *Colmer.* Although the transfer in this case was between two residents, and so was not directly a case on discrimination.

76 Terra and Wattel *op cit* n.23 at p 33.

77 E.g. *Biehl op cit*, where the discrimination was the denial of repayment of overpaid tax to a non-resident.

78 I still have some concern about the Advocate General's view in *Wielockx* that, had the non-resident had sufficient income in his state of residence, the taxing state would have been legitimately entitled to prevent the deduction of pension contributions from his profits in that state. It is at least arguable that these contributions, which were a proportion of profits, were income related rather than person related. See also Wattel *op cit* note 50 at p 250.

developed that where the state of residence is not able to give reliefs, the state of source must.

The danger with looking at the global tax bill in every situation is that the approach becomes impossibly subjective and imposes an obligation on the state to investigate how every non-resident is taxed in his country of residence and to adjust its tax treatment accordingly. However, if the above analysis is correct, it is simply the case that the global tax bill will be taken into account only where the treatment relates to income as a whole, and the state of residence *cannot* give relief. The application of the global approach is then narrowed considerably, as very few tax rules affecting companies rely on the company's global characteristics. This suggests that it will be extremely difficult for a member state to defend differences in the taxation of companies on the basis of whether they are resident or non-resident

Turning to the application of the above rules to the *Hoechst* and *Metallgesellschaft* cases, it is evident that new ground will have to be broken. The cases considered so far by the ECJ have involved one or other of two situations:

(i) a non-resident with a taxable presence in the taxing state through a permanent establishment, and

(ii) a resident company which is taxed more harshly than another resident because of its international connections.

The present case fits neither; it is one of the taxation of cross border income.

On the narrow view, i.e. looking just at UK taxation, if a non-resident is in a comparable situation to a resident if they *both* suffer tax in relation to a particular source of income, presumably they are still in a comparable situation if *neither* are taxed on that income. As discussed above, it is difficult to demonstrate that there is an effective difference between the UK taxation of dividends in the hands of a resident or non-resident parent. Taking the narrow view therefore, we find a comparable situation which receives similar treatment. The non-resident parent is not significantly disadvantaged by being denied the ACT tax credit.

It is only when the wider view is taken, namely that the income may well be taxable again in the parents' state of residence, or may have to bear the equivalent of ACT on subsequent distribution with no allowance, that we simultaneously move into a situation in which the companies become *not* comparable, *and* face unequal treatment.

It is suggested that these additional tax burdens arise not because of discriminatory treatment by any individual tax jurisdiction but as a result of the interaction of two different tax systems and this goes to the very heart of international taxation. The imperfect and incomplete treaty network and unsettled nature of international tax principles means that there is always a risk of under- or double taxation, especially with integrated systems of corporate taxation predominating in Europe. It has recently been confirmed that is entirely acceptable for member states to come to arrangements about the *allocation* of income to a tax jurisdiction, even if as a result, certain non-residents are paying more tax than others.[79] The ECJ has also recently affirmed allegiance to the "fiscal principle of territoriality" in a different context, confirming that it is entirely acceptable for a member state to limit loss relief to losses from activities within the jurisdiction.[80] Furthermore, each member state continues to have the right to determine the base of tax.[81] However, none of these decisions address the broader issues of the potential double taxation of cross border income.

The tentative view taken here is that the Court will take the narrow view, and judge the taxation of the income from the point of view of the United Kingdom only. On that basis, non-resident companies should be treated in the same way as residents. However, it is further suggested that even though on the face of it, the denial of an ACT credit in relation to payments to a non-resident parent appears to be discriminatory, on closer examination of the nature of the credit, the non-resident actually suffers little disadvantage. It would be a significant extension of the case law developed in relation to individuals for the ECJ to accept that it is legitimate to take into account subsequent treatment of the income in question in the hands of the company by the tax system of the state of residence.

Is any difference in treatment justified?

If the conclusion above is wrong, and there is discriminatory treatment, the question of justification will undoubtedly be raised. The restrictive nature of the arguments which have been accepted as justifications for breach of the freedoms have been discussed already. In order for the Court to decide that there has been discriminatory treatment, it must have widened the approach to include the treatment of the income in the hands of the non-resident parent, but it is not clear how one can take this into account when discussing the coherence of a particular tax system.

79 Case C 336/96 *Gilly v Directeur des Services Fiscaux du Bas-Rhin* [1998] ECR I-2793, [1998] STC 1014.

80 *Futura.*

81 *Futura.*

So, based on the above discussion on discrimination, either there is no discrimination, in which case no justification is required, or, taking into account the tax treatment of the parent, there is discrimination, but this cannot be justified by reference to coherence of the domestic tax system.

The effect of the existence of a more favourable double taxation agreement

The implications of the final question

The final question concerns the practice of offering certain EU treaty partners treaty benefits which are not available to all. Whilst the abolition of ACT means that the specific answers to the other issues raised here have become of historical interest to the UK, the right to claim a treaty credit is not dependent on ACT. The UK treaty system usually extends repayment of the credit to foreign investors - a half credit for corporate direct investors and a full credit to corporate portfolio investors and individual shareholders. At the relevant point, the UK Germany double taxation agreement did not provide for a repayment to the parent companies, in contrast to certain other agreements with other member states. Although in the UK there are still variations in the rights to repayment as between treaty partners, the value of the repayment is now very small after the reduction of the credit to one ninth of the (net) dividend, and after withholding tax.[82] However, the question goes far beyond the implications for non-resident owners of UK companies. It concerns all provisions in all EC treaties and for the ECJ to find against the member state would represent the most powerful or destructive (depending on viewpoint) tax decision issued by the ECJ to date.

The relationship between double taxation agreements and EC law

First, to sketch in the background. An important preliminary point to make is that member states are bound to observe the principles of EC law through both their national legislation and their tax treaties. Treaty freedoms cannot be made conditional on bi- or multilateral taxation agreements.[83] Although the Court has shown itself sensitive to the issue of the status of double taxation agreements, especially in *Wielockx* and *Gilly*, where frequent reference was made to the OECD

82 Assuming a withholding tax of 5% and half a tax credit, on a dividend of 90, the tax credit is 5. A 5% withholding tax on 95 is 4.75. There will be a repayment of 0.25, or 0.28% of the dividend.

83 *Avoir Fiscal*, *Schumacker*, *Saint Gobain*.

Model Treaty, it seems unlikely that any special treatment would be given to a double taxation agreement just because it is a treaty rather than domestic legislation.[84]

The issue raised under the third question again breaks new ground. Although the Court has discussed double taxation agreements before in various contexts, the issue as to whether it is permissible for a member state to give advantageous treaty benefits to residents of one or more member states has not yet been directly addressed by the Court[85]. It has however exercised academic commentators. Some have concluded that such treatment is required,[86] some that it is not,[87] whilst others are undecided. It is fair to say that the answer is not clear cut. Again, it is unnecessary here to rehearse these arguments in detail and a summary of the main points put by the commentators follows. Consideration will then be given to recent case law to what, if any, further light has been cast.

The debate has been conducted on two broad levels: sometimes the issue has been whether in terms of *policy* a European most favoured nation (MFN) clause would be useful, and whilst others have engaged in argument through examination of the legal issues.

At a policy level, there are those who argue that the disturbance caused by the application of a MFN clause throughout the EC would cause chaos[88]. In the words of Hinnekens:[89]

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84 Lang "The Binding Effects of the EC Fundamental Freedoms on Tax Treaties " in Gassner et al (eds) Tax Treaties and EC Law.

85 In the case in which this exact question was asked by the national court, the question was not answered by the ECJ: *Schumacker*. A broader question in *Werner* could have, but did not, generate an answer.

86 The ayes, with different degrees of certainty include Farmer "EC Law and Direct Taxation - some thoughts on recent issues" ECTJ 1/2 [1995/6[91, Radler "MFN clause in European tax law?" 1995 EC Tax Review 66, Gammie and Brannan (op cit), Schuch "Will EC law transform tax treaties into MFN clauses?" in Gassner et al (eds) Tax Treaties and EC law and Schuch "EC Law requires multilateral tax treaty" 1988 EC Tax Review 29.

87 The nos include Wattel (*op cit*) note 50, Hinnekens "Compatibility of Bilateral Tax Treaties with European Community Law Applications of the Rules" 1995 EC Tax Review p 202, Kemmeren "The termination of the MFN clause dispute in tax treaty law and the necessity of a Euro Model Convention" 1997 EC Tax Review 146, Richardson *op cit*.

88 E.g. Vanistendael.

89 *Op cit* note 87 at p 210.

> "Is it plausible that so many tax treaty privileges (is it thirty? forty?), promised in hundreds of tax treaties, negotiated by 15 Member States in a strictly bilateral perspective, consistently applied by them without multilateralized effects in almost forty years of EC Treaty application and without any protest or objection from the European Commission or from the European Court, are all of a sudden declared violations of that same treaty, and this for the sake of a new interpretation, which is not even the work of the pen of the founders of the Community?"

On the other hand, others believe that it is only a MFN which will give rise to a level playing field within the European Union.[90] The argument that it is necessary for member states to have the power to engage in negotiations over bilateral treaties which are designed to suit a state's own tax, budgetary and economic policies[91] is thought to be irrelevant in the context of a common market.[92]

Turning to legal arguments, some understand that the question as to whether EC law requires a MFN approach has long been decided by the ECJ - in the negative by *Bachmann*[93] and *Wielockx*[94] although in both cases the evidence is circumstantial and neither case is completely watertight.

Others believe that the answer lies in the Treaty itself; those who argue in favour of a MFN clause believe that the fundamental freedom of non-discrimination can be used to justify such an approach. If one member state discriminates between two non-residents, this falls fairly within the broad non-discrimination principle evident in the Treaty. Opponents of this view have pointed out that the right created by Article 43 "includes" the right to set up in other member states *on the same basis as that state's own nationals*. Other state's nationals are not mentioned. Arguing by analogy with reverse discrimination (discrimination against one's own nationals is not prohibited) and the non-discrimination Article in the OECD Model Tax Convention (in

90 E.g Radler *op cit*.

91 E.g Hinnekens.

92 E.g. Farmer 1995/96 *op cit*.

93 Kemmermen *op cit* (based on paragraph 26 where the court appear to say that positive integration is only possible through the treaty network, or the Council itself).

94 Wattel *op cit* (based on the evident approval of bilateral cohesion in that case).

admittedly different terms), the conclusion has been drawn that two non-residents are not appropriate comparators for the basis of Article 43.[95]

Yet another approach to view the matter to be one of constitutional competence, which means that until harmonisation is achieved at Community level by the Commission, the power to conclude tax treaties remains vested in the member state. Why otherwise does the Treaty expressly require member states to enter into negotiations with each other in order to abolish double taxation?[96] The dissenters have also gained support from the view expressed by the Commission in 1992 that EC law did not impose a requirement of equality of treatment in the context of double taxation treaties.[97]

On the evidence above, it would seem unlikely that further analysis alone is likely to find an answer which is unanimously accepted as representing the correct position. Most of the writings referred to above were published before two recent cases in which double taxation agreements were relevant, and it is to these we now turn.

First, to deal with the most recent, in *Saint Gobain*, the ECJ held that it was contrary to the freedom of establishment to deny a non-resident company operating through a permanent establishment the benefit of the country's tax treaties with third states, including non-member states[98]. In fact, this case falls squarely within the *Avoir Fiscal* principle, namely that permanent establishments cannot be discriminated against in comparison to residents where they are otherwise in the same situation. In the context of double taxation agreements, the case added little, except to reaffirm that double taxation agreements are indeed subject to the principles of the Treaty. Furthermore, the fact that one of the double taxation agreements was with a non-member state was not important: such agreements cannot be used to justify discrimination except where it is the rights of non-member states which are affected.[99]

The other recent case involving double taxation agreements was *Gilly*, and here the ECJ gives more food to legal commentators to chew. The question of the MFN

95 Richardson *op cit*.

96 Art. 293 (formerly 220).

97 Written question No 647/92 of 23rd March 1992 and answer of 9th Nov 1992. OJ 1993, C46/13.

98 Such cases are often referred to as triangular (although in fact they are L shaped).

99 Case C-121/85 *Conegate Ltd v Customs and Excise Commers* [1986] ECR 1007, C-286/86 *Ministére Public v Deserbais* [1988] ECR 4907.

treatment was not addressed by *Gilly*, so the decision provides nothing in the line of a direct answer and instead we must engage the usual extrapolation of shades of meaning from words addressed to an entirely different situation.

The issue in *Gilly* was fundamentally whether a double taxation agreement which allocated income to one or other tax jurisdiction on the basis of factors which included nationality was in breach of the freedom of movement of workers because, in this taxpayer's case, such an allocation involved her in a higher tax bill. The court held that the allocation of income between jurisdictions was a perfectly legitimate use of double taxation agreements, and the fact that she paid more tax as a result of her income being allocated to one state rather than another was a feature of the different tax schedules in the member states. The decision has received a certain amount of criticism[100], but not on the matter of its observations on double taxation agreements, the OECD Model Tax Convention and tax sovereignty, which overall, it appears the ECJ regards rather positively.[101] Although the statements are made in the context of allocation rather than the availability of tax credits, the overall tone is one of general endorsement of individually negotiated bilateral tax treaties. The case has been regarded as providing support to those who are not in favour of the introduction of an EU wide MFN clause.[102]

So, recent case law provides no more in the way of support for the adoption of the MFN clause, and by implication, supports the right of member states to enter into individually negotiated tax treaties. Even if the court decided that it could compare two non-residents, it would have to decide on what basis the comparison should be made. Obviously, adopting a narrow focus, one non-resident is discriminated against vis-a-vis another other to the extent of their tax treatment by the national tax system. If they are treated differently by tax treaties, discrimination is also present. However, if their overall tax bill is taken into account, it is not necessarily the case that the taxpayer denied the UK credit is in fact worse off. It very much depends on how the taxpayer is treated by the state of residence. If the state of residence exempts foreign income, and levies tax at a higher rate than the UK, then the company is better off not receiving a tax credit than if it received a tax credit, but was required to pay local tax.

100 Avery Jones "What is the difference between Schumacker and Gilly?" [1999] BTR 11, Hedemann-Robinson "Doubly Taxing for the European Community" [1999] BTR 128, Vogel "Some observations regarding Gilly" [1999] EC Tax Review 150.

101 Especially at paragraphs 30 - 32.

102 E.g Hughes "The Big Picture" IBFD 1998 52 p 329 ; Lehner "The *Gilly* case" IBFD 1998 52 p. 334.

Fiscal cohesion

Assuming that the ECJ does find that the use of another non-resident as a comparator is relevant, and that there is discrimination, or at least a restriction on the freedom of establishment,then the question as to how this can be defended on the basis of fiscal cohesion has to be addressed. Hinnekens has argued that the "need to safeguard the balance of essential reciprocal tax concessions, and thereby the coherence and even the continuation of the bilateral tax system itself, is a cause worthy of EC-protection under a broadened version of the *Bachmann* defence".[103] In *Wielockx*, it was accepted that a member state could achieve coherence through its treaty provisions. However, the concept of fiscal cohesion as developed in the context of the state's domestic tax system does not work in the context of its international relations.

One argument in favour of cohesion is that treaty benefits are usually only granted on a reciprocal basis. Therefore to require states to offer MFN treatment to all EU treaty partners would undermine this reciprocity. This argument has not in the past found particular favour with the ECJ,[104] and in any event, it is likely that the pattern of favour would even out as a result of the application of the MFN clause to all member states. It would only be those states who had been uniformly mean in their treaties which would benefit!

Another argument in favour of cohesion is that each treaty is negotiated in order for it to fit with the tax system of each state. The mismatch which would arise in the event of an EU wide MFN clause can only be imagined. The issue of retention of power over a negotiated tax credit is one of inter-jurisdictional equity and tax competition.[105] The equity argument is likely to be taken more seriously as a justification than the tax competition which is emphatically out of favour at the moment.[106] The difficulty with arguments based on inter-jurisdictional equity is that there is no generally accepted definition. Sometimes tax credits are granted by a source state, and the tax rights are shifted to the state of residence, and sometimes the credits are not available, and so the source state retains taxing rights. This is in fact what caused the problem in the cases under consideration. In a sense, it matters less what tax treaties determine than the fact that they make the determination, which is a pragmatic rather than a principled argument for their existence.

103 "Compatibility of bilateral tax treaties with EC Law" EC Tax Review 1995 p 206 at 214.

104 *Avoir Fiscal*.

105 Casson "International Aspects of the UK Imputation System" [1998] BTR 493.

106 E.g Code of Conduct signed by Finance Ministers at the ECOFIN Council Meeting in December 1997, also recent initiatives under the State Aid Rules.

In essence, the question is whether the ECJ would contemplate the (perhaps temporary) chaos which would follow upon a finding in favour of MFN treatment of all member states as a price worth paying for the strengthening of the internal market.

Conclusion

It is terribly difficult to predict the results of cases referred to the ECJ, and this is harder than most because there is limited case law of direct relevance, and much will depend on how the ECJ sees the policy implications ofits decision. The tentative conclusions drawn here is that the treatment of the UK resident subsidiaries is in breach of the treaty freedoms, but that the ECJ will not have to base this part of the decision on any particularly dramatic statements about EC law. Turning to the position of the foreign parents, at a technical level it is hard to see where these parents suffer a disadvantage in comparison with a UK parent. If it is decided that they do suffer a disadvantage, this will involve a fairly radical restatement of the relative positions of residents and non-residents. In relation to the final question, that of MFN treatment of all resident nationals of member states, the decision is harder to predict, but on the basis of a sensitivity shown towards international tax principles and bilateral agreements, it would be surprising if the ECJ would take the radical course. It is traditional in articles on the likely result of ECJ decisions to end with a lament that (a) matters of such importance are shrouded in so much uncertainty, and (b) that they have not been dealt with in a co-ordinated way by the Commission rather than being subject to the limitations of a case based approach. Another view is that member states get the tax regime they deserve.