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Press and Information

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Judgments of the Court of Justice in Cases C-374/04 and C-446/04

Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue
Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue

THE COURT RULES ON THE COMPATIBILITY OF THE UNITED KINGDOM TAX SYSTEM RELATING TO CROSS-BORDER PAYMENTS OF DIVIDENDS WITH COMMUNITY LAW

It emphasises that a Member State must treat the payment of dividends at national and cross-border level in the same way if the situations are comparable

Under the law which was in force in the United Kingdom, where a resident company distributed profits, it was required to pay advance corporation tax (ACT). A resident company receiving such dividends was not liable to corporation tax on those dividends and a system of tax credits for resident shareholders, both companies and natural persons, ensured that profits were, in principle, taxed only once. By contrast, non-resident shareholders did not receive such a tax credit unless a double taxation convention ('DTC') made provision to that effect.

In the case of a resident company which received dividends paid by a company which was not resident in the United Kingdom, those dividends were subject to corporation tax, but gave rise to an entitlement to relief in respect of any withholding tax levied in the State in which the distributing company was resident. Where the resident company controlled 10% or more of the voting rights in the distributing company, it could set off the corporation tax paid by the distributing company in the State in which it was resident against its liability for tax. When the resident company in turn paid those dividends to its own shareholders, it was liable to ACT. In such a case, it could elect for such a dividend to be treated as a 'foreign income dividend' ('FID'), on which ACT was payable, but which allowed surplus ACT to be repaid. ACT was required to be paid within 14 days of the end of the quarter in which the dividend was paid, but it was only nine months after the end of the accounting period that surplus ACT became repayable. An ultimate shareholder who received an FID was no longer entitled to a tax credit.

The ACT system, including the FID regime, was abolished in April 1999.

The disputes in the main proceedings are both part of group litigation consisting of a number of claims for restitution and/or compensation brought against the Commissioners of Inland Revenue before the High Court of Justice.

Four cases brought by the Pirelli, Essilor, BMW and Sony Groups, which oppose the refusal of the Commissioners of Inland Revenue to grant a tax credit in respect of dividends received by non-resident companies from resident subsidiaries, were chosen by the High Court as test cases representing the 'Class IV' group of the 'ACT Group Litigation' (Case C-374/04). Those groups contend that non-resident companies are in a less favourable situation inasmuch as they are not entitled to a tax credit in respect of the corporation tax paid by their resident subsidiaries.

Claims brought by British American Tobacco ('BAT') were chosen as test cases for the 'FII Group Litigation', which comprises actions brought by companies resident in the United Kingdom which received dividends from subsidiaries resident in another State. Those companies argue that the United Kingdom legislation results in less favourable tax treatment for resident companies having subsidiaries which are resident in other States (Case C-446/04).

The High Court has referred a number of questions to the Court of Justice concerning the compatibility of the United Kingdom tax legislation with Community law.

The Court notes that dividends paid by a company to its shareholders may be subject both to a series of charges to tax, since they are taxed, first, at distributing company level, as realised profits, and are then subject to corporation tax at parent company level, and to economic double taxation, since they are taxed, first, at the level of the company making the distribution and are then subject to income tax at ultimate shareholder level.

The Court also notes that, although direct taxation falls within the competence of the Member States, they must none the less exercise that competence consistently with Community law. The mere fact that, for holdings to which Directive 90/435 does not apply, it is for the Member States to determine whether, and to what extent, the imposition of a series of charges to tax and economic double taxation are to be avoided and, for that purpose, to establish, either unilaterally or through DTCs concluded with other Member States, procedures intended to prevent or mitigate the imposition of such a series of charges to tax and that economic double taxation, does not of itself mean that they are entitled to impose measures that contravene the freedoms of movement guaranteed by the Treaty.

Thus, freedom of establishment seeks to guarantee the benefit of national treatment to companies having their seat in the Community which wish to exercise their activity in another Member State, by prohibiting any discrimination based on the place in which companies have their seat. Such discrimination consists in treating differently situations which are identical, or treating in the same way situations which are different.

As regards the **payment of dividends by a resident company**, the Court holds that the situation in which the State in which the distributing company is resident finds itself as regards resident shareholders receiving dividends is not necessarily the same as the situation as regards non-resident shareholders in receipt of dividends. Where that State does not impose a liability to tax on non-resident shareholders, it is not in the same position, as regards the prevention or mitigation of the imposition of a series of charges to tax and economic double taxation, as the Member State in which the company receiving the dividend is resident, which is normally better placed to determine the shareholder's ability to pay tax.

As regards the United Kingdom legislation, the Court notes, first, that, where a company resident in the United Kingdom pays dividends to another company, neither the dividends received by a resident company nor those received by a non-resident company are subject to tax in the United Kingdom. Next, the Court states that only resident companies receiving dividends may pay those dividends to their ultimate shareholders under legal rules which provide those shareholders with a tax credit corresponding to the corporation tax paid by the distributing company. It is in its capacity as the Member State in which the shareholder is resident that that Member State grants a tax credit to ultimate resident shareholders. The position of a Member State in which both the companies making the distribution and the ultimate shareholders are resident is thus not comparable to that of a Member State which, when the ultimate shareholders are not resident in that Member State, acts only as the State in which the distributed profits are derived.

In those conditions, the Court holds that it **is compatible with Community law for a Member State, on a payment of dividends by a resident company, to grant a tax credit only to resident companies receiving the dividends** and not to grant such a tax credit to non-resident companies receiving the dividends which are not liable to tax in that Member State.

As regards **foreign-sourced dividends received by resident companies**, the Court considers that, where a Member State has a system for preventing or mitigating the imposition of a series of charges to tax or economic double taxation as regards dividends paid by resident companies, it must treat dividends paid by non-resident companies in the same way.

In that context, **the fact that nationally-sourced dividends are subject to an exemption system and foreign-sourced dividends are subject to an imputation system does not contravene the principles of freedom of establishment and the free movement of capital**, provided that the tax rate applied to foreign-sourced dividends is not higher than the rate applied to nationally-sourced dividends and that the tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the tax charged in the Member State of the company receiving the dividends. Conversely, the exclusion from that system of dividends received by a resident company from a non-resident company in which it holds fewer than 10% of the voting rights is contrary to Community law.

As regards payment of ACT, the Court holds that the ACT exemption under the system of tax credits for a resident company which receives dividends from another resident company, when it pays those dividends to its own shareholders, represents a cash-flow advantage, in so far as the company concerned may retain the sums which it would otherwise have had to pay by way of ACT until corporation tax is payable. By contrast, a resident company receiving dividends from a non-resident company does not have the benefit of that advantage, but must account for the whole of the ACT. As, in practice, that procedure leads to **less favourable treatment** for such a company, it is **contrary to Community law.**

As regards the **FID** regime, the Court holds that it **less favourable in two respects** than the system applying to companies receiving dividends from a resident company. In the first place, a resident company electing to be taxed under that regime must wait between eight and a half months and seventeen and a half months to obtain repayment of the ACT paid and, accordingly, is exposed to a cash-flow disadvantage which does not apply to resident companies receiving nationally-sourced dividends. In the second place, a shareholder receiving a payment of dividends from a resident company which has its origin in foreign-sourced dividends treated as FIDs, is not entitled to a tax credit. **Such a difference in treatment**, which makes the acquisition of a shareholding in a non-resident company less attractive than a shareholding in a resident company, **constitutes an infringement of the freedom of establishment** which cannot be justified**.**

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