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Dividend Taxation and the EU: a UK perspective

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Dividend Taxation and The EU: A UK Perspective

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Contents

Introduction and Scope

With the introduction of Section 34 of the FA 2009 Schedule 14 the emphasis for taxation of dividends in the UK switched from a worldwide to a territorial basis of taxation on foreign sourced income.

It is a well-established principle of EU law that it is for member states to determine whether, and to what extent, they exercise their taxing rights and they are, in principle, free to organise their system of taxation and to define the tax base and tax rates. However, they must nonetheless exercise that competence consistently with EU law[1]. Clearly it is critical, in relation to direct taxation, to understand the elements that are within the jurisdiction of the court and those that are outside it and this dissertation will examine these issues.

One of the main objectives of TFEU[2] is to create an internal market without frontiers[3].

Article 293 EC (now repealed) required member states to enter into negotiations with each other with a view to the abolition of double taxation within the EU. That article was not replaced but member states are now required to adopt the arbitration convention[4].

The TEFU contains a non-discrimination provision and articles guaranteeing the fundamental freedoms.

[1] *Verkooijen* paragraph 32

See Article "Eden"

This article reviews the case law leading up to the decision of the ECJ in *Kerchhaert – Morres and e*xplores the jurisprudence of the ECJ in relation to "double taxation". Sarah Eden examines ECJ case law to extract from the rulings how the Courts have attempted to reconcile the competing claims for removing obstacles to the internal market and member states assertions of national sovereignty in relation to direct taxation; starting with the case of *Gilly which* introduced the notion that the allocation of the right to tax between two states (i.e. juridical double taxation) was outside the jurisdiction of the Court.

[2] The Treaty of Lisbon (initially known as the Reform Treaty) signed by the EU member states on 13 December 2007, and entered into force on 1 December 2009.

[3] Article 26 TFEU

[4] That convention establishes a procedure to resolve disputes in relation to double taxation that may occur as a result of an upward adjustment of profits by one member state. Double taxation is recognised as an obstacle to the creation of the internal market and mechanisms are being devised to eliminate those impediments.

Any discrimination on the grounds of nationality is prohibited but this provision is limited in its application to the scope of the application of TFEU and is without prejudice to any special provisions contained in such treaty[5]. This article comes into play when there is discrimination on the grounds of nationality and the fundamental freedoms do not apply[6].

The fundamental freedoms secure for the benefit of nationals and legal persons in the EU the right to free movement of goods, persons, services and capital and cover all aspects of the economy including those in relation to direct taxation. The freedoms place significant limits on member states competences in relation to direct taxation matters: they require member states to abolish rules which represent discrimination on the grounds of nationality within the scope of TFEU and to remove obstacles to free movement unless justified by a public interest requirement[7]. The concept of non-discrimination on the grounds of nationality and non-restriction of the fundamental freedoms in the absence of any justification on public policy grounds operate alongside each other and member states must operate their rules systems within these rules.

In this regard the Courts have determined that it was a duty of the "host state" (the state into whose domestic market a non-national or legal person has entered) to ensure that EU nationals who exercise their rights in that state do not receive less favourable treatment than the nationals of the "host" state unless some objective reason can be established for the different treatment. Likewise it is the duty of the state of "origin" (i.e. the state of residence of the national/legal person) to ensure that they do not treat an "origin" state national who exercises a fundamental freedom (e.g. a UK parent who establishes a subsidiary in another member state) is treated no less favourably than an "origin" state national who carries on a similar activity in the "origin" member state[8].

The jurisprudence of the ECJ in relation to direct taxation has involved analysing the aim of the national legislation and applying either a discriminatory analysis in

[5] Article 18 TFEU

[6] *Gilly* paragraphs 37-39

[7] See EU Tax Law by O'Shea 8 page 32

[8] See EU Tax Law by O'Shea 8 pages 34 to 39

situations where there may be (direct or indirect) discrimination on the grounds of nationality or a restriction analysis where there may not be discrimination on the grounds of nationality[9].

Promoting equality of treatment between nationals and foreign nationals is an objective of the EU. The Courts operate a comparability analysis to determine whether the provision at issue has the effect of hindering or impeding access to the internal market.

The Court, when determining the compatibility of the domestic measure with the freedoms enshrined in TFEU will consider:

(a) whether one of the freedoms applies to the situation at issue;

(b) whether there is a difference in treatment of the same situation or the same treatment of a different situation, taking into account the specific legislative environment of a member state; and

(c) whether the measure leading to differences in treatment can be justified and if so, then whether it is proportional to the objective insofar as that objective is legitimate.

This dissertation seeks to determine whether the dual system of taxation of dividends operated by the UK as revised by the provisions enacted by s34 of FA 2009 create obstacles to free movement from the ”origin” state perspective and if they do then the extent to which they are contrary to EU law.

[9] *Schumacker* paragraph 30 et seq where the Court said:

“…..discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations. In relation to direct taxes the situations of resident and non- residents are not as a rule comparable.”

However, the Court in this case confirmed that if there is no objective difference between the situation of a resident and non- resident to justify different treatment then it can amount to discrimination.

See also *FII GLO* ECJ paragraphs 31 and 40

Structure and Approach

This dissertation is in four Chapters and the content of each Chapter is summarised below.

Chapter 1 undertakes a critical analysis of the case law principles in relation to the taxation of dividends, together with the geographical and temporal scope of the freedoms of establishment and capital. Special reference and in depth analysis of *FII GLO* has been undertaken as that case influenced the design of the system of taxation introduced by FA 2009.

Chapter 2 contains a brief outline of the UK's dividend tax rules and provisions enacted by s34 FA 2009 Schedule 14 and now contained in CTA 2009 Part 9A sections 931A to 931W.

Chapter 3 examines the overall regime summarised in Chapter 2 and evaluates from an "origin state" perspective whether, and if so to what extent, the provisions summarised in that Chapter are compliant with EU law, broadly under the following sub-headings:

- **Discrimination**

  Under this sub-heading, the UK system of taxation of dividends will be examined to determine the extent to which these rules give rise to a restriction, if at all, in a cross-border situation, with particular reference to the "qualifying territory" condition and the "deduction" condition.

- **Anti-avoidance**

  Under this sub-heading, both the anti-avoidance rules applicable to a small company and large and medium-sized companies respectively are examined to determine whether such restrictions conform to EU law.

Chapter 4 provides some conclusions.

Chapter 1

1. EU Law

The *FII GLO* was a test case[10]. The purpose of *FII GLO* was to determine a number of common or related questions arising out of tax treatment of dividends received by UK resident companies from non- resident subsidiaries compared with UK resident subsidiaries

The Claimants argued that there were unjustifiable differences in tax treatment between dividends received from non-resident companies then from resident companies and these differences were contrary to freedom of establishment and free movement of capital.

The ECJ was asked, inter alia, to give guidance on the lawfulness of the UK rules in relation to the taxation of dividends received from shareholdings of 10% or more and 10% or less ("portfolio holdings"). The Court, in particular, was asked to rule on whether, as a matter of principle, and, if so, subject to what conditions, it was contrary to the freedoms of establishment or capital (as appropriate) for a member state to have a dual system for preventing double taxation: an exemption system for domestically sourced dividends and a credit system for foreign source dividends.

2. Issues in FII GLO

Prior to the enactment of FA 2009, a company resident in the UK receiving a dividend from another UK company was not subject to tax on that dividend irrespective of the actual burden of tax suffered by the UK subsidiary whilst applying the "ordinary" credit method of taxation to foreign source dividends. The "ordinary credit" method relieved UK tax payable on the same item of foreign sourced doubly-taxed income. The relief for foreign taxes was either given unilaterally[11] under domestic rules or under DTC[12] entered into with other countries.

[10] The Franked Investment Income Group Litigation was established by a group litigation order. The claimants were all companies which belonged to groups which had UK resident parents and had foreign subsidiaries in the EU and TCs. The purpose of GLO was to determine a number of common or related questions arising out of taxation of dividends received by UK resident companies from foreign and UK resident companies.

[11] S790 ICTA 1988

[12] S788 ICTA 1988

The unilateral arrangements provided for crediting against a UK company's corporation tax liability of withholding taxes ("WHT") paid on foreign dividends.

In circumstances where a UK resident company controls directly or indirectly (or that company is itself a subsidiary that directly or indirectly controls) not less than 10% of the voting power of a company making the distribution, then the relief for foreign tax extends to the underlying tax suffered by the lower tier companies.

Credit relief for shareholdings of less than 10% did not attract the underlying tax incurred by the foreign distributing company or its lower tier companies; credit was only given for WHT levied by the source state on the dividends.

The effect of these rules was that inbound dividends received from overseas subsidiaries and taxed at a low rate were subject to UK corporation tax when brought to the UK so that the minimum UK tax paid was always at the UK "nominal" rate. If higher taxes were paid to the source state, then the foreign tax credit was limited to the UK tax payable on the same item.

The Claimants argued that the application of the exemption method for domestically sourced dividends and the credit method for foreign inbound dividends resulted in the latter being less favourably treated.

A subsidiary resident in the UK could, by virtue of the application of reliefs and allowances have its tax base reduced and suffer corporation tax at a rate lower than the "nominal" rate. From the UK investing company's point of view, dividends from UK resident companies may have borne tax at lower rates. By contrast, under the credit method, no account is taken of the underlying corporation tax allowances granted at the subsidiary level reducing its tax base; the foreign profits would simply have been subjected to further liability to UK corporation tax up to the UK's "nominal" rate. With the credit method, the rate would always be "topped" up to the "nominal rate". The effect was that the UK parent company did not benefit from reliefs and allowances that may otherwise have reduced the foreign subsidiary's tax base. It was pleaded that these differences constituted a restriction and were contrary to EU law.

3. Geographical and temporal scope of the freedoms

Freedom of establishment has basis in Articles 49 TFEU (ex 43 TEC) to 55 TFEU (ex 294 TEC) and this freedom includes the right to set up and manage undertakings, in particular companies or firms within the meaning of Article 54 TFEU (ex 48 TFC). The right of establishment is granted to natural and legal persons. Rules that have the effect of impeding those rights may potentially be contrary to freedom of establishment[13].

Article 63 TFEU (ex 56 TEC) prohibits, subject to the standstill provision, any restrictions on movement of capital and payments between member states and member states and TCs. This article generally covers any cross-border transfer of money.

Article 64(1) TFEU preserves the effect of restrictions under national or EU law that existed on 31 December 1993 in relation to free movement of capital to and from TCs involving "direct investment" including investment in real estate, establishment, provision of financial services or the admission of securities to capital markets.

4. Importance of economic activity

In order to invoke freedom of establishment, an economic activity[14] has to be exercised in another member state. With respect to free movement of capital, although cross-border movement of capital is not in itself such an activity, that movement often, although not necessarily, takes place with a view to financing economic activities.

[13] *FII GLO* ECJ paragraph 37

[14] See Tax Avoidance by Dennis Weber page 9 which contains an analysis of what constitutes "economic activity" in the EU context. There is no definition of economic activity in the Treaty but the conclusion drawn by the author from the ECJ case law is that it may not be interpreted restrictively since it determines the scope of the fundamental freedoms.

Determining whether there is "economic activity" is important to determine whether the right to free movement is engaged. Economic activity in the tax avoidance context must be "effective and genuine" and not such as to be regarded as purely marginal and ancillary.

Whilst the substantive principle for analysis of whether a breach has occurred is the same for both of these freedoms[15], the differences lie in the geographical and temporal scope of the freedom of establishment and free movement of capital.

Free movement of capital applies to movement between member states and member stares and TCs. On the other hand freedom of establishment is limited to movement between member states in the EU and EEA and does not extend to TCs.

By virtue of differences in the geographical and temporal scope of the above mentioned freedoms, the Court has had to consider matters that relate to the priority of application of freedoms where both freedom of establishment and free movement of capital could potentially apply at the same time and also on the issue of prevalence to the "stronger" or "older" right of establishment over free movement of capital.

In *FII GLO,* whilst concurring that the concept of restriction was the same for freedom of establishment and movement of capital, the ECJ on the question of priority of application of the freedoms agreed that, although both of those freedoms were capable of applying at the same time in a cross-border situation involving member states and resulting from a major investment, that is an investment that gives it a "definite influence over the foreign company's decisions" and allows it to "determine its activities"[16], it was freedom of establishment that was engaged where such a relationship existed and where there was no such relationship, then any compatibility had to be determined in relation to free movement of capital[17].

As regards TCs, at the time *FII GLO* was litigated, there was uncertainty as to the application of the right to free movement of capital where there was a relationship of "interdependence" between a company resident in a member state and TC. The national court, believing that free movement of capital could not apply in situations

[15] *FII GLO* AG Geelhoed Opinion delivered on 6 April 2006 Paragraph 34

[16] *FII GLO* AG Geelhoed Paragraph.31 et seq, ECJ paragraph 37 and *Baars*, paragraphs 21 and 22

Put another way this reflects situations where there is a relationship of interdependence between companies

See. Article O'Shea 5 which discusses the relationship required between corporates to engage freedom of establishment.

[17] *FII GLO* ECJ paragraph 37

where there was such a relationship, limited the scope of its reference to the ECJ to intra-community situations only[18].

It had been considered that freedom of establishment had prevalence where there was such a relationship and as that freedom was limited to activities between member states, Article 63 TFEU could only apply in TC situations where there was no such relationship between companies in a member state and TC.

Holböck shed light on the scope of free movement of capital. The ECJ in that case confirmed that such freedom could apply where the companies concerned were "interdependent" provided that the national legislation in question was not intended to apply *exclusively* to companies in such a relationship[19].

In *Haribo[20],* commenting on quality of free movement of capital, the ECJ said that "*in terms of spirit and purpose that freedom is guaranteed unilaterally by the EU member states who have made an unequivocal commitment to it*".

The Court upholding the constitutional guarantee in relation to free movement capital to TCs[21] : that is guaranteeing access to the internal market.

The Courts have consistently maintained that there is no hierarchy amongst the freedoms and there is no prevalence of the "stronger" or "older" right of establishment over free movement of capital. In the context of *FII GLO* this means the freedom of establishment (as the older right) does not have prevalence over free movement of capital. Free movement of capital is not precluded from applying in a TC situation where companies are interdependent. Accordingly a UK parent company with a subsidiary in a TC where they are interdependent are entitled to be treated no less favourably than their domestic counterpart.

[18] *FII GLO* H Ct paragraph 57

[19] *Holböck* paragraph 22 et seq

[20] See Article O'Shea 1 for a detailed discussion and analysis of the ECJ's ruling in *Haribo* and *Salinen*

[21] *Haribo* paragraph 127

5. Nature of dividends

A dividend, by its very nature, is not an investment in itself but a return on the investment of capital. As to whether the article on free movement of capital applies to that return, has been answered in the affirmative by the Court. In its judgment in *Verkooijen,* the ECJ affirmed that the article in relation to free movement of capital extended not only to the investment of share capital of a company by its shareholders but also the return resulting from such investments[22]. This establishes that any rules in relation to taxation of dividends must be designed in such a way that they are not an obstacle to free movement in a cross-border situation between a member state and TC, subject to the standstill provision.

6. Choice of system

The ECJ agreed that, whilst it was for the member state concerned to determine whether to relieve economic double taxation and to select the actual system (i.e. classical, scheduler, exemption or imputation) by which it chose to do this[23], member states were nonetheless required to exercise that competence in conformity with EU law. For Article 49 TFEU to be engaged the AG Geelhoed considered that:

"….*disadvantageous tax treatment should follow from direct or covert discrimination resulting from the rules of one jurisdiction and not purely from disparities or the division of tax jurisdiction between two or more member states tax systems or from the co-existence of national tax administrations*."[24]

In other words dividends, in a cross border situation, may be subject to heavier tax burdens by virtue of the application of the parallel exercise of powers of taxation by different member states, (i.e. the same taxpayer being taxed twice on the same income in the source state and state of residence through the exercise of fiscal sovereignty by those states –juridical double taxation). Exercise of sovereignty by those states cannot be considered to be an unjustified restriction of the freedom of establishment[25]. That freedom is only engaged if the disadvantageous tax treatment

[22] *FII GLO* AG paragraph 28 et seq

[23] *FII GLO* ECJ paragraph 43 et seq

[24] *FII GLO* AG paragraph 39

[25] *Salinen* paragraph 169 et seq

follows from the member state's own rules (i.e. economic double taxation which is the taxation of the same income twice, in the hands of two different tax payers).

The ECJ confirmed that there was no objection, in principle, to the adoption of the dual system of taxation and this was the case irrespective of the fact that foreign sourced dividends may, under the credit method, suffer a higher aggregate tax burden in the two states by virtue of the UK giving credit only up to the UK corporation tax rate leaving any foreign tax levied at higher rate unrelieved[26]. Despite bearing such a higher overall tax burden in comparison with domestically sourced dividends, such disparities, the Court considered, stemmed purely from tax systems being national and did not amount to "restrictions" in the context of EU law.

There was a divergence of view between AG and the ECJ on the question of whether the dual system of taxation achieved equality of tax treatment as required by the fundamental freedoms.

The UK and Commission argued that the effect of an exemption and credit system of relieving double taxation was the same and the adoption of an exemption system in the domestic context would result in pointless additional extra administration. Furthermore the exemption system did not favour domestically sourced income and provided no incentive for resident investors to invest at home rather than abroad because resident investors paid the same domestic–cum-foreign tax on their worldwide income, regardless of the domestic/foreign composition of that income.

AG Geelhoed dismissed that excuse. He considered that the reliefs and allowances that reduced the tax base of the distributing company formed part of the measures adopted to relieve economic double taxation and failure to pass these on in relation to foreign dividends constituted a restriction and there was no justification for the possible differences in treatment[27].

As regards portfolio dividends, the UK's justification for denying credit for the underlying foreign tax on the ground that it would be difficult to establish the tax actually paid in relation to holdings of this size, was rejected on the basis that

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[26] *FII GLO* AG's Opinion paragraph 46

[27] *FII GLO* ECJ Paragraph 50 et seq

possible difficulties in determining the tax could not justify an obstacle to the free movement of capital[28].

7. ECJ's views on the dual system of taxation

The ECJ agreed that the dual system of taxation adopted to relieve economic double taxation may not give rise to the same result for the shareholders: it was accepted that with regard to the exemption system, the shareholder receiving the dividend was not subject to tax on dividends irrespective of the rate to which the underlying profits were subject[29]. In contrast, a shareholder subject to the credit method would always be subject to corporation tax at the very least at the "nominal" rate, irrespective of the rate to which the underlying profits might have been subject.

8. Extent of relief for foreign taxes

The ECJ considered that if a member state chose to relieve economic double taxation then, in the context of a cross-border situation, that state must introduce rules that prevent foreign sourced dividends from being liable to a series of charges to tax by offsetting the amount of foreign tax paid by the non-resident company against the amount of tax for which the recipient company is liable in its state of residence.

The Court said that the objective of alleviating economic double taxation is achieved where credit for foreign taxes suffered is given only up to the amount of the national level of taxation. Therefore it was not contrary to EU law for a member state to grant foreign tax credit only up to the limit of the amount of corporation tax for which the company receiving the dividend is liable[30].

9. Dual system

On the central question of operating a dual system of taxation, the ECJ, did not consider that EU law in relation to relieving economic double taxation, prohibited the adoption of an exemption system for nationally sourced dividends whilst operating an

[28] Ibid paragraphs 53 and 54

[29] Ibid paragraph 43

[30] Ibid paragraph 49 et seq

imputation (credit) system for foreign sourced dividends: a credit system would be considered to be compliant in circumstances where a dual system is adopted provided foreign income is not subjected to "*higher"* rate of tax than the rate applicable to nationally sourced dividends[31] and the creditable underlying foreign tax to be compatible should have been at least equal to the underlying tax actually paid without exceeding the domestic corporate tax.

With respect to portfolio dividends, ECJ considered the absence of credit relief for underlying foreign tax (i.e. limiting credit relief only to foreign WHT up to the domestic corporation tax rate) on dividends received from companies resident in the EU/EEA to be an unjustifiable breach of free movement of capital.

10. Standstill

The legislation in relation to taxation of foreign dividends has been in existence prior to the standstill date and certain measures had been adopted after that date which had amended those national provisions. The question which the ECJ had been asked to answer was whether the tax treatment of dividends in the TC context were preserved.

ECJ ruled that holdings in a company that are not acquired with a view to the establishment or maintenance of lasting and direct economic links between the shareholder and that company and do not allow the shareholder to participate effectively in the management of that company or in its control, cannot be regarded as direct investments[32]. In this context dividends derived from portfolio holdings do not establish or maintain the necessary links to constitute "direct investments" and accordingly, are not protected by the exception in Article 64 (1) TFEU[33].

The Court has made it clear that the standstill clause may apply regardless of the fact that the rules that existed as of date of 31 December 1993 have changed since that date. If the rules in substance remain the same[34] following any changes, then this will not affect the application of the exception in Article 64 (1) TFEU.

[31] Ibid paragraph 47

[32] *FII GLO* ECJ Paragraph 5

[33] *FII GLO* ECJ paragraph 186

[34] *FII GLO* ECJ paragraph 193

The ECJ in *Konle* confirmed that"….*if the provision is, in substance identical to the previous legislation or is limited to or reducing or eliminating an obstacle to …….the freedoms in the earlier legislation, it will covered by the derogation*[35]."

In short, later changes or amendments to restrictions that existed as of the grandfathering date will not necessarily result in member states losing the protection of the exception in that article.

ECJ ruled that in effect Article 64 (1) preserved the effect of restrictions that existed as of the grandfathering date in relation to direct investments (if any) but not in relation to portfolio dividends. This is crucial because on this basis the taxation of portfolio dividends from TCs in *FII GLO* was considered to be contrary to EU law.

11. Excessive administrative burden

On the issue of tax compliance, the Courts have previously held that compliance burdens may constitute a restriction. In *Futura*, Luxembourg authorities required non-resident taxpayers to maintain separate accounts as a pre-condition to claiming losses in accordance with that member state's national law. The Court considered that requirement to be excessive, a covert discrimination and contrary to freedom of establishment. The Court, however, accepted that Luxembourg authorities were entitled to require taxpayers to keep proper records to prove their losses and that obligation to maintain proper records was not considered to be discriminatory[36].

In *FII GLO,* the ECJ, whilst accepting that an imputation system was more burdensome to operate when compared with an exemption system, considered the additional burdens associated with a credit system to be an intrinsic part of the operation of that system and rejected the notion that it constituted an excessive administrative burden and amounted to covert discrimination[37].

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[35] *Konle* paragraphs 52 and 53 and *Haribo* paragraph 136 et seq

[36] *Futura* paragraph 39 and *Haribo* paragraph 147

[37] *FII GLO* ECJ paragraph 53

See Article by Elmalis page 205 for a discussion of compliance burdens associated with the credit method. It has been argued that such method is *inherently* restrictive but that as member states retain the power to define the criteria for allocating their powers of taxation to eliminate economic double taxation any choice made must be

12. Matters for the National Court

The ECJ considered it a matter for the national court to determine whether the same rates of tax applied[38] to domestically and foreign sourced dividends and referred the case back to the High Court to determine:

(1) whether the (nominal) tax rates applied in the UK to domestic and foreign dividends are indeed the same; and

(2) whether the different levels of (effective) taxation occur in the UK only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs.

13. High Court

On the central issue of the correct rate of tax to be applied for the purposes of the compatibility analysis, Henderson J concluded that ECJ must have misunderstood the effect of the tax rules (i.e. not appreciated the distinction between “nominal” and “effective” rates of tax) and on that basis went on to hold that, in order to establish whether domestically sourced dividends were more favourably treated than foreign sourced dividends, it was necessary to compare the “effective” and not the “nominal” rates of corporation tax. This was on the basis that grant of reliefs and allowances at the distributing company level formed part of the measures to relieve economic double taxation. As companies resident in the UK frequently paid corporation tax at a lower rate than the “nominal” rate the differences in treatment constituted a restriction[39] and infringement of the freedom of establishment.

accepted as legitimate and potentially justify compliance burdens as proportional unless they can be considered to be excessive.

[38] Ibid paragraph 56

[39] *FII GLO* H Ct paragraph *65*

TCs

The order for reference had not requested any guidance from ECJ as regards tax treatment of dividends derived from TCs. Based on the ruling of the ECJ in *Holböck* and *Burda,* Henderson J held that, to the extent that free movement of capital applies the question whether the rules in relation to participation holdings of a non-resident company in TC situations infringed free movement of capital, was the same as the answer to the question of whether it infringed freedom of establishment[40].

As the UK corporation tax charge applied to all foreign dividends regardless of the size and nature of the shareholding, the article in relation to free movement of capital was engaged, subject to the proviso in Article 64(1) TFEU.

14. Court of Appeal

The parties to the case cross appealed to the CA. The Revenue contended that the correct inference of the ECJ's judgment was that the relevant tax rate to be applied was the "nominal" rate, as opposed to the "effective" rate, and that, provided full relief is given for the underlying foreign tax up to the limit of the corporation tax rate in the UK, there was no breach of Article 49. The Claimants considered the High Court to have correctly interpreted the ruling of the ECJ.

The UK Government and the Commission claimed that the exemption and credit method were equivalent.

The CA accepted that the two systems were far from being even-handed as in tax terms they produced different results[41]: that with a credit method a UK parent company would always be taxed at the "nominal" rate on foreign sourced dividends and was administratively more burdensome to operate.

On the central issue of the tax rate to be applied by a majority of two to one, the Court considered ECJ to have answered that question by holding that no account should be taken of the "effective" rate[42].

[40]Ibid paragraph *73*

[41] *FII GLO* CA Paragraph 34

[42] Ibid Annex 3 Paragraph 1

The CA considered that it was within the competence of member states to define the tax base and tax rates and that a state could adopt the exemption method, credit method or a combination of both systems for the relief of economic double taxation. However, if the "origin" state adopted the dual system then the requirements specified by the ECJ in relation to the credit method were required to be satisfied.

Since "*economic double taxation"* meant taxation of the same income twice in the hands of two different taxpayers the Court, by majority, considered that the principle of non-discrimination applied to the dividends themselves and not to the non-resident company. The grant of reliefs and allowances at the distributing company level did not form part of the measures adopted to relieve economic double taxation[43].

On the issue of hierarchy (and prevalence) of the freedoms, the CA confirmed that Henderson J was correct to hold that Article 63 TFEU is capable of being engaged in relation to payment of dividends by TC subsidiaries irrespective of whether there was a relationship of interdependence between them[44], subject to Article 64 (1) TFEU.

In the light of the sums involved, the CA has referred the matter back to the ECJ inviting that Court to clarify whether the rate for comparison was the "effective" rate or the "nominal" rate[45] .

15. WHT

As mentioned at the outset as the freedoms place significant limits on member states competences in relation to direct taxation it is critical to understand the elements that are within the jurisdiction of the court and those that are outside it. That is consideration of the jurisprudence of the court in relation to the "allocation of the right to tax" (i.e. juridical double taxation). The Courts response in relation to alleviating WHT in circumstances where a member state operates a dual system of taxation is reaffirmed in *Salinen.* Unlike the UK, the Austrian tax system did not provide credit

[43] ibid Annex 3 Paragraph 2

[44] Ibid Paragraph 70

[45] Ibid paragraph 43

relief for WHT levied by the source state, albeit that the rules allowed relief for the underlying foreign tax suffered by the distributing company.

ECJ was asked whether Article 63 TFEU obliged a member state to take into account, when applying the credit method, not only the underlying corporation tax paid in the state where the company distributing the dividends was established but also the tax withheld by the source state. ECJ said that the levying of WHT leads not to economic, but juridical double taxation[46]; that, EU law, as it stands at present, does not contain a general prohibition of juridical double taxation and there is no general duty on the part of a member state in which the shareholder resides to eliminate such taxation[47].

The issue raised by the claimants was whether the credit method, in circumstances where a member state operates a dual system of taxation, demanded the satisfaction of three conditions that is the relief of WHT, in addition to the two requirements laid down by the ECJ and discussed in paragraph in 9.

The Court did not, in *Salinen,* deviate from the principle that juridical double taxation was outside its jurisdiction and that the allocation of the right to taxation remains within the competence of member states.

16. Concluding remarks

The ECJ's approach is to align its comparability analysis on member states' legislative aims. If that aim is to avoid economic double taxation, then the member state must shape its system of taxation to ensure that foreign sourced income is not less favourably treated when compared to the domestic situation[48].

According to the ECJ if a member state chooses to adopt a dual system of taxation that is an exemption system for domestically sourced dividends and an imputation (credit) system for foreign sourced income then the later will not, in the context of EU law, be taken to have been less favourably treated provided the rules in relation to that system satisfy the requirements discussed in paragraph 9 of this Chapter.

[46] Ibid paragraph 166

[47] Ibid paragraph 171

[48] See discussion of migrant/non-migrant test in EU Tax Law by O'Shea 8 page 39 et seq

The “rate” of tax that applies to domestic and foreign source income raises important issues in relation to tax burdens. The question that it raises is whether it is permissible for member states only to take into consideration national tax burdens. The High Court clearly considers that the grant of reliefs at the distributing company level forms part of the measures to relieve economic double taxation.

The CA taking a contrary view which is that the principle of non-discrimination applied to domestic and foreign sourced dividends themselves and did not apply to any non-resident company.

With respect to administrative burdens associated with the credit method, the ECJ rejected the argument that the credit method imposed an excessive additional burden, indicating that requiring proof of the tax actually charged on the profits of the distributing company in its state of residence was an intrinsic part of the operation of the credit method.

Portfolio holdings are not “direct investments” for the purposes of the derogation from free movement of capital, Article 64 (1) and accordingly denying relief for the underlying foreign tax constitutes a restriction.

In relation to juridical double taxation the Courts have always held that the “*Treaty cannot guarantee to a citizen of the Union that the transfer of activities should be neutral as regards taxation*“[49]. Member states are not required to eliminate disparities that stem from the division of tax jurisdiction between two or more member states’ tax systems or from the co-existence of national tax administration.

The UK has altered its system of taxation. It has retained the dual system of taxation of dividends but, in part influenced by the findings of ECJ in *FII GLO,* instead of exempting UK to UK dividends and applying the credit method of taxation to foreign sourced dividends, it now subjects all dividends domestic or foreign to corporation tax. The system of taxation of dividends as revised by s34 FA 2009 are examined in Chapter 2.

[49] *Schempp* paragraph 45

Chapter 2

1. Commentary

This Chapter contains an outline of the system of taxation and in particular summarises the legislation enacted by s34 FA 2009 in relation to taxation of dividends.

The new regime provides that all dividends and distributions (other than distributions of a capital nature) of UK and non-UK resident companies are charged to corporation tax unless the distribution falls within one of the exceptions and is exempt[50].

As discussed the Government influenced by the responses of the ECJ in *FII GLO,* has removed the exemption for UK dividends; all dividends are subject to a charge to UK corporation tax. The exemption method applies subject to the satisfaction of certain conditions and in default the credit method applies in relation to the taxation of foreign dividends. The credit method underpins the system of taxation.

It is not always straightforward to characterize instruments in cross-border situations as to whether an instrument is in the nature of debt or equity, or a hybrid, and whether a payment constitutes a distribution[51]. In outline, a distribution covers any dividend, including profits paid out of the disposal of capital assets[52]. There is no statutory definition of a dividend but, according to established case law, a dividend represents a payment of a part of the profits for a period in respect of a share in the company[53].

Separate rules apply in relation to distributions received by small[54] and large and medium-sized companies. The small company's exemption is very differently structured from that of large and medium-sized companies.

[50] S931A CTA 2009

[51] s1000 CTA 2010

[52] *John Paterson (Motors)*

[53] *Esso Petroleum*

[54] s931B to 931C CTA 2009

2. Small company

A distribution received by a "small company" is exempt if:

- the paying company is resident UK or in a "qualifying territory" at the time the small company receives the distribution;

- distribution is not treated as interest (i.e. distributions that essentially represent interest will not qualify for the exemption treatment);

- receipt is a dividend in respect of which no tax deduction is given for the distribution outside the UK; and

- distribution is not made as part of a TAS.

A company is a "small company" in an accounting period if it is a micro or small enterprise as defined in the Annex to the Commission Recommendation 2003/361/EC of 6 May 2003 (i.e. a business that has fewer than 50 employees and whose turnover or balance sheet does not exceed ten million euros).

Provisions in relation to a "small company" were introduced at a late stage to ensure the legislation complied with EU law. The anti-avoidance provisions in relation to a "small company" are not as well thought out as those in relation to large and medium-sized companies in the EU context and this is apparent from the way that the anti-avoidance provisions relating to these companies has been framed.

Qualifying Territory condition

The exemption treatment is confined to dividends and other distributions paid by companies resident in the UK and qualifying territories with which the UK has a DTC, which includes a non-discrimination article along the lines of Article 24 of the OECD model treaty.

Liechtenstein[55] is within EEA but the DTC with the UK does not contain the non-discrimination in the form of Article 24[56]. This means that this country is not a "qualifying territory" for the purpose of the small company exemption.

The Treasury has the power to make regulations adding to the list of territories that qualify, even if the DTC in question does not contain an appropriate non-discrimination article, or to exclude territories even if the treaty in question does contain such an article.

The rationale for confining exemption treatment to distributions to countries, with which the UK has a comprehensive DTC, is to protect the UK Exchequer. The aim of the qualifying territory restriction is to limit distortions in investment activity and to dissuade investment in territories which have preferential tax regimes.

The question of whether there are any issues under EU law in affording different tax treatment according to where the income comes from has been addressed in Chapter 3.

General anti-avoidance rule

The exemption from a charge to UK incorporation tax is subject to the requirement that the distribution is not made as part of a TAS. A TAS is defined in the legislation as a "scheme the main purpose or one of the main purposes of which is to obtain a tax advantage[57]". Tax advantage[58] for the purposes of this legislation is defined as:

(a) a relief or increased relief from tax;

(b) a repayment or increased repayment of tax;

(c) the avoidance or reduction of a charge to tax or an assessment to tax, or

(d) the avoidance of a possible assessment to tax. "

[55] HMRC International Manual 432112 -http://www.hmrc.gov.uk/manuals/intmanual/INTM432112 (last accessed on 14 August 2011)

[57] S931V CTA 2009

[58] S1139 CTA 2010 for a definition of TAS.

This is a general anti-avoidance rule and is not as well targeted as the provisions that apply to large and medium-sized companies. The ECJ's jurisprudence in relation to anti-avoidance has been discussed latter but in the EU context, any anti-avoidance provision is strictly interpreted and such a provision in cases where the tax treatment constitutes a restriction, will only be upheld if the national courts determine that these provisions are limited in their application to "wholly artificial arrangements".

3. Large and medium-sized companies

Dividends received by large or medium-sized companies are, prima facie, subject to corporation tax. Unless the dividend falls into an exempt class, that dividend does not essentially represent interest and does not fall foul of the targeted anti-avoidance provisions; there are eight targeted anti-avoidance rules that would prevent a dividend from being treated as exempt and broadly, these provisions are designed to apply in circumstances where the main purpose is to achieve a tax advantage.

Exemptions

Save as mentioned above, the following five classes of dividends are exempt[59]:

Exemption 1: Distributions from controlled companies

A distribution is exempt if the recipient controls the payer so that distributions from a controlled company, whether in the UK or foreign, are exempt.

The dividend is not exempt if it is paid as part of a TAS, one of the purposes of which is to arrange for the dividend to fall into an exempt class and the dividend is paid out of pre-control profits.

Exemption 2: Distributions in respect of non-redeemable ordinary shares

A dividend on an ordinary, non-redeemable share is exempt. There is an anti-avoidance provision which provides that if a dividend is paid as part of a TAS and the shares are not "ordinary shares" or the shareholder has rights that are equivalent to the shares being redeemable, then they do not fall within the exempt class.

Exemption 3: Distributions in respect of portfolio holdings

Portfolio dividends qualify for the exemption treatment. There is an anti-avoidance provision which attacks schemes to manipulate holdings so as to come within this exempt class.

Exemption 4: Dividends derived from transactions not designed to reduce tax.

This exemption refers to a dividend paid in respect of "relevant profits". Under this exemption, a dividend should be exempt where it is paid from "relevant profits" resulting from transactions that are not designed to reduce tax. "Relevant profits" means any profits available for distribution when the dividend was paid, other than profits from avoidance transactions.

Exemption 5: Dividends in respect of shares accounted for as liabilities

Where shares are accounted for as liabilities under generally accepted accounting practice, any dividends on such shares may be exempt. These provisions are likely to be applicable to redeemable preference shares.

Exemption treatment is denied:

- where the distribution is made *as part of a TAS and a deduction is available to any overseas resident for that distribution (emphasis added)*;

- to distributions that represent interest;

- where the distribution or a right to receive the distribution is consideration given in return for receiving payment or giving up the right to receive income in respect of goods or services;

- where the dividend is part of a scheme that causes one party to receive less income or incur greater expenditure than would be the case if the dividend was not paid; or

[59] s931 E to s931 I CTA 2009

- where a company for which the distribution would represent a trade receipt diverts the distribution to a connected company so that it is not taxed.

A taxpayer can opt out of the exemption treatment in relation to any distribution by making an election that the distribution is treated as not being exempt. This may be to make the dividend subject to UK tax and so qualify for source country tax treaty reduction for example if the dividend is from Russia and access to the bilateral treaty reduction of WHT is desired on dividends.

With respect to the exempt classes the legislation identifies specific arrangements and transactions that provide opportunities for tax avoidance and targets those precisely and adopts a uniform approach in their application both in the domestic and cross border context.

Deduction condition

Like the small company exemption, exemption treatment for large and medium-sized companies is denied in the case of dividends where a deduction is allowed to a resident of a territory outside the UK under the law of that territory in respect of the distribution.

4. Credit Relief

Broadly, most dividends received by a UK company from the UK or overseas will be exempt from UK corporation tax. However there are exceptions.

UK to UK

The existing credit regime does not contain any provisions which extend credit relief to underlying UK corporation tax paid by a UK resident company which pays a non-exempt dividend or distribution directly to another UK resident company. So, if a UK to UK dividend does not qualify for the exemption treatment, then the dividend paid to the UK parent company will not qualify for credit relief for any underlying tax. In effect, situations that are the target of the anti-avoidance legislation are to be denied any relief on distributions.

UK companies are in a worse position than companies holding at least 10% or more of the share capital of another company in a cross-border situation that engage in tax avoidance.

DTC

Any double tax relief provisions in DTCs are unlikely to apply where the dividend exemption applies.

However, double tax relief in a DTC will apply to foreign inbound dividends that are not exempt under the specific terms of such a treaty.

Unilateral relief

Unilateral relief will apply, in the absence of the exemption treatment and DTC (if appropriate)

Under the unilateral relief provisions in relation to shareholdings representing more than 10% of the capital of a non-resident company, credit is allowed against UK tax both for WHT paid on the dividend and also for tax paid by lower tier companies up to the UK's "standard" rate of tax. However, this is subject to one exception, which provides that no underlying tax is to be taken into account if, under the law of any territory outside the UK, a deduction is allowed to a resident of the territory in respect of an amount determined by reference to the dividend[60].

Subject to a few exceptions under DTCs, credit for underlying foreign tax is not available to portfolio investors, such investors only being entitled to credit for WHT.

As the UK Government has chosen to include foreign sourced income of its corporate residents in the tax base, its rules must not discriminate between domestic and foreign sourced income and not treat foreign sourced income less favourably than domestically sourced income.

[60] S57(3) Chapter 2 Part 2 Taxation (International and other Provisions) Act 2010

In terms of the dual system of taxation, UK dividends will only be taxable to UK corporation tax if they are part of avoidance arrangements[61]; otherwise they are likely to be exempt from tax. As most dividends from UK companies are likely to qualify for exemption treatment, dividends from foreign companies must be accorded equality of treatment and any direct or covert unfavourable treatment could potentially be contrary to EU law.

The statutory provisions in relation to taxation of dividends are examined in Chapter 3 to establish whether they achieve a level playing field, in the EU context, between investments made in the UK and abroad.

[61] S931B and s931H CTA 2009

Chapter 3

1. System of Taxation

The UK Government has chosen to include inbound dividends in its tax base and to relieve economic double taxation. This Chapter examines the rules outlined in Chapter 2 and considers whether the dual system of taxation conforms to EU law[62].

In practice, most dividends, domestic or foreign, under the new regime are likely to be exempt but in circumstances where this is not the case, then the credit method will apply. What follows is an analysis of the credit method as it applies to participation dividends and portfolio dividends.

2. Participation holdings

As confirmed by the ECJ in *FII GLO,* the application of the credit method in relation to holdings of 10% or more, subject to the ECJ clarifying the "rate of tax" to be applied to foreign sourced dividends, conforms to EU law. This is because this method grants credit for WHT and underlying foreign tax suffered by the distributing company and lower tier companies up to the limit of the amount of tax charged in the UK.

3. Portfolio holdings

Dividends derived from holdings of less than 10% that do not qualify for exemption[63] (and subject to the provisions of any DTC) are taxed without allowance for the underlying corporation tax suffered by the distributing company. These only qualify for relief from WHT.

In situations where the shareholding interest held is less than 10%, the relevant freedom is free movement of capital rather than freedom of establishment as the latter is confined to situations of control or "definite influence"[64]. On this basis, any breach of EU law in principle can arise where the investment is in a TC, as the article

[62] *FII GLO* ECJ paragraph 73

[63] i.e. because they fail the "qualifying territory" condition, the general anti-avoidance rule or the targeted anti-avoidance provisions for large and medium-sized companies.

[64] *Baars* paragraph 22

in relation to free movement of capital extends to movements between member states and TCs.

Qualifying territory

With respect to tax treatment of portfolio dividends, dividends received by a UK-resident company from companies established in the UK are always likely to be exempt, whilst those received by such companies from companies established in a *non-qualifying territory* are neither exempt nor granted a credit for the underlying tax suffered by the distributing company (subject to any DTC). That difference in treatment is likely to have the effect of discouraging UK-resident companies from investing capital in companies established in non-qualifying territories.

As previously discussed, disparities in tax treatment will not give rise to a breach of EU law where differences relate to situations which are not objectively comparable. The situation of a corporate shareholder receiving a dividend from a non-qualifying territory is comparable to that of a corporate shareholder receiving a dividend from a UK-resident company, as in each case the profits of the distributing company are subject to a series of charges to tax. Any favourable treatment of domestically sourced dividends in comparison with foreign sourced dividends can constitute a restriction prohibited by Article 63 TFEU[65].

Justification

As discussed in Chapter 1, denial of relief for underlying foreign tax in relation to portfolio dividends on the basis that it is disproportionately expensive and complex to administer and supervise the grant of foreign tax credits was rejected by the ECJ on the basis that difficulties in determining the tax actually paid was not considered to justify an obstacle to free movement of capital.

[65] *FII GLO* ECJ paragraph 65

Can differences in tax treatment be justified by the place where the capital is invested?

It has been consistently held that the need to maintain tax revenue cannot justify a measure which is, in principle, contrary to a fundamental freedom[66]. The scope of free movement of capital in relation to TCs has been the subject of deliberations in a number of cases by the ECJ, and the Court has confirmed its position in *FII GLO* that it may apply different standards, both at the level of comparability and at the level of justification[67] (i.e. a member state may well be able to demonstrate that a restriction on movement of capital to and from non-member countries, i.e. TC, is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movement between member states[68]). The Court in *OESF* also accepted that need to maintain tax revenue as a justification to a restriction may be accepted in a TC situation[69]. Although any differences in treatment have to be appropriate for attaining the objective and must not go beyond what is necessary to attain it.

In S*alinen,* ECJ rejected the Austrian and Italian Government's assertions that differences in tax treatment of portfolio dividends in relation to member states and non-member states (other than an EEA State) was justifiable on the grounds that the different treatment was necessary to protect the tax base and to prevent the setting up of artificial arrangements to divert profits. This was on the basis that a company holding less than 10% of the share capital of another company was not in any position to set up artificial arrangements with a view to diverting profits from one company to another company[70]. The Court determined that the need to maintain tax revenue did not, for that reason, constitute justification for a restriction to free movement of capital.

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[66] *Manninen* paragraph 49

[67] *FII GLO* paragraph 170, at 171 the Court said that:

".....it may be that a Member State will be able to demonstrate that a restriction on capital movements to or from non-member countries is justified for a particular reason where that reason would not constitute a valid justification for a restriction on capital movements between Member States."

[68] F*II GLO* ECJ paragraph 171 and *Haribo* paragraph 120

[69] *OESF* Paragraphs 89 et seq

[70] *Salinen* paragraph 165

Article 64 (1) TFEU

The ECJ recognised in *FII GLO* that the standstill derogation is not applicable to portfolio dividends in relation to TCs, albeit the national rules in relation to such dividends were in place prior to the UK's accession to the EU.

The Court has confirmed that only shareholdings in companies acquired with a view to establishing or maintaining lasting and direct economic links and which allow a shareholder to participate effectively in the management of the company or in its control[71] can be regarded as "direct investments" within the meaning of the nomenclature annexed to Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty (article repealed by the Treaty of Amsterdam).

To sum up dividends derived from portfolio holdings in companies established in TCs are not covered by the exception in the above-mentioned article. Failure to grant relief for the underlying foreign tax is, as the ECJ ruled in *FII GLO,* contrary to EU law and this is the case both in relation to other member states and TCs. Subject to clarifying the situation in relation to the tax rate to be applied, tax treatment of participation dividends conforms to EU law according to the ruling of ECJ in *FII GLO.*

Is the "qualifying territory" condition discriminatory as income from some states is more favourably treated then from another?

The rationale for extending the exemption treatment to certain territories and not others was to ensure that the Government met its international obligations under DTCs as it would not have been practical to make changes to the system of double tax relief that depended for their effectiveness on wholesale re-negotiation of such treaties[72]. The "qualifying territory" condition meets this aim.

As to whether a difference in tax treatment between different member states/non-member states constitutes a restriction, has been deliberated in a number of cases.

[71] *FII GLO* paragraph 175 et seq

[72] See Discussion paper "Double Tax Relief for Companies"

OESF[73] claimed that its investments in Germany and Portugal were treated differently from those made in member states that had concluded a tax treaty with the Netherlands, providing for a tax credit for the benefit of Dutch resident individuals investing in these member states[74]. OESF claimed that this difference in treatment deterred Dutch investment enterprises from investing in certain member states, such as Germany and Portugal, and was therefore incompatible with free movement of capital[75].

This compensation measure resulted from the unilateral decision of the Government of the Netherlands to extend the benefit of the concession to fiscal investment enterprises and not from the application of bilateral treaties[76].

The comparability analysis developed by the ECJ is, as discussed, based on whether tax treatment is unfavourable judged by reference to the aim of the national legislation. This has frequently resulted in consideration of the "correct comparator", where benefits result from unilateral measures undertaken by a member state. In *OESF,* the aim of the Dutch legislation was to extend tax benefits to certain investment enterprises. Foreign shareholders could benefit from a credit regime or refund regime in their home country, depending on the applicable internal legislation and the applicable tax treaties[77].

A Portuguese Dutch tax treaty was not in force at the material time. The applicable Germany-Netherlands tax treaty did provide for a credit for foreign dividend WHT.

ECJ was asked to rule on whether an investment enterprise that invested in Germany and Portugal was in the same situation as an enterprise that invested in another member state with whom a tax treaty had been concluded, providing in a credit for foreign WHT to the benefit of Dutch individuals.

[73] For a detailed analysis, in particular in relation to differences in tax treatment between national states, see Article by An Weyn page 56

[74] *OSEF* paragraph 24

[75] Ibid paragraph 25

[76] Ibid paragraph 54

[77] Ibid paragraph 11

The refund measures at issue originated from the unilateral legislative decision taken by the Dutch authorities and not as a result of the application of tax treaties.

The ECJ took the view that an investment enterprise investing in Germany or Portugal was not in the same situation as an enterprise that invested in another member state with whom a tax treaty has been concluded, providing in a credit for foreign WHT to the benefit of Dutch individuals: the situation in which a tax treaty providing in a tax credit of such foreign WHT is not comparable to the situation in which no such treaty applies when taking into account the goal of the unilateral refund measures[78].

The Court stated that:

"*Article 56EC and 58EC do not preclude that Member State [Netherlands] from withholding that concession in respect of dividends from other member states with which it had not concluded bilateral agreements containing such provisions, as these are not objectively comparable situations*[79]."

In *Haribo* the ECJ, on the issue of the correct "comparator", confirmed that the comparator was as between tax treatment of income received from resident companies on the one hand and income received from another member state or non-member state on the other. That comparison was not between one non-member state compared to another such state[80].

In summary, extending the exemption method to income derived only from those territories that contain a non-discrimination article in the form of the OECD model treaty is not prohibited by TFEU.

Consultation over the tax treatment of portfolio dividends

In terms of the future, the UK Government has acknowledged that its tax treatment of foreign portfolio dividends is not in compliance with EU law[81] and is currently

[78] *OSEF* paragraph 63

[79] *OSEF* Paragraph 64

[80] *Haribo* paragraph 48

[81] Taxation of Foreign Profits of Companies: Discussion Document June 2007

consulting on the following possible methods of achieving parity of treatment between the UK and foreign inbound dividends from portfolio holdings:

- providing credit for underlying tax (as well as WHT) for foreign dividends;
- providing exemption for foreign dividends;
- charging to tax both UK and foreign dividends without giving credit for underlying tax (but credit for WHT) with crave-out for certain bodies.

4. Deduction Condition [82]

Exemption treatment is denied if a deduction is allowed for the distribution to a resident of a territory outside the UK under the law of that territory. This condition applies to a small company and large and medium-sized companies respectively.

If a tax deduction is allowed in the territory in which the distributing company is resident and an exemption is allowed in the UK in relation to that distribution than this would result in no taxation at all. It is considered that this is likely to distort allocation of capital and act as an (open) invitation for taxpayers to engage in cross border activity.

The issue of jurisdiction shopping has been discussed later but the ECJ has confirmed that the exercise of rights embedded in TFEU cannot generally be viewed as avoidance; EU natural and legal persons are free to exercise the fundamental freedoms and this right may be restricted only in limited circumstances.

Aberdeen[83]*, M&S and AA* deal with entirely different issues, but they demonstrate the circumstances in which the state in question is allowed to take into account the tax position of the legal person in the other member state. What differentiates these cases is the justification analysis; in the case of *M&S* and *AA* there was threat of real tax loss, on the other hand there was no such risk in *Aberdeen.*

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[82] s931(c) CTA 2009

[83] See "ECJ Finds Finnish Withholding Tax Rules Unacceptable In Luxembourg SICAV Case" for a detailed discussion of this case.

Aberdeen concerned the non-taxation of Finnish dividend income in Luxembourg. *Aberdeen* determined that Finnish WHT on dividends paid to a Luxembourg SICAV (*Société d'Investissement à Capital Variable*)) parent company were incompatible with the article in relation to freedom of establishment in which similar dividends paid to a Finnish parent company were exempt from taxation[84].

Aberdeen sought a preliminary ruling on the taxation of dividends paid by that company to its parent company, Aberdeen Property Nordic Fund I SICAV ("Nordic"). *Aberdeen* queried whether it had to charge WHT on dividends paid to Nordic, given that dividends paid to resident parent companies were not subject to WHT[85]. Alpha argued that this difference in tax treatment was contrary to both freedom of establishment and free movement of capital provisions in TFEU.

Finland's Central Tax Commission concluded that *Aberdeen* was required to charge WHT on dividends paid to Nordic on the ground that, inter alia, a SICAV was different from a Finnish share company in that a SICAV was not liable to tax in its state of residence whereas a Finnish share company was (i.e. subject to corporation tax)[86]. *Aberdeen* appealed against this decision to the Supreme Administrative Court, which referred the EU law issues to the ECJ for a preliminary ruling.

The Finnish and Italian governments argued that there was an objective difference in the situation between a Finnish resident company and a non-resident SICAV both in relation to the form of the SICAV and also on the basis that Finnish resident companies were subject to income tax in Finland but an SICAV resident in Luxembourg was not[87]. The problem of a series of tax charges did not arise in relation to a SICAV and accordingly, the objective of relieving economic double taxation was not an issue in relation to the Luxembourg entity.

The ECJ rejected these arguments and in relation to the non-taxation of a SICAV in Luxembourg, the Court said that such non-taxation did not justify the different tax

[84] Ibid paragraph 22

[85] Ibid paragraph 18

[86] Ibid paragraph 19

[87] Ibid paragraphs 45 and 47

treatment in Finland. It was Finland that imposed a series of tax charges and accordingly, it was that state that was obliged to accord equal treatment to dividends paid to a Finnish parent company and a SICAV in Luxembourg[88]. The ECJ said there was no objective difference between, on the one hand, a domestic resident company receiving dividends from another Finnish resident company and which was exempt from WHT and, on the other hand, dividends paid by a Finnish company to a non-resident company[89].

The Court held that non-taxation of Finnish dividend income in Luxembourg did not justify different tax treatment[90].

The Finnish and Italian governments argued that the Finnish tax rules were justifiable on three general interest grounds that related to the need to:

(1) prevent tax avoidance on the basis that the exemption from WHT tax to a company resident in a member state other than Finland, which itself does not pay tax on that income and the distribution of whose profits does not give rise to WHT, entailed a risk of artificial arrangements being set up with the intention of avoiding all forms of tax on income[91];

(2) preserve a balanced apportionment of power in the allocation of taxing rights between Finland and Luxembourg in the tax convention between the two countries[92];

(3) ensure the coherence of the Finnish Tax system, which is based on the principle that the exemption from WHT of dividends received by a Finnish resident company is offset by the taxation of corresponding income at the level of the natural person who pays tax on that dividend income[93].

[88] Ibid paragraph 46

[89] Ibid paragraphs 50 to 55

[90] Ibid paragraph 56

[91] Ibid paragraph 58

[92]Ibid paragraph 59

[93] Ibid paragraph 61

The Court rejected these arguments[94] and concluded as follows:

- In relation to *artificiality of arrangements,* the Court, said that a restriction in relation to a fundamental freedom could only be justified in circumstances where the specific objective of the restriction is to prevent conduct involving the creation of wholly artificial arrangements that did not reflect economic reality with a view to escaping tax normally due on the activities carried out on national territory[95].

  As the Finnish tax rules were not targeted at purely artificial arrangements, the Court concluded that they could not be justified on grounds of preventing tax avoidance[96].

- With regard to the *preservation of a balance in allocation of taxing rights,* the Court stated that such a justification may be accepted when the tax system was designed to prevent conduct capable of jeopardising the right of a member state to exercise its tax jurisdiction in relation to "*activities carried on in its own territory*"[97] (*emphasis added*).

  As Finland had not chosen to tax dividends paid to resident companies, it could not argue that its rules were necessary to maintain its taxing rights[98].

In contrast *M&S* concerned restrictions on the ability to offset losses to foreign companies in a group. The ECJ considered that although the denial of cross border relief between two companies in different states constituted a restriction, such a denial could be justified to, inter alia, prevent double dipping[99].

Within a group of UK companies, a system of group relief allowed companies to offset profits and losses arising to different group companies. M&S Plc. had

[94] Ibid paragraph 62

[95] Ibid paragraph 64

[96] Ibid paragraph 65

[97] Ibid paragraph 66

[98] Ibid paragraph 67

[99] *M&S* paragraphs 47

subsidiaries in the UK and in other member states. Unlike resident subsidiaries, foreign subsidiaries were unable to surrender their trading losses to the UK Parent, or any other member of that corporate group. Only non-UK subsidiaries trading in the UK through a branch or agency were entitled to surrender their losses. These restrictions, it was argued, infringed Articles 49 TFEU and 54 TFEU (ex. Article 48 TEC) as it made it less attractive to establish subsidiaries in other member states and restricted the freedom to choose the most appropriate form (i.e. branch or subsidiary) for pursuing activities in another member state.

The aim of the rules was to ensure *fiscal neutrality* (emphasis added) as to the form adopted for pursuing activities pursued in another state.

A company operating through a branch is treated as one corporate entity for tax purposes so financial consolidation is allowed: subsidiaries remain separate legal entities and there is no consolidation. The provision for transfer of losses is intended to make the taxation of groups of companies as neutral as possible so as to avoid penalising a company establishing a subsidiary as opposed to operating through a branch.

Losses are permitted to move freely in the group and relief is not linked with the power to tax foreign subsidiaries. Any company in a group can surrender its losses to another company in the same group. The surrendering company loses any right to use those losses for tax purposes and may not carry them forward to subsequent tax years, any advantage conferred by such transfer being neutralised by tax being charged on the surrendering company.

On the basis that group relief constituted a tax advantage for the companies concerned, the ECJ ruled that the difference in treatment[100] constituted a restriction[101] but pursued a legitimate objective which met the public interest requirement. That is, the restrictions, subject to the principle of proportionality, were required to protect the balanced allocation of the power to impose taxes[102]. Crucially,

[100] Comparing tax treatment of a foreign subsidiary versus a UK subsidiary of a UK parent company

[101] *M&S* paragraph 34

[102] The court said profits and losses were two sides of the same coin and must be treated symmetrically in the same tax system in order to protect the balanced allocation of power (i.e. only tax rules of the state in which the company is resident should apply to the profits and losses - see Article O'Shea 4 page 836 and that there was a danger they could be taken into account twice and there was a risk of tax loss.

in relation to the risk of double dipping, the Court accepted that there was a risk that losses could be taken into account twice and agreed that member states must be able to prevent that abuse[103]. The AG considered that double dipping was contrary to the "neutrality" sought by the regime[104]. That is it could frustrate the aim of the legislation which was to achieve the effect of financial consolidation and could open up opportunities for abuse which was to create an environment whereby the tax normally due on the profits generated by activities carried out on national territory could be avoided simply by trafficking of losses and securing loss relief in each of the territories in which the parent and subsidiary were respectively resident (double dip).

The issues and concerns in *AA* are similar to those raised in *M&S*. *AA* concerned companies who in a domestic situation were allowed to transfer profits between themselves. Such transfer was only available provided the transferor and transferee were Finnish national companies[105]. ECJ ruled that, although these provisions constituted a restriction in relation to freedom of establishment[106], the Court, inter alia, concurred that there was risk of double dipping, i.e. opening up the possibility of trafficking in profits by groups in a cross-border situation and securing loss relief as discussed[107].

The distinctions between *Aberdeen* on the one hand and *M&S and AA* on the other is that although the national measure in each case constituted a restriction in relation to *M&S* and *AA* there was a threat of opening up opportunities for abuse and the trafficking in losses or profits and the avoidance of any payment of tax in either territory. The restrictions in relation to losses and profits respectively were justified by the public interest requirement. In *Aberdeen* there was no such risk and accordingly no justification for the restriction.

So far as the deduction condition is concerned exemption treatment is denied by reference to the tax rules of another state. In the circumstances of this case there is

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[103] *M&S* paragraph 43

[104] See article O'Shea 5 pages 69 and 80 for a detailed analysis of the M&S case and AG Poiares Maduro's Opinion 7 April 2005 paragraph 72

[105] *AA* paragraphs 9 and 22

[106] Ibid paragraph 43

[107] Ibid paragraphs 54, 56 and 64

no risk of loss of tax normally due on profits generated by activities carried out in the UK. The Courts have consistently held that reduction in tax revenue[108] cannot be regarded as an overriding reason in the public interest to justify a measure that may be a restriction. Equally any defence based on distortions in investment activity also cannot be regarded as a sufficient justification for a restriction. This is on the basis that the ECJ has confirmed that jurisdiction shopping is permissible.

Although the deduction condition does create differences in tax treatment by virtue of the fact that the credit method is used as overarching framework, tax treatment of participation dividends conforms (subject to clarification of the tax rate) with EU law.

The tax treatment of portfolio dividends on the other hand constitutes a restriction and on the basis that the ECJ in *Haribo* and *Salinen* confirmed that Portfolio holdings do not pose a risk of artificial diversion of profits, there is no justification for any restriction on the basis of the deduction condition.

5. Attitude of the ECJ towards anti-avoidance

In the case of a small company, exemption treatment is denied if the distribution is made as part of a general anti-avoidance rule. More targeted rules designed to avoid or prevent the manipulation of the rules to secure exemption treatment apply in relation to large and medium-sized companies.

The desire of member states to protect their tax base and prevent abuses of its law in relation to direct taxation collides with the right to the principle of free movement. Starting from *Biehl* and then *ICI, X and Y II and the Lankhorst-Hohorst* case respectively, prevention of tax avoidance has been explicitly accepted by the Court as a justification for restrictions to the principle of free movement[109]. The European Court has affirmed that member states can take measures to prevent their nationals from "*attempting, undercover of rights created by the Treaty, improperly to circumvent their national legislation*……"[110]

[108] *M&S* paragraph 44

[109] See Tax Avoidance by Dennis Weber page 175

[110] *Centros* paragraph 24

So far as the Courts are concerned in relation to tax avoidance they have to play a role in balancing the interests of member states in the regulation of direct tax matters and preserving the right of nationals and legal persons to free movement within the Community.

Cadbury Schweppes demonstrates how the ECJ has addressed these competing interests. The UK's CFC rules were challenged in this case on the grounds that they were incompatible with EU law, in particular, in relation to the freedom of establishment. Cadbury Schweppes, a UK-resident company, had established two subsidiaries in the International Financial Services Centre in Ireland to take advantage of the 10% tax regime. On the question of whether establishing a company in another member state to take advantage of the more favourable tax regime constituted an abuse of the freedom of establishment, the Court said that nationals of a member state cannot attempt, under cover of the rights granted by the Treaty, improperly or fraudulently to take advantage of the Community provisions[111].

Accordingly a legal person who seeks to benefit from more favourable tax regime in another member state cannot be deprived of their right to free movement. Establishing a company in another member state to benefit from the more favourable tax regime in that state should not constitute abuse of such rights.

The UK Government argued that the CFC legislation was intended to counter specific type of tax avoidance involving the artificial transfer by a resident company of profits from the member states in which they were made to a low tax state by establishing a subsidiary in that state. The Court said that establishing a subsidiary in another member state did not give rise to a presumption of tax evasion and justify a measure which compromised the exercise of a fundamental freedom guaranteed by the Treaty. Moreover, the fact that the activities of the CFC could have been carried on in the UK did not warrant the conclusion that a wholly artificial arrangement had been put in place.

[111] *Cadbury Schweppes* paragraph 35.

The CFC rules could be justified if they were specifically targeted at wholly artificial arrangements aimed at circumventing the application of the legislation of the member state and that it was necessary to consider the objective of the freedom of establishment when assessing the conduct of the person establishing a subsidiary in another member state. That objective:

"…*was to allow a Community national to participate on a stable and continuing basis in the economic life of a member state other than his own …….*"

The Court explained that the foregoing involved the actual pursuit of a genuine economic activity in the host member state for an indefinite period.

The Court took the view that for a restriction on the freedom of establishment to be justified on the grounds of prevention of abusive practices, the specific objective of the restriction must be to prevent conduct involving the creation of wholly artificial arrangements which did not reflect economic reality. Furthermore, that it was for the national courts to determine whether the CFC rules, and in particular the "motive test", restricted the application of the CFC provisions to wholly artificial arrangements.

The conclusion that can be drawn in relation to what constitutes "tax avoidance" is that the exercise of rights embedded in the Treaty cannot generally be viewed as avoidance[112]. In addition, as the possibility of preventing avoidance is an exception, any restrictions must be interpreted strictly and the consequences of the measure should not extend further than is necessary to combat the avoidance (i.e. anti-avoidance measures should not be in conflict with the objectives and scope of EU law).

On the basis of the foregoing, there is no improper tax avoidance by virtue of the fact that a resident is subject to an advantageous tax system in another member state. Jurisdiction shopping is permissible as a matter of principle. Moving a tax residence or the source or origin of income by means of exercising free movement does not, in

[112] See EU Tax Law by O'Shea 7- Chapter 4 in particular headed "Tax Avoidance which is unacceptable to the ECJ" page 182

itself, constitute avoidance as long as the move is genuine and genuine economic activity is undertaken in that other state.

On the issue of whether national measures adopted by a member state to prevent abuse are restrictive, the ECJ will firstly consider whether TFEU has been engaged, that is whether genuine economic activity is being undertaken in the other state.

Secondly, the Courts will apply the comparability analysis, as discussed, and if the rules in their application are restrictive then thirdly, whether there is an issue of general public interest justifying the restriction and lastly, if the restrictions are justifiable, then whether they are proportionate.

EU law sets out a number of conditions with regard to the prevention of avoidance[113]:

- the objective of the legislation, the avoidance of which is prevented, must be in conformity with EU law;

- anti-avoidance measures must be applied without distinction – applying the comparability analysis;

- anti-avoidance measures must be consistent. Situations in which there is the same objective risk must be treated equally;

- if there is no advantage, there can be no avoidance;

- avoidance has to be established on the grounds of objective circumstances and the taxpayer must have a subjective intention to avoid tax.

  General anti-avoidance rules which deny the national courts power to assess fraudulent or abusive conduct on a case by case basis, may be incompatible with EU law[114].

[113] See Tax Avoidance by Dennis Weber

[114] *Centros* paragraph 25

In summary, as the application of anti-avoidance measures is derogation from the principle of free movement, any measures directed at avoidance to be compliant must be as limited as possible.

6. Anti-avoidance provisions in relation to the new regime

Large and medium sized companies are subject to more targeted provisions. These are likely to satisfy the criteria which the Courts have formulated in relation to avoidance. The compatibility of the provisions in relation to a small company depends on how widely the "TAS" is interpreted by the national courts in the UK. If the ambit of these provisions is limited to "wholly artificial arrangements" and any tax charge that follows is proportionate, then these rules may not constitute a restriction.

As the credit method overarches the system of taxation the application of the credit method to participation dividends, subject to clarification of the "rate" of tax, conforms to EU law.

Tax treatment of portfolio dividends (subject to DTCs) constitutes a restriction in relation to member states and TCs. Any justification based on protection of tax base and to prevent the setting up of artificial arrangements to divert profits has been rejected as a possible defence on public policy grounds by the ECJ in *FII GLO and Haribo*.

7. Concluding remarks

With regard to the methods for relieving double taxation, the ECJ has recognised that the exemption and credit method are equally valid methods for relieving double taxation. In this regard, the ECJ in *FII GLO* accepted in principle that the UK's credit method for relieving economic double taxation of dividends derived from shareholdings of 10% or more conforms to EU law (this is subject to clarification of the tax rate).

Tax treatment of portfolio dividends (subject to DTC (if appropriate)) generally constitutes a restriction on free movement of capital which is, in principle, prohibited by Article 63 TFEU in relation to member states, EEA and TCs. This is on the basis that the derogation in Article 64 (1) TFEU is not applicable to portfolio dividends from distributing companies resident in TCs.

With respect to the "qualifying territory" condition, ECJ has confirmed that it is not discriminatory to treat income derived from some states more favourably than from others.

The deduction condition attempts to prevent what may be considered to be legitimate form of tax mitigation. Having said that the tax treatment of participation dividends does not amount to a restriction as the credit method applies in place of the exemption method.

The ECJ has drawn a distinction between acceptable and unacceptable "tax avoidance". Only restrictions aimed at preventing "wholly artificial arrangements" designed to circumvent the legislation of the member state concerned conforms to EU law. The anti-avoidance provisions in relation to large and medium sized companies are better targeted and appear to comply with requirements of EU law.

The position of the general anti-avoidance provisions in relation to a small company is not as clear: these will be in conformity with EU law provided national Courts interpret these narrowly so that their application is confined to "wholly artificial arrangements". In this regard the likelihood is that HMRC will only seek to attack arrangements that seek to divert profits that relate to activities carried out in the UK.

The attitude of the UK Treasury and HMRC has recently changed. HMRC had always assumed that if an activity could have been undertaken in the UK any activity overseas represents a diversion of profits and ought to be taxed in the UK. As a departure from this attitude the Treasury and HMRC accept that this is an extreme position and confirmed that they are moving away from the default presumption that all activities that could have been undertaken in the UK would have been undertaken here were it not for the tax advantage afforded by the overseas location[115]. In deference to the proportionality principle there will be a greater focus on distinguishing between profit genuinely earned in the UK and that which represents the artificial diversion of profits from the UK.

Chapter 4 provides some conclusions and discusses some of the issues that the new regime potentially gives rise to.

[115] See Discussion paper proposals for CFC Appendix A.

Chapter 4 - Conclusions

The ECJ has confirmed that it is within the competence of member states to choose their system of taxation; an exemption, credit or a dual system of taxation. On the basis that with few exceptions domestically sourced dividends will qualify for the exemption treatment and as the credit method is the default position then that system of taxation in relation to foreign dividends must conform to EU law.

In relation to the conditions associated with a dual system, the credit method will conform to EU law provided the two requirements discussed in paragraph 9 of Chapter 1 are satisfied.

The High Court and CA have deliberated on the correct interpretation of the ECJ ruling in *FII GLO* in relation to the "rate" of tax to be applied. Those Courts have, in particular, considered whether the grant of reliefs at the level of the distributing company forms part of the measures adopted to relieve economic double taxation[116]. The CA has invited ECJ to clarify its response.

Of the two approaches, the CA interpretation resonates. This is because the ECJ:

(1) has repeatedly endorsed the principle of national treatment/territoriality;

(2) has acknowledged that there is no constitutional guarantee that any cross border activity by natural or legal person will be neutral as regards taxation[117]: ECJ has not deviated from the principle that juridical double taxation is outside its jurisdiction; and

(3) in *FII GLO* undertook a comparison of the relative tax burdens at the level of the subsidiary and the parent[118] and accepted that lower tier companies suffered tax by reference to their respective tax bases (i.e. accepting there is no common tax base).

[116] *FII GLO* ECJ paragraph 55 where the UK Government argues that different levels of taxation between the company making the distribution and to the company receiving it occur only in highly exceptional circumstances.

[117] See footnote 55

[118] *FII GLO* ECJ paragraph 43

If the High Court is correct in its interpretation then this may preclude the adoption of a dual system of taxation at least in relation to member states and in the case of TCs in relation to holdings that do not constitute direct investments as discussed in paragraph 10 Chapter 1. As it is difficult to envisage a system that lends itself to easily take account of reliefs at the level of the distributing company in a cross border situation.

On the central question of whether the system of taxation complies with EU law the answer is that the credit method, with exception of establishing the issue in relation to the tax rate and portfolio dividends, conforms to that law in large part. The system of taxation is balanced and meets the twin objectives of conforming to EU law and recommendations of the OECD that any practices that are considered to constitute harmful tax competition do not qualify for the exemption treatment.

The new system is not, however, without its complications. First as discussed earlier for EU reasons the old blank exemption for UK dividends has been removed so that it is no longer possible for a UK company to take it as read that exemption treatment will automatically apply in relation to domestically sourced dividends. In particular the general anti-avoidance rule applicable to a company that is small has created uncertainty in practice for example in many sales of subsidiaries it is not unusual to pay a pre-sale dividend for a whole range of reasons, doing so means that the value of that company may decline by the amount distributed so that in cases where the substantial shareholding exemption does not apply for capital gains tax purposes, the chargeable gain accruing to the parent company may be lower than it would otherwise have been the case, this may raise the question of whether the payment of dividend is part of a TAS.

Second the European Commission has recommended limiting the proliferation of definitions of SME's in use at the EU level. The draftsman has complied by adopting the EC's definitions of an SME. That definition can lead to surprising results and it may not always be straightforward to determine whether a company is, for example, a "small company" for the purposes of these provisions. Article 1 of the definition adopted by the European Commission defines an enterprise to be:

"*any entity engaged in economic activity irrespective of its legal form*….."

The holding and management of investments such as shares in a private limited company by a trust for the benefit of beneficiaries could, for instance, be construed as an economic activity by that trust and therefore an “enterprise” in relation to possible connections with the company in question. This can throw up all sorts of issues in practice.

Table of Abbreviations

AG	Advocate General
CA	Court of Appeal
CTA 2009	Corporation Taxes Act 2009
DTC	Double Tax Convention or Double Tax Treaty
ECT	European Court of Justice
EU	European Union
FA 2009	Finance Act 2009
HMRC	HM Revenue & Customs
ICTA 1988	Income and Corporation Taxes Act 1988
SME	Micro, small and medium sized enterprises[119]
TAS	Tax advantage scheme
TC	Third Country
TEFU	Treaty on the Functioning of the European Union

[119] See New SME definition user guide and model declaration.

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Report by OECD published in 1998 "Harmful Tax Competition, An Emerging Global Issue"	OECD 1998
ICC Policy Statement: "Tax Exemption versus Tax Credit Systems for Foreign Dividends: Comparison and International Trends" prepared by the Task Force on Tax Exemption versus credit Systems	ICC Policy Statement
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Appendix 1 – Form for the Submission of Coursework

Dissertation submitted in partial fulfillment of the requirement for the degree of MA in Taxation (Law, Administration & Practice) of the University of London in 2010 -11

Candidate Number:	R6605
School:	School of Advanced Legal Studies
Institute:	Institute of Advanced Legal Studies
Title of Course:	Dissertation
Name of Teacher:	Dr. Tom O'Shea
	Written Assignment

Candidate's authorship declaration:

I confirm that this dissertation is entirely my own work. All sources and quotations have been acknowledged.

I confirm that I have run this work through "Turnitin", and agree that the Institute may use this site to check my essay or assignment.

The total length of the dissertation is 15,244 words (excluding the cover page, table of contents, Table of Abbreviations and Bibliography and Appendix 1).

Candidate's signature:

……

Date: 27 August 2011