

Press and Information

Court of Justice of the European Union

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Judgment in Case C-35/11 Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue and The Commissioners for Her Majesty's Revenue & Customs

Application of the imputation method to foreign-sourced dividends as prescribed by the UK tax regime does not ensure a tax treatment equivalent to that resulting from application of the exemption method to nationally-sourced dividends

The Court also defines the scope of the Treaty provisions on the free movement of capital

In the United Kingdom, when a resident company received nationally-sourced dividends it was not liable to corporation tax in respect of those dividends (exemption method). By contrast, when a resident company received dividends from a non-resident company, it was liable to corporation tax on those dividends. It could nevertheless offset against that tax liability the tax that the company making the distribution had already paid in its country of residence on the profits thereby distributed (imputation method).

Some companies established in the UK which received dividends from subsidiaries resident in another State are disputing the compatibility of the UK's tax treatment of foreign-sourced dividends with EU law before the UK courts. They contend that the national legislation resulted in less favourable tax treatment of resident companies with subsidiaries in other States.

In 2006 the Court examined the legislation in question at the request of the High Court and held that it was contrary to EU law in several respects¹. In the present case, the national court has requested the Court of Justice to clarify that case-law established in 2006.

In its judgment delivered today, the Court recalls that EU law in principle permits a Member State to apply the exemption method to nationally-sourced dividends and the imputation method to foreign-sourced dividends. Those two methods may in fact generally be considered to be equivalent. The Court points out, however, that that equivalence is capable of being undermined. Indeed, when nationally-sourced dividends were paid, they were exempt from corporation tax in the hands of the company receiving them, irrespective of the tax actually paid by the company making the distribution. By contrast, when foreign-sourced dividends were paid, the tax credit to which the company receiving the dividends was entitled pursuant to the imputation method was determined by taking account of the effective level of taxation of the profits in the State of origin.

Thus, in such a situation the exemption of the nationally-sourced dividends from tax gives rise to no tax liability for the resident company which receives those dividends irrespective of the effective level of taxation to which the profits out of which the dividends have been paid were subject. By contrast, application of the imputation method to foreign-sourced dividends leads to an additional tax liability so far as concerns the resident company receiving them if the effective level of taxation to which the profits of the company paying the dividends were subject falls short of the nominal rate of tax to which the profits of the resident company receiving the dividends are subject. Unlike the exemption method, the imputation method therefore does not enable the benefit of the corporation tax reductions granted at an earlier stage to the company paying dividends to be passed on to the corporate shareholder.

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¹ Case <u>C-374/04</u> Test Claimants in Class IV of the ACT Group Litigation and Case <u>C-446/04</u> Test Claimants in the FII Group Litigation; see also Press Release 96/06.

The Court nevertheless observes that the exemption and imputation methods do not immediately cease to be equivalent as soon as exceptional cases exist in which nationally-sourced dividends are exempt although the profits out of which those dividends have been paid have not been subject in their entirety to an effective level of taxation corresponding to the nominal rate of tax. However, according to the information supplied by the High Court, the effective level of taxation of the profits of companies resident in the UK is lower in the majority of cases than the nominal rate of tax applicable in that Member State. It follows that application of the imputation method to foreign-sourced dividends as prescribed by the legislation at issue does not ensure a tax treatment equivalent to that resulting from application of the exemption method to nationally-sourced dividends, and therefore the UK legislation must be regarded as a restriction on freedom of establishment and on capital movements that is prohibited by the Treaty on the Functioning of the EU.

In this context, the Court finds that the objective pursued by the national rules of preserving the cohesion of the national tax system could have been achieved by less restrictive measures. It points out that the tax exemption to which a resident company receiving nationally-sourced dividends is entitled is based on the assumption that the distributed profits were taxed at the nominal rate of tax in the hands of the company paying dividends. The exemption thus resembles grant of a tax credit calculated by reference to that nominal rate of tax and therefore the UK legislature, with a view to preserving the cohesion of the tax system, could also have taken account under the imputation method of the nominal rate of tax applicable to the company making the distribution and not of the tax that it had actually paid.

The referring court also wished to ascertain whether a company that is resident in a Member State and has a controlling shareholding in a company established in a third country may rely upon the Treaty provisions on the free movement of capital in order to call into question the consistency with EU law of the tax treatment which the legislation of that Member State accords to dividends received from such a subsidiary. According to the Court, in a context relating to the tax treatment of dividends originating in a third country it is sufficient to examine the purpose of the tax legislation at issue in order to determine whether that legislation falls within the scope of the Treaty provisions on the free movement of capital. Where it is apparent from the purpose of such national legislation that it can only apply to those shareholdings which enable the holder to exert a definite influence on the decisions of the company concerned and to determine its activities, neither the Treaty provisions on freedom of establishment nor those on the free movement of capital may be relied upon.

On the other hand, national rules relating to the tax treatment of dividends from a third country which, like the UK rules at issue, do not apply exclusively to situations in which the parent company exercises decisive influence over the company paying the dividends must be assessed in the light of the Treaty provisions on the free movement of capital. A company resident in a Member State may therefore rely on those provisions in order to call into question the legality of such rules, irrespective of the size of its shareholding in the company paying dividends established in a third country.

NOTE: A reference for a preliminary ruling allows the courts and tribunals of the Member States, in disputes which have been brought before them, to refer questions to the Court of Justice about the interpretation of European Union law or the validity of a European Union act. The Court of Justice does not decide the dispute itself. It is for the national court or tribunal to dispose of the case in accordance with the Court's decision, which is similarly binding on other national courts or tribunals before which a similar issue is raised.

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The full text of the judgment is published on the CURIA website on the day of delivery.