OPINION OF ADVOCATE GENERAL GEELHOED

delivered on 29 June 2006 [1]

I — Introduction

1. The present case, a preliminary reference from the High Court of Justice of England and Wales, concerns the compatibility with the Treaty free movement provisions of the UK's so-called 'thin capitalisation' ('thin cap') rules, as variously amended, by which the UK restricts the deductibility of interest payments made by UK subsidiaries to non-resident parent or intermediate group companies.

2. The case raises once again the issue of the compatibility with the free movement provisions of national 'anti-abuse' direct tax legislation, as raised in particular in the *Lankhorst-Hohorst* judgment of 2002 (concerning the German thin capitalisation rules) and in the pending *Cadbury Schweppes* case (concerning the UK's controlled foreign corporation rules). [2] Following the *Lankhorst-Hohorst* judgment, however, the limits of permissible thin cap restrictions have not been wholly clear, leading certain Member States — including the UK and Germany — to extend their thin cap legislation to domestic intra-group payments, despite the fact that no possible risk of 'abuse' can arise in purely domestic situations. For this reason, and as the UK rules at issue differ in significant respects from the German legislation impugned in *Lankhorst-Hohorst*, this case requires a fresh look at the issue.

1 — Original language: English.

2 — Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779; Case C-196/04 *Cadbury Schweppes*, pending (see the Opinion of Advocate General Léger delivered in that case on 2 May 2006).

II — Legal background

A — *Applicable UK law*

1. Context and rationale of 'thin cap' rules

3. There are two principal means of corporate finance: debt and equity finance. Many Member States draw a distinction in the direct tax treatment of these two forms of finance. In the case of debt finance, companies are generally permitted to deduct interest payments on loans for the purpose of calculating their taxable profits (i.e., pre-tax), on the basis that this constitutes current expenditure incurred for the pursuit of the business activities. In the case of equity finance, however, companies are not permitted to deduct distributions paid to shareholders from their pre-tax profits; rather, dividends are paid from taxed earnings.

4. This difference in tax treatment means that, in the context of a corporate group, it may be advantageous for a parent company to finance one of the group members by means of loans rather than equity. The tax incentive to do so is particularly evident if the subsidiary is located in a relatively 'high-tax' jurisdiction, while the parent company (or indeed an intermediate group company which provides the loan) is located in a lower-tax jurisdiction. In such circumstances, what is in substance equity investment may be presented in the form of debt in order to obtain a more favourable tax treatment. This phenomenon is termed 'thin capitalisation'. By thus manipulating the manner in which capital is provided, a parent company can effectively choose where it wishes profits to be taxed.

5. Many States, viewing thin capitalisation as abusive, have implemented measures aimed at countering this abuse. These measures typically provide for loans which fulfil certain criteria to be regarded for tax purposes as disguised equity capital. This means that interest payments are recharacterised as profit distributions, so the subsidiary cannot deduct all or part of the interest payment from its taxable income, and the payment is subject to any applicable rules on dividend taxation. [3]

3 — Within the Community, Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ 1990 L 225, p. 6) prohibits the charging of withholding tax on dividends paid by a subsidiary to its parent company.

2. UK rules applicable until 1995

6. By section 209(2)(d) of the Income and Corporation Taxes Act 1988 (TA), any interest paid by a company on a loan which represented more than reasonable commercial return on the loan was to be regarded as a distribution of profits to the extent that it exceeded such return. [4] This rule applied whether the payment was made to a resident or a non-resident lender. It meant that the excess amount was not deductible as interest in calculating the company's taxable profits, but was treated as a distribution paid out of post-tax profits. The fact that the interest was treated as a distribution also meant that the company was liable to advance corporation tax ('ACT') upon making the payment. [5]

7. By section 209(2)(e)(iv) and (v) TA, any interest, other than interest already treated as a distribution under section 209(2)(d), paid to any non-UK-resident lender who was a member of the same group of companies (as defined), was treated as a distribution. In particular, this section applied to loans granted by a non-UK-resident company to a UK-resident company which was a 75% subsidiary of the lender company, or where both companies were 75% subsidiaries of a non-UK-resident third company. As a result, under the UK rules applicable until 1995 — without taking into account the effect of applicable bilateral Double Taxation Conventions ('DTCs'), which I outline below — interest payments made by a UK-resident company to another non-resident group member (as defined) were always treated as a distribution, even where the interest represented a reasonable commercial return on the loan.

8. The provisions of certain DTCs concluded by the UK prevented the application of the abovementioned rules provided for in section 209 TA and ensured that the interest was allowed as a deduction from profits for tax purposes in certain circumstances. Such arrangements had effect notwithstanding provisions to the contrary in the UK's domestic legislation. [6] While the wording of the provisions in these DTCs varies, the national court in its order for reference states that they may broadly be considered as falling into two categories.

4 — While the terms of the TA and its amendments generally refer to the granting of securities by the borrower to the lender rather than using the language of borrowing by means of a loan, I will in the present Opinion, in the interests of simplicity of expression, refer to the granting of a loan by a lender to a borrower.

5 — Section 14 TA.

6 — Section 788(3) TA.

9. The first category of provisions focuses on whether the interest rate is commercial having regard to the amount of the debt. They do not inquire whether the amount of the debt itself is commercial. Such provisions are to be found in, e.g., the Luxembourg, Japanese, German, Spanish, and Austrian DTCs. Thus, for example, Article 11(7) of the UK-Luxembourg DTC provides that, 'Where, owning to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the interest paid, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship ... the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.'

10. The second category of provisions involves a more general inquiry into whether the amount of the interest exceeds for any reason what would be paid on an arm's length basis. This included whether the amount of the loan itself exceeds the amount which would have been lent on an arm's length basis. Such provisions are to be found in, e.g., the United States, Irish, Swiss, Dutch, French, and Italian DTCs. Thus, for example, Article 11(5) of the UK-United States DTC provides that, 'Where, owning to a special relationship between the payer and the person deriving the interest or between both of them and some other person, the amount of the interest exceeds for whatever reason the amount which would have been paid in the absence of such relationship ... the excess part of the payments shall remain taxable according to the law of each contracting state, due regard being had to the other provisions of this convention.'

11. The broader scope of the second category of DTC provisions is confirmed by section 808A(2) TA, [7] which provides that, in determining whether such a 'special relationship' exists, account is to be taken of all the factors, including whether the loan would have been made at all, how much would have been lent and the rate of interest in the absence of such a relationship. As regards both categories of DTC, section 808A(3) provides that the special relationship provision shall be construed as requiring the taxpayer to show that there is no special relationship or (as the case may be) to show the amount of interest which would have been paid in the absence of the special relationship. These provisions apply to interest paid after 14 May 1992.

7 — Inserted by section 52 of the Finance Act (No 2) 1992.

3. The 1995 amendments

12. Section 209(2)(e)(iv) and (v) TA were deleted by the Finance Act 1995 and replaced by section 209(2)(da) TA, which essentially provided that interest paid between group members (as defined) which exceeded an amount that would have been paid on an arm's length [8] basis was to be treated as a distribution. This section applies where the borrower is a 75% subsidiary of the lender, or both are 75% subsidiaries of a third company.

13. Under section 212(1) and (3) TA, as amended, section 209(2)(da) TA does not apply if the payer and payee of the interest are both within the charge to UK corporation tax.

14. Section 209(8B) specifies the criteria to be used in determining whether interest payments are to be treated as distributions. These are listed as: the appropriate level of the borrower's overall indebtedness; whether it might be expected that the borrower and a particular person would have become parties to a transaction involving the issue of a security by the issuing company or the making of a loan, or a loan of a particular amount, to that company; and the rate of interest and other terms that might be expected to be applicable in any particular case to such a transaction. Section 209(8A), in conjunction with section 209(8D) to (8F), determines the extent to which companies can be grouped together for the purposes of assessing the levels of their borrowing on a consolidated basis. Essentially, the rules do not allow such consolidation of separate UK sub-groups which are part of a wider foreign group: the borrowing capacity of each UK sub-group is considered independently. [9]

4. The 1998 amendments

15. Schedule 28AA TA, introduced by the Finance Act 1998, provides for a detailed

8 — The section applies where the whole or part of the loan 'represents an amount which would not have fallen to be paid to the other company if the companies had been companies between whom there was (apart from in respect of the securities in question) no relationship, arrangements or other connection (whether formal or informal), except so much, if any, of any such distribution as does not represent such an amount or as is a distribution by virtue of paragraph (d) above or an amount representing the principal secured by the securities' (section 209(2)(da)(ii)).

9 — Section 209(8A)(b) provides that, in the determination of whether the factors in classification as a distribution set out in section 209(8B) apply, no account should be taken of any relationship, arrangements or connection (other than that between the borrower and the lender) between the borrower and any person except where that person (i) has no relevant connection (as defined in section 209(8C)) with the borrower and (ii) is a company that is a member of the same UK grouping (as defined in section 209(8D)) as the borrower.

code of transfer pricing rules, which also apply to interest payments. The transfer pricing rules apply where (1) there is 'provision by means of a transaction', or a series of transactions, between two companies under common control. For these purposes, control includes direct or indirect participation in the management, control or capital of any company concerned; [10] (2) the terms of the provision are different from what they would have been if the companies had not been under common control; and (3) the provision gives one of the affected persons a potential advantage in relation to UK tax. In such a case, the profits and losses of the potentially advantaged person(s) 'shall be computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision'. [11]

16. The provision was deemed not to give one of the affected persons a potential advantage where, inter alia, the other party to the transaction was within the charge to UK income or corporation tax, and certain other conditions were satisfied. These conditions required that (1) the person was not entitled to any exemption from income tax or corporation tax in respect of (part of) the income or profits within that charge; [12] (2) where that person was within the charge to income tax in respect of profits arising from those activities, the person was resident in the UK in the chargeable periods in which he is within that charge; [13] (3) the person was not entitled [14] to be given credit in any chargeable period for any foreign tax on or in respect of profits arising from the relevant activities, nor would have such an entitlement in any such period if there were any such profits or if they exceeded a certain amount; [15] and (4) the amounts taken into account in computing the person's profits or losses from the relevant activities in any chargeable period did not include any income the amount of which was reduced under section 811(1) TA (deduction for foreign tax where no credit allowable).

17. This rule was amended by the Finance Act 2004, so that it applies where both parties to the transaction are within the charge to UK tax.

10 — Schedule 28AA(1)(1)(b).

11 — Schedule 28AA(1)(2). By Schedule 28AA(5) TA, this requirement was satisfied in an individual case where the effect of making or imposing the provision would be to reduce the amount of profits subject to tax in any chargeable period for that person, and/or to increase the amount of losses in any chargeable period for that person.

12 — Schedule 28AA(5)(3)(b) TA.

13 — Schedule 28AA(5)(3)(c) TA.

14 — In pursuance of any double taxation arrangements or under section 790(1) TA.

15 — Schedule 28AA(5)(4) TA.

III — Factual background to the reference

18. The Thin Cap group litigation concerns claims for restitution and/or compensation for tax disadvantages and other adverse fiscal effects suffered as a result of the UK's Thin Cap regime, outlined above. These claims were brought in the High Court of Justice of England and Wales following the Court's judgment in *Lankhorst-Hohorst*, which declared the then German thin cap rules to be contrary to Article 43 EC.[16] For the purpose of the present preliminary reference, test cases were selected to represent different company structures, the facts of which were agreed by the parties. All test cases involve a UK-resident subsidiary company which is at least, directly or indirectly, 75% owned by a non-UK-resident parent company, in circumstances where either the parent has advanced a loan to the borrower, or another non-UK-resident company, which is also the direct or indirect 75% subsidiary of the parent, has advanced a loan to the borrower. As a result, the questions referred are formulated based upon the facts of one affected transaction of one test case — that of the Lafarge Group — and the manner in which the other test cases relevantly differ from it.

A — *Lafarge Group: relevant facts*

19. Lafarge SA, a publicly owned company with its seat in France, is the ultimate parent company of a multinational group of companies producing building materials. Relevant members of the Lafarge group for present purposes are: (1) Financière Lafarge SA (the lending company), which has its seat in France and is the indirect wholly-owned subsidiary of the parent company, Lafarge SA; and (2) Lafarge Building Materials Limited, resident in the UK, which is the ultimate holding company for most of the subsidiaries within the Lafarge Group who are resident in the UK, and which is itself a direct subsidiary of Financière Lafarge.[17] The claim also concerns a further nine claimant companies in the Lafarge Group, all of which are UK-resident direct or indirect subsidiaries of Lafarge Building Materials (which owned in each case more than 50% of the share capital in these companies).

20. In December 1997, the Lafarge Group acquired the shares of the UK-resident company Redland plc. To fund this acquisition, Financière Lafarge had available to it various credit facilities — ultimately guaranteed by Lafarge SA — with the external bankers to the Lafarge Group, which enabled

16 — *Lankhorst-Hohorst*, footnote 2 above.

17 — At all relevant times, Financière Lafarge owned in excess of 75% of the issued shares of Lafarge Building Materials.

it to advance loan finance to companies throughout the group or from which authorised subsidiaries could draw funding directly. In particular, to fund the Redland acquisition, Financière Lafarge granted a short term loan facility to Lafarge Building Materials, which in turn granted a similar loan facility to a further Lafarge Group entity, Minerals UK. In total, this loan facility (i.e., via Financière Lafarge and Lafarge Building Materials) financed approximately 50% of the purchase price of the Redland shares, with the rest being financed by direct drawings by Mineral UK against the Lafarge Group's credit facilities with its external bankers. Most of these direct drawings were paid off in 1998 by loans advanced by Lafarge SA to Minerals UK, following the refinancing by Lafarge SA and Financière Lafarge of their external credit facilities by the issue of bonds in order to achieve better financing terms.

21. Upon the advice of their UK tax advisors following completion of the Redland acquisition that the UK tax authorities would consider at least some of the interest paid on these loans by Lafarge Building Materials to be distributions by reason of section 209 (2)(da) TA, the Lafarge Group reduced Lafarge Building Materials' indebtedness to Financière Lafarge in about March 1998 by converting around 75% of the amount then advanced into equity. This was achieved by issuing additional share capital in Lafarge Building Materials to companies within the Lafarge Group — with the majority of the shares going to Financière Lafarge. These companies' payment for those shares was then set off against Lafarge Building Materials' debt to Financière Lafarge to the same value.

22. In March 1999, the UK Inland Revenue commenced enquiries into the Redland acquisition. The Inland Revenue did not accept the position of Lafarge that an external bank would ordinarily have lent similar advances on similar terms to those between Financière Lafarge and Lafarge Building Materials, and between Minerals UK and Lafarge SA, and contended that some of the interest should be characterised as distributions by reason of section 209(2)(da) TA. Following meetings between the Inland Revenue and Lafarge's advisors, an agreement was reached whereby certain of the interest payments made by Financière Lafarge to Lafarge Building Materials, and by Minerals UK to Lafarge SA, were recharacterised as distributions, in particular if a stated ratio of total net debt to pre-tax operating income exceeded certain thresholds.

B — *Other Test Claimants: relevant facts*

23. The other test cases selected for the purposes of the present preliminary reference concern the following corporate groups.

24. The first additional test case concerns the Volvo group, the relevant entities of which for present purposes comprise (1) AB Volvo, the Swedish-resident publicly listed parent company; (2) Volvo Treasury AB, a Swedish-resident company and the direct wholly-owned subsidiary of AB Volvo; (3) Volvo Truck and Bus Limited, a UK-resident company and the indirect wholly-owned subsidiary of AB Volvo through intermediate Swedish- and Dutch-resident companies; (4) VFS Financial Services (UK) Limited, a UK-resident company and the indirect wholly-owned subsidiary of AB Volvo through Swedish-resident intermediate companies. In particular, the test case concerns the advancing of finance by Volvo Treasury in October 1999 under a loan agreement to Volvo Truck and Bus. In circumstances similar to those of the Lafarge Group outlined above, a portion of that debt was converted into equity in Volvo Truck and Bus in December 1999. The Volvo group reached an agreement with the Inland Revenue on the conditions upon which its interest payments would not be recharacterised as distributions in 2000.

25. The second additional test case concerns the PepsiCo Group, the relevant entities of which for present purposes comprise (1) PepsiCo Inc, the US-resident parent company; (2) PepsiCo Finance Europe Limited, a company incorporated in the UK and resident in Luxembourg, which operated in Switzerland through a branch and was the indirect wholly-owned subsidiary of PepsiCo Inc through intermediate holding companies resident in Ireland and other third countries; (3) PepsiCo Holdings, a UK-resident company which was the indirectly wholly-owned subsidiary of PepsiCo Inc through intermediate companies resident in Member States and third countries. Starting in 1999, PepsiCo Finance Europe advanced loans via its Swiss branch to PepsiCo Holdings, the payment of interest upon which was subject to the UK-Luxembourg DTC of 1968.

26. The third and fourth additional test cases each concern the Caterpillar Group, which has brought claims that have been taken as two separate types of test case.

27. For the purposes of the third additional test case, the relevant entities of the Caterpillar Group comprise (1) Caterpillar Inc, the

US-resident parent company; (2) Caterpillar International Finance plc, an Irish-resident company and the indirect wholly-owned subsidiary of Caterpillar Inc through intermediate UK- or US-resident holding companies, (which holding companies include the US-resident Caterpillar Financial Services Corporation); (3) Caterpillar Financial Services (UK) Ltd, a UK-resident company and the indirect wholly-owned subsidiary of Caterpillar Inc, through intermediate UK- or US-resident holding companies, which holding companies include Caterpillar Financial Services Corporation. In particular, Caterpillar International Finance granted a loan to Caterpillar Financial Services (UK), interest upon which loan was subject to the UK-Ireland DTC of 1976.

28. For the purposes of the fourth additional test case, the relevant entities of the Caterpillar Group comprise (1) Caterpillar Inc; (2) Caterpillar Overseas SA, a Swiss-resident company and, depending on the time period at issue, either the direct or indirect wholly-owned subsidiary of Caterpillar Inc. In periods when the company was the indirect subsidiary, the intermediate holding companies were US-resident; (3) Caterpillar Peterlee Limited, a UK-resident company and the indirect wholly-owned subsidiary of Caterpillar Inc through UK-resident intermediate holding companies. In particular, Caterpillar Overseas granted a loan to Caterpillar Peterlee, interest upon which loan was subject to the UK-Switzerland DTC of 1977.

IV — Questions referred and procedure before the Court

29. Following agreement upon the facts of the test cases, the main proceedings were stayed on 21 December 2004 and the following questions referred to the Court:

'(1) Is it contrary to Article 43, 49 or 56 EC for a Member State ("the State of the borrowing company") to keep in force and apply provisions such as those in sections 209, 212 and schedule 28AA of the Income and Corporation Taxes Act 1988 ("the national provisions") which impose restrictions upon the ability of a company resident in that Member State ("the borrowing company") to deduct for tax purposes interest on loan finance granted by a direct or indirect parent company resident in another Member State in circumstances where the borrowing company would not be subject to such restrictions if the parent company had been resident in the State of the borrowing company?

(2) What difference, if any, does it make to the answer to Question 1:

(a) if the loan finance is provided not by the parent company of the borrowing company but by another company ("the lending company") in the same company group sharing a common direct or indirect parent company with the borrowing company and both that common parent and the lending company are resident in Member States other than the State of the borrowing company?

(b) if the lending company is resident in a Member State other than that of the borrowing company but all common direct or indirect parent companies of the borrowing company and the lending company are resident in a third country?

(c) if all the common direct or indirect parent companies of the lending company and the borrowing company are resident in third countries and the lending company is resident in a Member State other than that of the borrowing company, but advances the loan finance to the borrowing company from a branch of the lending company situated in a third country?

(d) if the lending company and all the common direct or indirect parent companies of the lending company and the borrowing company are resident in third countries?

(3) Would it make any difference to the answers to Questions 1 and 2 if it could be shown that the borrowing constituted an abuse of rights or was part of an artificial arrangement designed to circumvent the tax law of the Member State of the borrowing company? If so, what guidance does the Court of Justice think it appropriate to provide as to what constitutes such an abuse or artificial arrangement in the context of cases such as the present?

(4) If there is a restriction on the movement of capital between Member States and third countries within Article 56 EC, did

that restriction exist on 31 December 1993 for the purposes of Article 57 EC?

(5) In the event that any of the matters referred to in questions 1 or 2 are contrary to Articles 43, 49 or 56 EC, then in circumstances where the borrowing company, or other companies in the borrowing company's group ("the Claimants") make the following claims:

(a) a claim for the repayment of the additional corporation tax paid by the borrowing company as a result of the disallowance, as a deduction against its profits chargeable to corporation tax, of interest paid to the lending company, where those interest payments would have been regarded as allowable deductions from the borrowing company's profits if the lending company had also been resident in the State of the borrowing company;

(b) a claim for repayment of the additional corporation tax paid by the borrowing company where the full amount of interest on the loan has actually been paid to the lending company but the claim for a deduction in respect of that interest has been reduced because of the national provisions or the tax authority's application of them;

(c) a claim for the repayment of the additional corporation tax paid by the borrowing company where the amount of interest on loans from the lending company, allowable as a deduction against the borrowing company's profits, has been reduced because equity capital has been subscribed rather than loan capital, or has been substituted for existing loan capital, because of the national provisions or the tax authority's application of them;

(d) a claim for the repayment of the additional corporation tax paid by the borrowing company where the interest on loans from the lending company allowable as a deduction against the borrowing company's profits has been reduced by reducing the rate of interest chargeable on the loan (or making the loan interest free) as a result of the national provisions or the tax authority's application of them;

(e) a claim for restitution or compensation in respect of losses, or other tax reliefs or credits, of the borrowing company (or which were surrendered to the borrowing company by other companies in the borrowing company's group which were also resident in the State of the borrowing company) used by the borrowing company to offset the additional corporation tax liabilities referred to in paragraphs (a), (b) or (c) above, where such losses, reliefs and credits would otherwise have been available for alternative use or to be carried forward;

(f) a claim for repayment of un-utilised advance corporation tax paid by the borrowing company upon interest payments to the lending company which were re-characterised as distributions;

(g) a claim for restitution or compensation in respect of amounts of advance corporation tax paid in the circumstances referred to in paragraph (f) above but which were subsequently set off against the borrowing company's corporation tax liabilities;

(h) a claim for compensation for costs and expenses incurred by the Claimants in complying with the national provisions and the Revenue authority's application of them;

(i) a claim for restitution or compensation for the loss of return upon loan capital invested as equity (or converted to equity) in the circumstances described in (c); and

(j) a claim for restitution or compensation for any tax liability incurred by the lending company in its State of residence upon the deemed or imputed receipt of interest from the borrowing company which was recharacterised as a distribution under the national provisions referred to in question 1

are such claims to be regarded, for the purposes of Community law, as:

claims for restitution or repayment of sums unduly levied which arise as a consequence of, and adjunct to, the breach of the abovementioned Community provisions; or claims for compensation or damages; or

claims for payment of an amount representing a benefit unduly denied?

(6) In the event that the answer to any part of Question 5 is that the claims are claims for payment of an amount representing a benefit unduly denied:

(a) are such claims a consequence of, and an adjunct to, the right conferred by the abovementioned Community provisions; or

(b) must all or some of the conditions for recovery laid down in Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and Factortame* be satisfied; or

(c) must some other conditions be met?

(7) Does it make any difference whether as a matter of domestic law the claims referred to in Question 6 are brought as restitutionary claims or are brought or have to be brought as claims for damages?

(8) What guidance, if any, does the Court of Justice think it appropriate to provide in the present cases as to which circumstances the national court ought to take into consideration when it comes to determine whether there is a sufficiently serious breach within the meaning of the judgment in Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and Factortame*, in particular as to whether, given the state of the case law on the interpretation of the relevant Community provisions, the breach was excusable?

(9) As a matter of principle, can there be a direct causal link (within the meaning of the judgment in Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and*

Factortame) between any breach of Articles 43, 49 and 56 EC and losses falling into the categories identified in Question 5(a)-(h) that are claimed to flow from it? If so, what guidance, if any, does the Court of Justice think it appropriate to provide as to the circumstances which the national court should take into account in determining whether such a direct causal link exists?

(10) In determining the loss or damage for which reparation may be granted, is it open to the national court to have regard to the question of whether injured persons showed reasonable diligence in order to avoid or limit their loss, in particular by availing themselves of legal remedies which could have established that the national provisions did not (by reason of the application of double taxation conventions) have the effect of imposing the restrictions set out in Question 1? Is the answer to this question affected by the beliefs of the parties at the relevant times as to the effect of the double taxation conventions?'

30. In accordance with Article 23 of the Statute of the Court of Justice, written submissions were lodged by the Test Claimants, the United Kingdom and German Governments, and by the Commission. An oral hearing was held on 31 January 2006, in which oral submissions were made by each of these parties, as well as by the Netherlands Government.

V — Analysis

A — *Applicable Treaty provision(s)*

31. As the national court has raised the compatibility of the relevant UK legislation with the freedom of establishment, free movement of services and free movement of capital provisions of the Treaty (Articles 43, 49 and 56 EC), the first issue to consider is against which of these Treaty provisions the legislation should be assessed. This issue is important for two reasons. First, while Articles 43 and 49 EC apply only to restrictions on the exercise of freedom of establishment and freedom of services between Member States, Article 56 EC also prohibits restrictions on the movement of capital between Member States and third countries. Second, the temporal scope of Article 56 EC is different to that of Articles 43

and 49 EC: in particular, Article 56 EC entered into force and became directly effective on 1 January 1994, and is subject to a 'standstill' provision (Article 57 EC) as regards third States (although the principle of free movement of capital had already been established by Council Directive 88/361).[18]

32. Dealing first with Article 43 EC, the Court has consistently held that a company established in one Member State with a holding in the capital of a company established in another Member State which gives it 'definite influence over the company's decisions' and allows it to 'determine its activities' is exercising its right of establishment.[19]

33. In the present case, it seems to me that, by its wording in each of the amended versions before the Court, the relevant UK legislation applies only to situations where one company has (or at the relevant time had) a definite influence over the decisions of another company within the meaning of the Court's case-law. Thus, in the version of the legislation in force until the 1995 changes, section 209(2)(e) applied in particular to loans granted by a non-UK-resident company to a UK-resident company which was a 75% subsidiary of the lender company, or where both companies were 75% subsidiaries of a non-UK-resident third company (i.e., where the loan was provided via another subsidiary of the parent company). This condition for applicability was retained following the amendments made by the Finance Act 1995.[20]

34. The situation was altered somewhat by the UK's Finance Act 1998, which brought transactions formerly caught by its specific thin cap rules under the UK's general transfer pricing rules. However, the latter apply only where there is provision by means of a transaction made or imposed between two companies under common control, i.e., where one of these companies participates directly or indirectly in the management, control or capital of the other party, or where the same person participates directly or indirectly in the management, control or capital of both of these companies.[21] This condition is sufficient to indicate, to my mind, that the 'definite influence' criterion is satisfied for present purposes. In any event, each of the test cases involves a UK-resident subsidiary which is at least, directly or indirectly, 75% owned by a non-UK-resident parent company, or another non-UK-resident company, which is also the direct or indirect 75% subsidiary of the parent. Indeed,

18 — Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty (OJ 1998 L 178, p. 5).

19 — Case C-251/98 *Baars* [2000] ECR I-2787, paragraph 22. Although this case concerned a shareholding of a national of a Member State, not a company, the principle applies equally to companies established in that Member State. See also, Article 58(2) EC, which provides that the application of the freedom of movement of capital shall be 'without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty'.

20 — See section 209(2)(da) TA.

21 — Schedule 28AA(1)(1)(b) TA.

one could say that the conclusion that Article 43 EC applies based on the express wording of the UK legislation is reinforced by the very rationale of national thin cap and transfer pricing rules which, as I observed above, are predicated on the idea that it may in some circumstances be advantageous to the overall tax position of cross-border groups to seek to agree on transaction terms, or on the nature of a transaction, other than would be agreed upon under arm's length conditions. This idea only makes sense in group situations, i.e., where the parent (and/ or intermediate group companies) have a definite influence over downstream subsidiary companies. [22]

35. As a result, the UK legislation at issue here falls to be considered for compatibility with the Treaty rules on freedom of establishment. Clearly, this means that Article 49 EC, which presupposes not a permanent but a temporary base in another Member State, does not apply. [23] In contrast, however, it is in principle possible that the Treaty free movement of capital provisions could be concurrently applicable with those on freedom of establishment. [24] On this point, I would refer to the Opinion of Advocate General Alber in *Baars*, where he expressed the view that, in a case where the free movement of capital and freedom of establishment are both potentially at issue, the Court should look to see which of these freedoms is directly restricted by the relevant national rules. Thus, where both freedoms are directly affected, the national rules should be examined for compatibility with Articles 43 and 56 EC. In contrast, where the right of establishment is directly restricted such that the ensuing obstacle to establishment leads indirectly to a reduction of capital flows between Member States, only the rules on the right of establishment apply. [25] I respectfully concur with this reasoning.

36. Applying this test to the present case, although the exercise of non-UK-resident parent companies' freedom of establishment via the setting-up of a UK-resident subsidiary

22 — See also, Article 4(1) of the Arbitration Convention, providing that a condition for the application of the transfer pricing rules set out therein is direct or indirect participation by an enterprise of one Member State in the management, control or capital of an enterprise in another Member State, and direct or indirect participation by the same persons in the management, control or capital of an enterprise of one State and an enterprise of another State. See likewise, Article 9(1) of the OECD Model Taxation Convention on Income and on Capital, with Commentaries to the Articles, OECD, Paris, 1977, as revised.

23 — See, for example, Case 205/84 *Commission* v *Germany* [1986] ECR 3755.

24 — Case C-484/93 *Svensson and Gustavsson* [1995] ECR I-3955.

25 — *Baars*, footnote 19 above, paragraph 26. See also, my Opinion in Joined Cases C-515/99, C-519/99 to C-524/99 and C-526/99 to C-540/99 *Reisch and Others* [2002] ECR I-2157, paragraph 59.

inevitably necessitates the movement of capital into the UK insofar as this is necessary to set up this subsidiary, this movement is in my view a purely indirect consequence of such establishment. It follows that the UK legislation at issue should only be considered for compatibility with Article 43 EC.

B — *Question 1*

37. By its first question, the national court asks whether it is contrary to Article 43, 49 or 56 EC for a Member State to keep in force and apply provisions such as those in sections 209, 212 and schedule 28AA of ICTA 1988 which impose restrictions upon the ability of a company resident in that Member State to deduct for tax purposes interest on loan finance granted by a direct or indirect parent company resident in another Member State, in circumstances where the borrowing company would not be subject to such restrictions if the parent company had been resident in the State of the borrowing company.

38. The test case relevant to this question is that of the Lafarge group. For the reasons I have just explained, I will consider the legislation's compatibility with Article 43 EC alone.

39. It is well established that, while direct taxation is in principle an area of Member State competence, Member States must none the less exercise this competence consistently with Community law, which includes the Article 43 EC obligation prohibiting restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. [26] Article 43(2) EC specifies that freedom of establishment includes the right to set up and manage undertakings in a Member State under the conditions laid down by that State for its own nationals.

40. As I observed in my Opinions in *Test Claimants in Class IV of the ACT Group Litigation, Test Claimants in the FII Group Litigation, Kerckhaert and Morres*, and *Denkavit*, [27] Article 43 EC applies where different treatment of cross-border and purely domestic situations is not a direct

26 — See, for example, judgment of 13 December 2005 in Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, paragraph 29, and cases cited therein.

27 — See my Opinion of 23 February 2006 in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*, pending before the Court, point 32 onwards; my Opinion of 6 April 2006 in Case C-446/04 *Test Claimants in the FII Group Litigation*, pending before the Court, point 37 onwards; my Opinion of 6 April 2006 in Case C-513/04 *Kerckhaert and Morres*, pending before the Court, points 18 and 19; and my Opinion of 27 April 2006 in Case C-170/05 *Denkavit*, pending before the Court, point 20.

and logical consequence of the fact that, in the present state of development of Community law, different tax obligations for subjects can apply for cross-border situations than for purely internal situations.[28] This means in particular that, in order to fall under Article 43 EC, disadvantageous tax treatment should follow from direct or covert discrimination resulting from the rules of one tax system, and not purely from disparities or the division of tax jurisdiction between two or more Member States' tax systems, or from the coexistence of national tax administrations (which I have termed 'quasi-restrictions').[29]

41. Applying this test to the present case, the first question is whether the UK rules result, as the Test Claimants allege, in disadvantageous tax treatment of UK-resident subsidiaries based on the location of their direct or indirect parent companies. If so, the next question is whether such disadvantageous tax treatment is purely the result of a quasi-restriction, and so does not fall within the scope of Article 43 EC. If this is not the case, the final question is whether the disadvantageous tax treatment is the result of discrimination, and whether this discrimination can be justified.

28 — See, for extended reasoning on this, points 31 to 54 of my Opinion in *Test Claimants in Class IV of the ACT Group Litigation*, footnote 27 above.

29 — Ibid., point 55; see also my Opinion in *Denkavit*, footnote 27 above, point 20.

1. Disadvantageous tax treatment of UK-resident subsidiaries based on the location of their direct or indirect parent companies?

42. It seems clear to me that, in the versions in force up to 2004, the distinction in tax treatment contained in the UK's rules amounted to disadvantageous tax treatment of UK-resident subsidiaries with non-UK-resident parent companies in comparison to UK-resident subsidiaries with purely UK-resident parent companies.

43. In the first place, the distinction in tax treatment drawn by the UK's rules was effectively between UK-resident subsidiaries based on the location of their parent company. Thus:

— Under the rules applicable until 1995, while in principle any interest paid by a company on a loan – whether to a resident or a non-resident lender — representing more than reasonable commercial return on the loan was to be regarded as a distribution of profits to the extent that it exceeded such a return,[30] in the case of interest paid to any non-UK-resident lender who was a member of the same group of com-

30 — Section 209(2)(d) TA.

panies, this was always treated as a distribution. [31] In other words, it was in no case possible that interest paid to a non-UK-resident lender would remain treated for UK fiscal purposes as such.

— Under the rules applicable between 1995 and 1998, the provision by which interest paid between group members which exceeded an amount that would have been paid at arm's length was treated as a distribution, [32] did not apply if the payer and payee of the interest were both within the charge to UK corporation tax. [33] (Evidently, a distinction in treatment based on whether the payee is within the charge to UK corporation tax is most likely to be relevant where the payee is legally formed or principally active in a Member State other than the UK.)

— Under the rules applicable between 1998 and 2004, intra-group interest payments were dealt with via the UK's general transfer pricing rules. [34] However, a provision by means of a transaction was deemed not to give one of the affected parties a potential advantage where, inter alia, the other party to the transaction was within the charge to UK income or corporation tax (and certain other conditions were satisfied). [35]

44. In contrast, however, the UK's Finance Act 2004 amended this distinction such that the UK's transfer pricing rules also apply where both parties to the transaction are within the charge to UK tax. This evidently had the aim and effect of removing the difference in treatment that I have described (albeit that, as I discuss below, it may have meant extending the application of the UK's legislation to cover cases falling outside its *raison d'être*). As a result, the UK's legislation from 2004 onwards falls outside the scope of Article 43 EC: the reasoning I set out below therefore applies only to the legislation in force up to this date.

45. In the second place, the treatment given to subsidiaries with the specified 'non-UK' group elements plainly amounted to a fiscal disadvantage. From the subsidiary's perspec-

31 — Section 209(2)(e)(iv) TA.

32 — Section 209(2)(da) TA.

33 — Section 212(1) and (3) TA, as amended.

34 — Schedule 28AA TA.

35 — Schedule 28AA(5)(2) TA.

tive, re-qualification of (part of) interest payments as distributions meant that such payments were no longer deductible from the subsidiary's taxable profit such that, other things being equal, its UK tax bill would be larger than would have been the case if no re-qualification had taken place. Further, in cases where the UK's Advance Corporation Tax (ACT) system was still in force — which system was abolished in 1999 — re-qualification meant that the subsidiary was liable to pay ACT upon making the 'distribution'.

46. In this regard, the UK argues that, because the criterion for differentiation is not the nationality or residence of the UK subsidiary, but rather that of its parent company, this does not amount to a distinction on the basis of nationality within the sense of Article 43 EC. Further, insofar as it could be argued that the UK legislation might deter parent companies wishing to establish subsidiaries in the UK from so doing, the UK contends that such a possibility is not a sufficiently direct and certain consequence of its rules for it to fall under Article 43 EC, by analogy with the Court's *Keck* case-law in the field of free movement of goods. In the UK's view, there was no practical obstacle for non-UK-resident parent companies in setting up UK secondary establishments, or evidence that the Claimants were in fact deterred from setting up such an establishment. Indeed, the UK wished to encourage such investment in their territory. Rather, the aim of the UK's legislation was to ensure equal treatment for UK-resident subsidiaries in that they sought to close a 'loophole' available to cross-border groups which did not exist for wholly UK groups.

47. I am not convinced by either of these arguments. First, the fact that the difference in treatment is made on the basis not of the residence of the subsidiary itself, but its parent company, does not mean that it cannot amount to a relevant difference in treatment for Article 43 EC purposes. As the Court has held in cases such as *Metallgesellschaft* and *Lankhorst-Hohorst*, legislation creating a difference in treatment between UK-resident subsidiaries depending on whether or not their parent company has its seat in the United Kingdom, whereby subsidiaries with UK-resident parent companies are given a tax advantage, fall in principle under Article 43 EC. [36] Second, as regards the allegedly indirect effect of the UK rules on non-UK parent companies' decisions to establish a UK subsidiary, I would observe that, in order for Article 43 EC to apply, it suffices to prove a relevant difference of treatment and fiscal advantage. There is no requirement to prove that

36 — See, for example, Joined Cases C-397/98 and C-410/98 *Metallgesellschaft* [2001] ECR I-1727, paragraphs 43 and 44; *Lankhorst-Hohorst*, footnote 2 above, paragraphs 27 to 32.

particular non-resident companies were in fact deterred by the rules from exercising their right to freedom of establishment.

48. I would add that I do not find that the *Keck* jurisprudence, developed in the free movement of goods field, can without more be applied in considering the compatibility of national direct tax measures with Article 43 EC. [37] In particular, as I have explained in my Opinion in the *ACT* case, the concept of indistinctly applicable 'restrictions' of freedom of movement used in the Court's general free movement case-law cannot meaningfully be transposed *per se* to the direct tax sphere. Rather, due to the fact that criteria for asserting tax jurisdiction are generally nationality- or residence-based, the question is whether the national direct tax measure is indirectly or directly discriminatory, as opposed to a 'quasi-restriction' as I have described above. [38]

49. This is not to say that the gravity of the effect on the exercise of free movement cannot be taken into account at any stage in the assessment for compatibility with Article 43 EC. It may be an important consideration at the justification stage of the analysis, and in particular when assessing proportionality of the measure.

2. Is the disadvantageous tax treatment the result of a quasi-restriction?

50. The next question is whether the disadvantageous tax treatment of UK subsidiaries with a direct or indirect non-UK parent results purely from quasi-restrictions — that is to say, restrictions caused by disparities or the division of tax jurisdiction between two or more Member States' tax systems (meaning that Article 43 EC does not apply), rather than from discrimination resulting from the rules of one tax system.

51. On this point, the UK argues that the impugned rules were solely concerned to allocate fiscal competence between it and its Double Taxation Convention ('DTC') partners. It follows in the UK's opinion from the Court's reasoning in *Gilly* [39] that Article 43 EC does not apply at all in the present case: this article applies only to the exercise, not the allocation, of national taxation powers. In particular, the UK contends that the rules at issue reflected the allocation exercise carried

37 — Joined Cases C-267/91 and C-268/91 *Keck and Mithouard* [1993] ECR I-6097.

38 — *ACT*, footnote 27 above, paragraph 32 onwards.

39 — Case C-336/96 [1998] ECR I-2793.

out upon negotiation of the applicable DTCs, as all of its DTCs concluded with other Member States contain a provision permitting the respective competent authorities to agree a compensating adjustment whereby any increase in taxable profits chargeable in the UK is matched by a reduction of equal amount in the taxable profits of the lender in the country where it is established.

52. I am not persuaded by this argument.

53. It is true that, as I observed in my Opinion in the *ACT* case,[40] in the present state of Community law, the power to choose criteria of, and allocate (priority of) tax jurisdiction lies purely with Member States (as governed by international tax law). The Court has recognised this on numerous occasions, in particular in *Gilly* and in the *D* case.[41] There are at present no alternative criteria to be found in Community law, and no basis for laying down any such criteria. Moreover, the necessity to divide tax jurisdiction over the income of cross-border economic operators between Member States (dislocation of tax base) is an inevitable consequence of the fact that direct tax systems are national: restrictions flowing from such division should indeed be viewed as quasi-restrictions falling outwith the scope of Article 43 EC.

54. In my view, however, the UK rules at issue in the present case go further than simply allocating jurisdiction between the UK and its DTC partners. Prior to 1998, they essentially required re-qualification of loans made by non-UK parents to UK subsidiaries as distributions (until 1995, in all cases, save where otherwise provided by DTC; post-1995, where the amount of interest paid exceeded that which would have been paid on an arm's length basis). This, it would seem to me, represents the UK's purely unilateral choice of how it wishes to classify transactions for tax purposes in order to organise and avoid abuse of its own tax system — in other words, how it wishes to exercise its taxation powers. This basic objective of the rules is clear, whether expressed in domestic statutory form or, as happened pre-1995 in certain cases, in a DTC provision. Moreover, this unilateral choice was in turn made in the context of a prior unilateral choice of the UK to distinguish between the tax treatment of interest

40 — *ACT*, footnote 27 above, paragraphs 48 to 54.

41 — *Gilly*, footnote 39 above; Case C-376/03 *D* [2005] ECR I-5821.

payments (treated in UK law as pre-tax, deductible payments) and distributions (treated in UK law as post-tax, non-deductible payments). Similarly, although from 1998 onwards the UK dealt with the issue of thin capitalisation via its general transfer pricing rules rather than discrete thin cap legislation, this still represented a unilateral choice by the UK to treat certain transactions concluded on non-arm's length terms as if they had been concluded on arm's length terms, in the interest of avoiding abuse of the UK tax system.

55. I would add that the fact that such practices may be accepted in international tax law does not necessarily mean that they amount to a rule of allocation of tax jurisdiction; nor does it necessarily mean that such a practice conforms with Article 43 EC.[42]

56. Nor does the UK's argument that its DTCs with Member States contain provisions requiring the other contracting party to compensate for any re-classification carried out by the UK authorities alter this analysis. It would seem to me that such provisions are aimed at reducing, via a bilateral DTC, potential double taxation caused by the UK's unilateral re-classification rules (for example, to avoid cases where the UK requalifies an interest payment as a distribution, but the parent company's home State continues to view it as an interest payment). They do not negate the unilateral nature of the original national rule upon which the DTC provision is premissed. However, as I have observed in my Opinions in the *ACT* case and *Denkavit*[43] and as I discuss further below, the effect of these DTC provisions on a given taxpayer's situation should indeed be taken into account in assessing whether a Member State's legislation is in fact discriminatory — in particular, whether there is in reality a difference in treatment between residents and non-residents amounting to a tax disadvantage.

57. As a result, the disadvantageous tax treatment by the UK's rules of UK subsidiaries with non-UK parents, in comparison to those with UK parents, cannot simply be

42 — See, for example, my Opinions in *Kerkhaert and Morres*, footnote 27 above, point 37, and in *Denkavit*, footnote 27 above, point 43.

43 — *ACT*, footnote 27 above, point 70 onwards; *Denkavit*, footnote 27 above, point 33 onwards.

viewed as a quasi-restriction, but rather as a difference in treatment resulting solely from the rules of one tax jurisdiction.

3. Is the disadvantageous tax treatment a result of discrimination?

58. The final question is whether the disadvantageous tax treatment can be said to result from discrimination. The Court has held that discrimination consists in the application of different rules to comparable situations or in the application of the same rule to different situations, unless such differentiation is justified. [44]

59. As I have already discussed, prior to the 2004 changes the UK applied different rules to UK subsidiaries with non-UK parents, resulting in a tax disadvantage for these subsidiaries. On the face of it, it seems clear that this should be viewed as different treatment of undertakings in a comparable position; indeed the UK has not in its submissions argued to the contrary. The nature and extent of the relevant tax jurisdiction exercised by the UK over UK subsidiaries with non-UK parents was, in principle, the same as that exercised over UK subsidiaries with UK parents. In the exercise of this jurisdiction, the UK was therefore obliged by Article 43 EC not to differentiate in tax treatment of UK-resident subsidiaries purely on the basis of the location of their parent company. *Prima facie*, the UK failed to fulfil this obligation.

60. However, it is open to the UK to prove that this difference in treatment was justified. In order to do so, the UK must prove that (1) its legislation pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest; (2) the application of its legislation is appropriate to ensuring the attainment of the objective thus pursued and (3) the application of its legislation does not go beyond what is necessary to attain this objective. [45]

61. In this regard, the UK contends that its rules were a proportionate response to legitimate policy objectives, which may be classified variously as the objectives of fiscal cohesion (as in *Bachmann*), [46] the prevention of tax avoidance (as in *ICI*), [47] or the need to prevent wholly artificial arrangements

44 — See, for example, Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, and cases cited therein.

45 — See *Marks & Spencer*, footnote 26 above, paragraph 35.

46 — Case C-204/90 [1992] ECR I-249.

47 — Case C-264/96 [1998] ECR I-4695.

designed to circumvent tax legislation. Essentially, these objectives amount in the UK's view to the lawful objective of ensuring fair and coherent tax treatment, in particular by providing for the economic activity of the borrowing company to be taxed in the country where it took place. I will consider the applicability of these justifications in turn.

(a) Justification on anti-abuse grounds

62. The Court has on numerous occasions recognised that, in principle, Member States may be justified in taking otherwise-discriminatory direct tax measures in order to prevent abuse of law (although to date, it has never in fact found a national measure to be so justified). This is most recently evident in the *Marks & Spencer* judgment, where the Court held that in principle a national rule restricting deduction of cross-border losses could be justified by the risk of tax avoidance, and in particular the risk that within a group of companies losses would be transferred to companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses was therefore the highest. [48] Such recognition is also evident in the Court's judgments in *Lankhorst-Hohorst*, *X & Y*, and *ICI*, [49] as well as in *Leur-Bloem* (on the Merger Directive), *Halifax* (on indirect tax), and numerous judgments in non-taxation fields. [50]

63. The rationale underlying acceptance of such a justification is as follows. In principle, it is quite valid, and indeed fundamental to the idea of an internal market, for taxpayers to seek to arrange their (cross-border) tax affairs in a manner most advantageous to them. [51] However, this is only permissible insofar as the arrangement is genuine; that is to say, not a wholly artificial construct aimed at abusing and circumventing national tax legislation. [52] For example, the mere fact that a resident company establishes a secondary

48 — *Marks & Spencer*, footnote 26 above, paragraphs 49 and 50.

49 — *Lankhorst-Hohorst*, footnote 2 above; Case C-436/00 *X and Y* [2002] ECR I-10829; *ICI*, footnote 47 above.

50 — Case C-28/95 *Leur-Bloem* [1997] ECR I-4161; Case C-255/02 *Halifax*, ECR I-1609. See also Case C-367/96 *Kefalas* [1998] ECR I-2843 and Case C-110/99 *Emsland-Stärke* [2000] ECR I-11569.

51 — See, for example, the Court's judgment in *Halifax*, footnote 50 above, paragraph 73. See also the Court's judgment in C-294/97 *Eurowings* [1999] ECR I-7447: 'Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State ... As the Commission rightly observed, such compensatory tax arrangements prejudice the very foundations of the single market' (paragraphs 44 and 45).

52 — See in particular the formulations of the Court in *Lankhorst-Hohorst*, footnote 2 above, and *ICI*, footnote 47 above.

establishment in another Member State cannot in itself give rise to a general presumption of tax evasion or avoidance,[53] even where that Member State is a relatively low tax jurisdiction (or even a regime falling under the definition of 'harmful tax measures' set out in the Code of Conduct for business taxation).[54]

64. The next issue is whether the UK's legislation is apt to achieve this aim. This is clearly so: if the concern of the UK is to avoid that cross-border groups abusively and artificially qualify what are in reality distributions as interest payments on loans, requalification of interest paid as distributions is evidently effective in counteracting such abuse.

65. The final issue is whether the UK's anti-abuse legislation represents a proportionate response, and is applied in a proportionate manner, to this aim.

66. On this point, it is my view that, depending on its formulation and application, legislation aimed at avoiding thin capitalisation may in principle be a proportionate anti-abuse measure. It is true that the idea that companies have the right to structure their affairs as they wish means that, in principle, they should be allowed to finance their subsidiaries by equity or debt means. However, this possibility reaches its limit when the company's choice amounts to abuse of law. It seems to me that the arm's length principle, accepted by international tax law as the appropriate means of avoiding artificial manipulations of cross-border transactions, is in principle a valid starting point for assessing whether a transaction is abusive or not. To use the reasoning of the Court developed in the indirect tax sphere and other non-tax spheres, the arm's length test represents in this context an objective factor by which it can be assessed whether the essential aim of the transaction concerned is to obtain a tax advantage.[55] Moreover, it is in my view valid, and indeed to be encouraged, for Member States to set out certain reasonable criteria against which they will assess compliance of a transaction with the arm's length principle, and in case of non-compliance with these criteria for them to presume that the transaction is abusive,

53 — See the Opinion of Advocate General Léger in *Cadbury Schweppes*, footnote 2 above, points 53 and 56. See also Case C-436/00 *X and Y*, footnote 49 above, paragraph 62.

54 — See the Opinion of Advocate General Léger in *Cadbury Schweppes*, footnote 2 above, point 54.

55 — See the judgment of the Court in *Halifax*, footnote 50 above, paragraph 86.

subject to proof to the contrary.[56] The setting out of such criteria is, to my eyes, in the interests of legal certainty for taxpayers, as well as workability for tax authorities. This approach is to be contrasted, for example, with the use of a single fixed criterion to be applied in all cases — such as a fixed debt-equity ratio — which does not allow other circumstances to be taken into account.

67. However, the formulation and application in practice of such a test must also satisfy the requirements of proportionality. This means in my view that:

— It must be possible for a taxpayer to show that, although the terms of its transaction were not arm's length, there were nonetheless genuine commercial reasons for the transaction other than obtaining a tax advantage. In other words, as the Court noted in its *Halifax* judgment, 'the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages'.[57] An example that comes to mind is the situation on the facts in *Lankhorst-Hohorst*, where the purpose of the loan, as accepted by the Court, was a rescue attempt of the subsidiary via minimising the subsidiary's expenses and achieving savings on bank interest charges. One could imagine, however, that similar situations (i.e., where a transaction was not concluded on arm's length terms, but was nonetheless made non-abusively and not purely to obtain a tax advantage) would be relatively exceptional;[58]

— If such commercial reasons are put forward by the taxpayer, their validity should be assessed on a case-by-case basis to see if the transactions should be seen as wholly artificial designed purely to gain a tax advantage;

— The information required to be provided by the taxpayer in order to rebut the presumption should not be disproportionate or mean that it is excessively difficult or impossible to do so;

56 — One can distinguish this from cases such as *Kefalas*, footnote 50 above, paragraph 26 onwards, where the Court found that the application of a presumption of abuse where the taxpayer had not performed a certain action was contrary to Community law (in that case, exercise of a preferential right under Article 29(1) of the Second Council Directive 77/91/EEA of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 EC, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (OJ 1977 L 26, p. 1)). In such cases, the factor giving rise to the presumption could not — contrary to the arm's length test here — be said to be an objective factor by which it could be assessed whether the essential aim of the transaction concerned was to obtain a tax advantage.

57 — *Halifax*, footnote 50 above, paragraphs 74 and 75.

58 — *Lankhorst-Hohorst*, footnote 2 above.

— In cases where the payments are found to be abusive (disguised distributions) in the above sense, only the excess part of the payments over what would have been agreed on arm's length terms should be re-characterised as a distribution and taxed in the subsidiary's state of residence accordingly; and

— The result of such examination must be subject to judicial review. [59]

68. Nor am I of the view that, in order to conform with Article 43 EC, Member States should necessarily be obliged to extend thin cap legislation to purely domestic situations where no possible risk of abuse exists. I find it extremely regrettable that the lack of clarity as to the scope of the Article 43 EC justification on abuse grounds has led to a situation where Member States, unclear of the extent to which they may enact *prima facie* 'discriminatory' anti-abuse laws, have felt obliged to 'play safe' by extending the scope of their rules to purely domestic situations where no possible risk of abuse exists. [60] Such an extension of legislation to situations falling wholly outwith its rationale, for purely formalistic ends and causing considerable extra administrative burden for domestic companies and tax authorities, is quite pointless and indeed counterproductive for economic efficiency. As such, it is anathema to the internal market.

69. I would add that I agree with the Commission that, in order for the application of thin cap rules to be proportionate to their aim, the Member State applying these rules must ensure via DTC that the requalification of the transaction within its tax jurisdiction is mirrored by a counterpart requalification (i.e., from receipt of interest payments to receipt of dividend distributions) in the parent company's Member State. Failure to do so would in my view go beyond what is necessary to achieve the aim of the thin cap rules, and would impose a disproportionate burden (double taxation) on the group as a whole. I have already observed elsewhere that the effect of DTCs on a taxpayer's situation should be taken into account in assessing the compatibility of a Member State's legislation with Article 43 EC. [61] This is subject to the caveat that it is

59 — See *Leur-Bloem*, footnote 50 above, paragraph 41.

60 — An example is the extension of the German thin cap rules to wholly domestic situations following the judgment in *Lankhorst-Hohorst*, footnote 2 above.

61 — See my Opinions in the *ACT* case, footnote 27 above, point 71 onwards; and *Denkavit*, footnote 27 above, point 33 onwards.

no defence to an action for breach of Article 43 EC to argue that the other Contracting State to the DTC was in breach of its DTC obligations by failing to treat the payments received by the parent company consistently with their re-qualification by the UK.[62]

70. It will be clear from the above that the wording of the particular thin cap legislation, and the manner in which it applies in practice, is crucial to assessing whether it satisfies the proportionality test.

71. Looking, for example, at the only other case to date where the Court has considered national thin cap legislation — *Lankhorst-Hohorst* — the German legislation challenged in that case provided that payments would be requalified if the loan capital was more than three times the shareholder's proportional equity capital (i.e., a fixed criteron), a presumption rebuttable only if the subsidiary 'could have obtained the loan capital from a third party under otherwise similar circumstances or the loan capital constitutes borrowing to finance normal banking transactions'.[63] This meant that, as I observed above, it was not possible to rebut the presumption in cases where no abuse was present, but the loan nonetheless did not satisfy the legislative criterion (such as in that case, where the Court stated that the loan had been made to assist a loss-making subsidiary by reducing the interest burden resulting from its bank loan, in circumstances where the loss largely exceeded the interest paid to the parent). Further, it would seem that the German legislation had the effect of requalifying not just the excess of the payment over what would have been granted on commercial terms, but the whole of the payment from subsidiary to parent. Finally, there would seem, from the terms of the judgment, to have been no mechanism via the applicable DTCs ensuring that Germany's requalifications of interest would be 'compensated for' by other Member State contracting parties, to avoid causing double taxation.

72. The situation under the UK's legislation under review in the present case was (and is), as the UK notes in its submissions, in many respects different.

73. Dealing first with the UK legislation applicable until 1995, any interest paid by a company — whether to a resident or non-resident lender — on a loan representing more than a reasonable commercial return on the loan was to be regarded as a distribution of profits to the extent that it

62 — See, for example, *Denkavit*, footnote 27 above, paragraph 43.

63 — *Lankhorst-Hohorst*, footonote 2 above, paragraph 3.

exceeded such return (section 209(2)(d) TA). However, any interest paid to a non-UK-resident lender which was a member of the same group (other than interest already treated as a distribution under section 209(2)(d)) was in any event treated as a distribution.[64] This provision was clearly disproportionate, in the sense I described above, for two reasons. First, a loan granted to a UK subsidiary by a parent company resident in another Member State was in all cases requalified as a distribution without an assessment for compliance with any arm's length test. Second, there was absolutely no opportunity for such a subsidiary to prove that the loan was made for valid commercial reasons and not purely abusively to attain a tax advantage. This blanket rule went beyond what was reasonably necessary to achieve the aim of the UK's legislation.

74. The UK argues, however, that the effect of the DTCs it concluded with other Member States was that interest was in fact deductible, unless and to the extent that the interest rate was excessive. Interest was excessive if, in the case of older DTCs based on the 1963 Model,[65] the rate of interest exceeded what was commercial having regard to the amount of the debt or, in the case of the newer DTCs based on later OECD models,[66] if the amount of the interest exceeded for any reason what would be paid on an arm's length basis because either the rate or the amount of the loan itself was uncommercial. Further, for the second category of DTCs, from 1992 onwards statutory guidance as to the circumstances in which the amount of a loan or the rate of interest thereon exceeded that which would have been agreed on an arm's length basis was contained in section 808A TA. This guidance required account to be taken of all factors in making the arm's length assessment, including the question whether the loan would have been made at all in the absence of the special relationship (between the lender and borrower); the amount which the loan would have been in the absence of the relationship; and the rate of interest and other terms which would have been agreed in the absence of the relationship.[67]

75. In the case of each of these categories of DTC, their wording seems to me in principle to be proportionate to the stated anti-abuse aim of the UK's legislation. The basis for assessment is in each case essentially the arm's length principle. In neither case is there an absolute fixed decree (such as a fixed debt-equity ratio) of what is permissible: each category permits, on the face of the terms used, the circumstances of each particular case to be taken into account in determining what is commercial. In addition,

64 — Section 209(2)(e)(iv) and (v) TA.

65 — For example, the Luxembourg, German, Spanish and Austrian DTCs.

66 — For example, the Netherlands, French, Irish and Italian DTCs.

67 — Section 808A(2) TA.

in each case only the excess part of the cross-border payments (over what would have been paid on commercial terms) is requalified as a distribution. In principle, therefore, such provisions would seem to me justified under Article 43 EC. This conclusion is, however, subject to the following important qualifications, verification of each of which is for the national court.

76. First, it must have been possible for the taxpayer to demonstrate, without undue burden, that a transaction was in fact carried out for genuine commercial reasons other than to gain a tax advantage. Although, as I observed above, one can imagine that the circumstances in which this can be shown will be relatively limited (an example being a parent's rescue of its subsidiary), it is unclear to me from the wording of the sample DTCs put before the Court whether the possibility existed under the UK system. This is for the national court to ascertain on the facts of the case before it.

77. Second, this analysis is based purely on the formal wording of those DTCs put before the Court. If, for example, the UK authorities applied these provisions in practice in such a way as amounted to an absolute inflexible rule applied without heed to the circumstances of the particular case at hand, and without real opportunity for the taxpayer to plead and have such circumstances taken into account (or indeed failed to apply the DTC provisions at all, meaning that section 209(2)(e)(iv) and (v) applied), this would nonetheless be disproportionate. On this point, while the presence of an 'advance clearance procedure' whereby taxpayers can ascertain their position before the thin capitalisation provisions can be applied to them, adds welcome transparency and certainty to Member States' tax regimes in the interests of good administration, it is not in my view decisive for the compatibility of otherwise-proportionate national rules with Article 43 EC. I note that in the present case the Test Claimants dispute the efficacy and reliability of the advance clearance procedure relied upon by the UK in support of its arguments.

78. Third, the analysis evidently applies only insofar as the UK had in fact concluded a DTC with such wording with the relevant Member State. The number of similar DTCs concluded between the UK and Member States is unclear from the order for reference.

79. Finally, even in cases governed by such DTCs, the compatibility of the rules with Article 43 EC would, as I observed above, depend on the reciprocal recognition of the UK's requalification by the other Member State party to the DTC (to ensure, in particular, that the requalification does not cause double taxation). As I observed above, it would be no defence for the UK to argue that the other Contracting State to the DTC was in breach of its DTC obligations by failing to treat the payments received by the parent company consistently with their requalification by the UK. While I note that, in the present case, the UK contends that such a corresponding adjustment was in fact almost always made, it is for the national court to investigate whether, in a particular case before it, this was indeed so.

80. I would add that, contrary to the Test Claimants' contentions, the fact that the domestic arm's length 'test' for requalification set out in section 209(2)(d) might be different to (and wider than) the DTC 'test' does not in itself mean that the UK's rules infringed Article 43 EC: as I observed above, Member States cannot justifiably be required to assess purely domestic intra-group loans in the same way as cross-border intra-group loans for this purpose. Further, the expansion of the assessment to include examination not only of whether the interest rate, but also the amount of the loan, granted was on commercial terms seems perfectly in line with the anti-abuse aim of the UK legislation, as increasing the size of a loan to non-commercial proportions could in theory form an equally as effective way of 'moving' the taxation of profits to another jurisdiction.

81. I turn now to the proportionality of the amendments introduced in 1995. As the UK notes, these amendments essentially incorporated the arm's length principle, which had previously had effect via DTCs, into statutory form. They thus provided that interest paid between group members exceeding an amount that would have been paid on an arm's length basis was to be treated as a distribution.[68] A loan was treated as having been granted other than on an arm's length basis where whole or part of the loan represented 'an amount which would not have fallen to be paid to the other company if the companies had been companies between whom there was (apart from in respect of the securities in question) no relationship, arrangements or other connection, except so much, if any, of any such distribution as does not represent such an amount ...'.[69] Further, the legislation set out a list of criteria to be used in determining whether

68 — Section 209(2)(da) TA.

69 — Section 209(2)(da)(ii) TA.

interest payments were to be treated as distributions. These were: the level of the borrower's overall indebtedness; whether it might be expected that the borrower and a particular person would have become parties to a transaction involving the issue of a security by the issuing company or the making of a loan, or a loan of a particular amount, to that company; and the rate of interest and other terms that might be expected to be applicable in any particular case to such a transaction.

82. On its face, and for similar reasons to those discussed as regards the pre-1995 law, the terms of this legislation seem to me in principle proportionate to its end, subject to the four important qualifications I set out above. The test for requalification is explicitly based on the arm's length principle, as specified by the listed criteria. It has not been argued in the present case that these criteria, and the manner in which the legislation is worded, fail properly to express the arm's length principle. Once again, the fact that the provisions do not apply if the payer and payee of the interest are both within the charge to UK corporation tax [70] does not in itself mean that they are disproportionate.

83. Precisely the same considerations apply to consideration of the proportionality of the UK's 1998 changes to the rules, which deal with the thin cap issue as part of the UK's general transfer pricing rules. Again, the reference point taken is the arm's length standard, expressed on this occasion as terms 'different from what they would have been if the companies had not been under common control'. Once again, the same qualifications I set out above apply.

84. While the UK changed its transfer pricing rules in 2004 so as to apply also where both parties to the transaction are within the charge to UK tax, it will be clear from what I have already stated that this is not, in my view, necessary in order for the rules to comply with Article 43 EC.

(b) Justification on fiscal cohesion grounds?

85. An alternative justification put forward by the UK is that the legislation at issue was necessary to ensure cohesion of the tax system. In the UK's contention, its legislation had the aim of ensuring that covert distributions were taxed once, and in the appropriate fiscal jurisdiction (as the jurisdiction in which the profits were generated). Further, the UK argues that, looking at fiscal cohesion

70 — Section 212(1) and (3) TA.

from a group-wide and Community-wide perspective, the application of its thin cap rules ensured cohesion in ensuring that profits could not be 'exported' by the use of an artificial device, to be taxed in a jurisdiction where the profits were not earned.

86. This argument can be dealt with briefly, as applied in the present context it raises in my view precisely the same issues, and is subject to the same limitations, as those discussed above regarding justification on anti-abuse grounds.

87. It does, however, give the opportunity for some more general observations on the nature and function of the rather amorphous 'fiscal cohesion' defence. The Court has only explicitly accepted this defence in one case — *Bachmann*[71] — although it has been unsuccessfully raised in very many cases since then. In the *Bachmann* case, the Court used the concept to express the idea that Belgium could justifiably maintain a 'connection' between the deductibility of contributions under pension and life insurance contracts and the subsequent liability to Belgian tax of sums paid out under such contracts. It was justifiable for Belgium to limit deductibility of the contributions to cases where Belgium could tax the sums subsequently paid out. Since then, the Court has stated that, in order to rely on this defence, a 'direct link' must exist between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy. In cases such as *Verkooijen*, it emphasised that, in *Bachmann*, the tax advantage and disadvantage related to the same tax and the same taxpayer, rejecting the application of the defence on the facts of that case because it concerned two separate taxes levied on different taxpayers.[72] This approach was followed in cases such as *Baars* and *Bosal*.[73]

88. The limitation of the scope of the defence to a formalistic 'one tax, one taxpayer' has been criticised, inter alia, by Advocates General Kokott and Maduro in their respective Opinions in *Manninen* and *Marks & Spencer*.[74] Indeed, the Court in its judgments in these cases seemed to adopt a broader approach to the concept. In *Manninen*, while it rejected the application of the defence on the facts of that case, it reasoned that the cohesion of the Finnish tax system in that case was ensured as long as there was a correlation (link) between the tax advantage granted in the shareholder's favour (a tax credit) and the corporation tax paid on the

71 — *Bachmann*, footnote 46 above (see also the parallel case, Case C-300/90 *Commission* v *Belgium* [1992] ECR I-305, on very similar issues).

72 — Case C-35/98 *Verkooijen* [2000] ECR I-4071, paragraph 58.

73 — *Baars*, footnote 19 above; Case C-168/01 *Bosal* [2003] ECR I-9409.

74 — C-319/02 *Manninen* [2004] ECR I-7477; *Marks & Spencer*, footnote 26 above.

profits contained in those shares. The fact that such corporation tax had been paid not in Finland, but in Sweden, did not negate this correlation.[75] In *Marks & Spencer*, the Court structured its reasoning in a slightly different manner, using the concept of a 'balanced allocation of power to impose taxes between Member States'.[76] While in principle national legislation restricting group relief to resident subsidiaries of a resident parent company pursued the legitimate objective of protecting this balanced allocation of taxation power — as giving subsidiaries the option to have their losses taken into account in their State of residence or another State would jeopardise the balance — in that case, the means employed by the UK's legislation to achieve this objective were, in the Court's judgment, disproportionate.

89. In the light of this, one could be forgiven for feeling uncertain as to the scope and function of this defence. In my view, however, in the vast majority of cases in which the Court has rejected the applicability of the defence (in response to specific submissions of the parties on this point), it has in reality simply been expressing the basic non-discrimination principles that I have outlined in my Opinions in the *ACT* case, the *FII* case, *Kerkhaert and Morres*, and *Denkavit*, namely: (1) if acting in home State capacity, Member States must not discriminate between foreign-source and domestic-source income insofar as they exercise tax jurisdiction over the former; and (2) if acting in source State capacity, Member States must not discriminate between non-residents' and residents' income, insofar as they exercise tax jurisdiction over the former.[77] Clear examples of this are the *Verkooijen* and *Manninen* cases, where the Court was essentially upholding the home State non-discrimination obligation in rejecting the arguments of the Dutch and Finnish Governments that no sufficient link existed between the tax advantage (exemption and credit respectively) and the tax paid (which, as foreign-source income, had been paid in another Member State).[78] Likewise, in the *Marks & Spencer* judgment, the Court was essentially expressing the limits of the (home State) non-discrimination obligation — as the UK did not exercise jurisdiction to tax non-resident subsidiaries of UK parent companies, it was in principle consistent that it did not allow the losses of these subsidiaries to be deducted by the UK parent

75 — *Manninen*, footnote 74 above, paragraph 46.

76 — *Marks & Spencer*, footnote 26 above, paragraph 46.

77 — See footnote 27 above.

78 — *Verkooijen*, footnote 72 above; *Manninen*, footnote 74 above.

company.[79] Any 'restrictions' to cross-border activity flowing from such limits on loss deduction would be the result not of discrimination, but of quasi-restrictions.

90. In such cases, therefore, assessment of the applicability of the 'fiscal cohesion defence' was in fact conceptually indistinct from that of determining whether national legislation is discriminatory. In the vast majority of cases, therefore, one could indeed question whether the defence of 'fiscal cohesion' really has any useful separate function.

91. In the present case, the result of applying reasoning based on fiscal cohesion is in my opinion precisely the same as that explained above as regards anti-abuse justification. Thus, while it is in principle justified for the UK to seek to enforce and to prevent abuse of the tax rules applicable within its own tax jurisdiction (i.e., the distinction in tax treatment of interest and profit distributions) based on the accepted arm's length principle of apportionment, it may only do so in a proportionate manner.

79 — *Marks & Spencer*, footnote 26 above.

4. Conclusion on Question 1

92. For these reasons, in my view the reply to the national court's first question should be that Article 43 EC does not preclude the keeping in force and application of national tax provisions such as the UK provisions at issue in the present case, which impose restrictions based on an arm's length test upon the ability of a UK-resident subsidiary to deduct for tax purposes interest on loan finance granted by a direct or indirect non-resident parent company, where the subsidiary would not be subject to such restrictions if its parent company had been UK-resident, as long as (1) it is nonetheless possible for a subsidiary to demonstrate without undue burden that the transaction was in fact carried out for genuine commercial reasons other than to gain a tax advantage; and (2) the UK ensures the reciprocal recognition by the State of residence of the parent company of any UK requalification of interest paid by the subsidiary.

C — *Question 2*

93. By its second question, the national court essentially asks whether the answer to its first question would be different if the

loan finance to the UK-resident subsidiary was provided not directly by its parent company, but by an intermediate lending company also part of the same group, and if such a lending company and/or parent company were resident not in another Member State but in a third country.

94. As I have discussed above, because the UK legislation at issue applies only to situations where one company has a definite influence over the decisions of another company within the meaning of the Court's case-law, it should be considered for compatibility with Article 43 EC only. The relevant prohibition contained in this article for present purposes is the prohibition of restrictions on the setting-up of subsidiaries by companies formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community. [80]

95. This means to my mind that, as long as the direct or indirect parent company — whose right of establishment is allegedly being restricted — is resident in a Member State (other than the UK), Article 43 EC (and the analysis set out above) applies. The possibility that the intermediate lender company actually providing the loan may be resident in a third country makes no difference to this conclusion. Thus, the analysis is exactly the same as set out for the first question in the scenarios posed by Question 2(a) (both parent and lending company resident in another Member State).

96. Conversely, if the direct or indirect parent company is resident in a third country, Article 43 EC does not in principle apply, even if the loan is in fact made via another group member which is resident in another Member State. As a result, in the scenario posed by Question 2(d) (parent company and lending company each resident in third countries), Article 43 EC does not apply (nor indeed does any other Treaty free movement provision).

97. The exception to this would be where that lending company itself exercises a definite influence over the decisions of the UK subsidiary (i.e., where the UK company is in fact a subsidiary of the lending company), and where the UK rules discriminated against the UK subsidiary based on the location of this lending company. In such a case, the alleged restriction would be of the right of establishment of the lending company, and not the third-country parent company. Thus, in the scenarios posed by Questions 2(b) and (c) (lending company

80 — See Article 48 EC.

resident in another Member State, parent company resident in third country), the analysis set out above for Article 43 EC only applies where the UK borrower is a subsidiary of the lending company. This is equally so notwithstanding the variation posed by Question 2(c) (loan advanced by a third country branch of the Member State-resident lending company), as long as the lending company itself satisfies the conditions for applicability of Article 43 EC as set out in Article 48 EC (i.e., is formed in accordance with the law of a Member State and has its registered office, central administration or principal place of business within the Community).

98. For these reasons, the response to the national court's second question should be that Article 43 EC, and the analysis set out in my answer to Question 1, applies where (a) the loan is provided by a lending company, and not by the parent company itself, if both of these companies are resident in a Member State other than the UK; or (b) the lending company is resident in a Member State other than the UK and the borrowing company is a subsidiary of the lending company, even if their common parent company is resident in a third country or the lending company advances the loan from a branch situated in a third country. However, Article 43 EC does not apply where (a) the lending company is resident in a Member State other than the UK, the borrowing company is not a subsidiary of the lending company, and their common parent company is resident in a third country; or (b) the lending company and all common direct or indirect parent companies of the lending company and the borrowing company are resident in third countries.

D — *Question 3*

99. By its third question, the national court asks whether it would make any difference to the answers to Questions 1 and 2 if it could be shown that the borrowing constituted an abuse of rights or was part of an artificial arrangement designed to circumvent the tax law of the Member State of the borrowing company. As I have answered this question as part of my response to Question 1, and in particular in the section concerning applicability of the anti-abuse justification put forward by the UK, I will not provide a separate response here.

E — *Question 4*

100. By its fourth question, the national court asks whether, if there is a restriction on

the movement of capital between Member States and third countries within Article 56 EC, that restriction existed on 31 December 1993 for the purposes of Article 57 EC. As I have answered this question in section VA above, where I concluded that the UK legislation should only be assessed for compatibility with Article 43 EC, and not with Articles 49 or 56 EC, I will not provide a separate response here.

F — *Questions 5 to 10*

101. Questions 5 to 10 of the order for reference raise questions relating to the nature of remedies that should be available to affected UK-resident subsidiaries or other companies in the same group in the event of any of the UK legislation at issue being in breach of any of the Community provisions referred to in those questions.

102. It will be clear from my answer to Question 1 that the issue of remedies should only arise in relatively limited circumstances, as the UK rules by and large in my view comply with Article 43 EC. Thus, the question of remedies will only apply in cases where (1) a taxpayer can show that payments requalified by the UK pursuant to these rules were in fact made for genuine commercial reasons other than the attainment of a tax advantage; (2) as regards situations governed by the rules applicable up to 1995, there was no applicable DTC providing for an arm's length test, and the taxpayer can show that payments requalified by the UK pursuant to these rules would have passed the arm's length test or that such payments were in fact made for genuine commercial reasons other than the attainment of a tax advantage; or (3) there was no reciprocal recognition of the UK's requalification of the payment by the Member State of the parent company, which led to double taxation of the payment that would not otherwise have occurred.

103. Due to the narrow scope of these circumstances, and the fact that I have dealt with very similar questions in my Opinion in *Test Claimants in the FII Group Litigation*, [81] I will keep my responses to these questions brief.

104. As I observed in my Opinion in the *FII* case, [82] the Court has consistently held that that the right to a refund of charges levied in

81 — Opinion in *FII*, footnote 27 above, point 125 onwards.

82 — Ibid., point 126, and cases cited therein.

a Member State in breach of rules of Community law is the consequence and complement of the rights conferred on individuals by Community provisions as interpreted by the Court. The Member State is therefore required in principle to repay charges levied in breach of Community law.[83] In the absence of Community rules on the recovery of sums unduly paid, it is for the domestic legal system of each Member State to designate the courts and tribunals having jurisdiction and to lay down the detailed procedural rules governing actions for safeguarding rights which individuals derive from Community law, provided, first, that such rules are not less favourable than those governing similar domestic actions (principle of equivalence) and, second, that they do not render practically impossible or excessively difficult the exercise of rights conferred by Community law (principle of effectiveness).[84]

105. The question raised in the present case is precisely the same as that raised in the *FII* case; namely whether the plaintiffs' claims should be characterised as claims in restitution, damages or for an amount representing a benefit unduly denied.

106. In that case, I noted (with reference to the *Metallgesellschaft* case) that in principle, it is for the national court to decide how the various claims brought should be characterised under national law. However, this is subject to the condition that the characterisation should allow the Test Claimants an effective remedy in order to obtain reimbursement or reparation of the financial loss which they had sustained and from which the authorities of the Member State concerned had benefited as a result of the payment of the unlawfully levied tax.[85] This obligation requires the national court, in characterising claims under national law, to take into account the fact that the conditions for damages as set out in *Brasserie du Pêcheur* may not be made out in a given case and, in such a situation, ensure that an effective remedy is nonetheless provided.

107. Applying this to the present case, it seems to me that the heads of relief put forward by the Test Claimants should be assessed under the principles set out in the Court's case-law on recovery of charges unlawfully levied; that is, the UK should not profit and companies (or groups of companies) which have been required to pay the unlawful charge must not suffer loss as a result of the imposition of the charge.[86] As such, in order that the remedy provided to the Test Claimants should be effective in

83 — Ibid., and cases cited therein.

84 — Opinion in *FII*, footnote 27 above, point 127 and cases cited therein.

85 — *Metallgesellschaft*, footnote 36 above, paragraph 96.

86 — See, Opinion of Advocate General Fennelly in *Metallgesellschaft*, footnote 36 above, point 45.

obtaining reimbursement or reparation of the financial loss which they had sustained and from which the authorities of the Member State concerned had benefited, this relief should in my view extend to all direct consequences of the unlawful levying of tax. *Prima facie*, this would to my mind include: (1) repayment of unlawfully levied corporation tax (Question 5(a), (b), (c), (d)); (2) restoration of relief used to offset unlawfully levied corporation tax (Question 5(e)); and (3) repayment of un-utilised advance corporation tax paid on wrongly re-characterised distributions (Question 5(f)). I would emphasise, however, that it is for the national court to satisfy itself that the relief claimed was a direct consequence of the unlawful levy charged.

108. I would add that, in the *FII* case, which concerned the UK's tax treatment of incoming dividends, I expressed serious doubts whether the *Brasserie du Pêcheur* [87] conditions — and in particular the requirement of a sufficiently serious breach — was fulfilled for the aspects of the UK's system which breached Community law. I have even stronger doubts on this point in the present case. The application of Article 43 EC to national thin cap legislation was confirmed by the Court only in 2002 with its *Lankhorst-Hohorst* [88] judgment, and even following this judgment the scope of such application has not been totally clear. Moreover, the UK altered its legislation on numerous occasions, making the application of its rules more transparent and seemingly, in the case of the 2004 changes, keeping compatibility with Community law in mind. This does not seem to me sufficient to constitute a manifest and grave disregard of the limits on its discretion within the meaning of the Court's case-law.

109. As a final point, in response to the national court's 10th question regarding the relevance of reasonable diligence in loss limitation on the part of injured persons, I would note that, as the Court held in *Metallgesellschaft* and in line with the general principle of national procedural autonomy, actions such as those in the main proceedings are subject to national rules of procedure, which may in particular require plaintiffs to act with reasonable diligence in order to avoid loss or damage or to limit its extent. [89] Once again, however, this is subject to the principles that the procedural rules must be equivalent to those governing similar domestic actions, and must not render practically impossible or excessively difficult the exercise of rights conferred by Community law. In *Metallgesellschaft*, for example, the Court held that this principle of effectiveness would not be satisfied were a

87 — Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and Factortame* [1996] ECR I-1029.

88 — Footnote 2 above.

89 — *Metallgesellschaft*, footnote 36 above, paragraph 102.

national court to refuse or reduce a claim for reimbursement or reparation of the financial loss suffered simply because the claimants had not applied to the tax authorities to benefit from a given taxation regime relying directly on their Community law rights, despite the fact that 'upon any view' national law denied them the benefit of that taxation regime. In this regard, I would observe that it is not clear from the Order for Reference whether, in a given case, the national provisions in the present case, combined with the applicable DTCs, would have upon any view led to the conclusion that the restrictions set out in Question 1 applied. It is for the national court to determine whether the procedural rule at issue in fact complies with the principles of effectiveness and equivalence.

110. The response to Questions 5 to 10 should therefore in my view be that, in the absence of Community rules on the recovery of taxes unduly paid, it is for the domestic legal system of each Member State to designate the courts and tribunals having jurisdiction and to lay down the detailed procedural rules governing actions for safeguarding rights which taxpayers derive from Community law, including the characterisation of actions brought by the claimants before the national court. However, in exercising such jurisdiction, national courts are obliged to ensure that the claimants have an effective legal remedy in order to obtain reimbursement or reparation of the financial loss which they have sustained as a direct result of tax levied in breach of Community law.

G — *Temporal limitation*

111. In its oral submissions, the UK Government requested that, in the event that the Court should find that it has breached Community law in the present case, the Court should consider limiting the temporal effects of its judgment. It submits that the potential cost of a negative judgment for the UK could amount to EUR 300 million, given the large number of claimants involved in the case. Further, it asks that the Test Claimants in the present case should not be exempted from the effect of any temporal limitation.

112. On this point, it suffices to note that the extremely limited nature of the circumstances in which the UK rules breached Article 43 EC, as I set out above, mean that the amounts concerned by the judgment will very likely be considerably less than the UK's

estimates. In any event, as I observed in my Opinion in the *FII* case, it is for the UK, when raising a plea of temporal limitation, to ensure that the Court has before it sufficient information to allow it to come to a judgment on the issue. For similar reasons as I enunciated in that case — in which the UK also raised the issue of temporal limitation solely at the oral stage of the procedure, without indicating how it arrived at its estimate of the cost of the case, or giving argument as to the proposed cut-off date for the effects of the judgment — the Court should dismiss the plea.

VI — Conclusion

113. For these reasons, I am of the view that the Court should give the following response to the questions referred by the High Court of Justice of England and Wales, Chancery Division:

— Article 43 EC does not preclude the keeping in force and application of national tax provisions such as the UK provisions at issue in the present case, which impose restrictions based on an arm's length test upon the ability of a UK-resident subsidiary to deduct for tax purposes interest on loan finance granted by a direct or indirect non-resident parent company, where the subsidiary would not be subject to such restrictions if its parent company had been UK-resident, as long as (1) it is nonetheless possible for a subsidiary to demonstrate without undue burden that the transaction was in fact carried out for genuine commercial reasons other than to gain a tax advantage; and (2) the UK ensures the reciprocal recognition by the State of residence of the parent company of any UK requalification of interest paid by the subsidiary.

— Article 43 EC, and the analysis set out above, applies where (a) the loan is provided by a lending company, and not by the parent company itself, if both of these companies are resident in a Member State other than the UK; or (b) the lending company is resident in a Member State other than the UK and the borrowing company is a subsidiary of the lending company, even if their common parent company is resident in a third country or the lending company advances the loan from a branch situated in a third country. However, Article 43 EC does not apply where (a) the lending company is resident in a Member State other than the UK, the borrowing company is not a subsidiary of the lending company, and their common parent company is resident in a third country; or (b) the lending company and all common direct or indirect parent companies of the lending company and the borrowing company are resident in third countries.

— In the absence of Community rules on the recovery of taxes unduly paid, it is for the domestic legal system of each Member State to designate the courts and tribunals having jurisdiction and to lay down the detailed procedural rules governing actions for safeguarding rights which taxpayers derive from Community law, including the characterisation of actions brought by the claimants before the national court. However, in exercising such jurisdiction, national courts are obliged to ensure that the claimants have an effective legal remedy in order to obtain reimbursement or reparation of the financial loss which they have sustained as a direct result of tax levied in breach of Community law.