

IFA/Victoria Tax Bar Association

A UK Perspective on International Tax before the European Court of Justice: Process and Outcomes

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EC Treaty Provisions - 1

- Articles 2 & 3 set clear objectives for achieving a single market based on freedom of movement of goods, persons, services and capital
- Article 12 prohibits discrimination on grounds of nationality but the Article applies independently only to situations in respect of which EC Treaty makes no specific prohibition of discrimination
- Specific Treaty freedoms:
 - Movement of goods Article 23
 - Movement of workers Article 39
 - Freedom of establishment Article 43/48
 - Freedom to provide services Article 49
 - Freedom of movement of capital Article 56 (with 3rd country application – but see *Fidium Finance* and *UK Thin Cap GLO*)

EC Treaty Provisions - 2

- Scope for Community action in direct tax matters limited to measures for the approximation of laws having a direct impact on the establishment and functioning of the common market – Article 94
- Unanimity is required in all tax matters, Article 95, para 2
- Article 293 contemplates ‘negotiations’ to secure the abolition of (juridical) double taxation

National Sovereignty in Direct Tax Matters

- Direct tax systems must be compatible with Community law
- “Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law.”
- *Schumacker* Case C-279/93, para 21

References to the ECJ - 1

- Case 270/83 *Commission v France* (the “Avoir Fiscal” Case)
- But Commission unable/reluctant to pursue direct tax infringement actions
- Article 234 rulings by ECJ on the interpretation of the EC Treaty on a reference by a national court

References to the ECJ - 2

- Mandatory references where no further judicial remedy available under national law
 - usually only applies to House of Lords
- Discretionary references where a ruling is necessary for a court to give its judgment
 - includes Special Commissioners (e.g. C-196/04 *Cadbury Schweppes*)
 - But not bound to refer (e.g. C-446/03 *Marks & Spencer*)

References to the ECJ - 3

- The ECJ does not rule on matters of national law but on matters of EC treaty interpretation and application
- There must be a referable ‘question’
 - Not covered by considerable and consistent ECJ authority
 - That arises on the facts of the case, and
 - Is in issue between the parties

References to the ECJ - 4

- A reference can take considerable time, e.g. up to 2 years
- French is the ECJ's working language but most materials have to be translated into the 23 official languages
- There are 27 Judges (one per MS) and 8 Advocates General, none of whom may have any tax experience
- Most cases are heard in 'chambers' of 5 Judges
- It is not a tax court but applies Community law principles to the variety of issues (tax and non-tax) that are raised with it by national courts
- The frequency of tax references from different MS varies considerably (e.g. North v South split)

References to the ECJ - 5

- The case is a non-contentious dialogue between the national court and the ECJ
 - The “parties in the main proceedings” are entitled to participate
 - Member (and EEA) States and Community Institutions (usually the Commission) may intervene
- Procedure
 - Written submissions (within 2 months of OJ ‘listing’)
 - Judge *rapporteur*’s report (for the Court and for Hearing)
 - Oral hearing (≤ 30 mins parties; ≤ 15 mins interveners)
 - Advocate General’s Opinion
 - The judgment is on a majority vote with no dissenting opinions
- The matter then returns to the national court for decision

Continuing UK Litigation

- BT Pension Trustees [2005] EWHC 3088 (Ch)
- Autologic Holdings [2005] UKHL 54
- Pirelli Cable [2006] UKHL 4
- NEC Semiconductors [2006] EWCA Civ 25
 - House of Lords' decision 23 March 2007
- Deutsche Morgan Grenfell [2006] UKHL 49
- Sempra Metals [2007] UKHL 00

Community Rights

- There must be an exercise of Community rights
- *Werner* C-112/91
 - German national resident in Holland working in Germany
 - taxed less favourably in Germany
 - i.e. ‘reverse’ discrimination is possible
- *Commerzbank* C-330/91
 - Interest exempted under 1945 UK/US DTC
 - Not justify denial of interest supplement on repayment of overdue tax

Allocation of Taxing Jurisdiction

- *Gilly* C-336/96
 - German national married to Frenchman, living in France but working in German public sector
 - Taxing right given to Germany under Ge/Fr DTC leading to unrelieved double taxation
 - Absence of harmonisation not justify claim
 - Article 293 not have direct effect

The Community Law principles

- Two basic principles:
 - Market access, i.e. a measure must not impede or restrict access to the single market
 - Non-discrimination, i.e. a measure must not discriminate on grounds of nationality (overt) or other factors liable mainly to affect nationals of other MS (covert)
- Applied from the perspective of the origin/host State, not by comparison with other Member States

Discrimination

- The situations must be objectively comparable
- Position of residents and non-residents not usually comparable because source of income or ability to take account of personal and family circumstances differ
- But comparable if subject to the same taxation
- Relatively straight-forward in terms of host state
- E.g. branch or subsidiary of non-resident may not be treated less favourably than host state company

Market Access Restrictions

- *Dassonville* formulation – all trading rules which are capable of hindering directly or indirectly actually or potentially intra-Community trade
- A prohibition on national measures which are not discriminatory (treating nationals of all states alike) but which operate to impede the exercise of a fundamental freedom or make its exercise less attractive
- *Keck* retrenchment – the application of national provisions restricting or prohibiting certain selling arrangements does not hinder or impede trade so long as applied without discrimination
- *Futura* - first use of market access/restriction language in tax cases but with qualified development since

Market Access Restrictions

- The issue is whether the *effect* of the measure is to restrict access
- Discrimination is not a necessary feature of market access (but it is usually the difference in treatment between domestic and cross-border tax rules that identifies the issue)
- “Quasi-restrictions” (e.g. interaction of tax systems) do not breach Treaty (contrast ECJ’s attitude to double regulation)

Domestic & International Rules

- Direct taxes have to draw lines between national and international and differentiate the two
- It now seems clear that any such line is liable to represent a *prima facie* breach if cross-border is treated differently (as it usually is), see *Manninen* and *Marks & Spencer*
- The issue is then what amounts to “equal treatment” (see *Bouanich*) and what can be justified subject to proportionality (see *Marks & Spencer*)

“Equal Treatment”

- Exit tax on transfer of residence ruled in breach – *Hughes de Lasteyrie du Saillant*
- But need not be – ‘N’
 - If tax deferred until shares sold without requirement of e.g. security for tax
 - Final tax levied is no higher than that imposed if had remained resident

Justifications

- The only justifications for discrimination are those mentioned in the Treaty (public authority, public policy, public health, public security – not used to justify tax measures!)
- A market access restriction may be justified if
 - It pursues legitimate aim compatible with Treaty
 - Is justified by pressing reason of public interest
 - Is of a nature that ensures achievement of aim
 - Does not go beyond what is necessary

Allocation and Territoriality

- Allocation of taxing rights – no breach (*Gilly*)
- But loss of tax revenue is not a justification
- Can treat residents and non-residents differently where difference relates to scope of taxing rights (worldwide vs. source) but
- just because you don't tax it (outside taxing jurisdiction) is not part of territoriality – it does not mean it is untaxed – it is subject to taxing rights in another MS

Justifications – Tax Avoidance

- In principle, can justify measures but limited to wholly artificial arrangements – an abuse of the freedoms
 - “the fact that the company was formed in a particular Member State for the sole purpose of enjoying the benefit of more favourable legislation does not constitute abuse even if that company conducts its activities entirely or mainly in that second State” (*Centros*).
- A ‘blanket’ avoidance provision is never accepted – *ICI*; *Lankhorst*; *de Lasteyrie*
- Must be ‘targeted’ and justified at a Community level – insufficient that another MS taxes at lower rate or on different basis – must respect its choices
- But:
 - can justify anti-‘double dipping’ measures – *M&S*
 - CFC abuse where no genuine economic activity – *Cadbury Schweppes*
 - Thin capitalisation provisions – *UK Thin Cap GLO*

Justifications – ‘Cohesion’

- Accepted once in *Bachmann*
- Always argued but never accepted:-
 - One taxpayer, same tax; direct link between taxation and relief
- *Bachmann* can be seen as a case of ‘equal treatment’
- “new cohesion justification” is to look at the aim of the legislative measure from the perspective of taxing State – *Manninen*; *M&S*
- Can require elimination of economic double taxation, but what about juridical double taxation?
- Case C-513/04 *Kerckhaert - Morres*

Proportionality

- Even if the measure is justified it must be proportionate:
 - “the Court must ascertain whether the restrictive measure goes beyond what is necessary to attain the objectives pursued.”
- A blanket restriction unrelated to the accepted justification will not be proportionate

Case C-374/04 Class IV ACT GLO

- Related to UK partial imputation system between 1973 and 1999
- Under that system:
 - Resident individuals – taxable with full tax credit
 - Resident companies – exempt FII (full tax credit)
 - Non-residents with no DTC – exempt and no tax credit
 - Non-residents with DTC – taxable with full or half tax credit (depending on size of holding and DTC)

Case C-374/04 ACT GLO

- Source country not obliged to relieve economic double taxation by repaying tax on company profits
- From source country perspective resident and non-resident shareholders are only comparable if source country taxes both on dividends (regarded separately from underlying profits from which paid)
- If source country taxes it must treat shareholders equally, relieving economic double taxation on dividends paid abroad if does on domestic dividends
- Dividend taxation concerns taxation of shareholders. Who is taxing shareholders? If two states no Community competence; if one state must ensure compatibility (consistent with Parent Subsidiary Dividend Directive)

Case C-374/04 ACT GLO

- MFN and LoB issues on this approach are easily disposed of on this basis
- The UK claim to tax non-resident shareholders rests on an allocation of taxing powers under the relevant DTC
- Where there is no allocation of taxing powers to UK, there is no tax credit
- Contrast M&S residence country perspective

Case C-446/04 FII GLO

- The UK dividend taxation system – as a residence not source country
- Now the question is does the UK treat domestic and foreign dividends equally?
- The UK exempts domestic dividends but taxes foreign dividends with credit
- In principle, this is permitted but in practice it depends upon whether this results in equal treatment

Case C-446/04 FII GLO

- Equal treatment implies:
 - Taxation of foreign dividends at no higher rate than domestic-sourced dividends
 - Credit for the underlying foreign tax up to the amount of the domestic tax (but not beyond)
 - The additional administrative burden of a credit system (*vs.* domestic exemption) is in principle compatible with Articles 43 and 56
- For the national court to determine whether the system is in fact compatible in any case

Case C-446/04 FII GLO

- UK direct holdings ($\geq 10\%$) allow credit for both WHT and underlying tax
- UK portfolio holdings ($< 10\%$) allow credit for WHT tax only
- The first may be compatible but the second is not because it does not eliminate economic double taxation
- Practical difficulty of allowing underlying credit in such cases is not a justification

Case C-446/04 FII GLO

- Surplus ACT and aspects of UK group system regulating interaction of ACT and DTR plus FID regime incompatible with Articles 43 and 56 (but mainly of historical interest only)
- Consultation document anticipated June 2007 considering impact of decisions on taxation of foreign income and foreign tax credit system
 - Possible adoption of exemption rather than credit system?
 - Reform of CFC regime from entity to tainted income system?

International tax solutions in a single market context

Single market	International
Jurisdiction to tax not depend upon residence	Need to determine corporate residence
Source based taxation only	Treaty allocation based on residence/source
Exemption of non-State income	Exemption of foreign income or credit
Formulary apportionment	Arm's length transfer pricing

EC Treaty Principles

- Differences in tax systems impede or restrict access between the different markets of 27 MS
- These differences do not breach the EC Treaty but are a natural outcome of MS competence in the direct tax field
- I.e. each MS must have tax rules that ensure a level playing field but there can be 27 fields (of difference sizes, heights, etc)

ECJ case law issues

- Freedom to allocate taxing jurisdiction but
- Must respect other MS taxing rights
- Cannot impede access to other markets just because they have different tax rules/rates
- Cannot impose tax at the border that you would not impose internally
- Cannot impose measures to protect national tax revenues if that impedes access to other markets