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Duke of Westminster to Vodafone2 – a journey from literal interpretation to liberal rewriting?

Conforming construction of UK law in the context of EU direct tax

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Abbreviations

Abbreviation	Full reference
CFC	Controlled Foreign Company
EC	European Community Treaty
ECA	European Communities Act 1972
ECJ	European Court of Justice
EEA	European Economic Area
EEC	European Economic Community
EU	European Union
HRA	Human Rights Act 1998
HMRC	Her Majesty's Revenue and Customs (formerly known as "Inland Revenue")
ICTA	Income and Corporation Taxes Act 1988
TEC	Treaty establishing the European Community
TEU	Treaty on European Union

Abbreviation	Full reference
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom of Great Britain and Northern Ireland
VAT	Value Added Tax
VATA 1994	Value Added Tax Act 1994

Table of Cases

Abbreviation	Full Citation
Adeneler	*Adeneler v Ellinikos Organismos Galaktos* C-212/04 [2006] ECR I-6057
Astall	*Astall and another v HM Revenue and Customs* [2009] EWCA Civ 1010
Avoir Fiscal	*Commission of the European Communities v French Republic* C-270/83 [1986] ECR 273 I- 55
Barclays Mercantile	*Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UKHL 51
Bulmer v Bollinger	*H. P. Bulmer and Another v J. Bollinger S.A. and Others* [1974] Ch 401
Cadbury Schweppes	*Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* C-196/04 [2006] ECR I-7995.
Centrosteel	*Centrosteel Srl v Adipol GmbH* C-456/98 [2000] ECR I-6007
Cheney v Conn	*Cheney v Conn (Inspector of Taxes)* [1968] 1 All ER 779
Costa v ENEL	*Flaminio Costa v ENEL* C-6/64 [1964] ECR 585

Abbreviation	Full Citation
Damseaux	*Jacques Damseaux v État belge* C-128/08 [2009] 3 CMLR 1447
Duke of Westminster	*Duke of Westminster v IRC* HL 1935, 19 TC 490.
EB Central Services	*Revenue and Customs Commissioners v EB Central Services Ltd and another* [2008] STC 2209
Evobus Austria	*EvoBus Austria GmbH v Niederösterreichische Verkehrsorganisations GmbH (Növog)* C-111/97 [1998] ECR I-5411
Factortame (No. 2)	*R v Secretary of State for Transport, ex p Factortame Ltd (No 2)* [1991] 1 AC 603
Felixstowe Dock	*Felixstowe Dock and Rly Co and European Ferries Ltd v British Docks Board* [1976] 2 CMLR 655
Filipiak	*Filipiak v Dyrektor Izby Skarbowej w Poznaniu* C-314/08 [2010] All ER (EC) 168
Fleming/Condé Nast	*Fleming (trading as Bodycraft) v Revenue and Customs Commissioners; Condé Nast Publications Ltd v Revenue and Customs Commissioners* [2008] STC 324
Francovich	*Francovich and Bonifaci v Italy* C-6/90 & C-9/90 [1991] ECR I-5357

Abbreviation	Full Citation
Furniss v Dawson	*Furniss (Inspector of Taxes) v Dawson* [1984] AC 474
Ghaidan	*Ghaidan v Godin-Mendoza* [2004] 2 AC 557
Grundig II	*Grundig Italiana SpA v Ministero delle Finanze* C-255/00 [2002] ECR I-8003
Humblet	*Jean-E. Humblet v Belgian State* C-6/60 [1960] ECR 559
ICI v Colmer	*Imperial Chemical Industries plc v Colmer (Inspector of Taxes)* [2000] 1 All ER 129
IDT Card Services	*Revenue and Customs Commissioners v IDT Card Services Ireland Ltd* [2006] EWCA Civ 29
Lankhorst-Hohorst	*Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* C-324/00 [2002] ECR I-11779, 5 ITLR 467
Littlewoods	*Littlewoods Retail Ltd & Ors v The Commissioners for Her Majesty's Revenue and Customs (2010)* [2010] EWHC 1071 (Ch)
Macarthys Ltd v Smith	*Macarthys Ltd v Smith* [1979] 3 All ER 325 (CA)
Marks & Spencer II	*Marks & Spencer plc v Revenue and Customs Commissioners* C-309/06 [2008] ECR I-2283

Abbreviation	Full Citation
Marleasing	*Marleasing SA v La Comercial Internacional de Alimentacion SA*, C-106/89 [1990] ECR I-4135
Marshall	*Marshall (Inspector of Taxes) v Kerr* [1994] STC 638
Mayes	*Mayes v HM Revenue and Customs Commissioners* [2009] EWHC 2443 (Ch)
R v Secchi	*R v Secchi* [1975] 1 CMLR 383
Ramsay	*WT Ramsay Ltd v Inland Revenue Commissioners* [1981] 1 All ER 865
Reyners	*Jean Reyners v Belgian State* C-2/74 [1974] ECR 631
Pfeiffer	*Pfeiffer v Deutsches Rotes Kreuz, Kreisverband Waldshut eV* C-397/01 to C-403/01 [2004] ECR I-8835
Sanz de Lera	*Criminal proceedings against Lucas Emilio Sanz de Lera* C-163/94, C-165/94 & C-250/94 [1995] ECR I-4821
Scotch Whisky Association	*The Scotch Whisky Association v Compagnie Financière Européenne de Prises de Participation (Cofepp), Prisunic SA and Centrale d'Achats et de Services Alimentaires SARL (Casal),* C-136/98 [1998] ECR I-4571

Abbreviation	Full Citation
Scottish Provident	*Scottish Provident Institution v Inland Revenue Commissioners,* [2005] STC 15
SEVIC	*SEVIC Systems AG* C-411/03 [2005] ECR I-10805
Simmenthal	*Amministrazione delle Finanze dello Stato v. Simmenthal SpA* C-106/77 [1978] ECR 629
Thin Cap GLO	*Test Claimants in the Thin Cap Group Litigation v Revenue and Customs Commissioners* [2010] STC 301
Überseering	*Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)* C-208/00 [2002] ECR I-9919
van Binsbergen	*Johannes Henricus Maria van Binsbergen v Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid* C-33/74 [1974] ECR 1299
van Gend en Loos	*NV Algemene Transporten Expeditie Onderneming van Gend en Loos v Nederlandse Administratie der Belastingen* C-26/62 [1963] ECR 1
Vodafone 2 (EWCA)	*Vodafone 2 v The Commissioners of Her Majesty's Revenue and Customs* [2009] EWCA Civ 446
Vodafone 2 (EWHC)	*Vodafone 2 v The Commissioners of Her Majesty's Revenue and Customs* [2008] EWHC 1569 (Ch)

Abbreviation	Full Citation
von Colson	*Sabine von Colson and Elisabeth Kamann v Land Nordrhein-Westfalen,* C- 14/83 [1984] ECR 1891
Wagner Miret	*Wagner Miret v Fondo de Garanatia Salarial* C-334/92 [1993] ECR I-6911

1. Introduction

From literal interpretation to a liberal rewriting of the UK tax code – how could it be possible to go from one extreme in *Duke of Westminster* to the other in *Vodafone 2*?

When the Court of Appeal handed down its judgment in the *Vodafone 2* case, many commentators[1] could not understand how it felt able to read words into the statute which were not even printed in black and white. It is one thing to adopt differing interpretations of words one can read, but quite another to read in words that are nowhere to be seen. With this in mind, this paper seeks to explain and analyse the judicial journey from one end of the interpretative spectrum to the other.

The analysis is divided into distinct sections. Firstly, the paper reviews the evolution of domestic conforming interpretation jurisprudence in the field of direct tax, starting with *Duke of Westminster*, and tracing through to more recent cases such as *Astall* and *Mayes*. It is not the intention to furnish the reader with a full history of the development of jurisprudence in the area of tax avoidance, but these cases do provide a relevant basis from which to develop the further analysis.

Secondly, the paper addresses the question of the supremacy of EU law. In this section, it reviews the content of the European Communities Act 1972; the Act of Parliament which ratified the UK's accession to the European Economic Community in 1973, and analyses what impact this had on the area of parliamentary sovereignty and competence. It then considers the jurisprudence of the ECJ in respect of EU law supremacy, looking at cases such as *Filipiak* which relates to the freedom of establishment but also considering the key supremacy case law of the ECJ.

[1] Including the author - see Wellens (Pt 2), p.5.

In the next section, the focus remains with the ECJ's jurisprudence, but the emphasis shifts to its approach to conforming interpretation. The paper considers the key cases which established the principle of conforming interpretation in the ECJ such as *von Colson* and looks at how that principle has been maintained and reasserted. Following this, the paper then turns its attention to how the UK courts view EU law supremacy.

In the next section, the topic is conforming interpretation of the UK tax code in the field of EU law. This section brings together the principles which have thus far been discussed and explored, and analyses the extent to which they have been applied to jurisprudence in the tax field. This forms the basis for a subsequent more detailed discussion of the *Vodafone 2* case and the principles of conforming interpretation which are contained therein. Finally, the paper also considers a recent decision of the High Court in *Thin Cap GLO* where the principles clarified in *Vodafone 2* were examined but ultimately a different conclusion was reached.

2. Conforming interpretation in UK domestic direct tax

In the context of examining the extent to which it is possible to introduce a new exception into the CFC legislation, it is helpful to re-visit the domestic view of conforming interpretation. Although domestic jurisprudence in direct tax affairs does not exist in a vacuum (interpretation of the statute is practised in many areas of law), there is a body of case law relating specifically to interpretation of direct tax statues.

2.1. *Duke of Westminster* – letter of the law

The generally accepted progression of interpretation of tax law jurisprudence starts with *Duke of Westminster* where a structure for payment of wages in the

form of covenants was put in place in order to avoid surcharge tax. The House of Lords ruled that such an arrangement was legitimate and that it fell within the literal interpretation of the relevant statute:

> *"Every man is entitled to arrange his affairs so that the tax attaching under the appropriate Acts is less than it could be... This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable."*[2]

2.2. *Ramsay* – substance over form?

Things have evolved since the substance of a transaction was so robustly rejected in the *Duke of Westminster* judgment. The *Ramsay* doctrine is now well established in UK domestic jurisprudence, bringing a purposive approach to the interpretation of tax legislation. In *Ramsay*, the taxpayer sought to offset an existing taxable gain by the creation of a corresponding loss[3].

The series of steps put in place in *Ramsay*, each evaluated on an individual basis, produced such an effect. However, the House of Lords ruled that where such a series of steps served no commercial purpose other than to avoid tax, it is the overall effect of the transaction as a whole that should be taxed, and not the individual steps.

The core of the judgment in *Ramsay* rested on the fact that there was no longer a requirement to literally interpret the tax statute; it was permissible for the court to take a purposive approach and interpret the law in light of what it was trying to achieve.

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[2] 19 TC 490 at 520

[3] See Way, pp.65-68 for a description of the facts in *Ramsay*.

2.3. *Barclays Mercantile* and *Scottish Provident* – the narrowness and breadth of the Ramsay principle

This concept was refined in *Barclays Mercantile* where the point in question was whether or not a finance lessor, in purchasing an asset, had incurred qualifying expenditure which entitled it to capital allowances under the relevant UK legislation, where complex security arrangements in the related lease transaction meant that the funds used by the lessor to acquire the asset were made available on the same day to an affiliate company.

In its ruling, the House of Lords fell back on a purposive approach to the statute which looked solely at the treatment of the party incurring the capital expenditure and which was not concerned with the remaining "transaction steps". The House of Lords did qualify its ruling by explaining that *Ramsay* required the courts to give a purposive construction to the statute and then determine whether or not the transaction in question fell within such a construction. As such, it may still be possible to apply statutory provisions by reference to the end result of a series of transactions[4].

Just such an approach was taken in *Scottish Provident*, in which the taxpayer had acquired two options over Gilts which, if exercised, would cancel each other out for economic purposes, but would generate a loss for tax purposes. In this instance, the House of Lords ruled that there was a practical certainty of the two options being exercised at the same time and therefore felt able to disregard the "commercially irrelevant contingencies", and thus deny the tax deduction[5].

[4] Mortimer, p.445
[5] *ibid.*, p.446

2.4. *Astall* and *Mayes* – the limits of purposive interpretation[6]

Astall and *Mayes* are two cases which at first glance seem to contradict one another but yet go some way to confirming the principle of purposive interpretation.

In *Astall*, the taxpayer entered into a pre-arranged scheme that involved the subscription for debt securities where, in the event of an early redemption, a "deep gain" would have been recognised for the purposes of the UK relevant discounted securities legislation. However, the terms upon which the debt securities could be redeemed altered drastically where an "exchange rate event" occurred. The probability of such an event taking place was calculated at around 85%.

In such circumstances, the redemption value of the debt securities was amended so as to give rise to a tax loss (but no corresponding economic loss) in the hands of the original subscriber. The analysis of the case turned on whether or not the debt securities could be classified as relevant discounted securities for the purposes of Schedule 13 of the Finance Act 1996.

The Special Commissioners, High Court and Court of Appeal all in turn rejected this argument on the basis that there was no realistic prospect of the securities being redeemed at anything other than a loss. In so ruling, the courts reaffirmed the "commercially irrelevant contingencies" principle referred to in *Scottish Provident*.

Mayes related to the relief available to holders of life assurance policies upon partial surrender of such policies. In the present case, the UK taxpayer was not the holder of the life assurance policies when they were partially surrendered; they were held by a Luxembourg resident company that did not suffer any UK

[6] See Mortimer, pp.446-449 and Harrison & Bates, p.4. for a summary of the facts and further analysis of *Astall* and *Mayes*.

tax. The UK taxpayer did however later acquire these policies and made a corresponding claim for deficiency relief.

The High Court ruled[7] that the legislation as drafted did not consider the consequences of applying deficiency relief in circumstances where both parties to a transaction were not UK taxpayers, and was very prescriptive in terms of what is was trying to achieve[8]. As a result, it allowed the appeal, citing[9] Lord Hoffmann's 2005 article on tax avoidance and purposive construction:

> *"It is one thing to give a statute a purposive construction. It is another to rectify the terms of highly prescriptive legislation in order to include provisions which might have been included but are not actually there."*[10]

2.5. Domestic interpretation – some observations

This evolution of the domestic courts' thinking in respect of conforming interpretation – particularly in the field of direct tax – shows that the concept of interpretation is constantly developing, and that a literal interpretation of the tax statue as demonstrated in *Duke of Westminster* has to a large extent been usurped by a more purposive, almost pragmatic, approach to interpretation.

Having said that, whereas *Ramsay* seems to go quite far in extending the courts' ability to interpret legislation, this was tempered by *Barclays Mercantile*. Furthermore, *Scottish Provident* and *Astall* seemed to give additional powers to the courts to consider the commercial reality of a transaction.

Yet is it clear that, even up to the present day, there is still juridical debate over what constitutes interpretation of the legislation and this is evident in the

[7] [2009] EWHC 2443 (Ch) at 22
[8] Harrison & Bates, p.4
[9] [2009] EWHC 2443 (Ch) at 30
[10] [2005] BTR 197

opposing views reached in *Astall* and *Mayes* which, ostensibly, were looking at the same points of interpretation (i.e. whether or not a pre-arranged transaction step should be disregarded under the *Ramsay* principle).

This line of domestic case law provides some of the backdrop for the decision of the Court of Appeal in *Vodafone 2*, but it does not give the full picture. The essential extra element of this case is the EU dimension. Where a company is exercising its Treaty right to freedom of establishment, it is not sufficient to examine only the domestic jurisprudence; the domestic courts must also consider the jurisprudence of the ECJ.

3. The supremacy of EU law

The starting point for any analysis of the impact of ECJ jurisprudence on the domestic direct tax statute is the assumed overriding principle that Parliament retains sovereignty over its own affairs; that it can do anything other than bind itself for the future[11]. However, equally clear is the principle that the UK operates a dualist approach to international law and that international treaties ratified by the UK are not part of the domestic statute and must be incorporated through Parliament[12]. This contrasts with the monist approach adopted in some jurisdictions[13], where treaties may become part of domestic law once concluded, without any separate requirement for domestic legislation[14]. Following the UK's dualist approach, the Act of Parliament which incorporated the terms and conditions of the UK's entry into the EEC in 1973 was the European Communities Act 1972.

[11] Craig in Jowell & Oliver, p.92
[12] Craig & De Búrca, p.365 & Baker, pp.21-22
[13] For example, Poland. See Aust, p.148 for details.
[14] Aust, p.146

3.1. The European Communities Act 1972

S2(1) ECA 1972 reads:

> *"All such rights, powers, liabilities, obligations and restrictions from time to time created or arising by or under the Treaties, and all such remedies and procedures from time to time provided for by or under the Treaties, as in accordance with the Treaties are without further enactment to be given legal effect or used in the United Kingdom shall be recognised and available in law, and be enforced, allowed and followed accordingly; and the expression "enforceable Community right" and similar expressions shall be read as referring to one to which this subsection applies."*

This section provides for an *en bloc* incorporation of EU law into domestic UK law, but crucially it also allows for the adoption of future EU law, through the construct 'from time to time provided for'[15].

The Act goes on to address the issue of Parliamentary sovereignty in s2(4), the key part of which reads:

> *"The provision that may be made under subsection (2) above includes, subject to Schedule 2 to this Act, any such provision (of any such extent) as might be made by Act of Parliament, and* ***any enactment passed or to be passed****, other than one contained in this Part of this Act,* ***shall be construed and have effect subject to the foregoing provisions of this section****."*[16]

[15] Turpin & Tomkins, p.319
[16] Author's emphasis

The language contained in s2(4) ECA 1972 serves to ensure that any Act of Parliament previously passed, or which is passed in the future, should be interpreted in such a way as to comply with EU law[17].

Furthermore, s3(1) ECA 1972 states:

> *"For the purposes of all legal proceedings any question as to the meaning or effect of any of the Treaties, or as to the validity, meaning or effect of any Community instrument, shall be treated as a question of law (and, if not referred to the European Court, be for determination as such in accordance with the principles laid down by and any relevant decision of the European Court)."*

This section of the Act ensures that not only must the domestic courts follow their own jurisprudence when ruling on points of law, they must also take into account any relevant jurisprudence of the ECJ.

This effect has not been lost on the judiciary, as observed by Lord Denning in *Bulmer v Bollinger*:

> *"The Treaty is like an incoming tide. It flows into the estuaries and up the rivers. It cannot be held back. Parliament has decreed that the Treaty is henceforward to be part of our law. It is equal in force to any statue."*[18]

This view has been consistently upheld in the national courts, as recently evidenced by Mr Justice Vos in *Littlewoods*:

[17] A similar right is enshrined in s3 HRA 1998, and was used as the basis of a conforming interpretation in the leading human rights case, *Ghaidan*. In this case, the House of Lords was able to construe a reference which protected the rights of spouses under tenancy agreements to include same-sex partners.
[18] [1974] Ch 401 at 418, as cited in Turpin & Tomkins, p.310

> *"Section 2 of the European Communities Act 1972 requires English legislation 'to be construed and have effect subject to' EU rights."*[19]

Furthermore, the Act, through s2(4), requires the domestic courts to interpret legislation, where possible, in such a way so as to be in accordance with EU law. Finally, s 3(1) of the Act obliges the courts to consider the jurisprudence of the ECJ when ruling on domestic points of law.

3.2. The question of competence

As outlined above, s2(1) ECA 1972 provides for an adoption into domestic law of the rights and obligations under EU law as contained in the Treaty. The question is – what does this mean for concept of UK Parliamentary sovereignty and, of particular relevance in the context of *Vodafone* 2, its competence in respect of direct tax affairs?

member states of the EU (including the UK[20]) have transferred to the EU certain limited powers specified in Article 5 TEU, which states "t*he Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein"*[21]. Although the Treaty makes no explicit reference to direct taxes, it is clear from *Humblet* that power to tax Community officials' salaries resided with the EU alone[22], and that this represented a full transfer of competence under the Treaty from member states to the EU, which first occurred (subject to the transitional arrangements put in place) upon establishment of the EEC by the Treaty of Rome in 1958.

Furthermore, repeated case law of the ECJ – starting famously with *Avoir Fiscal* in 1986 – dictates that whilst member states retain control over direct tax affairs,

[19] Para. 74, *Littlewoods*
[20] Through its signing of the EEC Accession Agreement in 1973
[21] See O'Shea (competence), p.72 for more details.
[22] O'Shea (competence), p.72

they do so under the requirement to comply with their obligations as laid down in the Treaty[23].

Many of such obligations are included in the area of shared competence between the EU and member states, as stipulated in Article 4(2) TFEU. Shared competence is defined as an area in which member states cannot exercise competence or legislate where the EU has already done so[24].

Crucially, from the point of view of *Vodafone 2*, one of the areas of shared competence is the internal market[25], which includes the freedom of establishment. Therefore, since the Treaty confers the freedom of establishment, this particular competence has been exercised by the EU and cannot be exercised by member states. The logical result of this is that s2(1) ECA 1972 gives immediate direct legal effect in the UK to the freedom of establishment, and all other freedoms which the ECJ has interpreted as having direct effect[26].

3.3. ECJ jurisprudence and the supremacy of EU law

If the domestic statute, through the ECA 1972, requires the UK courts to consider the jurisprudence of the ECJ when assessing domestic law, then what does the ECJ say about the supremacy of EU law?

3.3.1. *van Gend en Loos* – an early assertion of supremacy

The ECJ first articulated its doctrine of supremacy in *van Gend en Loos*. In this case, the appellant argued that the imposition of an increased import duty after

[23] See para. 24, *Avoir Fiscal*
[24] Chalmers, Davies & Monti, p.208
[25] Article 4(2)a TFEU
[26] See section 3.4 below for examples of the direct effect of the freedom of establishment. For an example of direct effect in freedom to provide services, see *van Binsbergen* and for an example of direct effect in free movement of capital see *Sanz de Lera*.

the implementation of the EC Treaty was contrary to Article 12 EC[27]. One of the questions put to the ECJ was whether or not this article had direct effect and could therefore be invoked by nationals of a member state. The Dutch government argued that the EC Treaty was the same as all international treaties and that the concept of direct effect would contradict the intentions of the Treaty drafters[28]. The ECJ disagreed with this submission, stating:

> *"The implementation of Article 12[29] does not require any legislative intervention on the part of the states. The fact that under this Article it is the member states who are made the subject of the negative obligation* [not to impose import duties] *does not imply that their nationals cannot benefit from this obligation."*

3.3.2. *Costa v ENEL* – confirmation of the position

This view was confirmed by the ECJ in *Costa v ENEL*. Costa was an Italian national and shareholder in Edison Volta; a company which was subsequently nationalised and renamed ENEL. Costa argued that the nationalisation of the company was contrary to the EU law on state distortion of the market. The Italian government countered that it was not within the jurisdiction of the national court to refer such a matter to the ECJ. The ECJ disagreed and, asserting its authority and the supremacy of EU law, ruled:

> *"The member states have limited their sovereign rights, albeit within limited fields, and have thus created a body of law which binds both nationals and themselves."*

[27] Now Article 30 TFEU
[28] Craig & De Búrca, p.272
[29] Now Article 30 TFEU

3.3.3. *Simmenthal* – a forward looking view of supremacy

The ECJ further applied and extended this doctrine of supremacy in *Simmenthal*. In this case, an Italian import duty – in the form of a public health inspection fee – introduced after the enactment of the EU Treaty, was challenged as a restriction on the free movement of goods. This was upheld by the ECJ but the Italian authorities then argued separately that, although the law introducing the fee had been after accession to the Community, it was for the Italian constitutional court to rule on the validity of the law, and not the ECJ[30].

The ECJ ruled that the existence of Community law rendered inapplicable any existing national law which contradicted it, and furthermore precluded the adoption of any new rule which was contrary to Community provisions[31], stating:

> *"Every national court must, in a case within its jurisdiction, apply Community law in its entirety and protect rights which the latter confers on individuals and must accordingly set aside any provision of national law which may conflict with it, whether prior or subsequent to the Community rule."*

3.4. Freedom of establishment and the supremacy of EU law

Supremacy of EU law and the principle of direct effect is also present in ECJ case law referring to the freedom of establishment; the freedom in question in *Vodafone 2*.

[30] Turpin & Tomkins, p.306
[31] Craig in Pernice & Miccù, p.35

3.4.1. *Reyners* – an example of direct effect

In this case, a Dutch national who was qualified to practise as an *advocat* (solicitor) in Belgium was prevented from doing so by a domestic rule in Belgium which contained a nationality clause, requiring all *advocats* in Belgium to be Belgian nationals. Reyners argued, and the ECJ ruled, that this restriction was contrary to the freedom of establishment, even where the European Council had not issued the Directives which were supposed to apply to the transitional period of introduction of freedom of establishment:

> *"In laying down that freedom of establishment shall be attained at the end of the transitional period, Article 52[32] thus imposes an obligation to attain a precise result, the fulfilment of which had to be made easier by, but not made dependent on, the implementation of a programme of progressive measures. The fact that this progression has not been adhered to leaves the obligation itself intact beyond the end of the period provided for its fulfilment... It is not possible to invoke against such an effect the fact that the Council has failed to issue the Directives provided for."*[33]

The case is a good example of the ECJ developing the doctrine of direct effect in the area of freedom of establishment[34] which, of course, is especially relevant in the case of *Vodafone 2*. It also establishes the precedent that it is not necessary to have a Directive in place in order to assert supremacy of the Treaty provisions.

[32] Now Article 49 TFEU
[33] Paras. 26-27 & 29, *Reyners*
[34] Moens & Trone, p.370

3.4.2. *Filipiak* – reinforcing the direct effect of freedom of establishment

In *Filipiak*, the taxpayer – a Polish resident for tax purposes, carried on economic activity in the Netherlands as a partner in a Dutch partnership and paid mandatory social security and health insurance contributions in the Netherlands. As a Polish resident for tax purposes, the taxpayer was liable to Polish tax on his worldwide income, but sought to deduct the expenses incurred in the Netherlands on the insurance payments.

This deduction was denied in Poland and the taxpayer appealed. Shortly thereafter, the Polish Constitutional Tribunal held that these particular rules regarding income tax were unconstitutional, but that the date on which they would lose their binding force should be delayed to a specified date in the future. The national court referred the case to the ECJ to determine the legislation's compatibility with the freedom of establishment.

What is, on the face of it, a fairly clear cut case of "less favourable treatment" was given additional significance by the fact that even though the Constitutional Tribunal had ruled the legislation to be unconstitutional and that it would lose its binding status, the ECJ held that its current existence contravened Community law and that the legislation must be disapplied with immediate effect:

> *"… the primacy of Community law obliges the national court to apply Community law and to refuse to apply the conflicting provisions of national law, irrespective of the judgment of the national constitutional court which has deferred the date on which those provisions, held to be unconstitutional, are to lose their binding force."*[35]

[35] Para. 85, *Filipiak*

3.5. Freedom of establishment and the supremacy of EU law – some observations

These three freedom of establishment cases further reinforce the ECJ's jurisprudence in the area of direct effect and confirm that the freedom of establishment is a directly applicable Treaty right.

4. ECJ jurisprudence and the principle of conforming interpretation

It is clear from the jurisprudence examined above that the ECJ considers EU law to be supreme, and the freedom of establishment to be directly effective; both of which are important principles when examining how the Court of Appeal reached its judgment in *Vodafone 2*. Equally important is the approach taken by the ECJ to domestic courts' requirement to interpret EU law which it regards as supreme and it is to this topic which the analysis will now turn.

The ECJ leaves the responsibility of interpreting domestic law in light of EU law obligations to the national courts[36], since the ECJ's area of competence lies with the interpretation of EU law only[37]. It does, however, offer some guidance on how national courts should approach the issue. For example, in *Scotch Whisky Association*, the Advocate General ("AG") stated in his opinion that:

> *"it is a fundamental principle of statutory interpretation that words which do not require interpretation, because they are perfectly clear, should not be distorted under pretence of interpretation"*[38]

At first glance, this approach to conforming interpretation appears to tie in with that espoused in the UK domestic courts; the basis of interpretation should be

[36] See para. 72 of *Cadbury Schweppes* for – in the context of *Vodafone 2* – one of the most relevant examples of this practice.
[37] See para. 20 of *Damseaux* for an example of the ECJ's jurisprudence on this issue. See also O'Shea (*Damseaux*) for a description of the facts and further analysis of the case.
[38] Para. 18 of the AG's opinion in *Scotch Whisky Association*

the ordinary and natural meaning of the words, and interpretation should not be used as a method of materially altering the statue. However, the ECJ has developed a set of principles over and above this narrow definition of domestic courts' obligation to interpret national law according to the simple meaning of the words used.

4.1. *Von Colson* – laying the foundations of conforming interpretation

In *von Colson*, the appellants were women who were respectively refused employment in a German male prison and a German company trading in Saudi Arabia on the grounds of their sex. The appellants claimed that this treatment was contrary to Council Directive (EEC) 76/207, the Equal Treatment Directive.

The ECJ ruled that the Directive in question was not sufficiently precise to guarantee a specific remedy, but the important part of the judgment – from the point of view of conforming interpretation – came in relation to the effect that the Directive's aims may have on the interpretation of national law[39]. In respect of this, the ECJ ruled:

> *"In applying the national law and in particular the provisions of a national law specifically introduced in order to implement Directive No 76/207, national courts are required to interpret their national law in the light of the wording and the purpose of the Directive."*[40]

At first glance, such a statement seems to confirm that interpretation should be based on the 'simple meaning of the words used'. However, the main difference is that it is the words and purpose of the piece of EU law (in this case, the Directive) which are key and not the meaning of the national law.

[39] Craig & De Búrca, p.287
[40] Para. 26, *von Colson*

4.2. *Marleasing* – an extension of the principle of conforming interpretation

Whereas *von Colson* alluded to the requirement for national courts to apply a conforming interpretation more widely than just to Directives, the ECJ's judgment in *Marleasing* made this explicit. In this case, the appellant sought in the Spanish Courts to have nullified the founders' contract which established the defendant's company on the basis that the contract was a sham.

The ability to do this under Spanish domestic law was not mirrored in Council Directive (EEC) 68/151 which – in Article 11 – contained an exhaustive list of conditions under which a contract could be nullified. Since the Spanish law had existed prior to Spain's accession to the (then) European Communities, and Spain had not transposed the Directive into its domestic code, the Spanish courts referred to the ECJ the question of whether or not domestic law in this area should be interpreted in line with the requirements of the Directive.

The ECJ held that the Spanish court was, to the extent possible, required to interpret national legislation in line with the wording and purpose of the Directive, even where such a Directive had not been transposed into domestic law, and the domestic legislation in question had existed prior to the introduction of the Directive:

> *"In applying national law, whether the provisions in question were adopted before or after the Directive, the national court called upon to interpret it is required to do so, as far as possible, in the light of the wording and the purpose of the Directive in order to achieve the result pursued by the latter."*[41]

The ECJ went further, to suggest that in this particular case, the Spanish courts must interpret the domestic law so as to exclude the possibility of nullifying a contract which was a sham[42]:

[41] Para. 8, *Marleasing*
[42] Amstutz, p.771

> *"… a national court hearing a case which falls within the scope of Directive 68/151 is required to interpret its national law in the light of the wording and the purpose of that Directive in order to preclude a declaration of nullity of a public limited company on a ground other than those listed in Article 11 of the Directive."*[43]

In so ruling, the ECJ widened the conforming interpretation doctrine espoused in *von Colson* to include national legislation which had no specific connection with a Directive[44].

4.3. *Pfeiffer* – further evidence of the conforming interpretation principle in EU law

The issue in *Pfeiffer*[45] was whether or not there had been a breach of Directive (EEC) 93/104 – the Working Time Directive, which stipulated that the average working time over 7 days should be no more than 48 hours. Central to the analysis was whether 'duty time' should be taken into account. The ECJ ruled that it should[46] and as a result the average working time of the appellant was 49 hours. Since this was in excess of the 48 hours stipulated by the Directive, the ECJ was asked to rule on the direct effect of a Directive, where the Directive had not been correctly transposed into national law. The ECJ held:

> *"Although the principle that national law must be interpreted in conformity with Community law concerns chiefly domestic provisions enacted in order to implement the Directive in question,* ***it does not entail an interpretation merely of those provisions but requires the national court to consider national law as a whole***

[43] Para. 13, *Marleasing*
[44] Craig & De Búrca, p.289
[45] See Sawyer for a summary of the facts in *Pfeiffer*.
[46] See para. 94, *Pfeiffer*

> *in order to assess to what extent it may be applied so as not to produce a result contrary to that sought by the Directive."*[47]

It went on to rule:

> *"In that context,* ***if the application of interpretative methods recognised by national law enables****, in certain circumstances, a provision of domestic law to be construed in such a way as to avoid conflict with another rule of domestic law or the scope of that provision to be restricted to that end by applying it only in so far as it is compatible with the rule concerned, the national court is bound to use those methods in order to achieve the result sought by the Directive."*[48]

Pfeiffer is an example of the continuing principle of conforming interpretation seen in *von Colson* and *Marleasing*. However, perhaps more interesting is the fact that it extends the scope of the conforming interpretation to require national courts to consider all national law when attempting to reach a conforming interpretation. Furthermore, it requires national courts to use recognised domestic methods of interpretation to construe laws in such a way as to avoid conflict with EU law. This is of particular relevance to the issue of conforming interpretation, as addressed by the Court of Appeal in *Vodafone 2*, and raises an interesting question of how EU law could be interpreted differently in various member states as a result of differing domestic methods of interpretation.

4.4. The limits of conforming interpretation: *contra-legem* application of EU law

It is clear from the jurisprudence of the ECJ that national courts are under an obligation to interpret domestic law – to the extent possible – in accordance with the obligations placed upon member states by the Treaties. However, the ECJ

[47] Para. 115, *Pfeiffer* (author's emphasis)
[48] Para. 116, *Pfeiffer* (author's emphasis)

has ruled on several occasions that where such an interpretation is not possible under domestic law, the national courts are not required to take a *contra-legem* position.

In *Wagner Miret* the ECJ ruled[49] that the national provisions could not be interpreted in a manner which would conform to the provisions of the relevant Directive and, as such, the Member State would be required to make good any losses suffered under the *Francovich* principle. This view was echoed in *Evobus Austria*; a case in which a Directive[50] which had not been transposed into national law and the existing domestic law could not be interpreted in such a way so as to comply with the Directive, since certain provisions of the domestic law were in direct contradiction to the provisions of the Directive. A further example of this can be found in *Adeneler*, where the ECJ held that the application of conforming interpretation should not be at the expense of legal certainty and non-retroactivity:

> *"It is true that the obligation on a national court to refer to the content of a Directive when interpreting and applying the relevant rules of domestic law is limited by general principles of law, particularly those of legal certainty and non-retroactivity, and that obligation cannot serve as the basis for an interpretation of national law contra legem."*[51]

4.5. EU principles of conforming interpretation – some observations

The body of existing and continuing case law from the ECJ in the area of conforming interpretation represents a consistent theme to the ECJ's jurisprudence in this area. From the examples outlined above, it is possible to

[49] See para. 22, *Wagner Miret*
[50] Council Directive (EEC) 92/13 coordinating the laws, regulations and administrative provisions relating to the application of Community rules on the procurement procedures of entities operating in the water, energy, transport and telecommunications sectors.
[51] Para. 110, *Adeneler*

distil a set of principles which the ECJ applies to cases where questions of conforming interpretation arise:

a) *EU law is supreme*: it is clear from *van Gend en Loos* and *Costa v ENEL* that where an existing national law is found to be incompatible with EU law, it is EU law which prevails. This concept was further advanced in *Simmenthal*, where the principle was applied to any national law introduced after the enactment of the relevant EU law;

b) *Supremacy applies to all Treaty freedoms*: although a large body of the case law in the area of supremacy is focused on the interaction between national law and EU Directives, it is clear that all directly effective Treaty obligations and freedoms rank above any contradictory domestic law provisions. This principle is confirmed in *Filipiak*, but had already been seen previously in *Überseering* and *SEVIC*;

c) *National courts are obliged to adopt a conforming interpretation*: the ECJ is clear that national courts are required – where possible - to reach a conforming interpretation of EU law. The principle has been expanded over the years, starting with interpretation of Directives in *von Colson*, being widened to include national law which was not specifically enacted for the purposes of implementing a Directive in *Marleasing*, and then expanding to include a requirement to use domestic methods of interpretation of all national law in *Pfeiffer*; and

d) *The obligation does not extend to contra legem interpretations*: whilst the requirement to reach a conforming interpretation is well established and consistently stated in ECJ jurisprudence, it does not oblige national courts to adopt a *contra legem* interpretation of national law where it simply is not possible to interpret the provisions of the relevant piece of EU law. However, in this scenario, member states may suffer a liability under the *Francovich* principle.

5. The UK domestic view of EU law supremacy

The ECJ jurisprudence as outlined above provides a basis for the principle of EU law supremacy and conforming interpretation. However, before analysing the specific details of *Vodafone 2*, it is beneficial to examine how the domestic courts in the UK[52] have addressed these particular issues.

5.1. Supremacy of EU law and UK domestic jurisprudence

As outlined above[53], the UK courts quickly realised the impact of the ECA 1972 and the responsibilities that accession to the EEC brought. Accordingly, there is a body of case law in which the UK courts have affirmed the principle of supremacy of EU law.

5.1.1. *Macarthys Ltd v Smith* – an early ruling on EU law supremacy

One of the early landmark cases which established the supremacy of EU law in the UK (but also addressed the concepts of conforming interpretation) was *Macarthys Ltd v Smith*[54]. In this case, an employer replaced its stockroom manager – a male employee – with a female employee, but at a lower rate of pay. An industrial tribunal held that the female employee was entitled to be paid at the same rate as the previous male employee. The employer appealed on the basis that for the Equal Pay Act 1970 to apply, the male and female employees must be employed by the same employer on like work *at the same time*. In the

[52] The analysis in this paper is focused on the law of England and Wales, but "UK" is used in a more generic sense.
[53] See section 3.1.
[54] See Turpin & Tomkins, pp.322-327 for a summary of the Court of Appeal case and the subsequent ECJ and House of Lords rulings in *the case*

view of the employer, since the female employee was employed *after* the male employee, the terms of the Equal Pay Act 1970 could not apply.

Lord Denning began his analysis with Article 119 of the EC Treaty[55] (the Article requiring equal pay for men and women), since in his view it *"takes priority even over our own statute"*[56]. He confirmed that the EC Treaty and Article 119 had direct effect in the UK, stating:

> *"Article 119 of the EEC Treaty says:*
>
> > *'Each Member State shall during the first stage ensure and subsequently maintain the application of the principle that men and women should receive equal pay for equal work ... '*
>
> *That principle is part of our English law. It is directly applicable in England. So much so that, even if we had not passed any legislation on the point, our courts would have been bound to give effect to art 119."*[57]

Furthermore, Lord Denning made reference to the binding nature of EU law as per the ECA 1972:

> *"Under s 2(1) and (4) of the European Communities Act 1972 the principles laid down in the Treaty are 'without further enactment' to be given legal effect in the United Kingdom; and have priority over 'any enactment passed or to be passed' by our Parliament. So we are entitled and I think bound to look at art 119 of the EEC Treaty because it is directly applicable here."*[58]

Having established that the EC Treaty had direct effect, Lord Denning then analysed whether or not the implementing legislation in the UK (namely, the

[55] Now Article 157 TFEU.
[56] [1979] 3 All ER 325 at 328
[57] *ibid.*
[58] *supra.*, fn. 56

Equal Pay Act 1970) could be construed so as to cover a situation where a female employee was subsequently employed at a lower rate pay than a male employee, rather than only covering a situation where the employment was contemporaneous. He ruled:

> *"Article 119 is framed in European fashion. It enunciates a broad general principle and leaves the judges to work out the details. In contrast the Equal Pay Act is framed in English fashion. It states no general principle but lays down detailed specific rules for the courts to apply (which, so some hold, the courts must interpret according to the actual language used) without resort to considerations of policy or principle."*[59]

Going on to state:

> *"In my opinion therefore art 119 is reasonably clear on the point; it applies not only to cases where the woman is employed on like work at the same time with a man in the same employment, but also when she is employed on like work in succession to a man, that is, in such close succession that it is just and reasonable to make a comparison between them."*[60]

Finally, Lord Denning analysed the impact of Article 119 on the domestic legislation and concluded:

> *Now stand back and look at the statutes as a single code intended to eliminate discrimination against women. They should be a harmonious whole. To achieve this harmony s1(2)(a)(i) of the Equal Pay Act should not be read as if it included the words 'at the same time'. It should be interpreted so as to apply to cases where a woman is employed at the same job doing the same work 'in*

[59] [1979] 3 All ER 325 at 329
[60] *ibid.*

> *succession' to a man. By so construing the Treaty and the statutes together we reach this very desirable result: it means that there is no conflict between art 119 of the Treaty and s 1(2) of the Equal Pay Act; and that this country will have fulfilled its obligations under the Treaty.*

This view of the construction of the domestic statue was not shared by Lawton LJ, who fell back on a more traditional interpretation of the relevant sections of the Equal Pay Act:

> *"In my judgment the grammatical construction of s 1(2) is consistent only with a comparison between a woman and a man in the same employment at the same time. The words, by the tenses used, look to the present and the future but not to the past. They are inconsistent with a comparison between a woman and a man, no longer in the same employment, who was doing her job before she got it."*[61]

Despite this difference of opinion over how the legislation should be interpreted, the Court of Appeal ruled that there was sufficient ambiguity so as to warrant a referral of the case to the ECJ, which duly ruled that Article 119 of the EC Treaty was not confined to contemporaneous employment[62].

Aside from its acceptance of the supremacy of EU law, one of the most important aspects of this judgment is the approach that the court took to interpretation of the domestic statute. Lawton LJ (and Cumming-Bruce LJ) both adopted the traditional view of interpretation which focused on the 'meaning of the words used'. Lord Denning can perhaps be seen in this context as somewhat of a visionary, since he was prepared as early as 1979[63] to take a more purposive approach to interpreting the legislation – a principle which was cited as one of

[61] [1979] 3 All ER 325 at 332
[62] See para. 16 of case C-129/79 *Macarthys Ltd v Smith*, cited at [1981] 1 All ER 111 at 119
[63] There are earlier examples of domestic jurisprudence which involved the EC Treaty (see *R v Secchi*, *Felixstowe Dock* and, of course, *Bulmer v Bollinger*), but *Macarthys Ltd v Smith* is one of the first EU law cases to consider the requirement to construe the language of the statute in a different manner to traditional domestic principles of statutory interpretation.

the central principles of conforming interpretation in *Vodafone 2 (EWCA)* some 30 years later.

5.1.2. *Factortame (No. 2)* – confirmation of EU law supremacy

Supremacy of EU law in the UK was reaffirmed in *Factortame (No. 2)*. This case was concerned with prohibition of Spanish owned vessels from fishing in UK waters. The first *Factortame* case[64] was focused on whether or not the appellants were entitled to interim relief in order to protect their financial interests; the absence of which the ECJ ruled was contrary to EU law[65]. In the subsequent ruling in the House of Lords, Lord Bridge stated:

> *"Whatever limitation of its sovereignty Parliament accepted when it enacted the European Communities Act 1972 was entirely voluntary. Under the terms of the Act of 1972 it has always been clear that it was the duty of a United Kingdom court, when delivering final judgment, to override any rule of national law found to be in conflict with any directly enforceable rule of Community law."*[66]

This judgment from the House of Lords establishes the supremacy of EU law in the jurisprudence of the UK domestic courts. Importantly, it also refers to the fact that any national law which is found to be in conflict with directly effective EU law should overridden. As explained above[67], the freedom of establishment (along with the other fundamental freedoms) has been ruled by the ECJ as a directly effective EU law. As such, the UK courts have confirmed that the principle of freedom of establishment has direct effect, which is especially relevant in the context of *Vodafone 2*.

[64] *Factortame Ltd v Secretary of State for Transport* [1990] 2 AC 85
[65] *R. v Secretary of State for transport, ex p. Factortame Ltd and others* C-213/89 [1990] ECR I-2433
[66] [1991] 1 AC 603 at 658
[67] See section 3.4.2.

This contrasts with the view of some commentators[68] that the UK Parliament retains is sovereignty over international law, and therefore EU law, as a result of the judgment in *Cheney v Conn*. In this case the taxpayer, Cheney, refused to pay a portion of his income tax after the 1964 Finance Act was passed, as he considered that this Act was in breach of the UK's obligations not to fund the construction of nuclear weapons under the international law-based Geneva Convention, as enacted in the UK through the Geneva Conventions Act 1957. In dismissing the appeal, Ungoed-Thomas J ruled:

> *"What the statute itself enacts cannot be unlawful, because what the statute says and provides is itself the law, and the highest form of law that is known to this country. It is the law which prevails over every other form of law, and it is not for the court to say that a parliamentary enactment, the highest law in this country, is illegal."*[69]

5.2. The UK domestic view of EU law supremacy – some observations

It may be true that Parliament retains the right to enact into statue any law it so chooses, regardless of whether or not it would be contradictory to obligations under international or EU law. However, in the context of EU law, this line of reasoning does not adequately consider the fact that Parliament has already codified its wish to operate within its obligations as defined in the EU Treaty through its acceptance into law of the ECA 1972. Therefore, until such time as Parliament expresses a clear desire to no longer be subject to such constraints (through, for example, a repeal of the ECA 1972), it must consider itself duty bound to legislate within the boundaries of its obligations under EU law.

[68] See, for example, Bradley & Ewing, p.59
[69] [1968] 1 All ER 779 at 782

6. Conforming interpretation of the UK tax code in the context of EU law

It is clear from the case law of both the ECJ and the domestic courts that EU law is considered to be supreme. With this in mind, the analysis will now focus on how such principles have been applied to case law in the field of UK tax. The inclusion at this stage of indirect tax jurisprudence is a deliberate one, since matters of conforming interpretation in the field of direct tax are necessarily shaped and moulded by other examples of conforming interpretation in the related field of indirect tax.

Taking into account Lord Bridge's comments in *Factortame (No. 2)* where he declared that EU law should override incompatible domestic law, the focus will now turn to an examination of domestic tax law jurisprudence in which this approach has been adopted. The first example to be discussed is *ICI v Colmer*.

6.1. *ICI v Colmer* – conforming interpretation or disapplication?

ICI v Colmer centred on the availability of consortium relief in the UK. ICI held 49% of the shares in a company, and its claim for consortium relief could only succeed if this company was considered to be a holding company under the relevant UK tax legislation[70]. Furthermore, the definition of company in the legislation was restricted to companies resident in the UK. In the present case, the majority of the 23 subsidiary companies were resident outside the UK and as a result HMRC initially denied the consortium relief.

[70] s258(5)(b) of the Income and Corporation Taxes Act 1970, as updated by s413(3)(b) ICTA 1988. S27, sch 1, para 5 of Finance Act 2006 ultimately inserted a definition of "EEA territory" with effect from 19 July 2006.

6.1.1. Early rulings on the case

This view was upheld by the Special Commissioners, although overturned in the High Court where the judge held that the residence requirements did not apply. This was upheld in the Court of Appeal and the case found its way to the House of Lords for the first time. The House of Lords took an opposing view to that held by the High Court and the Court of Appeal, but in so doing it requested a ruling from the ECJ on the compatibility of the residence requirement contained in the consortium relief legislation, in respect of the EU resident subsidiaries and the corresponding freedom of establishment under Article 52[71].

6.1.2. *ICI v Colmer* in the ECJ

The ECJ conducted a fairly straightforward restriction analysis in this case, ruling that a restriction of consortium relief where all or the majority of eligible subsidiary companies must be resident in the same member state as the holding company would be contrary to the freedom of establishment:

> *"Art 52[72] of the Treaty precludes legislation of a member state which, in the case of companies established in that state belonging to a consortium through which they control a holding company, by means of which they exercise their right to freedom of establishment in order to set up subsidiaries in other member states, makes a particular form of tax relief subject to the requirement that the holding company's business consist wholly or mainly in the holding of shares in subsidiaries that are established in the member state concerned."*[73]

[71] Now Article 49 TFEU.
[72] Now Article 49 TFEU.
[73] Para. 30 of the ECJ's judgment in *ICI v Colmer* C-264/96 [1998] ECR I-4695

However, in the case at hand, since only 6 of the subsidiaries were resident in EU member states and the majority of the subsidiaries were based outside of the EU, the ECJ did not see the facts of this case as being affected by EU law[74]. Therefore, it was left to the national courts to decide how to address a situation where the same law could conceivably be contrary to EU law in some circumstances, but fall outside the scope of the treaty obligations in others:

> *"Where a particular provision must be disapplied in a situation covered by Community law, but that same provision could remain applicable to a situation not so covered, it is for the competent body of the state concerned to remove that legal uncertainty in so far as it might affect rights deriving from Community rules."*[75]

In essence, the ECJ was advocating a principle of "limited disapplication"[76] of the consortium relief rules in circumstances where they restricted the freedom of establishment of companies seeking to incorporate subsidiary companies in other member states.

6.1.3. *ICI v Colmer's* return to the House of Lords

On its second hearing before the House of Lords, the key issue in the case was how to interpret the ECJ's ruling. The first option was that in order to conform with the ECJ ruling, the UK legislation should be read as if there were no restriction on residence in the consortium relief rules. The counter argument was to disapply the residence requirement in cases which fell within the scope of the ECJ's judgment (i.e. where all or the majority of the subsidiaries were EU resident companies).

[74] Para. 32, *ibid.*
[75] Para. 34, *ibid*.
[76] See Airs, p.8 for a wider discussion on this piece of terminology.

Counsel for ICI submitted that the adoption of the second alternative would create anomalies between groups of companies, that the legislation itself was ambiguous and the ambiguity would be remedied by adopting the approach ruled by the Court of Appeal[77]. Giving the lead judgment in the case, Lord Nolan rejected this argument, ruling:

> *"... while the construction adopted by the* [Court of Appeal] *would certainly avoid the difficulty raised by Art 52[78], it can scarcely be described as conforming with the Article, because it draws no distinction between companies resident within and those resident outside the Community."*[79]

Lord Nolan then moved on to consider the question of disapplication and the interaction of the consortium relief legislation with s2 ECA 1972. He stated:

> *"So, in the present case, the effect of s 2 of the 1972 Act is the same as if a subsection were incorporated in s 258 of the 1970 Act which in terms enacted that the definition of 'holding company' was to be without prejudice to the directly enforceable Community rights of companies established in the Community. As the concluding paragraphs of the judgment of the Court of Justice make plain, this in no way affects the application of the definition to companies established outside the Community."*[80]

Consequently, the House of Lords held in favour of HMRC in ruling that consortium relief was not available to the ICI holding company, on account of the fact that the majority of the subsidiary companies were resident outside the EU and therefore there was no requirement to disapply the legislation.

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[77] [2000] 1 All ER 129 at 133
[78] Now Article 49 TFEU
[79] *supra.*, footnote 77.
[80] *ibid.*

6.1.4. *ICI v Colmer* – some observations

Although ICI as the taxpayer was unsuccessful in the case, this was as a result of the specific facts of the case. Had the majority of the subsidiary companies been resident in the EU, the consortium relief rules would have been ruled as being incompatible with the freedom of establishment, and it is this principle of conformity through disapplication which stands out and is repeated in *ICI v Colmer* as it was originally espoused in *Factortame (No. 2)*.

6.2. *IDT Card Services* – creating a taxpayer obligation towards the member state?

In *IDT Card Services*, differences in the application of the Sixth VAT Directive[81] between the UK and Ireland meant that no VAT was ever charged to the ultimate UK customers of an Irish telecommunications company. This was due to the fact that Ireland levied VAT on the sale of phone cards but no VAT on the provision of telecommunications services, whereas the UK charged no VAT on the sale of phone cards but did levy VAT on the provision of telecommunications services. In this case, the supplier of the phone cards was a UK based company (and so not required to levy VAT in the UK) and the provider of the telecommunications services was an Irish company (and therefore not required to charge VAT in Ireland).

6.2.1. Arden LJ in the Court of Appeal

In reaching a conclusion contradictory to that of the High Court in which the Court of Appeal agreed with the Special Commissioners and HMRC, that VAT could be levied in the UK on the business in question, the court (with Arden LJ

[81] Council Directive (EEC) 77/388

giving the lead judgment) conducted an analysis of the principles of conforming construction which it felt were in point in the case.

The Court of Appeal began by reiterating the point made in *Pfeiffer* that:

> *"A national court is required, when applying the provisions of domestic law adopted for the purpose of transposing obligations laid down by a Directive, to consider the whole body of rules of national law and to interpret them, so far as possible, in the light of the wording and purpose of the Directive in order to achieve an outcome consistent with the objective pursued by the Directive."*[82]

Since one of the purposes of the Sixth VAT Directive, stated in the preamble to the Directive is *"to harmonise the obligations of taxpayers so as to ensure the necessary safeguards for the collection of taxes in a uniform manner"*, was it therefore possible to reach a conforming interpretation of VATA 1994 in line with the objectives and purpose of the Sixth VAT Directive?

The Court of Appeal felt that it was possible, citing *Ghaidan* as an example of how such interpretation is within the remit of the courts, provided that it does not *"produce a meaning which departed substantially from a fundamental feature or cardinal principle of the legislation"*[83].

The final result was that the Court of Appeal ruled in favour of a sort of "conformity through disapplication", since it was through the disapplication of sch. 10A, para 3(3) VATA 1994 that the Court was able to reach a conforming interpretation.

[82] Para. 119, *Pfeiffer* as cited in para. 80 of *IDT Card Services*
[83] See para. 87, *IDT Card Services*

6.2.2. *IDT Card Services* – some observations

For some commentators[84], this analysis and interpretation went too far by creating an obligation on the taxpayer towards the State, as a result of the implementation of a Directive. Is it argued[85] that the creation of such an obligation is nowhere to be found in the jurisprudence of the ECJ, and *Centrosteel* is cited as evidence of this, in which the ECJ ruled:

> *"It is true that, according to settled case law of the Court, in the absence of a proper transposition into national law, a Directive cannot* ***of itself*** *impose obligations on individuals."*[86]

The key phrase of which to take note here is "of itself". The Directive (or any piece of EU law for that matter) is not the only piece of legislation to which the domestic courts should have regard. It is important to keep in mind the obligation placed on the UK courts, as a result of s2(4) ECA 1972, to interpret legislation in accordance with Treaty obligations.

Therefore, rather than seeing *IDT Card Services* as an example of where the Court of Appeal has strayed into judicial legislation, perhaps it should be viewed as simply an extension of the principle of conformity through disapplication which can be seen in a long line of case law, as evidenced above in *Factortame (No. 2)* and *ICI v Colmer*, and as will be seen below in *Fleming/Condé Nast* and *Thin Cap GLO*. The fact that such conformity in this particular case rules against the taxpayer should not be surprising, given the judiciary's ability to rule for and against the taxpayer according to the bare facts of the case, as demonstrated in the *Ramsay* line of cases.

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[84] See Airs, p.2
[85] *ibid.*
[86] Para. 15, *Centrosteel*, author's emphasis.

6.3. *Fleming/Condé Nast* – an extension of the principle of disapplication

The facts in *Fleming/Condé Nast* focused on the modification of time limits during which taxpayers could claim repayment of amounts incorrectly remitted as VAT. The previously set limit of 6 years was reduced to 3 years without any transitional period and, as per the ECJ's ruling in *Marks & Spencer II* and *Grundig II*, was found to be incompatible with EU law.

In the subsequent House of Lords decision, the key issue was whether or not the UK courts could interpret the UK legislation as being subject to a time limit which did comply with EU law. Lord Hope stated:

> *"Legislation that is incompatible with EU law must be disapplied. But can the court go further and make good the defect which has led to its disapplication?"*[87]

He answered the question by ruling:

> *"I would not rule out the possibility, in a suitable case, of the court reaching its own decision as to what would be a reasonable time for the making of claims and rejecting claims that were made after a period which it held to be reasonable. But I do not think that the situation disclosed by these appeals lends itself to that treatment. In my opinion this is a step too far for the court to take. The issue is not one of statutory interpretation, for which the court must accept responsibility. There is a gap in the legislation which is unfilled."*[88]

The House of Lords ultimately ruled that it was not able to read into legislation a time limit which was compatible with UK law and, as such, the taxpayers were free to make claims for the repayment of VAT without any limitation of time[89]. One interesting element of this decision was the fact that the House of Lords saw

[87] Para. 6, *Fleming/Condé Nast*
[88] Para. 10, *Fleming/Condé Nast*
[89] Airs, p.6

the case in point as one of disapplication rather than conforming construction, and that these two concepts were fundamentally different. Lord Walker ruled:

> *"Disapplication of national legislation is an essentially different process from its interpretation so as to conform with EU law. Only in the most formal sense (because of the terms of s 2(4) of the European Communities Act 1972) can disapplication be described as a process of construction."*[90]

In the purest sense, it must be the case that conforming interpretation and disapplication are fundamentally different. In relation to the former, the domestic legislation continues to exist but is construed in a manner to render it compatible with EU law. In the latter case, the domestic rule is set aside in favour of a directly enforceable EU law right. However, as should later become clear in the context of *Vodafone 2* and *Thin Cap GLO*, from a practical point of view it is often not entirely relevant whether or not the principle of conforming interpretation or that of disapplication is applied, since the result will often be the same.

6.4. Conforming interpretation in the field of UK tax – some observations

It was clear in *Macarthys Ltd v Smith* that the UK courts were prepared to adopt a conforming interpretation approach in order to read domestic legislation in line with EU law. However, this method was not considered applicable in *Factortame (No. 2)* and the principle of disapplication was applied.

A similar approach has been taken in areas of the UK tax statue which are held to be inconsistent with EU law rights and obligations. Consistent rulings in *ICI v Colmer*, *IDT Card Services* and *Fleming/Condé Nast* have shown that the UK courts are willing to strike out domestic legislation where it is shown to be incompatible with EU law. The interesting question, therefore, is why the Court

[90] Para. 25, *Fleming/Condé Nast*

of Appeal felt able to adopt a conforming interpretation approach in *Vodafone 2* which is viewed by some as having stepped over the line into judicial policy making, particularly in light of the effectively contemporaneous judgment handed down in *Thin Cap GLO*. It is on these points which the analysis in this paper will now concentrate.

7. *Vodafone 2* and conforming construction

A full analysis of the reasoning behind the judgment handed down by the Court of Appeal in *Vodafone 2* requires a summary of the facts of the case.

7.1. *Vodafone 2* - the facts

As part of its acquisition of the rival German telecommunications company, Mannesmann AG, Vodafone Group Plc established a Luxembourg resident holding company, Vodafone Investments Luxembourg SarL ("VIL"). Another Vodafone group company in the UK, Vodafone 2, held the share capital in VIL.

In the financial year ended 31 March 2001, VIL earned substantial income from its newly acquired assets. HMRC argued that VIL constituted a CFC under the UK CFC legislation[91] and issued an enquiry notice to Vodafone 2 in respect of the additional tax payable.

Vodafone 2's analysis of the UK CFC legislation concluded that whilst it did not meet the traditional exemptions from the CFC apportionment charge that were available, its shareholding in VIL also did not fall into s748(3) ICTA; the so-called "motive test". The motive test is the section of the CFC legislation that seeks to prevent profits from being artificially diverted away from the UK and thus

[91] It is not the intention of this paper to explain in detail the UK CFC legislation, but see Wellens (Pt 1) pp. 1-2 for an overview of the relevant sections of the UK tax code which applied at the time of the case.

avoiding any charge to UK tax. It achieves this by apportioning such profits as earned in a CFC to the UK parent company and taxing those profits at the prevailing UK corporation tax rate.

Vodafone 2 contested the enquiry notice issued by HMRC, on the basis that it was contrary to the freedom of establishment under Article 43 EC[92]. The challenge was based on an argument that Vodafone 2 would not be subject to the same set of rules if it had established a UK resident subsidiary and, furthermore, the administrative burden of complying with the UK CFC legislation constituted of itself a restriction on Vodafone 2's freedom of establishment[93].

7.1.1. *Cadbury Schweppes*[94]

A considerable precedent for this line of argumentation had recently been established in the ECJ. In its *Cadbury Schweppes* ruling, the ECJ found that it was possible for the UK CFC rules to constitute a restriction on the freedom of establishment (for much the same reasons as argued by Vodafone 2), but that this restriction may be justified where the facts in question related to:

> *"wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned."*[95]

This limited level of justification was consistent with the ECJ's interpretation of the freedom of establishment in *Cadbury Schweppes*, which:

> *"presupposes actual establishment ... in the host Member State and the pursuit of genuine economic activity there."*[96]

[92] Now Article 49 TFEU.
[93] See para 13, *Vodafone 2 (EWHC)*
[94] There is a large selection of material available which explains the *Cadbury Schweppes* case. See, in particular, Wellens (Pt 1), pp. 2-9 and O'Shea (CFC rules) for further details and analysis.
[95] Para. 51, *Cadbury Schweppes*
[96] Para. 54, *Cadbury Schweppes*

In summary, the ECJ ruled[97] that where the national court could interpret the motive test in the UK CFC legislation as excluding overseas subsidiaries from taxation, except in circumstances where wholly artificial arrangements arise, then the UK's CFC rules were compatible with the freedom of establishment.

However, where the motive test has to be interpreted as meaning that:

- None of the exceptions to the UK's CFC rules applies;
- The intention to obtain a reduction in UK tax is central to the reasons for incorporating the CFC; and
- The UK parent company comes within the scope of the CFC rules, despite the absence of objective evidence to indicate that a wholly artificial arrangement exists;

then the UK CFC legislation must be considered to be incompatible with the freedom of establishment.

7.2. *Vodafone 2* in the High Court

The first main examination in the national courts of how to interpret the motive test contained in the CFC legislation came in the *Vodafone 2* case at the High Court.

Evans-Lombe J began his analysis by considering the extent to which the national courts are required to find a conforming interpretation of domestic legislation in respect of obligations under ECA 1972. He stated:

> *"where legislation can be reasonably construed as to conform with the United Kingdom's Community obligations, the English Courts*

[97] See paras. 72-74 of *Cadbury Schweppes* and O'Shea (CFC rules), p. 20.

> *must do so, even if this involves a departure from the strict and literal interpretation of the words in the legislation."*[98]

Despite this initial analysis, Evans-Lombe J ultimately ruled that the motive test in s748(3) ICTA could not be interpreted such that the application of the CFC rules was restricted to companies which form part of a wholly artificial arrangement. He confirmed that:

> *"the Cadbury case establishes that an intention to avoid tax does not, by itself, render a transaction involving a CFC resident in a member state, an artificial arrangement and so abusive."*[99]

Stating further:

> *"The provisions of subsection (3)* [of s748 ICTA - the motive test] *are unambiguous and its purpose is plain, namely, to defeat tax avoidance by parent companies resident for tax purposes in the UK ... There are no words in subsection (3) which, using conventional rules of construction, are capable of being construed as limiting the operation of the subsection so as to comply with Article 43*[100] *as explained in the Cadbury case."*[101]

7.3. *Vodafone 2* in the Court of Appeal

Whereas Evans-Lombe J in the High Court restricted his conforming interpretation analysis to the motive test (since this was the element of the UK CFC legislation analysed by the ECJ), the Court of Appeal took a much wider starting approach, disagreeing with submissions from Vodafone 2's counsel and stating:

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[98] Para. 42, Vodafone 2 *(EWHC)*
[99] Para. 73(v), *Vodafone 2 (EWHC)*
[100] Now Article 49, TEU
[101] Para. 73(ii) *Vodafone 2 (EWHC)*

> *"the obligation of the national court is to examine the whole of the national law to consider how far it may be applied so as to conform to enforceable Community rights."*[102]

This is consistent with the ECJ jurisprudence in cases such as *Pfeiffer* and domestic jurisprudence in the field of EU law in *IDT Card Services*. It is for this reason that the Court of Appeal felt able to review the CFC rules in their entirety and not just the purpose of the motive test, such limited analysis as had been conducted by Evans-Lombe J in the High Court[103]. Consequently, the Court of Appeal was able to consider the 'thrust' of the CFC legislation as being to cast the net widely, covering ostensibly all foreign subsidiary companies, and then to narrow the impact as the relevant exclusions contained in the legislation were met[104].

In this context, counsel for HMRC contended that it would be possible simply to add another exclusion to the list, which would remove any potentially unjustified restriction of EU Treaty rights, namely:

> *"if it* [the CFC] *is, in that accounting period, actually established in another member state of the EEA and carries on genuine economic activities there."*[105]

Vodafone 2 argued against this, citing Lord Roger of Earlsferry in *Ghaidan*:

> *"*[s.3 HRA 1998] *does not allow the courts to change the substance of a provision completely, to change a provision from one where Parliament says that x is to happen into one saying that x is not to happen."*[106]

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[102] Para. 34, *Vodafone 2 (EWCA)*
[103] See para. 60, *Vodafone 2(EWCA)*
[104] See para. 39, *Vodafone 2 (EWCA)*
[105] *ibid.*
[106] Para. 110, *Ghaidan* as cited in para. 41, *Vodafone 2 (EWCA)*

The Court of Appeal did not accept this line of reasoning, and held that the proposed wording from counsel for HMRC did not alter the essence of the legislation:

> *"…the words which the Revenue suggest should be inserted into the Act to ensure its compliance with Article 43[107] of EU Treaty do not create a new and different scheme nor do they offend any of the Act's cardinal principles…"*[108]

7.4. The principles of conforming construction in *Vodafone 2*

In reaching the conclusion above, the Court of Appeal conducted analysis of previous case law in the area of conforming interpretation, and it summarised the central tenets of such an approach when dealing with EU law[109]. The analysis now turns to consider the extent to which these guiding tenets of interpretation as stated by the Court of Appeal in *Vodafone 2* are consistent with the principles espoused in previous jurisprudence of both the ECJ and the domestic courts in respect of supremacy of EU law and conforming interpretation.

7.4.1. How and when can a conforming interpretation be applied?

In *Vodafone 2 (EWCA)*, the Court of Appeal first gives guidance as to when a conforming interpretation can be applied and the circumstances in which it is possible to do so. Firstly, there is no requirement for any ambiguity in the area of the statute to be construed[110]. This seems to contrast with the traditional

[107] Now Article 49 TFEU
[108] Para. 71, *Vodafone 2 (EWCA)*
[109] See paras. 37(a)-(f) and 38(a)-(b), *Vodafone 2 (EWCA)*.
[110] See para. 37(b), *Vodafone 2 (EWCA)*

domestic approach to interpretation, where the words should be given their *"ordinary meaning and purpose"*[111].

In domestic situations, where the meaning of the words is clear, there is no option (or indeed any requirement) to invoke a conforming interpretation, but in the EU context this restriction on attempting a conforming construction does not, in the view of the Court of Appeal, apply. Secondly, and linked to this point, the Court of Appeal ruled that conforming interpretation is not constrained by the conventional rules of construction[112].

This release from the conventional rules of construction is important in the context of EU law, since domestic courts are being asked to interpret domestic legislation in light of overriding EU law principles which are not as tightly drafted as specific national legislation where conventional rules have been developed and can be consistently applied.

7.4.2. "Going with the grain"

Arguably the most important of the principles put forward in the judgment was that stated in para. 38(a), which held that a conforming interpretation must "go with the grain" and "be compatible with the underlying thrust of the legislation being construed". This language was drawn from *Ghaidan*[113] and *EB Central Services*[114] and was further supplemented by the notion that any interpretation which was not consistent with a cardinal feature of the legislation would cross the boundary between interpretation and amendment[115].

This principle of conforming interpretation is crucial in any analysis, because if the proposed construction does not fall into the broad categories outlined above, any further analysis of the form or substance of the construction is meaningless.

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[111] See, for example, *Marshall* [1994] STC 638 at 649
[112] See para. 37(a), *Vodafone 2 (EWCA)*
[113] See para. 33, *Ghaidan*
[114] See para. 81, *EB Central Services*
[115] See paras. 33 & 110-113, *Ghaidan* and paras. 82 & 113, *IDT Card Services* for the reference in previous case law to this element of the principle.

This approach is not entirely dissimilar to the jurisprudence built up in the domestic courts in the *Ramsay* line of cases. As described above, the current position according to the *Ramsay* principle is that domestic courts are entitled to take a purposive view of the legislation when interpreting the facts of the case and their application to the legislation in question. This does not seem too far removed from the principle of interpreting legislation so as to "go with the grain" and "be compatible with the underlying thrust of the legislation".

Finally, it should not be forgotten that quite apart from the domestic and ECJ jurisprudence which permitted this type of analysis of the CFC legislation, the Court of Appeal was ultimately obliged to adopt this approach through obligations imposed on the UK through s2 ECA 1972 to comply with EU law.

7.4.3. A question of semantics?

Having established that conforming construction with EU law does not require ambiguity to be present, is not bound by traditional rules of construction and should not offend the cardinal features of the relevant legislation, the remaining part of the guidance issued by the Court of Appeal then falls to describe the linguistic techniques which are permissible in reaching such a conforming interpretation.

The guidelines in respect of this are contained in paras. 37(c) – (f) of the *Vodafone 2 (EWCA)* judgment, and can be summarised thus:

i. Conforming construction is not an exercise in semantics or linguistics;
ii. Departure from the literal meaning of the words used by Parliament is permitted;
iii. It is permitted to substitute words in the statute for those which enable a conforming interpretation with EU Treaty obligations;

iv. The precise form of the words does not matter:

At first glance, these principles may seem anathema to those used to more traditional approaches to statutory interpretation. However, ECJ jurisprudence confirms[116] that domestic courts should "*if the application of interpretative methods recognised by national law enables*", construe national law so as to be in accordance with EU law. Using traditional methods of construction in the UK would most likely limit the ability of the courts to apply a conforming construction as suggested in *Vodafone 2*.

However, s2 ECA 1972 releases the domestic courts from the requirement to apply a strict and literal approach to interpretation (as might be expected in domestic jurisprudence) and permits, or even obliges, the courts to use broader interpretative techniques. Indeed, this was recognised by the Court of Appeal when it ruled:

> *"It is inevitable that … conforming interpretation will lack the crispness to be expected of a properly considered legislation."*[117]

7.4.4. The conforming construction safety valve

The ability of the courts to use what would be considered from a domestic point of view non-standard methods of construction when considering compatibility with EU law does seem to give them a wider scope to adopt a conforming interpretation. Having said that, the judgment in *Vodafone 2 (EWCA)* did provide for a check and balance on the extent to which the courts could pursue a given line of interpretation. This safety valve was summarised thus:

> *"The exercise of interpretative obligation cannot require the courts to make a decision for which they are not equipped or give rise to*

[116] See para. 116, *Pfeiffer*
[117] Para. 57, *Vodafone 2 (EWCA)*

> *important practical repercussions which the court is not equipped to evaluate."*[118]

A hypothetical example of such a situation was given by Arden LJ in *IDT Card Services*[119] where, in construing domestic law so as to comply with obligations under EU law, the resulting interpretation had the effect of limiting the rights of third parties such as creditors or consumers. Despite this qualification of the limits of conforming interpretation, the reading in of the additional exception in the CFC legislation in *Vodafone 2 (EWCA)* cannot be viewed as having such consequences, and so cannot constitute a decision for which the courts are not equipped and which gives rise to important practical repercussions, since it does not infringe on the rights of any third parties.

7.5. *Vodafone 2* – some observations

One view of the conforming interpretation reached in *Vodafone 2 (EWCA)* might be that it stepped across the line into judicial activism rather than protectionism. However, as outlined in the judgment itself, the courts view it as their duty to use all possible techniques to achieve an interpretation which is compatible with EU law. In *Vodafone 2 (EWCA)*, the court ruled:

> *"... there are likely to be other ways of achieving conformity ... and the choice of one rather than another may well involve policy decisions. But if that consideration alone could render a conforming interpretation illegitimate it would considerably restrict the occasions in which a conforming interpretation could be adopted and lead to an increase in disapplications. The choice of a conforming interpretation which faithfully follows a conclusion of the ECJ, as in this case, does not in my view trespass on the forbidden ground of legislation."*[120]

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[118] Para. 38(b), *Vodafone 2 (EWCA)*
[119] See para. 113, *IDT Card Services*
[120] Para. 59, *Vodafone 2 (EWCA)*

The implication of this is that the courts should not be viewed as stepping outside their spheres of influence when following an ECJ judgment, even where to so do would involve reinterpreting domestic legislation in a manner which – in domestic circumstances – might be left to Parliament[121]. The reason for this inference is plain: Parliament gave the courts the interpretative tools[122] to take this type of approach in dealing with EU law issues when it enacted s2(4) ECA 1972.

8. *Thin Cap GLO* – conforming interpretation or disapplication?

8.1. Facts of the case

The latest case to come before the domestic courts where the principle of conforming interpretation versus that of disapplication was considered was *Thin Cap GLO*[123]. It concerned the thin capitalisation ("thin cap") rules in the UK prior to 1994 which treated certain interest payments from UK resident companies to non-resident group companies as non-deductible where the interest charged was not on an arm's length basis.

A raft of claims in the domestic courts to the UK's thin cap rules followed the ECJ's ruling in the *Lankhorst-Hohorst* case which address substantively the same issue in respect of Germany's thin cap rules, and eventually the issue was referred to the ECJ from the High Court.

[121] Klass, p.545
[122] At the same time as, through s2(1) ECA 1972, giving freedom of establishment and EU law rules which carry direct effect the same status as other UK legal rights.
[123] See Camp, p.1 and Fichardt, p.90 for a full description of the facts in the case.

8.2. The ECJ's view

The ECJ held that the thin cap rules constituted a restriction on the freedom of establishment[124], but that such a restriction was justified in circumstances where the domestic legislation was designed to prevent *"wholly artificial arrangements"*[125]. In the context of the thin cap rules, such arrangements were defined as interest charged at a non-arm's length rate[126], but crucially were subject to the taxpayer being afforded the opportunity to prove a commercial justification for the transaction[127].

8.3. The High Court ruling

In the High Court, Henderson J found that the UK's pre-1994 thin cap rules did breach the Treaty obligation in respect of the freedom of establishment because although they contained an arm's length test, there was no corresponding commerciality test. He ruled:

> *"In simple terms, the arm's length test, which the ECJ regarded as essentially objective and capable of independent verification, needed to be, but was not, supplemented by an essentially subjective motive test, in order to filter out and save from counteraction those transactions which, although they failed the arm's length test, nevertheless had (either in whole or in the relevant part) a genuine commercial justification."*[128]

[124] See para. 63 of the ECJ's ruling on the *Thin Cap GLO* case C-524/04 [2007] ECR I-2107
[125] See paras. 71-74 of the ECJ's judgment in *Thin Cap GLO*.
[126] See paras. 81-82 of the ECJ's judgment in *Thin Cap GLO*.
[127] See para. 82 of the ECJ's judgment in *Thin Cap GLO*.
[128] Para. 77, *Thin Cap GLO*

8.4. Conforming interpretation or disapplication?

Henderson J then turned to consider whether or not a conforming interpretation was possible, and he drew on the principles as defined in *Vodafone 2 (EWCA)*. He found that it was not possible to construe the thin cap rules in such a way so as to include the commercial justification test which was required under the ECJ ruling to meet the principle or proportionality:

> *"In my judgment there is no process of construction, even allowing for the width and potency of the principles identified by the Court of Appeal in Vodafone 2, which could treat the arm's length test in the UK thin cap rules, either before or after 1995, as supplemented by a separate test of commercial motive or purpose."*[129]

It is clear that the introduction of a "motive test" to the thin cap rules via the principle of conforming interpretation would have cut across the grain of the legislation and offended the cardinal principles of the legislation. This is in contrast to the reading in of an additional exception in the CFC rules in *Vodafone 2 (EWCA)* which was seen as permissible since the legislation itself already contained a list of qualifying exceptions and adding another one was simply an extension of that principle.

Having ruled out a conforming interpretation, the court then turned to analyse the extent to which the legislation should be disapplied. Henderson J ruled that the thin cap rules should be disapplied where they relate to transactions with a commercial rationale:

> *"The right solution … is to disapply the national rules only in relation to transactions which satisfy the test of commercial justification"*[130]

[129] Para. 83, *Thin Cap GLO*
[130] Para. 94, *Thin Cap GLO*

The court did acknowledge that the result of disapplying the legislation in this way had a similar effect to that which may have been achieved through a conforming interpretation, but it ruled that such an approach was consistent with the requirement to disapply the offending legislation only in so far as to remedy the breach of EU law:

> *"The crucial point, so far as disapplication is concerned, is to identify the nature of the infringement of Community law which the ECJ has found to be established, and then to perform the necessary surgery on the offending national legislation so as to give effect to the claimant's Community rights. Such surgery, to pursue the metaphor, need not always consist of amputation of a limb or the removal of a diseased organ, but may in appropriate cases be of a reconstructive nature."*[131]

8.5. *Thin Cap GLO* – some observations

This approach by the High Court is interesting because it shows that it is possible to achieve similar results to those which may result from a conforming interpretation exercise (as in *Vodafone 2*) by employing the principle of disapplication[132], but that such techniques do remain very different methods of addressing breaches of EU law obligations.

9. Conclusions

However many times one reads s747 ICTA 1988, it is impossible to find any words which exclude from a CFC apportionment charge a subsidiary which is "*actually established in another member state of the EEA and carries on genuine*

[131] Para. 97, *Thin Cap GLO*
[132] Farmer & Coutinho, p.18

economic activities there". On the basis that the words do not exist, how could one read in this exception to the CFC rules?

This was the starting point of the discussion which has moved from a review of the traditional approach to statutory interpretation, under which it would arguably never have been possible to reach an interpretation of the CFC rules such as that put forward by the Court of Appeal in *Vodafone 2*, through to the acknowledgement that such an approach is entirely appropriate and consistent with the principles of conforming construction. How was it possible to reach this conclusion?

Some see the judgment in *Vodafone* 2 as evidence of the courts' increasing willingness to "legislate" on behalf of Parliament, and cannot see how such a conclusion could have been reached[133]. In a comparable domestic situation, such as *Mayes*, there was a simple reading of the legislation by the court and a confirmation that purposive construction does not permit the rewriting of legislation, which is the accepted domestic view of interpretation. Indeed, even when asked to consider legislation which interacted with EU law obligations as in *Macarthys Ltd v Smith*, the court originally had difficulty applying a meaning to the words other than their literal one.

Even in *Pfeiffer,* the ECJ acknowledged that the application of interpretative methods by national courts was limited to those methods as permitted by national law. This begs the question as to whether or not – given the domestic jurisprudence in the field of statutory interpretation – the techniques adopted by the Court of Appeal in *Vodafone 2* were indeed permitted under national law.

The key to answering this question and therefore understanding the judgment is found in the obligations conferred on Parliament and the judiciary through the European Communities Act 1972. It was this Act which established the supremacy of EU law in the UK, and furthermore it was this Act which obliged –

[133] As acknowledged in footnote 1, this was the previously held view of the author.

and continues to oblige – courts to use all options available in order to interpret domestic legislation in accordance with EU law.

The ECA 1972 amended and extended the permitted methods of interpretation under UK domestic law. Once one accepts this truth, the jurisprudence both in the ECJ and the domestic courts serves only to support the assertion that the addition of an additional exception to the CFC rules was a logical outcome of the courts' obligation to conform with EU law.

One natural question which flows from this is whether or not this expansion of the interpretative tools at the courts' disposal in the field of EU law has in any way refocused the way in which domestic legislation can be interpreted. Given the constraints of the principle of legal certainty – particularly in relation to tax matters – it is not clear that courts would be willing to go as far in a domestic context.

However, the purposive approach to domestic legislative interpretation does bear some of the characteristics of the approach adopted in the field of EU law; one need only look at how the courts viewed composite transactions in *Furniss v Dawson* and then again more recently in *Scottish Provident* and *Astall* to understand that the courts are willing to interpret domestic legislation in a way which is not based solely on the literal meaning of the words. In a sense, the techniques used in the EU law field are just a widening of principles which have been already consistently applied in domestic jurisprudence.

To address a separate point, as is apparent from comparisons between *Thin Cap GLO* and *Vodafone 2 (EWCA)*, it is sometimes possible to achieve through disapplication a result similar to that which would be achieved through applying a conforming interpretation. In this context, would it have been more appropriate for the Court of Appeal simply to have ruled that where substance in an EU resident CFC could be proved, the CFC legislation should be disapplied?

This argument has some compelling factors in its favour. ECJ jurisprudence, particularly in the field of direct tax, has developed on the basis of "negative integration"; that is to say, the Treaty and the fundamental freedoms generally stipulate what member states are not permitted to do, rather than what they can do. On this basis, it could be argued that instead of trying to construe the legislation in a way which makes it compatible with EU law, rather the courts should read it in a way which *excludes* those elements which make it incompatible. Having said that, it is not an argument which can be sustained for a number of different reasons – all of which have a different underlying premise upon which they are based.

Firstly, and clearly, the obligation of domestic courts to interpret legislation in accordance with EU law principles is enshrined in the statute book and until Parliament decides to remove this obligation it should be respected.

Secondly, many comparisons in the jurisprudence are made to the requirement under s3 of the HRA 1998 for courts to interpret legislation in accordance with the UK's obligations under that Act. Indeed, the main principle of conforming construction espoused in *Vodafone 2 (EWCA)* was that the interpretation should "go with the grain" of the legislation and this concept was argued in *Ghaidan*.

In the context of human rights, failure to reach a conforming interpretation renders the offending legislation incompatible with the human rights at stake. To subject UK citizens to obligations under domestic legislation which has been ruled directly incompatible with their human rights is an emotive conclusion to reach. It is this author's contention that as a result, the courts feel able to apply under s3 HRA 1998 a broader set of interpretative principles to legislation when assessing its compatibility with human rights. The effect of this has spilled over into, and been complemented by, an analogous approach to interpretation in the field of EU law.

Finally, perhaps a somewhat more contentious reason why courts will continue to prefer a conforming interpretation approach over that of disapplication. In

tax cases, the courts have ruled that the burden of proof where disapplication is employed rests with HMRC. For example, in *Thin Cap GLO* HMRC is required to prove that the loans granted were not at arm's length and therefore the resulting interest deduction should be denied. The author invites you simply to contrast this with a conforming interpretation approach in *Vodafone* 2, where the taxpayer was under the obligation to prove that it had a genuinely established subsidiary in an EEA country, and consequently ended up settling with HMRC for a cool £1.25bn.

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