Press and Information

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Judgment of the Court of Justice in Case C-524/04

Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue

THE UNITED KINGDOM "THIN CAP" LEGISLATION MAY BE APPLIED ONLY TO PURELY ARTIFICIAL TAX ARRANGEMENTS

In order to be justified, those rules must allow the companies concerned to produce evidence as to the commercial reasons for entering into the transaction in question and the re-characterisation of interest paid as a distributed profit must be limited to the proportion of the interest which exceeds what would have been paid on an arm's-length basis

The United Kingdom tax legislation contains anti-avoidance rules which are targeted at 'thin capitalisation'. Where a company repays loan interest, such payments are deductible from taxable profits. By contrast, distributions of profits are subject to advance corporation tax. Thin capitalisation consists in financing a company by way of loan in preference to equity capital, in order to benefit from a more advantageous tax treatment. Those rules, which were in force in various forms until 2004, therefore restrict, in certain circumstances, the deductibility of interest paid by United Kingdom subsidiaries to non-resident companies. Those restrictions do not apply to companies which pay interest to another resident company.

Between 1988 and 1995, where the loan was granted by a non-resident company to a resident subsidiary, all the interest was treated as a distributed profit save where there was a provision to contrary effect in a double taxation convention (DTC). The DTCs concluded with a number of countries provide that interest is deductible where the amount of interest does not exceed what would have been paid on an arm's-length basis.

Between 1995 and 2004, interest paid between the members of the same group of companies was treated as a distributed profit to the extent to which it exceeded the amount that would have been paid at arm's length between the companies. However, those rules did not apply where both of the companies were subject to corporation tax in the United Kingdom.

Following a judgment of the Court of Justice of 2002 concerning the German rules relating to thin capitalisation[1], a number of groups of companies brought claims for restitution and/or compensation regarding the tax disadvantages which they alleged to have arisen as the result of the application of the United Kingdom tax legislation to them. Each of those groups has a United

[1] Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779

Kingdom-resident subsidiary which was granted a loan by a company established in another Member State.

The claims formed part of a group litigation, designated “Thin Cap Group Litigation”. The High Court chose as test cases the actions concerning the Lafarge and Volvo groups (with a parent company in a Member State) and the Caterpillar and PepsiCo groups (with a parent company in a non-member country). The High Court referred to the Court of Justice a number of questions relating to the compatibility of the rules on thin capitalisation with Community law, in particular freedom of establishment.

As a preliminary point, the Court noted that, although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law. Since the thin capitalisation rules apply only to situations in which the lending company has a definite influence over the borrowing company or is itself controlled by a company which has such an influence, those rules should be examined only in the light of freedom of establishment.

Whether there is a restriction on freedom of establishment

The Court notes that the fact that interest paid to a related company is treated as a distribution is capable of increasing the liability of the borrowing company to tax. That increase arises not only because taxable profits cannot be reduced by the amount of the interest paid, but also because the borrowing company may be liable to advance corporation tax.

The Court holds that the United Kingdom thin capitalisation provisions give rise to a difference in treatment between resident borrowing companies according to the place in which the lending company has its seat and that the tax position of a company which pays interest to a non-resident company is less advantageous. Accordingly, **the United Kingdom rules relating to thin capitalisation constitute a restriction on freedom of establishment.**

The justification for the restriction

The Court notes that a national measure restricting freedom of establishment may be justified where it specifically targets wholly artificial arrangements, which do not reflect economic reality, with a view to escaping the tax normally due. By preventing the practice of thin capitalisation, the United Kingdom legislation is an appropriate means of attaining that objective.

Nevertheless, in order to be justified, the legislation must not go beyond what is necessary to attain the objective of the prevention of abusive practices (principle of proportionality). In that context, national legislation is to be considered as proportionate if, **in the first place, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial reasons there may have been for entering into a transaction** and, **in the second place, if the re-characterisation of interest paid as a distribution is limited to the proportion of the interest which exceeds what would have been agreed had the relationship between the parties been one at arm’s length.**

The Court considers that, **between 1988 and 1995,** the United Kingdom legislation **did not satisfy those conditions where a DTC was not applicable.**

By contrast, **where a DTC was applicable, and between 1995 and 2004, the second condition is indeed satisfied.** In that context, **it is for the national court to determine whether the**

United Kingdom legislation satisfies the first condition by allowing the companies concerned to provide evidence of the commercial reasons for the transactions concerned.

Application to groups with a parent company which is resident in a non-member country

The Court adds that freedom of establishment does not apply to the implementation of the thin capitalisation rules in a situation where the parent company is resident in a non-member country.

Repayment of the tax unlawfully levied and compensation for loss and damage

Lastly, the Court notes that where a Member State has levied charges in breach of the rules of Community law, individuals are entitled to reimbursement of the tax unduly levied and the amounts paid which relate directly to that tax.

However, other expenditure which is not directly linked to the tax, but which arises from decisions taken by companies, for example, the loss suffered by a company because it has substituted financing by way of equity capital for loan capital, do not fall within that category. As far as that expenditure is concerned, it is for the national court to determine whether it represents financial losses suffered by reason of a breach of Community law for which the United Kingdom is liable.

In that context, in order to determine whether the breach is sufficiently serious to give rise to liability on the part of a Member State, the national court must take into account the fact that, in a field such as direct taxation, the consequences arising from the freedoms of movement guaranteed by the Treaty have been only gradually made clear and that, until the judgment in *Lankhorst-Hohorst* in 2002, the problem of thin capitalisation had not yet been addressed by the Court.

The full text of the judgment may be found on the Court's internet site
http://curia.europa.eu/jurisp/cgi-bin/form.pl?lang=EN&Submit=rechercher&numaff=C-524/04
It can usually be consulted after midday (CET) on the day judgment is delivered.

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