TAXATION OF FOREIGN DIVIDENDS – THE PERMITTED WAY TO CALCULATE CREDIT RELIEF FOR THE PURPOSES OF UK CORPORATION TAX[1]

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Introduction

The Court of Appeal (Civil Division) handed down its (preliminary) judgment on *FII Group Litigation*[2] on 23 February 2010.[3] The judgment, insofar as it related to whether the UK's provisions determining corporation tax credit relief for *underlying tax*[4] were permissible, appears to have been:

> "*In the unusual circumstances of this case, all the members of the Court therefore consider that there should be a reference back to the ECJ to clarify its decision….*"[5]

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2 *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue* C-446/04 [2006] ECR I-11753 ("*FII Group Litigation*")

3 *Test Claimants in the Franked Investment Group Litigation and Commissioners of the Inland Revenue (1) [and] Commissioners of Her Majesty's Revenue and Customs (2)* [2010] EWCA Civ 103.("*Court of Appeal judgment*")

4 See ICTA 1988 sections 790(6) and 799: Relief claimable where the shareholder directly or indirectly controls not less than 10% of the voting share capital of the distributing company – references will be made to the UK statutes current at the time of the original appeal

5 *Court of Appeal judgment*, paragraph 43 and paragraph 1 of Annex 3

The principal issue appears to have been whether granting corporation tax exemption of dividends received from UK companies[6], notwithstanding that may have paid a reduced effective rate of tax on their profits because of tax reliefs claimed, whilst granting credit relief against corporation tax payable on foreign dividend income that is based on the actual amount of foreign tax paid after claiming similar types of deduction, results in discriminatory treatment of foreign source dividend income contrary to EU law and has the consequence that the UK's dual system of relieving *economic double taxation* infringes the EC Treaty freedoms[7].

There appears to be a secondary issue relating to the UK's '*small companies' relief*'', which is discussed in section 3.2 below.

The objective of this article is to consider the case law of the Court of Justice of the European Union ("ECJ") and to propose a reasoned answer to the principal issue and to propose how the *underlying tax* should be ascertained.

It is the contention of the author that the ECJ did provide the necessary guidance although, possibly, not in the clearest of terms. As will be explained, the EU law rule is that the foreign dividend income must be treated *no less favourably* than the UK source dividend income but that does not necessarily require exemption from corporation tax of foreign source dividend income as subsequently enacted in Finance Act 2009[8].

However, the basis on which *underlying tax* credit relief was calculated under the UK provisions then in force did not achieve the required result of treating foreign source dividends *no less favourably*.

It is necessary, therefore, to modify the basis of calculation but it is not for the ECJ to specify how the national legislation is to be interpreted to achieve that:

> "…*it must be noted that it is not for the Court, in the context of a reference for a preliminary ruling, to give a ruling on the interpretation of provisions of national law or the definition of the factual context*…" [9]

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6 ICTA 1988. s.208 subject to some specific exceptions

7 Since the coming into force of the Lisbon Reform Treaty on 1st December 2009, the EC Treaty has been re-named The Treaty on the Functioning of the European Union ("TFEU") and the provisions have been renumbered or, in some cases, re-enacted in The Treaty on European Union ("TEU"). The UK law was changed before the Treaty changes and, because the citations in the cases refer to the former EC Treaty, the 'old references' will be used throughout this article.

8 FA 2009 Section 34 and Schedule 14

9 *Jobra Vermögensverwaltungs-Gesellschaft mbH v Finanzamt Amstetten Melk Scheibbs* C-330/07 [2008] ECR I-9099 paragraph 17

The conclusion reached in section 7 below is that credit for *underlying tax* should be calculated using the nominal rate of the foreign tax assessable on the profits distributed in the period in which they were distributed.

Where the freedom of establishment is engaged and the foreign distributing company's profits include dividend income received from companies resident in a different state ("*lower tier companies*"), it will be necessary to take account of the nominal rate of tax assessed on the profits distributed by those *lower tier companies* in certain circumstances where the UK shareholder could have achieved a greater *underlying relief* tax credit against corporation tax had it held the investment in the *lower tier company* direct.

There will be some preliminary matters to consider before the case law can be analysed.

1. The Litigation History

A group litigation order ("GLO") was formed on 8th October 2003. The litigants primarily involved UK companies having foreign subsidiaries established in both the EU and elsewhere. The lawfulness of the UK rules applying ACT to re-distributed foreign source dividends and that of the UK's 'Foreign Income Dividend' scheme were challenged, and issues relating, but of concern here, for the purposes of this article, is only the challenge of the lawfulness of the UK's scheme for charging to Corporation Tax dividends received by UK companies from non-resident companies.

The matter came before the High Court of England & Wales (ChD) and Mr Justice Park made an order for reference to the ECJ on 13 October 2004.

Where an interpretation of the EC Treaty is required by a national court or tribunal to enable it to determine a matter before it, it may request the ECJ to give such a ruling.

The 'order for reference' was made by the High Court pursuant to Article 234 EC[10]. The function of the ECJ in relation to such an order is defined in the Article. It is:

- *…to give preliminary rulings concerning…the interpretation of [the EC] Treaty….*

It should be noted that the function of the ECJ is to give an interpretation of the Treaty, not to deliver a judgment on the national law that gave rise to the reference.

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10 Now Article 267 TFEU

As is clear from Article 220 EC[11], which defines the duty of the ECJ, the ECJhas jurisdiction neither to interpret Member State laws[12] nor to make findings of facts.[13] The ECJ relies upon explanations provided to it of the national law and of the facts and circumstances pertaining. It is for the national court, which, alone, has jurisdiction to determine the meaning of the national law, to determine whether the national law complies with EU law as interpreted and explained by the ECJ.

The form of the request by the national court under the Article 234 EC procedure is the posing of one or more specific questions and the obligation of the ECJ is to answer those questions.

Advocate General Geelhoed delivered his Opinion on 6 April 2006 and the ECJ handed down its ruling on 12 December 2006.

The matter returned to the High Court and Mr Justice Henderson handed down his judgment on 27 November 2008[14]. His decision was appealed to the Court of Appeal (Civil Division) and its (preliminary) judgment was handed down on 23 February 2010[15].

The Court of Appeal determined that it was obliged to refer back to the ECJ a further question requesting clarification of paragraph 56 of the Court's ruling in *FII Group Litigation*. That part of the ruling was in answer to the first of the questions in the High Court's order for reference.

2. Background – The EC Treaty freedoms

It is common ground that the ECJ examined the UK tax scheme in the context of Article 43 EC (freedom of establishment)[16] and Article 56 EC (free movement of capital)[17].

Neither EC Treaty provision makes any mention of taxation of dividends.

11 Official Journal C-115/367 9 May 2008: "*Repealed – replaced, in substance, by Article 19 TEU*"

12 *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) and Belgische Staat* C-141/99 [2000] ECR I-11619 at paragraph 18

13 *Margaretha Bouanich v Skatteverket* C-265/04 [2006] ECR I-923 at paragraph. 54

14 [2008] EWHC 2893 (Ch)

15 *Court of Appeal Judgment ibid*

16 Now Article 49 TFEU

17 Now Article 63 TFEU

It is necessary to consider why these freedoms are engaged. But first it is necessary to consider whether those provisions give effect to a more fundamental principle of the EC Treaty. The ECJ has explained:

> "*The Court has confirmed that Articles [39] … [43] [49 and 56] of the Treaty implement the fundamental principle contained in Article [3(1)(c)]*[18] *of the Treaty in which it is stated that, for the purposes set out in Article 2, the activities of the Community are to include the abolition, as between Member States, of obstacles to freedom of movement [of goods]… persons[,services and capital]*[19]

The fundamental principle is that obstructions to the free movement goods, persons, services and capital within the internal market shall be abolished. The ECJ interprets the more specific provisions, the freedoms, in the light of this fundamental principle.

2.1 The Freedom of Establishment and the Free Movement of Capital

The concept and scope of the freedom of establishment are determined from the wording of Article 43 EC, which refers to the taking up and pursuit of activities as self-employed persons in another Member State through a subsidiary, a branch or through an agency.

In the ECJ's words:

> "*The concept… is therefore a very broad one, allowing a Community national to participate, on a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom, so contributing to economic and social interpenetration within the Community in the sphere of activities as self-employed persons*"[20]

The delineation between the application of the freedom of establishment and the free movement of capital in relation to an investment in a company is determined by whether the shareholder pursues (economic) activities **through** the company he is invested in and whether the action or transaction in point relates to the exercise of that activity or to the establishment of that company:

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18 Official Journal C-115/367 9 May 2008: "*Repealed – replaced, in substance, by Articles 3 to 6 TFEU"*

19 *Dieter Kraus v Land Baden-Wurttemberg* C-19/92 [1993] ECR I-1663 at paragraph 29: the ECJ referred only to Article 39 EC (workers) and to Article 43 EC (establishment) but Article 3(1)(c) refers also to goods (Article 28 EC), services (Article 49 EC) and capital (Article 56 EC).

20 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* C-55/94 [1995] ECR I-4165 at paragraph. 25

> "*…a national of a Member State who has a holding in the capital of a company established in another Member State* ***which gives him definite influence over the company's decisions and allows him to determine its activities*** *is exercising his right of establishment.*"[21]

The Court is not specifying a level of holding and it is not necessarily just the holding of shares that is considered.

> *"…Moreover, according to the order for reference, there are links between those companies at management level."*[22]

The Court will take account also of so-called 'concert parties' of shareholders acting together to secure management of a company:

> "*In the present case, it is apparent from paragraph 14 of this judgment that all shares in Columbus are held, either directly or indirectly, by members of one family. The latter pursue the same interests, take decisions concerning Columbus by agreement through the same representative at the general meeting of Columbus and decide on its activities.*"[23]

Thus, in the context of a shareholding in a company, a person is exercising the freedom of establishment when the company in the other Member State is, broadly speaking, a vehicle through which he is conducting his business. For convenience, such a vehicle will be referred to as a 'subsidiary' whether or not it satidfies the company law definition. The concept of a group might be that of a parent company conducting its business through its incorporated branches (subsidiaries).

Where an investment in a company does not engage the freedom of establishment it will engage the free movement of capital, Article 56 EC. A feature of that freedom, in the context of investments in companies, is that a national provision that infringes the freedom will both deter the investor from making the investment and obstruct the investee company from raising new capital in the Member State whose provision causes the infringement.

A 'capital movement' is not defined in the EC Treaty but the ECJ has long held that:

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21 *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem* C-251/98 [2000] ECR I-2787 at paragraph. 22

22 *Société de Gestion Industrielle SA (SGI) v État belge* C-311/08 at paragraph. 35

23 *Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt* C-298/05 [2007] ECR I-10451 at paragraph. 31

> "*…Annex 1 to Directive 88/361contains a non-exhaustive list of the operations which constitute capital movements…*"[24]

The ECJ also held in *Verkooijen*[25]:

> "*Although receipt of dividends is not expressly mentioned in the nomenclature annexed to Directive 88/361 as 'capital movements', it necessarily presupposes participation in new or existing undertakings referred to in Heading I(2) of the nomenclature*."

Verkooijen concerned the differential taxation of foreign dividend income under Dutch rules and is cited at paragraph 215 of *FII Group Litigation.*

2.2 Restriction or discrimination?

Looking now at Article 43 EC, one finds, firstly, the prohibition of '*restrictions*' to the exercise of the freedom of establishment and, secondly, a requirement that the host state shall not discriminate against persons exercising the freedom[26]. Both *restrictions* and *discrimination* or unequal treatment must be considered to be obstacles to the free movement of persons.

Article 56 EC, however, refers only to '*restrictions*'.

Firstly, it is necessary to consider the meaning of '*discrimination*' in the context of tax provisions and EU law. It would be inappropriate to conduct an extensive review here of the case law to settle this point as it would distract from the principal focus of the article. It is a contentious area, not least of all because of the ECJ's reference to '*covert discrimination*' in the context of direct taxation in *Biehl*[27]:

> "*…the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead to the same result…*"

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24 *Staatssecretaris van Financien and B G M Verkooijen* C-35/98 [2000] ECR I-4071 at paragraph 27

25 *Verkooijen ibid* at paragraph 28

26 "*Freedom of establishment shall include the right to take up and pursue activities as self-employed persons…under the conditions laid down for its own nationals by the law of the country where such establishment is effected.*"

27 *Klaus Biehl v Administration des contributions du grand-duche de Luxembourg* C-175/88 [1990] ECR I-1779 at paragraph 13

However, Arden and Stanley Burnton LJJ did make this statement[28] and the point does need to be addressed in relation to *FII Group Litigation*:

> "…*There is an obligation under the EC Treaty not to discriminate on grounds of nationality in taking measures to mitigate economic double taxation (subject to any question of justification)*"

To relate direct tax provisions applied by reference to '*tax residence*' to '*nationality*' involves tortuous analysis. There may be direct tax provisions that do refer to '*nationality*' but the UK provisions concerned in this matter do not.

It is necessary to try to identify the basic underlying principle.

The ECJ has said that:

> "…*discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations*"[29]

But this is merely a specific expression of the overriding general EU law principle of equality:

> "*26 The prohibition of discrimination laid down in the above-mentioned provision is merely a specific enunciation of the general principle of equality which is one of the fundamental principles of community law.*
>
> *27 That principle requires that similar situations shall not be treated differently unless the differentiation is objectively justified*."[30]

Accordingly, '*nationality*' is but one of the criteria by which an EU citizen might be discriminated against. The underlying principle in this context, an expression of the general *principle of equality*, is the *principle of equal treatment*, which requires equal treatment of persons in objectively comparable situations.

To avoid confusion with different treatment on the basis of *nationality*, different treatment on the basis of *tax residence* will be referred to henceforth in this article as '*unequal treatment*'.

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28 *Court of Appeal judgment*, Annex 3, paragraph 2

29 *Finanzamt Koln-Altstadt V Roland Schumacker* C-279/93 [1995] ECR I-225 at paragraph 30

30 *Royal Scholten-Honig (Holdings) Limited v Intervention Board for Agricultural Produce ; Tunnel Refineries Limited v Intervention Board for Agricultural Produce* C-103 & 145/77 [1978] ECR 2037

To distinguish '*unequal treatment*' from '*restriction*' the author proposes a simple rule that '*unequal treatment*' can only arise where the treatment of **different persons** is in point and that will almost invariably be in the context of host state rules (as, indeed, suggested by the second paragraph of Article 43 EC itself).

Where **different treatment of a person** arises not because of who he is, but because of what he has done, that different treatment will be referred to as a '*restriction*' and that will almost invariably be in the context of origin state rules.

FII Group Litigation is concerned with origin state rules that apply to companies within the charge to Corporation Tax. There is a difference of treatment of dividend income dependent upon whether the source is a UK resident company or otherwise. Potentially, the UK resident investor may suffer a disadvantage because of where it made its investment – that is, because of what it did.

The ECJ has defined a '*restriction*' in these terms:

> "*…all measures which prohibit, impede or render less attractive the exercise of freedom of establishment must be regarded as constituting […] restrictions…*"[31]

In the field of direct taxation, a '*restriction*' is likely to be a financial disadvantage or an administrative burden. In simple terms, if a person who invests in a foreign company can expect to be taxed more highly on the income than he would be on the income from an investment made in a domestic company, or can expect to be burdened with additional administration, he may be deterred from making that investment in a foreign company. National law that imposes those disadvantages is considered to obstruct the free movement of persons, or of capital, as the case may be, and is considered to infringe the EC Treaty freedoms engaged.

More specific to the issue in *FII Group Litigation*, if the UK rules for taxing dividends cause profits repatriated from foreign subsidiaries (dividends) to be subject to a greater tax burden than would be borne in respect of dividends from UK subsidiaries, UK companies might be deterred from setting up foreign subsidiaries. That would be a *restriction* to the freedom of establishment.

2.3 Comparable situations

Different rules applied by national legislation will only give rise to a *restriction* or to *unequal treatment* if the different rules apply to *comparable situations*.

Thus, for there to be an infringement of the Treaty freedom resulting from different rules applying to the taxation of dividend income, an investor in a foreign company

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31 *Etat belge – SPF Finances v Truck Center SA* C-282/07 [2008] ECR I-10767 at paragraph.33

must be in a situation that is comparable, as regards taxation of the dividend income, to the situation that he would be in when he invests in a domestic company.

What the ECJ compares in the instance of such an investor is the exposure to *economic double taxation*: that is, indirect taxation by reason of company tax assessed on the distributing company in respect of the underlying profits distributed and then direct taxation of the dividend income in the hands of the shareholder.

Priority is generally given in international tax law to source state taxation: that is, the state of residence will generally provide the relief from *economic double taxation*. EU law has little to say on the matter:

> "*Whilst abolition of double taxation within the Community is…one of the objectives of the Treaty, it must none the less be noted that…no unifying or harmonising measure for the elimination of double taxation has yet been adopted at Community level, nor have the Member States yet concluded any multilateral convention to that effect under Article [293] of the [EC] Treaty.*
>
> *The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation — by means, inter alia, of international agreements — and have concluded many bilateral conventions based, in particular, on the model conventions on income and wealth tax drawn up by the Organisation for Economic Cooperation and Development ('OECD').*"[32]

Where withholding tax is applied to distributions by the state of residence of the distributing company, that state, too, causes the investor to be subject to *economic double taxation* and it is that state, in the first instance, that must ensure that non-resident investors receive '*national treatment*': that is, any reliefs from *economic double taxation* granted by the source state to its own residents must be granted also to non-resident investors.[33]

Thus, where the foreign tax on the dividend income of a UK corporate taxpayer includes source state withholding tax, the UK would be obliged to provide credit relief for that tax only to the extent that the source state's own (corporate) residents are left in charge to it under source state rules. The UK would not be obliged to compensate its residents for a breach of its Treaty obligations by the foreign source state.

32 *Mr & Mrs Robert Gilly v Directeur des Services Fiscal du Bas-Rhin* C-336/96 [1998] ECR I-2793 paragraphs 23 & 24

33 *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* C-374/04 [2006] ECR I-11673 at paragraph. 70

The UK corporation tax rules ensure that a UK corporate investor in domestic companies cannot suffer *economic double taxation* and it does that by exempting the dividend income in the hands of the corporate investor. That is **the objective of the legislation**.[34] To avoid infringing the freedom of establishment, the UK must provide similar relief from *economic double taxation* for foreign dividend income but it may do that by allowing a credit for foreign taxation against the UK corporation tax charged on the foreign dividend income in the hands of the investor.[35]

However, this is subject to the condition that the tax credit relief provided is '*no less favourable*' (than the exemption scheme for UK source dividends) and the ECJ did observe that the two systems for providing relief from *economic double taxation*: "*do not necessarily have the same result*" because an exemption scheme relieves a shareholder of tax on dividend income '*irrespective of the rate of tax to which the underlying profits are subject to tax in the hands of the company making the distribution*'.[36] This is the crux of the problem and will be considered below.

Exceptionally, where the underlying profits distributed are exempt from tax in the state of residence of the distributing company, and no withholding tax is levied by the source state in lieu of a profits tax, the UK investor in such a foreign company is not in the same situation as a UK investor in a UK company as he cannot suffer *economic double taxation* by reason of being charged to corporation tax on the dividend income[37]. The Court has specifically confirmed this analysis.[38]

In summary, when a UK company invests in a foreign company it is in a *comparable situation* to that it is in when it invests in a UK company because, in both cases, it can suffer *economic double taxation* unless, exceptionally, the state of residence of the foreign investee company exempts from tax profits that are distributed.

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34 See, by analogy, *Manninen* paragraph 44

35 *FII Group Litigation ibid* paragraph.48

36 *FII Group Litigation ibid* paragraph 43

37 If the foreign source state exempts the profits in the hands of the distributing company and levies a withholding tax in lieu, the source state will not be subjecting the investor to economic double taxation but EU law, the principle of equal treatment, would not permit the source state to levy a higher rate of tax on that income when in the hands of non-residents.

38 *Manninen ibid* paragraph. 34

2.4 The restriction in *FII Group Litigation*

The ECJ did find a restriction to the free movement of capital where the investor's holding was insufficient to entitle him to claim relief for *underlying tax*[39] but, for cases where relief for *underlying tax* could be claimed, left it to the national court to confirm that:

> "…*the rate of tax applied to foreign-sourced dividends is no higher than the rate of tax applied to nationally-sourced dividends and that the tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the amount of the tax charged in the Member State of the company receiving the distribution*."[40]

The ruling is substantially as stated in *FII Group Litigation* paragraph 57.

The first leg of the *proviso* appears to refer to the direction to the national court set out in *FII Group Litigation* paragraph 56.

This is where the uncertainty lies.

The ECJ, in *FII Group Litigation* paragraph 54, cited the contention by the claimants that a UK distributing company might have:

> "…*no liability to tax or pays corporation tax at a rate lower than that which normally applies in the United Kingdom*."

The ECJ then continued in paragraph 55:

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

So, when the ECJ continued in paragraph 55 with: "*That point*…", was it referring to both of the two, different, points made in paragraph 54 or was it referring only to the second point made in paragraph 54, having shrugged off the more important first point and, if so, why?

That is considered in the next section.

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39 Where the direct and indirect holding amounted to less than 10% of the voting share capital: see *FII Group Litigation* at paragraphs 58 - 65 for the ECJ's analysis and ruling

40 *FII Group Litigation* ruling at paragraph 226

3 The Court of Appeal Judgment

It is not the objective of this article to analyse the *Court of Appeal judgment*. The review of the judgment will be limited to gleaning points of interpretation of the ECJ ruling in *FII Group Litigation* and to identifying the points of uncertainty that the Court of Appeal identified.

3.1 "The Guiding Principle"

Etherton LJ expressed the view that:

> "*The guiding principle is set out in paragraph [46] of the ECJ's judgment: that is to say, whatever mechanism is adopted for preventing or mitigating the imposition of a series of charges to tax or economic double taxation, the freedoms of movement guaranteed by the Treaty preclude a Member State from treating foreign-source dividends less favourably than domestic-source dividends, save in situations which are not objectively comparable or where difference in treatment is justified by overriding reasons in the general interest.*"[41]

The author respectfully concurs with that view and will endeavour to identify how that principle is expressed and applied in the ECJ's case law in sections 5 - 7 below.

However, whilst considering this paragraph of the ECJ ruling, it should be noted also that the ECJ prefaced the 'guiding principle' explained by Etherton LJ with the words:

> "*It is thus clear from the case-law…*"

And it cited two cases and the entirety of its analysis in those cases:

> *"…(see, to that effect, Case C-315/02 Lenz [2004] ECR I-7063, paragraphs 20 to 49, and Case C-319/02 Manninen [2004] ECR I-7477, paragraphs 20 to 55)…"*

Those cases were not analysed in the *Court of Appeal judgment*.

Referring back to paragraph 54 of the ECJ's *FII Group Litigation* ruling mentioned briefly in section 2.4 above, and the claimant's contention that a UK distributing company may have no liability to UK tax, it would seem that the apparent failure of the ECJ to address this particular contention in its analysis was considered by the

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41 *Court of Appeal judgment* Annex 3 paragraph 28

Court of Appeal to be an additional reason to justify a further question to the ECJ to clarify parts of its ruling.[42]

Whilst *Lenz* is discussed more fully in section 5.1 below, paragraphs 41 and 42 of that ruling might have relevance to the apparently unaddressed contention of the claimants mentioned above. The ECJ said in *Lenz*:

> "*41* *…contrary to what the Austrian and Danish Governments argue, the level of taxation on companies established in another Member State is not relevant in relation to Austrian tax legislation when assessing the compatibility of national legislation with Articles [56] and [58](1) and (3) of the Treaty.*
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> *42* *It should be noted in that regard that, in respect of capital from revenue of Austrian origin,* ***the tax legislation at issue establishes no direct link between the taxation of company profits*** *by means of corporation tax* ***and the tax advantages enjoyed****, in relation to income tax,* ***by taxpayers living in Austria. In those circumstances****, the level of the taxation of companies established outside Austrian territory cannot justify a refusal to grant those same financial advantages to persons receiving revenue from capital paid by those latter companies*."

The ECJ is referring to the fact that the Austrian tax rule examined charged Austrian source dividends to income tax without having any regard for the tax actually paid by the Austrian distributing company. The Austrian shareholder paid the same amount of income tax on the dividend income regardless of whether the Austrian distributing company had paid a full rate of tax on the underlying profits or whether it had paid no tax at all on the underlying profits. Accordingly, it was equally irrelevant what rate of tax (if any) was paid by a foreign company when assessing to Austrian income tax an Austrian resident in receipt of foreign source dividends.

The claimants in *FII Litigation Group* were pointing to the fact that UK source dividends are exempt from Corporation Tax regardless of whether the distributing company had paid a full rate of UK Corporation Tax or none at all.

It may be that the ECJ had considered in *FII Group Litigation* that the point noted in paragraph 54 of the ruling had been already answered in paragraph 46 of the ruling.

This analysis will be expanded in sections 5 – 7 below.

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42 *Court of Appeal judgment*, paragraph 43.

3.2 The two views

The matter of contention appealed by the claimants to the Court of Appeal that is the subject of this article was summarised in the *Court of Appeal judgment* as:

> "*Issue 1: Do the provisions of Case V Schedule D infringe Article 43 of the Treaty (Freedom of Establishment) (Judge's judgment paragraphs [39] – [66])*"[43]

The Court of Appeal said in paragraph 25 of its judgment:

> "*This Issue was the subject of the reference to the ECJ. Unfortunately there is controversy between the parties as to what the ECJ decided. Both parties have been able to present to us (as they did to the Judge) cogent submissions in support of opposite conclusions as to the judgment of the Court.*"

The source of the "*controversy between the parties*" appears to be that the ECJ gave its ruling subject to a *proviso* set out in paragraph 56 of its *FII Group Litigation* judgment and the national courts cannot decide how to settle that *proviso*.

The ruling was set out in paragraphs 47 – 53 of *FII Group Litigation* and the ECJ simply said "yes", it is permissible to have a dual system whereby UK dividend income is exempted and foreign dividend income is taxed but with credit for foreign tax "paid".

The difficulty in accepting the ruling appears to arise from the inherent difference in consequence of exempting UK dividend income regardless of whether the distributing company had paid a full amount of tax, on the one hand, and taxing foreign dividend income with credit for 'foreign tax paid', on the other.

Instead of reviewing the case law to see what the ECJ might mean by '*foreign tax paid*' in such a situation, the claimants, supported by Mr Justice Henderson and Lord Justice Etherton, appear to have taken the view that the ECJ's *proviso* was not satisfied and that the UK's dual system infringed the EC Treaty freedoms and could not be read in a manner that would conform with their requirements.

Arden and Stanley Burnton LJJ, however, took the view that the ECJ's *proviso* in paragraph 56 referred only to the UK's "*small companies' relief*"[44], which was referred to as such by HMRC in its written observations to the ECJ.[45]

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43 *Court of Appeal judgment*, heading immediately above paragraph 25

44 ICTA 1988 section 13.

45 See *Court of Appeal judgment* paragraph 39 and paragraph 59 of Mr Justice Henderson's judgment cited by the Court of Appeal

It is perfectly evident from the UK statute that the scheme in ICTA 1988, s.13 acts both as a lower rate of Corporation Tax, where the profits in question are less than the ‘*lower relevant maximum amount*’, and as a relief, by way of a deduction from Corporation Tax calculated at the standard rate, where the profits lie between the ‘*lower relevant maximum amount*’ and the ‘*upper relevant maximum amount*’. It is also perfectly clear that HMRC correctly referred to the scheme in section 13 using the statutory heading for that section.

It would not be technically correct, in the author’s view, to refer to the relief as a “*…change to the tax base…*”, however.

Nevertheless, the author respectfully concurs with Arden and Stanley Burnton LLJ’s view that the *proviso* refers only to the nominal rate of Corporation Tax applied to different income sources, and it was uncontested common ground that Corporation Tax at a uniform rate is charged on Corporation Tax Profits comprising net income from all sources and gains after deductions, including Group Relief. HMRC’s contention that the application of the *small companies’ relief*, in the context of a group, would be exceptional must be correct because of the adjustment in ICTA 1988 section 13(3)(b).

3.3 “Foreign tax paid”

Whilst it is the view of the author that the ECJ has accepted the UK’s dual system in principle, the author is unable to identify either approval or analysis of the UK’s use of *underlying tax* calculated in accordance with ICTA 1988 section 799 to determine the appropriate tax credit, that is, the “*foreign tax paid*”.

In the author’s view, that must be interpreted by reference to the ECJ’s relevant case law and it is concluded in section 7 that a different basis is required.

4 Regard for the ECJ’s case law – permissible or obligation?

The Court of Appeal focussed almost exclusively on the ECJ’s *FII Group Litigation* ruling.

It raises the questions of whether it is permissible to consider other case law of the ECJ to assist understanding of the ruling and whether it is, indeed, obligatory to do so.

FII Group Litigation does not constitute a judgment on the UK’s dual scheme for relieving *economic double taxation*. Only the national courts may make that judgment and they must do so having regard to the ECJ’s interpretation of EU law. But it cannot be that *FII Group Litigation* provides an interpretation that solely relates to the UK’s tax provisions taxing dividend income and it must be equally the case that it cannot be that other rulings in other referred matters have no bearing on those provisions. Indeed, the ECJ specifically cited cases involving the Austrian system (*Lenz*) and the Finnish system (*Manninen*) designed to relieve *economic double taxation*.

4.1 Article 10 EC[46] – the cooperation obligation

It is not thought necessary to conduct an extensive review of the Authorities to justify the proposition that a review of the ECJ's case law to clarify a ruling is not only permissible but obligatory.

There is, possibly, a case for justifying a review of rulings handed down at a later time.

It should be noted, firstly, that:

> *"…a preliminary ruling does not create or alter the law, but is purely declaratory, with the consequence that in principle it takes effect from the date on which the rule interpreted entered into force.*"[47]

Then it should be noted that:

> *"The Court has…held that specific circumstances may be capable, by virtue of the principle of cooperation arising from Article 10 EC, of requiring a national administrative body to review an administrative decision that has become final following the exhaustion of domestic remedies, in order to* ***take account of the interpretation of a relevant provision of Community law given subsequently by the Court***"[48]

Thus, even if a national court has determined a matter, it might be required to re-open it in certain circumstances to take account of a subsequent ruling by the ECJ where an individual's rights under EU law have not been given full effect under the determination.

46 Official Journal C-115/367 9 May 2008: "*Repealed – replaced, in substance, by Article 4, paragraph 3, TEU*"

47 *Willy Kempter KG v Hauptzollamt Hamburg-Jonas* C-2/06 [2008] ECR I-411 at paragraph 36

48 *Willy Kempter ibid* at paragraph 38

5 The *FII Group Litigation* ruling and the Cited Cases

The purpose of the review of the ECJ's case law is to understand why the ECJ accepted the UK's dual system for relieving *economic double taxation* and to understand how the credit relief system for foreign dividends should operate in order to satisfy the requirement that investors in companies not resident in the UK are treated '*no less favourably*' as regards UK taxation of income derived from such investments as they would be treated as regards taxation of income derived from investments made in UK resident companies.

In short, the UK taxation system is prohibited by EU law from deterring a UK investor from investing in a company that is tax resident outside the UK.

5.1 The *FII Group Litigation* ruling

Regard should firstly be paid to paragraphs 41 to 46 of the ECJ's ruling in *FII Group Litigation*.

41 The ECJ summarises the dual system that it is examining. That is what it is looking at. That is the system that it comments on in the paragraphs that follow.

42 The ECJ clearly recognises the claim made by the claimants that exemption of UK source dividend income and taxation of foreign dividends results in the latter being treated *less favourably*.

43 The ECJ clearly recognises that a tax credit system can lead to a result that is different from that under an exemption system because:

> "*…a shareholder who receives a dividend is not, in principle, liable to tax on the dividends received, irrespective of the rate of tax to which the underlying profits are subject to tax in the hands of the company making the distribution and the amount of that tax which that company has in fact paid.*"

It cannot possibly be said that the ECJ disregarded the claimants' claim.

44 The ECJ notes that both components of the UK's dual system are recognised as permissible in the Parent/Subsidiary directive. The UK has not infringed the requirements of the directive.

45 However, that is necessary, but not sufficient. Member States must also comply with the requirements of the Treaty freedoms. This is just a general

statement introducing the statement of what the requirements of the Treaty freedoms are in this context.

46 The ECJ states the requirement. Firstly, the treatment of domestic source income is to be identified: the degree to which *economic double taxation* is mitigated is entirely up to the Member State in question. Then, the treatment of foreign source income is to be identified and the degree to which *economic double taxation* is mitigated for foreign source income must be at least equivalent.

That is the answer.

The answer is expanded in the paragraphs of the *FII Group Litigation* ruling that follow:

47 Member States are free to adopt different mechanisms, to define tax rates and tax bases provided that they do so in compliance with EU law.

48 Accordingly, a dual system involving exemption of domestic dividend income and an imputation credit for foreign source dividend income is, **in principle**, acceptable.

49 However, the two sources of income must be taxed at the same rate – this appears to be a reference to *Lenz*.

50 The mechanism of the imputation system operated alongside an exemption system must result in UK tax payable on the income being reduced by the amount of the foreign tax already 'paid' – this appears to be a reference to *Manninen*.

51 To clarify, when the UK tax rate is higher, the UK tax assessed must be reduced to the excess of UK tax chargeable over foreign tax already borne.

52 To clarify further, when UK tax is lower, the UK has no obligation to relieve the excess of the foreign tax borne – this principle was clearly stated in *Gilly*[49].

53 The additional administrative burden relating to an imputation system does not, of itself, infringe the Treaty freedoms.

It is then that we get into the troubled waters of whether the ECJ is again re-visiting the point that a UK distributing company may have paid less, little or no UK tax because of tax reliefs reducing the profits in charge to Corporation Tax or is solely

49 *Gilly ibid* paragraph 48

referring to a distortion that might arise as a result of the *small companies' relief* mechanism applying to it.

Reviewing the ruling in its entirety (from paragraph 41), it appears to the author most unlikely that the ECJ is contradicting what it has patiently set out in paragraphs 41 – 52 of the *FII Group Litigation* ruling.

It is suggested that it is necessary to review the case law that the ECJ was considering when it delivered this part of its *FII Group Litigation* ruling in order to resolve the matter.

5.2 *Lenz*[50]

The case concerned the Austrian tax rules applicable to dividend income. The system for taxation of domestic dividend was that such income was chargeable at one half the average rate levied on the taxpayer's income including, for the purpose of calculating that rate, the dividend income from domestic companies.

Foreign dividends were taxable at a flat rate of 25%.

When the ECJ mentioned different rates of tax in, for example, paragraph 56 of the *FII Group Litigation* judgment, it should be remembered that it had looked at the *Lenz* case.

The Austrian system applicable to domestic dividends was designed to mitigate *economic double taxation* levied by Austria, firstly, on the profits of the distributing company and, secondly, on the distributed profits in the hands of a resident shareholder.[51] However, foreign dividends will be almost always paid out of profits that have borne tax levied by the state of residence of the distributing company and the levy of Austrian income tax on distributed profits in the hands of Austrian shareholders gives rise to *economic double taxation* in the same way.[52]

The analysis is similar to the analysis of the UK situation suggested above. An Austrian taxpayer investing in a foreign company is in a situation comparable to that he would be in if he invested in a domestic company as, in both situations, he may be subject to *economic double taxation* as a result of the Austrian income tax on dividend income.[53]

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50 *Anneliese Lenz v Finanzlandesdirektion fur Tirol* C-315/02 2004] ECR I-7063

51 *Lenz ibid* paragraph. 30.

52 *Lenz ibid* paragraph. 31.

53 *Lenz ibid* paragraph 32.

The ECJ observed that the special rule for taxing domestic dividends did not depend upon Austrian corporation tax actually having been paid by the distributing company.[54] This is similar to the observation about the UK's system of exemption for domestic source dividends.[55] There was no link between the tax paid by the distributing company and the Austrian income tax payable by the shareholder.

The ECJ observed also that, whilst extension of the special tax rate to foreign dividend income would result in a lower overall tax burden where the distributing company pays a lower rate of tax on its profits in its state of residence than it would if resident in Austria, that potential situation could not justify the restriction of that special rate scheme to Austrian source dividend income.[56]

The different rates charged by the Member States are disparities and do not give rise to an infringement of the Treaty. They can be resolved only through harmonisation.[57] The same applies to tax bases. An investor making an investment abroad is not protected from higher tax burdens arising from disparities. What he is protected against is his state of residence causing that increased burden or from the foreign host state taxing him more onerously than it does its own residents.

Thus Austria was not required to have a mechanism that relieved *economic double taxation* by reference to the actual amounts of tax paid. The 'half-rate scheme' did not, in itself, cause an infringement. What was required was that the same, or an equivalent, rule was applied to foreign source dividends.

Accordingly:

- An investor in a foreign company is in a comparable situation to an investor in a domestic company where the application of tax on dividend income by his state of residence can give rise to *economic double taxation*;

- It was not necessary to consider the actual tax paid by the distributing company on its profits;

- The taxpayer should be subject to income tax on dividend income under the same or equivalent rule regardless of whether the source is a domestic company or a foreign company.

54 *Lenz ibid* paragraph 36.

55 *FII Group Litigation ibid* paragraph 43

56 *Lenz ibid* paragraph 43

57 *Gilly ibid* paragraph 47

This is subject to a *proviso* specifically noted by the ECJ in *Manninen*[58] that the situation of a shareholder having a holding in a company resident in a state that exempts from corporation tax profits that are distributed, and is therefore not subject to *economic double taxation* on the dividend income, is not comparable to that of a shareholder in a company resident in a state that taxes profits that are subsequently distributed

Whilst *Lenz* does not provide the answer because the UK used different mechanisms to relieve *economic double taxation*, it does underline that there is no prerequisite that the national systems must achieve equal burdens of tax on domestic source and foreign source dividend income. What is required is that the rule or an equivalent is applied equally to both domestic and foreign sources of dividend income.

5.3 *Manninen*[59]

Manninen concerned the Finnish scheme that used a system of imputed credits to avoid *economic double taxation*. Mr Manninen was a resident of Finland in receipt of dividends from a Swedish company.

Finland taxed both company profits and dividend income in the hands of resident shareholders at the same rate and permitted shareholders an imputed tax credit that had the "*end result…that dividends are no longer taxed in the hands of the shareholder*". That imputation credit was restricted to dividends from domestic companies.[60]

The Finnish scheme also required Finnish companies to top up their corporation tax payments (if necessary) so that they paid no less than the aggregate amount of the tax credits attaching to distributions made.[61] The credit imputed against income tax assessed on Finnish shareholders was, thus, fully funded by payments of tax made at the distributing company level.

Following *Lenz*, the ECJ stated that Finnish residents were in comparable situations whether they invested in domestic companies or in foreign companies. In both cases, they could suffer *economic double taxation*.[62]

As the Finnish tax system mitigated that burden in the case of domestic source dividends through the imputation credit, the objective of that legislation could be

58 *Manninen ibid* paragraph 34

59 *Petri Manninen* C-319/02 [2004] ECR I-7477

60 *Manninen ibid* paragraph. 20.

61 *Manninen ibid* paragraphs. 44 and 53

62 *Manninen ibid* paragraph. 35

achieved by providing a similar credit in respect of dividends received from foreign companies[63] calculated by reference, not to Finnish taxes, but to the "*tax actually paid*" by the foreign company on the profits distributed.

The ECJ put it in these terms:

> "*..the calculation of a tax credit granted to a shareholder fully taxable in Finland, who has received dividends from a company established in Sweden,* ***must take account of the tax actually paid*** *by the company established in that other Member State,* ***as such tax arises from the general rules on calculating the basis of assessment and from the rate of corporation tax in that latter Member State***." [64]

Although domestic dividends were 'effectively exempt' from Finnish income tax in the hands of a Finnish resident, Finland was required only to apply a similar tax imputation rule (not effective exemption) to foreign dividends and to grant an imputation credit based on the foreign tax actually levied on the underlying profits.

The emphasis by the ECJ that the imputation credit for foreign dividends should be based on the amount of foreign tax *actually paid* can be related to the structure of the Finnish scheme. The domestic tax imputation credit was linked to the domestic corporation tax actually paid by domestic distributing companies and the corporation tax 'top-up' mechanism ensured that the rate of imputation tax credit could be fixed.

The ECJ was not prescribing a general rule: it was saying that the system applied to tax foreign dividends must reflect the system applied to tax domestic dividends which, in this case, provided an imputation tax credit based on the tax actually paid by Finnish companies.

5.4 The discerned principle

At one level, the ECJ seems to be saying different things in these two cases.

It says in *Lenz* that no regard need be paid to taxes paid by the distributing companies, domestic or foreign, as long as an Austrian shareholder is taxed in the same way regardless of whether his dividend income is Austrian or foreign source.

It says in *Manninen* that regard must be paid to the tax actually paid by a foreign company on the profits distributed to a Finnish resident and (by construction) that it is permissible that a Finnish resident may have a residual Finnish income tax liability in respect of foreign dividend income even though he is effectively exempt from tax on Finnish source dividend income.

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63 *Manninen ibid* paragraph. 48

64 *Manninen ibid* paragraph. 54

But the differences in the outcomes to, respectively, an Austrian shareholder and a Finnish shareholder, the former paying precisely the same amount of income tax on dividend income regardless of its source, and the latter possibly paying income tax on a foreign source dividend but never paying income tax in respect of a domestic source dividend, is a consequence only of the disparity between the national schemes in operation in the two Member States.

The EU law principle applied is precisely the same in both cases.

The tax treatment of foreign dividend income is determined by that applied to domestic income. The principle is that foreign dividend income must be treated '*no less favourably*', precisely as the ECJ stated in paragraph 46 of its *FII Group Litigation* ruling.

The author proposes in section 7 below how this principle might be applied in the UK context.

Firstly, it is necessary to test this thesis further.

6 Other case law – testing the discerned rule

There is no proposal to test the discerned rule exhaustively. *Meilicke* has been chosen because of both its similarities and differences to *Manninen* and *Bouanich* & *Gerritse* because they are host state cases (the discerned rule is universal) and demonstrate that it is not necessarily 'equality' that is required in the context of tax. What is required is that the person exercising the freedom of movement is not deterred from so doing by tax provisions of the state of origin that impose a less favourable regime because of the exercise of the freedom or of the host state that impose a less favourable regime than that to which its own residents are subject.

6.1 *Meilicke*[65]

The heirs of Mr Meilicke (deceased) sought relief from German income tax levied on the Danish and Dutch source dividend income received by his estate.

Under German tax laws, German companies were required to pay 30% corporation tax on profits distributed and *economic double taxation* was eliminated by granting an imputation credit to shareholders equal to 3/7 of the net dividend received.

There is similarity between this system and the Finnish system examined in *Manninen*. In both cases, distributed profits are paid out of profits that have borne

65 *Wienand Meilicke, Heidi Christa Weyde, Marina Stöffler v Finanzamt Bonn-Innenstadt* C-292/04 [2007] ECR I-1835

the full rate of corporation tax assessed on such income. The ECJ drew a direct parallel to *Manninen* in its judgment.[66]

The applicants claimed that, applying a similar calculation to Dutch and Danish source dividends based on the Dutch and Danish nominal rates of corporation tax, would yield corresponding imputation credits of 35/65 and 34/66 respectively.

The ECJ did not endorse the calculations. It made no comment. It possibly had no evidence before it explaining the Danish and Dutch corporation tax systems. Instead, it commented that providing a German resident shareholder in receipt of dividend income derived from a company resident in another Member State with: "…*a tax credit, calculated by reference to the corporation tax payable by that company in that latter Member State*…" would constitute a "…*measure less restrictive of the free movement of capital than that laid down by the German tax legislation.*"[67]

The German rule taxed the profits distributed by a German company at a specific rate and, as in *Manninen*, the shareholder received an imputation credit calculated by reference to **that** corporation **tax rate**. Accordingly, if the profits of the foreign company were subject to local taxation in the same way, whether by way of direct assessment or by way of a Finnish style top-up scheme, the rate of credit should be calculated by reference to the foreign corporation rate applied to the distributed profits.

In other cases, the credit would be calculated in the manner of the UK's system for calculating *underlying tax* relief.

This is evident from *Manninen* where the ECJ states that the imputation tax credit to be granted by the Finnish authorities:

> *"…**must take account of the tax actually paid** by the company established in that other Member State, **as such tax arises from the general rules on calculating the basis of assessment and from the rate of corporation tax in that latter Member State**."*[68]

Thus, it is not necessary for Germany to grant a credit against tax due on foreign dividends substituting **its** basis of assessment of distributed profits for the basis of assessment of the other Member State. If, as is possibly more usual, there is no mechanism to specifically tax profits distributed, then the tax borne on those

66 *Meilicke ibid* paragraph 21

67 *Meilicke ibid* paragraph 29: Note that the ECJ could not be coerced into specifying precisely how the national legislation should be read to conform or should be amended to conform.

68 *Manninen ibid* paragraph 54

distributed profits must be determined by reference to the tax assessed on the total profits out of which the distributions were made.

The fact that the German shareholder may have to pay German income tax on a foreign dividend when the foreign tax levied on the distributing company is lower than the German corporation tax rate does not result in him being treated '*less favourably*' in respect of that source of income. It results from disparities in the rates applied in different Member States.

6.2 *Bouanich*[69]

Unlike the other cases considered so far, *Bouanich* was a host state case. The analysis was therefore conducted on the basis of a different treatment suffered by the applicant because of who she was, a non-resident.

Mrs Bouanich, a French resident, invested in a Swedish company. That company subsequently repurchased a proportion of its shares. The transaction was assessed under Swedish law on Swedish residents as a disposal and the capital gain, calculated as proceeds less cost of acquisition, was taxed at 30%.

Sweden applied a different tax rule to non-residents. It treated the transaction as a distribution taxable at 30% on the proceeds. The France/Sweden Double Tax Convention contained a provision that modified the Swedish rule and the national court's second question in the order for reference requested the ECJ to provide an analysis on the basis of the Swedish rule modified by the DTC.

Under this modified rule, tax was levied at 15% on the excess of the proceeds over the nominal value of the shares repurchased. No account was taken of Mrs Bouanich's cost of acquisition.

She was considered to be in a situation comparable to that of Swedish residents as regards the assessment to Swedish tax on her gain as she, like Swedish residents, had incurred cost in acquiring the investment.[70] Whilst Swedish residents were taxed on the basis of the gain that they had realised, she was taxed on a different basis.

Clearly it is a matter of arithmetic which calculation results in the higher tax liability. The ECJ referred the matter back to the national court to determine the facts saying:

> *"It is therefore a matter for the national court to determine in the proceedings before it whether the fact that non-resident shareholders are permitted to deduct the nominal value and are liable to a maximum tax rate*

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69 *Margaretha Bouanich v Skatteverket* C-265/04 [2006] ECR I-923

70 *Bouanich ibid* paragraph 40

> *of 15% amounts to treatment that is **no less favourable** than that afforded to resident shareholders, who have the right to deduct the cost of acquisition and are taxed at a rate of 30%"*[71]

The ECJ's ruling was:

> "*Articles 56 EC and 58 EC must be interpreted as precluding national legislation which derives from a double taxation agreement…except where, under such national legislation, non-resident shareholders **are not treated less favourably** than resident shareholders*"[72].

In this case, the ECJ:

- Rejected as a point of principle the alternative rule for assessing the Swedish tax due (this is inevitable in a host state situation where the principle of equal treatment applies); but

- Accepted that the alternative rule did not infringe the Treaty freedoms in instances where a non-resident is assessed to Swedish tax in an amount that does not exceed the amount that would be assessed applying, instead, the rule used for assessing tax on Swedish residents.

Thus, the comparator is the domestic situation and the test is whether the different rule applied to a foreigner results in a higher tax burden and, thus, '*less favourable*' treatment.

6.3 *Gerritse*[73]

This case concerned the provision of performance services (Mr Gerritse was a musician) by a Dutch resident on tour in Germany and the German tax rule for taxing his performance fees on a source basis. Two issues arose. The first issue was the tax basis: whilst German residents were taxed on the profit of such self-employment after deduction of costs incurred in relation to the provision of the services, Mr Gerritse was subject to taxation on his gross performance fees. The second issue was that the German tax was charged at progressive rates on residents but a flat rate was applied to Mr Gerritse's income.

This was a host state case and, thus, the principle of equal treatment was in point and a direct comparison was made, as in *Bouanich*, with the rule that applied to [German] residents.

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71 *Bouanich ibid* paragraph 55.

72 *Bouanich ibid* paragraph 56

73 *Arnoud Gerritse v Finanzamt Neukolln-Nord* C-234/01 [2003] ECR I-5933

In this case, Mr Gerritse was considered to be in a comparable situation to that of a German resident as regards assessment of the income to German tax because he, like a resident, incurred costs in generating the income.[74]

Germany advanced no justification for the rule and the ECJ ruled simply that the rule applied to Mr Gerritse, as a non-resident, infringed the Treaty, in this case, the freedom to provide services.[75] Clearly, the rule, taxing the gross fee income, would always work to the disadvantage of a non-resident.

The second issue concerned the flat rate of tax applied to non-resident's income.[76] Argument was put to the ECJ on this issue. It should be noted here that Mr Gerritse did not claim that he was in a situation comparable to that of a German resident as regards his total income, and therefore entitled to a personal allowance, but claimed that the flat rate applied to his income might be a higher rate than that, on average, applied to a German resident's taxable income under the German progressive rates of income tax.

The German rule applied to his income would infringe the Treaty if it resulted in a greater amount of German tax being levied by Germany on his income derived from that state than would be levied on a German resident under the German progressive rates, making adjustment by addition to Mr Gerritse's income, for this purpose, of an amount equal to the personal allowance deductions claimable by German residents against total income.[77]

As in *Bouanich*, the different rule applied to a non-resident was permissible if it resulted in the charge of the same or a lesser amount of tax as compared to the amount that would be charged applying the rule used for assessing residents. Although the ECJ did not express the phrase '*no less favourable*', it is clearly applying the same thinking as it applied in *Bouanich* (decided, as it so happens, at a later date).

74 *Gerritse ibid* paragraph. 27

75 *Gerritse ibid* paragraph. 29

76 It should be noted that the national court asked a single composite question but the ECJ analysed deductibility of expenses and the flat rate of tax levied separately.

77 *Gerritse ibid* paragraph. 53: the author does not fully follow the ECJ's analysis relating to comparable situations. In particular, the author cannot see how, in a source state situation, the tax scheme of another Member State can determine whether the German rule for taxing non-residents gives rise to unequal treatment as compared to the German rule applied to residents. Reference should be made to paragraph 20 of the ECJ's ruling in *Commission of the European Communities v French Republic ('Avoir Fiscal')* C-270/83 [1986] ECR 293

7 Defining an equivalence of the UK Corporation Tax exemption scheme for UK source dividends.

To define the characteristics of a compliant credit relief scheme, it is necessary to define a credit relief equivalent of the UK exemption scheme for UK dividend income.

Under general principles, but for the special exemption, UK dividends would be taxable on the shareholder when declared as payable. The appropriate corporation tax rate would be that set for the financial year in which each dividend in question is taxable. Accordingly, an equivalence of the UK exemption is a tax credit set at a rate corresponding to the Corporation Tax rate at which the dividend income would be taxed.

The tax credit provided against UK Corporation tax assessed on foreign dividend income should be calculated applying the same principle.

No account is taken of the actual tax paid by a UK distributing company. The hypothetical credit provided under the credit relief equivalent is based purely on the nominal rate of Corporation Tax in force at the time that the dividend income would become taxable in the hands of the shareholder.

The credit that should be granted against UK Corporation Tax chargeable on foreign dividend income as *underlying tax* relief should be based on the nominal rate of foreign corporation tax in force at the time that the dividend income becomes payable, which is when it will become chargeable to UK Corporation Tax.

On the face of it, this might seem a bit odd to some readers but one consequence of the UK exemption scheme, particularly evident in a group of companies, is that the shareholder is not taxed on the special reliefs enjoyed by the investee company.

If relief was given only for Corporation Tax actually paid by the distributing company, a tax benefit obtained by that company would, in effect, result in a transfer of part of the distributing company's tax liability to the shareholder and the greater the tax benefits obtained, the greater the tax burden transferred to the shareholder.[78]

In a group, where the distributing company is a 100% subsidiary that distributes all of its profits, the parent might find itself reimbursing to HMRC a considerable proportion of its subsidiary's tax benefits turning the subsidiary's '*deferred taxation*'

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78 See *FII Group Litigation ibid* AG Opinion paragraph 50: *"…While, under an exemption system, the benefits of underlying corporation tax exemptions and allowances may be passed on to the parent company receiving the dividends, under a credit system these benefits cannot be passed on as the tax borne by the dividends is topped up to the standard UK corporation tax rate…"*

in its Financial Accounts into '*current taxation*' in the Group Accounts with no prospect of reversal.

That is also the situation where the *underlying tax* relief is calculated on the basis of foreign tax actually paid, which will reflect foreign tax reliefs granted to the distributing company.

As the system applied to relieve *economic double taxation* of UK source dividends avoids taxing the shareholder on reliefs granted to the distributing company, EU law requires that the UK's system of relief for foreign source dividends should do similarly. Otherwise, it is clear that foreign source dividends will be *treated less favourably* and the EC Treaty freedoms will be infringed.

What EU law does not require, which is quite evident from paragraphs 50 – 52 of the ECJ's *FII Group Litigation ruling*, is that the credit against UK Corporation Tax be calculated by reference to UK rates where the foreign tax rate is lower than the UK tax rate: that is, provide effective exemption of the foreign dividend income.

The EC Treaty is not infringed if a UK company is liable for a residual Corporation Tax liability on foreign dividend income where the foreign distributing company is subject to taxation at a rate that is lower than the UK's at the time that the distribution becomes payable.

Where, however, the profits of the foreign company making the distribution partly or wholly comprise dividends received from *lower tier companies* and the foreign company is exempt from tax on that dividend income or the rate of tax levied on that dividend is less than the rate of UK corporation tax, the correct calculation of the tax credit will require account to be taken of the foreign tax rates borne on their income by those *lower tier companies* if the freedom of establishment is engaged.

The tax credit provided to the UK shareholder against corporation tax chargeable on the dividend income received from its foreign 'subsidiary', insofar as that dividend income represents redistributed dividends from *lower tier companies*, must not be less than the tax credit that the UK shareholder could have claimed had it held the investment in the *lower tier companies* directly rather than through its foreign 'subsidiary'.

A *lower tier company* may itself redistribute dividends that it has received and the same rule should be applied until a level is reached where the dividend income can no longer be regarded as deriving from an establishment of the UK shareholder or the dividend income is taxed at a rate equal or exceeding the rate of UK corporation tax.

An establishment relationship will persist where the UK shareholder can exercise 'control' (in the EU law sense – see section 2.1) over the subsidiary (which must be regarded as a 'national' of a Member State)[79] directly or indirectly through intermediate subsidiaries, regardless of where those intermediate subsidiaries are established[80].

The (former) UK rules for identifying foreign tax borne should be suitable for this purpose with substitution of foreign nominal rates for foreign tax paid.

8 Concluding comments

Examination of four other situations engaging the free movement of capital[81] has demonstrated that there is a simple, binding, principle and that is the principle that the investor investing abroad should be treated *no less favourably* by either the state of origin (his state of residence) or by the host state (the state of residence of the investee company).

The same principle applies in relation to the provision of services.

Accordingly, the rulings given by the ECJ must be viewed individually in the context of the domestic rule examined. Each is an application of the general principle.

If the national rule applied to domestic source income is linked to tax paid by the distributing company, a credit for foreign tax paid by a foreign distributing company must be linked to foreign tax paid by the distributing company in the same way.

If the domestic rule has a different basis, that basis must be applied to foreign source income or, if a different basis is used for that, it must result in a liability that does not exceed the liability calculated on the basis used for domestic source income.

It is for the Member States to decide how they mitigate *economic double taxation* but, whatever scheme or method they choose to apply for domestic profits and sources of income, they must ensure that foreign profits or sources of income are not taxed more heavily than the equivalent domestic sources.

79 See Article 48 EC (now Article 54 TFEU)

80 See *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* C-524/04 [2007] ECR I-2107 paragraphs 96 to 102

81 The analysis in relation to schemes to mitigate *economic double taxation* on dividend income is the same for freedom of establishment – *FII Group Litigation* paragraph 60(but in reverse)