

## COMMENTARY ON THE *ICI V COLMER* CASE

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This article considers the ruling of the ECJ in the *ICI v Colmer* case issued on 16th July 1998.<sup>2</sup>

### Introduction

The case had been referred to the ECJ by the House of Lords in July 1996<sup>3</sup> in relation to two questions concerning the interpretation of Articles 5 and 52 of the EC Treaty.

Although the facts of this case concern the availability of consortium relief in specific circumstances, the issues considered may have a significant impact on other aspects of group/consortium relief, the UK's controlled foreign companies legislation and other UK domestic legislation concerned with direct taxes.

### The facts

The relevant facts were that ICI and Wellcome Foundation Ltd, both UK resident companies, had formed a consortium through which they beneficially owned 49% and 51% respectively of another UK resident company, Coopers Animal Health (Holdings) Ltd ("Holdings"). Holdings held shares in 23 trading companies. Out of the 23 subsidiaries, 4 were UK resident, 6 were resident in other EU Member States and 13 were resident in non-Member States. One of the UK subsidiaries, Coopers Animal Health Ltd ("CAH") had incurred losses and ICI sought to set 49% of CAH's losses against its chargeable profits by way of consortium relief.

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<sup>2</sup> [1998] STC 874.

<sup>3</sup> [1996] STC 352.

UK domestic legislation relating to consortium relief provided that "Group relief shall...be available...where [one company] is a member of a consortium and the other is...a trading company which is a 90% subsidiary of a holding company which is owned by the consortium". For this purpose, a "holding company" is defined as meaning "a company the business of which consists wholly or mainly in the holding of shares or securities of companies which are its 90% subsidiaries and which are trading companies".<sup>4</sup> Section 258(7) ICTA 1970<sup>5</sup> stated that "References in this...Chapter to a company apply only to bodies corporate resident in the United Kingdom."

The Inland Revenue refused ICI's claim for relief on the grounds that, since the majority of Holdings' subsidiaries (19 out of 23) were not UK resident, Holdings' main business was not that of a holding company within the meaning of sub-section 258(5)(b).

ICI won its case against the Inland Revenue in the High Court and the Court of Appeal. The House of Lords decided that the Inland Revenue's refusal to allow consortium relief was justified on the wording of the relevant UK domestic legislation. However, ICI argued for the first time in the case before the House of Lords that the requirement that the holding company's business should consist wholly or mainly in the holding of shares in UK resident companies was a restriction on the freedom of establishment of companies and therefore infringed Articles 52 and 58 of the EC Treaty.

### **Referral to the ECJ**

The House of Lords referred two questions to the ECJ for a preliminary ruling:

1. Whether the requirement under UK legislation that the business of Holdings should consist wholly or mainly in the holding of shares in UK resident subsidiaries constitutes a restriction on the freedom of establishment under Article 52 of the EC Treaty and, if so, whether such treatment is justified under Community Law?
2. If the requirement in question 1 above is an unjustified restriction upon Community law, whether Article 5 of the EC Treaty would require a UK court to interpret its domestic legislation so as to comply with Community

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<sup>4</sup> Section 258(5)(b) ICTA 1970, now Section 413(3)(b) ICTA 1988.

<sup>5</sup> Now Section 413(5) 1988.

law where the effect would be to give relief in circumstances where the business of the company consisted mainly in the holding of shares in subsidiaries established outside the EC/EEA?

The ECJ began by analysing whether it should consider the first question at all, since the majority of Holdings' subsidiaries were resident not in the EU but in non-Member States. However, the ECJ decided that once the House of Lords had considered it necessary to refer an issue for a ruling, then that request would be turned down only if it was clear that the interpretation of Community law sought had no bearing in the matter of the main proceedings. The ECJ felt that this was not the position and that therefore the issue should be considered.<sup>6</sup>

### **The First Question**

Article 52 grants nationals of one Member State "Freedom of establishment...to set up and manage...companies...under the conditions laid down for [another Member State's] own nationals" and Article 58 provides that companies formed in accordance with the law of a Member State are to be treated in the same way as natural persons who are nationals of Member States. The ECJ emphasised that these Articles should be interpreted as prohibiting the Member State of origin from hindering the establishment in another Member State of one of its nationals or a company incorporated under its legislation<sup>7</sup>. The ECJ noted that UK domestic legislation allowed consortium relief only if the holding company controlled wholly or mainly subsidiaries whose seats are in the UK. This did result in inequality of treatment under the Treaty's provisions on freedom of establishment and it was therefore necessary to ascertain whether this could be justified.

The UK Government argued before the ECJ that the limitation was justified because the purpose of the legislation was to prevent the creation of foreign subsidiaries which could be used to deprive the UK Treasury of taxable revenues (by, for example, channelling charges of non-UK resident subsidiaries to a UK resident subsidiary, with profits accruing outside the UK).

The ECJ held that this did not justify discriminatory treatment. First, the establishment of a non-UK resident company did not necessarily entail tax avoidance. Secondly, the risk of charges being transferred could exist if there was even one non-UK resident subsidiary. Thirdly, a concern about the loss of tax revenue occurring

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<sup>6</sup> See paragraphs 14 to 16.

<sup>7</sup> Daily Mail, Case 81/87 [1988] ECR 5483, paragraph 16.

in this way was not sufficient to justify the discriminatory legislation. In the case of the consortium relief legislation there was no direct link between the consortium relief granted for losses incurred by a resident subsidiary and the taxation of profits made by a non-UK resident subsidiary.<sup>8</sup>

The ECJ ruled that Article 52 precludes domestic legislation which, in the case of members of a consortium holding shares in a holding company, provides that a particular form of tax relief is dependent upon the holding company mainly holding shares in UK subsidiaries since this is a restriction on freedom of establishment. Therefore, a shareholder in the holding company should be entitled to consortium relief where a majority of the subsidiaries are resident in the EU.

### **The Second Question**

Article 5 requires Member States to "take all appropriate measures...to ensure fulfilment of the obligations arising out of [the] Treaty". According to the ECJ the House of Lords was, in its second question, essentially asking the Court to explain the scope of its duty to cooperate in good faith, as provided by Article 5. In a case where a UK holding company had a majority of its subsidiaries in non-EU Member States, must it disapply the UK legislation or construe it in a way to take account of Community law?

The ECJ ruled that a difference of treatment applied according to whether or not the holding company's business consisted wholly or mainly of holding shares in non-EU subsidiaries lay outside the scope of Community law. Articles 5, 52 and 58 did not affect domestic law in this case and there is no requirement, in this regard, for the UK to interpret its legislation in a way which conforms with Community law.<sup>9</sup>

In his judgment in the House of Lords in the ICI case Lord Nolan had raised the issue of whether what was determinative was the number of subsidiaries or whether, for example, if there was an equal number of UK resident and non-UK resident subsidiaries, one could consider factors such as turnover. The Advocate General referred to this in his Opinion delivered on 16 December 1997 but the ECJ did not take this further. Where there is a majority of non-UK subsidiaries, the UK domestic court could, on this basis, decide to ignore some subsidiaries if, for example, their turnover was minimal, rather than adopting a simple headcount as the criterion.

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<sup>8</sup> See paragraph 29.

<sup>9</sup> See paragraphs 32 to 35.

### **The consequences for ICI**

The majority of Holdings' subsidiaries are resident in non-EU Member States. This judgment therefore did not assist ICI because the ECJ has ruled that Community law does not fetter UK domestic legislation in such a situation.

### **Short term effect in relation to consortium relief.**

Companies which are in a similar position to ICI but which have a majority of EU resident subsidiaries should, as a consequence of the ECJ's ruling, be able to make a claim for consortium relief provided that they have adhered to the normal time limits. It is likely that the relevant part of the consortium legislation will be altered to take the decision into account.

### **Other effects on group relief.**

The ECJ ruling may also have an effect upon other aspects of group/consortium relief. In particular, it would now appear that UK domestic legislation may be in breach of Article 52 because it denies group relief between two UK resident subsidiaries of a parent company which is resident in another EU Member State, when group relief would be available if the parent was UK resident.

### **Other areas of legislation in relation to which this decision may have an impact**

The ruling raises questions as to whether UK domestic legislation under which capital assets are transferred on a no-gain/no-loss basis between the UK resident subsidiaries of a UK parent company is discriminatory, since the legislation requires there to be a UK resident parent company.

A further area of potential discrimination in UK domestic legislation arises in relation to the controlled foreign companies (CFC) regime. Under this legislation, non-UK resident subsidiaries (unless carrying on exempt activities or satisfying certain other conditions) of UK companies which are, broadly, in lower-tax jurisdictions, can be deemed to dividend profits back to the UK, if they do not follow an "acceptable distribution policy". The question of whether this breaches Articles 52 and 58 in relation to freedom of establishment in other Member States is therefore raised. In the ICI judgment the ECJ made some distinction between legislation which had "the specific purpose of preventing wholly artificial arrangements, set up to circumvent UK tax legislation, from attracting tax benefits" and domestic legislation relating to

consortium relief, which discriminated in all cases where the majority of a UK company's subsidiaries were established for whatever reason outside the UK in other Member States. It accepted that in some circumstances legislation can be necessary to maintain the cohesion of tax systems. It is therefore still an open question as to whether the UK's CFC legislation is in breach of Articles 52 and 58.

The Inland Revenue are understood to be planning to issue a press release in relation to the *ICI v Colmer* case in the Autumn.

Following the ECJ's decision in the ICI case, it must be expected that, unless the Inland Revenue take pre-emptive action to amend some aspects of domestic legislation, more questions relating to the "freedom of establishment" issue will reach the ECJ in future.