

Treatment of dividends received from subsidiaries which are resident in another Member State or resident in third countries: exemption vs. imputation method in the recent ECJ decision - The Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue.

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Introduction

In November 2012 the European Court of Justice delivered its second judgement in *Test Claimants in the FII Group Litigation* (Case C-35/11). The judgment concerns, *inter alia*, the treatment of cross border dividends and third state capital movement.

In particular, the legislation at issue provided an imputation method for cross border dividends and an exemption method for domestic source dividends.

The European Court of Justice decided the case by referring to freedom of establishment and free movement of capital.

The outcome of the judgment has been discussed by scholars who believe that the ECJ moved away from its previous settled cases law.

For that purpose, the aim of this dissertation is to analyse Case C-35/11. This paper commences with an overview of the domestic and European legislation at issue including questions referred by the national Court, followed by a focus on the treatment of dividends and on article 63 of TFEU.

The result of this analysis is that the ECJ did not “*change its mind*” and it only follows its jurisprudence.

Chapter 1 – Legal framework and facts

Legal framework – UK

Following the tax legislation in force in the United Kingdom at the time of the facts, the double taxation of distributed corporate income has been reduced by introducing “*partial imputation*”¹ system, under which the corporate and personal income tax were integrated “*by allowing individual taxpayers to offset their personal income taxes otherwise payable on dividends by corporate-level taxes paid with respect to the profit out of which the dividends were paid*”.²

In other words, it consists in “*taxing the company in the first instance, usually at a flat rate of tax, and then including in the shareholder’s taxable income not only the amount of dividend actually received, but also the company tax attributable to that dividend*”.³

Until 6 April 1999 that system had been working through an Advance Corporation Tax (*breviter*, ACT) and a tax credit granted to shareholders who had received a dividend.

The ACT system required companies resident in the United Kingdom which have made certain activity,⁴ as making a qualifying distribution to its shareholders, to pay ACT.⁵ ACT, which was calculated by reference to the amount or value of the distribution, could be offset against the corporation tax for the accounting period.⁶ If the Company had no liability to corporation tax the year that it made the qualified distribution, the ACT could become a “*surplus*”⁷ and it could carry forward “*indefinitely*”.⁸ Also, group of companies established in UK could join a special tax regime

¹ Introduced in 1973. From 1965 to 1973 in UK operated a “classical” system of corporation tax which provides that the profits of a company were subjected to corporation tax and they were taxed again in the hands of the shareholders.

² BRIAN, J. – ARNOLD, M. J., *International Tax Primer*, Kluwer, The Hague, page 163.

³ MILLER, A. – OATS, L., *Principles of International Taxation*, Bloomsbury Professional, Haywards Heath, 2012, page 12.

⁴ See Section 14 of the Income and Corporation Taxes Act 1988 (ICTA) in force at the time of the facts.

⁵ Taxes Act 1988, Section 14 (1).

⁶ HMRC, Draft Statutory Instruments, Corporation Tax, available at: <http://www.hmrc.gov.uk/drafts/draft-sact.pdf>.

⁷ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty’s Revenue & Customs*, [2008] EWHC 2893 (Ch).

⁸ TILEY, J., *Revenue Law*, Oxford, 2008, pages 887.

which allowed them to postpone the payment of ACT until the “*parent company in the group made a distribution by way of dividend*”.⁹

Once the ACT was paid, the legislation granted to a UK company receiving the dividend from another UK company a tax credit equal to the amount paid by the UK subsidiary because “intra-UK” dividends were not subject to corporation tax (when paid to a company) and ACT could not be offset against corporation tax, so parent companies received from their UK subsidiaries dividends and a tax credit (called franked investment income – “FII”) which could be used to reduce their ACT liability when making a qualified distribution to their individuals shareholders.

On the other side, if a UK resident company had received dividend from a subsidiary resident outside the UK, dividends were subjected to corporation tax and a relief for taxes paid in the foreign countries were granted. The Company did not receive any credit which could be used to mitigate ACT liability.

In this scenario companies receiving significant foreign dividend income generated a huge surplus due to the fact that:

“(i) *foreign dividends did not attract a tax credit and therefore did not create FII which could be sued to reduce the companies’ ACT liability on distributions made by them; and*

(ii) any credit given for foreign tax reduced the mainstream corporation tax liability against which the ACT could be set off”.¹⁰

Legal framework – European Union

As well know, direct taxation is not a competence conferred to European Union by Member States but due to the fact that taxation affects intra-EU market it is “*clearly and internal market*

⁹ European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 7. Available at www.curia.europa.eu. This tax arrangements were discussed by the European Court of Justice in the case European Court of Justice, 8 March 2004, Case C-397/98 and C-410/98, *Metallgesellschaft*.

¹⁰ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty’s Revenue & Customs*, [2008] EWHC 2893 (Ch).

issue, other indirect taxation and direct taxation are caught under the competence heading “internal market” in article 4(2)(a) TFEU, which is a shared competence with pre-emption”.¹¹

Also, according ECJ leading cases known as *Humblet*,¹² “*the direct tax systems of the Member States could come into conflict with Community law*”.¹³

Coming to our case, the principal European Union legislation coming into relevance is the Parent-Subsidiary Directive¹⁴ “*which provides for a framework of tax rules regulating the relations between parent companies and subsidiaries of different Member States, with the aim of facilitating the grouping together of companies*”.¹⁵

The mentioned Directive “*bars the imposition of withholding taxes on dividends paid by a company resident in one Member State of the Community to a company resident in another Member State, where the company receiving the dividend holds a minimum of 25 per cent of the capital of the company paying the dividend*”.¹⁶

In particular, article 4 of the Directive “*expressly allows*”¹⁷ Member States to adopt Credit and Exemption methods for relieving cross-border double taxation. In other words, Member State shall:

- a. “*refrain from taxation such profits; or*
- b. *Tax such profits while authorising the parent company to deduct from the amount of tax due that fraction of the corporation tax paid by the subsidiary which relates to those profits and, if appropriate, the amount of the withholding tax levied by the Member*

¹¹ TERRA, B. – WATTEL, P., *European Tax Law*, The Netherlands, 2012, page 9.

¹² European Court of Justice, 16 December 1960, Case C – 6-60, *Humblet v. Belgian State*, Available at www.curia.europa.eu: “*Under the terms of Article 31 of the Treaty it has responsibility for ensuring that Community law is observed and by Article 16 of the Protocol has jurisdiction to rule on any dispute relating to the interpretation or application of the Protocol but it may not, on its own authority, annul or repeal the national laws of a Member State or administrative measures adopted by the authorities of that State*”.

¹³ O’SHEA, T., *EU Tax Law and Double Tax Convention*, London, 2008, page 11.

¹⁴ Council Directive 90/435/EEC of 23 July 1990. For a general overview on directives see CRAIG, P. – DE BURCA, G., *EU Tax Law, Text, Cases and Materials*, Oxford, third edition, pages 114-115.

¹⁵ Opinion of Mr Geelhoed released on European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 23. Available at www.curia.europa.eu.

¹⁶ HMRC on the Directive. Full article available on <http://www.hmrc.gov.uk/manuals/intmanual/intm164030.htm>.

¹⁷ Opinion of Mr Geelhoed released on European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 23. Available at www.curia.europa.eu.

*State in which the subsidiary is resident, pursuant to the derogations provided for in article 5, up to the limit of the amount of the corresponding domestic tax”.*¹⁸

Factual background

The Franked Investment Income (“FII”) Group Litigation was established by a Group Litigation Order (“GLO”) made by Chief Master Winegarten on 8 October 2003.¹⁹ The GLO is composed by 12 groups of companies which have foreign subsidiaries, in other Member States or in third countries.

Companies claimed that they were suffering unjustified different tax treatments²⁰ consisting in the refusal of the Commissioners of Inland Revenue to grant to foreign (non-UK) distributed profits (*id est* inbound dividends) the tax credit provided to UK parent companies receiving dividends from their UK subsidiaries for the ACT already paid by the subsidiaries.

In particular, profits distributed by non UK subsidiaries were subjected to corporate tax, while profits distributed by UK subsidiaries were exempt from corporate taxation (when distributed to companies).²¹

Also, when the UK parent companies receiving foreign dividends made qualified distribution they did not have any ACT credit to mitigate their ACT liability because the dividend received did not constitute FII.

Thus, a UK parent company was entitled to benefit a credit equal to the withholding tax paid in the subsidiary’s State (when double tax treaty applied or when domestic legislation provides such

¹⁸ Council Directive 90/435/EEC of 23 July 1990, article 4.

¹⁹ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty’s Revenue & Customs*, [2008] EWHC 2893 (Ch).

²⁰ “*The claimants in the main proceedings seek repayment of and/or compensation for losses arising from the application to them of the United Kingdom legislation*”. European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 30.

²¹ The effect of the Section 208 of the ICTA was to prevent the same amount of profits being taxed twice at the same rate: “*this is because both parent and subsidiary would be chargeable to the same tax, at the same rate, on the same profits*”.

relief). However, the withholding taxes paid in the foreign countries were creditable against UK corporation tax up to the amount of UK corporation tax due (and, maybe, not in full).

In the end, if UK companies paid more ACT than what they could offset against its taxes due, companies were allowed to carry forward and back that “credit” or they could surrender it only to UK member of the group and, regarding the payment of FIDs, “*the loss of use of the money paid as ACT between the date of payment of the ACT and the date of its repayment and the enhanced payments the claimants in the main proceedings had to make to their shareholders to compensate for the lack of any tax credit in their hands*”.²²

First judgment

In 2004, the High Court of England and Wales referred to ECJ for preliminary ruling questions which “*cover a large number of topics. They covered the compatibility of the treatment of dividends paid by non-resident companies, ACT, the lawfulness under Community law of new rules introduced from 1 July 1994 relating to FIDs, repayment remedies, Member State liability in damages for sufficiently serious breach of Community law, defences and limitation*”.²³

In particular, “*emphasis [were] placed on five main issues*”:²⁴ i) dividend payment treatment;²⁵ ii) payment of dividend income; iii) advanced corporate tax (ACT) setoff and surrender; iv) foreign income dividend (FID) regime; and v) free movement of capital.

The result of the judgement raised “*difficult issues, and very large amounts of money are at stake*”²⁶ so when the case came back to the High Court of Justice the claimants and the defendants submitted different interpretations of the ECJ decision.

²² European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 30.

²³ Court of Appeal (Civil division) on Appeal from the High Court of Justice (Chancery Division), paragraph 10.

²⁴ O’SHEA, T., *Dividend Taxation Post-Manninen: Shifting Sands or Solid Foundations?*, in *Tax Notes International*, 5 March 2007, pages 887-918.

²⁵ The High Court of Justice of England and Wales, Chancery Division, asked if it was contrary to article 43 or 56 of EC to keep in force exemption method for UK-UK dividends while it was providing with a tax credit in Member State/third Countries -UK dividends.

In particular, the High Court agreed with the interpretation of the ECJ decision given by the claimants. Then, the defendants appealed to the Court of Appeal which, due to the fact that the national Court was divided on the interpretation of paragraph 56 of the first FII judgement, decided to refer back to the ECJ for another preliminary ruling. This decision was appealed to the Supreme Court which referred back the case to the High Court of Justice for making the preliminary ruling.

Claimants and the defendants made “*high quality written and oral submissions*”²⁷ and the High Court of Justice, to whom the case was referred back from the Supreme Court of UK, decided “*to obtain clarification regarding paragraph 56 of the judgement Test Claimants in the FII Group Litigation and point 1 of its operative part*”.²⁸

In particular, the High Court of Justice seeks to obtain clarification on the first issue underlined above, *id est* dividend payment treatment, because the ECJ, analysing it from a freedom of establishment point of view and from a freedom of movement of capital stand point, stated that:

“*the fact that nationally-sourced dividends are subject to an exemption system and foreign-sourced dividends are subject to an imputation system does not contravene the principle of freedom of establishment laid down under Article 43 EC, provided that the tax rate applied to foreign-sourced dividends is not higher than the rate applied to nationally-sourced dividends and that the tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the tax charged in the Member State of the company receiving the dividends*”.²⁹ And, from a free movement of capital, the ECJ reached the same conclusion when the UK parent company holds more than 10% of voting rights of the foreign subsidiary because that

²⁶ The Supreme Court, *Test Claimants in the Franked Investment Income Group Litigation (Appellants) v. Commissioners of Inland Revenue and another (Respondents)*, 23 May 2012, par. 3.

²⁷ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty's Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 8.

²⁸ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 21.

²⁹ European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 57.

percentage of voting rights qualifies “*for underlying tax credit under the UK’s DTC network*”.³⁰ In other words, the ECJ stated that “*article 43 EC and 56 EC must be interpreted as meaning that, where a Member State has a system for preventing or mitigating the imposition of a series of charges to tax or economic double taxation as regards dividends paid to residents by resident companies, it must treat dividends paid to residents by non-resident companies in the same way*”³¹ but the ECJ decided to send back to the High Court of Justice the case in question because “*it is for the national court to determine whether the tax rates are indeed the same and whether different levels of taxation occur only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs*”.³² When the case returned to the High Court the Claimants and the Defendants proposed different interpretation of the meaning of the wording “tax rates” and “different levels of taxation” used by the ECJ and if the ECJ refers to effective or to nominal rate. For this reason the High Court made a preliminary reference asking to the ECJ to clarify its ruling

Second, the High Court of Justice asked to the ECJ to “*rule on a more complex structure*”.³³ In particular “*it asks whether those points apply solely in the case where a United Kingdom-resident company is in direct receipt of dividends from a non-resident subsidiary that has paid corporation tax in its State of residence on the dividends paid, or whether they also apply in the case where the non-resident subsidiary itself paid no tax*”.³⁴

Third, the High Court of Justice questioned if the ACT paid by the company higher up the corporate structure shall be qualified as an infringement of European Union law as underlined by the ECJ in the Case 199/82³⁵ which gives the right to repayment or the loss suffered by the company “*can only be subject-matter of a claim for damages, where the conditions set out by the*

³⁰ O’SHEA, T., *Dividend Taxation Post-Manninen: Shifting Sands or Solid Foundations?*, in *Tax Notes International*, 5 March 2007, pages 893.

³¹ European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 72.

³² European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 56.

³³ HOULDER, V., *Dickensian tax row still has pages to run*, in *Financial Times*, May 24, 2012.

³⁴ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 26.

³⁵ European Court of Justice, 9 November 1983, Case 199/82, *San Giorgio*.

Court in joined Cases C-46/93 and C-48/93 Brasserie du Pecheur and Factortame [1996] ECR I-1029”.³⁶

Fourth, according to the fact that the claimants in the main proceeding contented that in the light of the most recent ECJ cases article 65 of TFEU “*could be relied upon even where the companies concerned were in such a relationship, provided that the national legislation in question was not intended to apply exclusively to companies in a such relationship*”³⁷, the High Court of Justice asked if “*article 63 TFEU was applicable as the United Kingdom legislation applied irrespective of the extent of the holding which the shareholder concerned had in the company making the distribution that was resident in a third country*”.³⁸

Finally, question five referred by the High Court of Justice concerned the UK legislation which allowed UK Parent Company to surrender surplus ACT to its UK subsidiaries (so the ACT could be set off against the subsidiaries corporation tax liability) while the legislation was not allowing the same surrendering to UK Parent’s subsidiaries established in other Member State. In particular, and according to the answer already given by the ECJ in the case *The Claimants in the FII Group Litigation*,³⁹ the High Court of Justice asked if the mentioned UK legislation was contrary to article 43 TFEU because it did not provide “*some form of equivalent relief such as a refund of ACT which could be matched against the corporation tax paid by subsidiaries established in the European Union*”.⁴⁰

The ECJ gave his second preliminary judgement in the case *The Test Claimants in the FII Group Litigation* on the 13 of November 2012. Even if it is not matter of this dissertation, since the

³⁶ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 29.

³⁷ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty’s Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 74.

³⁸ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 30.

³⁹ In the previous case, the ECJ was asked to rule on the “*inability of a resident company to surrender surplus ACT to non-resident subsidiaries in order for them to set it off against the corporation tax for which they are liable in the UK in respect of the activities carried on in that Member State*”, European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 33.

⁴⁰ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 33.

30 of July 2012, a third preliminary referral has been pending before the ECJ. The third preliminary ruling concerns the compatibility of section 320 of the 2004 ACT with EU law. In particular, as stated by Lord Walker, the third ruling may be summarised as “*whether EU law requires only that the member state must make available an adequate remedy which meets the principles of effectiveness and equivalence, or whether it requires every remedy recognised in domestic law to be available so that the taxpayer may obtain the benefit of any special advantages that this may offer on the question of limitation*”.⁴¹

In the present case, FII GLO II, the ECJ focussed, *inter alia*, on two main issues⁴² which may be resumed as following:

- a. Treatment of dividend;
- b. Article 65 of the TFEU – free movements of capital – and third Countries.

Chapter 2 – Treatment of dividend

Question n. 1 referred by the High Court to the ECJ concerns a clarification of the meaning of “*tax rates*” and “*different levels of taxation*” used by the ECJ at paragraph 56 of the FII GLO judgement. In particular, the High Court asked whether the references to tax rates and different levels of taxations:

- a. “*Refer solely to statutory or nominal rates of tax;*
- b. *Refer to the effective rates of tax paid as well as the statutory or nominal rates of tax; or*

⁴¹ The Supreme Court, *Test Claimants in the Franked Investment Income Group Litigation (Appellants) v. Commissioners of Inland Revenue and another (Respondents)*, 23 May 2012, paragraph 13.

⁴² The author of this dissertation agrees with prof. Peter Wattel who wrote: “*I will only address these two issues (raised by the preliminary question 1 and 4), as the answers to questions 2,3 and 5 are not surprising, or concern national UK tax law already repealed*” in WATTEL, P., *Test Claimants in the FII Group Litigation (FII-2). Equivalence of the exemption and imputation methods. Dividends from third countries. Free movement of capital. Court of Justice (comments by Wattel)*, in *Highlight Insights on European Taxation*, n. 3/2013, pages20.

c. *Whether the phrases referred to have some different meaning and, if so, what.*⁴³

The ECJ used that wording because it was asked to examine, from articles 49 and 63 TFEU prospective, the different tax treatments between UK sources dividends (exemption method) and foreign sources dividends (imputation method) received by a UK Parent Company from its UK/foreign subsidiaries. The Court concluded that a Member States could use different methods for relief and it “*does not contravene the principle of freedom of establishment laid down under article 43 EC, provided that the tax rate applied to foreign-sourced dividends is not higher than the rate applied to nationally-sourced dividends and that the tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the tax charged in the Member State of the company receiving the dividends*”.⁴⁴

In other words, the ECJ recognizes that Member States are allowed to adopt exemption or credit method.

According to the settled case law “*a discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situation*”.⁴⁵ In our case discriminations occur when different “tax rates” applied to comparable situation as “*the situation of a corporate shareholder receiving foreign-source dividends [and] corporate shareholder receiving nationally-source dividends*”⁴⁶ or when “*different levels of taxation*” occur in some situations.

The High Court asked itself the meaning of same “tax rates” and “different levels of taxation” and it concluded that the ECJ may refer to the nominal rate or to effective tax rate.

⁴³ O’SHEA, T., *ECJ Examines German Tax Credit Rules Again*, in *Tax Analyst*, September 19, 2010, page 877.

⁴⁴ European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 57. This wording was reaped again in paragraph 73.

⁴⁵ European Court of Justice, 14 February 1995, Case C-279/93, *Finanzamt Köln-Altstadt v. Schumacker*, Paragraph 30.

⁴⁶ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 37.

The High Court reached this ambiguous conclusion due to the fact that paragraph 54 of the judgement “*seeks to draw a distinction, in the domestic UK context, between the exemption accorded to dividends in the hand of the recipient and the fact that the company paying the dividend may have paid corporation tax at an effective rate which is lower than the nominal rate, or may even have paid no tax at all, because of the availability of various reliefs*”.⁴⁷

This interpretation found, as state by the High Court, a confirmation in the French version of FII GLO I decision due to the fact that the decision “*refers to situations where the paying company “n’est pas débitrice d’impôt ou paie un impôt sur les sociétés inférieur au taux nominal applicable au Royaume-Uni”*. The contrast appears to be between the tax actually paid (“*impôt*”) on the one hand, and the nominal rate of tax (“*taux nominal*”)”.⁴⁸

It seemed, continued the High Court of Justice, that the ECJ followed one half of the argument underlined by the Advocate General Mr Geelhoed at paragraph 49 of his opinion where he reported the arguments of the claimants who argued that “*a difference exists between the exemption and credit systems in cases where the UK distributing subsidiary has, pursuant particular UK corporation tax exemptions and benefits (e.g. for investment or Research & Development), in fact paid a lower net rate of corporation tax than the standard UK rate*”.⁴⁹ According to the Advocate General’s Opinion the different treatment consists in the possibility to “pass on” the lower tax regime to the parent company when the subsidiary resides in UK.

The claimant’s argument was not discussed by the ECJ and it stated that “*that point is not contested by the United Kingdom Government, which argues, however, that the application to the*

⁴⁷ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty’s Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 57.

⁴⁸ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty’s Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 57.

⁴⁹ Opinion of Mr Geelhoed released on European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 49. Available at www.curia.europa.eu

*company making the distribution and to the company receiving it of different levels of taxation occurs only in the highly exceptional circumstances, which do not arise in the main proceedings”.*⁵⁰

Then, *«while this was not contested, the Court referred the matter back to the national court to investigate “whether the tax rates are indeed the same and whether different levels of taxation occur only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs”».*⁵¹

The High Court considered that a misunderstood of the argument advanced by the UK government due to the fact that the *“written observation submitted by the UK did not deal at all with the distinction between nominal and effective rates of tax”.*⁵²

In particular, the argument of the High Court moved from a footnote to section 208 ICTA which said: *“in very exceptional circumstances, not applicable on the fact of the present case, the subsidiary and the parent may be liable to differing rates of corporation tax due to the availability of small companies relief”.*⁵³

In other words, the UK government arguments were not directed to the contrast between nominal and effective rates and, according to the High Court, *“there is obviously nothing exceptional about the proposition that companies often pay corporation tax at an effective rate lower than the nominal rate, because the existence and availability of reliefs which reduce the tax base (such as group relief, or the carry forward of trading losses) are commonplaces of UK*

⁵⁰ European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 57. This wording was reaped again in paragraph 55.

⁵¹ O’SHEA, T., *Dividend Taxation Post-Manninen: Shifting Sands or Solid Foundations?*, in *Tax Notes International*, 5 March 2007, pages 890.

⁵² High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty’s Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 59.

⁵³ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty’s Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 59.

corporate taxation. The UK government could not rationally have argued that such cases were exceptional".⁵⁴

The High Court concluded that the right way to interpret paragraph 54 and 55 of the first FII GLO judgement is in favour of claimants and *"lacking the competence to decide questions of national law for themselves, and believing that there might be a dispute about the factual premises of the argument which the Advocate General had accepted, the ECJ left it to the national court to determine:*

a) *Whether the (nominal) tax rates applied in the UK to domestic and foreign dividends are indeed the same (which I take to be a reference back to the question posed in paragraph 49 of the judgement); and*

b) *Whether different levels of (effective) taxation occur in the UK "only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs"*.⁵⁵

This interpretation was criticised by part of the Court of Appeal which stated that *"the ECJ on this point does not, with very great respect, make it clear to the Claimants why important parts of their case have been rejected [and] the jurisprudence of the ECJ specifically contemplates that a national court may in an appropriate case refer a question of law to it where it encounters difficulty in applying its judgement."*⁵⁶ The case was referred back to the ECJ for obtaining a clarification on that point.

The Court examined the different treatment of dividend income in the context of articles 49 TFEU and 63 TFEU. In particular it was asked whether those articles preclude legislation of Member State, which applies exemption method to the nationally-sourced dividends while foreign-

⁵⁴ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty's Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 61.

⁵⁵ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty's Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 63.

⁵⁶ Court of Appeal (Civil division) on Appeal from the High Court of Justice (Chancery Division), paragraph 43.

sourced dividends is suffering imputation method, when the companies' effective level of taxation is lower than the nominal rate.⁵⁷

As known from the first judgement, "*FII concerns an origin state rule rather than a host state rule: the UK tax rules affect the dividends received from the state of establishment or investment of capital; it is not an establishment state rule that is at stake*". It means that the Court applied the migrant/non migrant test from the origin state perspective.⁵⁸ The claimants argued that when in a Member State companies' effective level of taxation is lower than the nominal rate, applying different relief methods to nationally-sourced dividends and to foreign-sourced dividends lead to less favourable treatment of cross-border dividends.

The ECJ underlined that Member States are, in principle, free to use different systems to eliminate double taxation due to the fact that "*European Union law, as it currently stands, does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to eliminate of double taxation within the European Union, each Member State remains free to organise its system for taxing distributed profits, provided, however, that the system in question does not entail discrimination prohibited by the FEU Treaty*".⁵⁹ It is clear that "*EU law regards CIN – Capital Import Neutrality (exemption) – and CEN – Capital Export Neutrality (Credit Method) – with equal affection*".⁶⁰ In particular, the Parent-Subsidiary Directive, as underlined above, expressly allows Member States to choose between the methods for Double Tax Relief. It is indeed that "*The Committee does not hold any strong views concerning the relative*

⁵⁷ On that purpose, the High Court asked to an expert – Mr John Whiting, OBE of PricewaterhouseCoopers LLP – to give a survey of the levels of corporation tax paid by UK parent companies (in percentage) and he concluded that "*the majority of companies with accounting profits pay corporation tax at a level lower than the applicable statutory rate*" in High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty's Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 64.

⁵⁸ The migrant/non migrant test is used by the ECJ for "*determining whether the different treatment at issue is a restriction of a fundamental freedoms [and] the Court checks firstly for comparability in situation between the "migrant" and the "non-migrant", and then examines the different (tax) treatment*". In O'SHEA, T., *EU Tax Law and Double Tax Convention*, London, 2008, page 42.

⁵⁹ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 40. In FII GLO I, at paragraph 47, the Court stated: "*it is for each member state to organise, in compliance with community law, its system for taxing distributed profits and, in particular, to define the tax base and the tax rate which apply to the company making the distribution and/or the shareholder receiving them, in so far as they are liable to tax in that member state*".

⁶⁰ CRAIG, P. – DE BURCA, G., *EU Tax Law, Text, Cases and Materials*, Oxford, third edition, page 220.

merits of the two methods of providing relief for double taxation, believing that both methods can coexist".⁶¹

In this scenario, the Court has to apply the migrant/nonmigrant test in checking if the tax treatment of foreign-source dividends is less favourable than the tax treatment granted to domestic-source dividends "*when the recipients are in a comparable situation vis-à-vis the tax rules of the recipient's member state*".⁶² Once that (*id est*: the same tax treatment is granted to foreign/domestic dividends in the same situation) is verified, "*very surprising*",⁶³ the ECJ accepts the so called asymmetrical choice: exempting domestic dividends while an indirect tax credit is provided to foreign dividends.

In paragraph 56 of the FII GLO I judgement the ECJ underlined that the national court must determine "*whether the tax rates are indeed the same and whether different levels of taxation occurs only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs*". In fact, following settled cases law, the ECJ stated, at paragraph 42 of the present judgement, that "*the equivalence of the exemption and imputation methods will be compromised, in the following circumstances*".⁶⁴

- a. When the company which pays the dividend is subjected to a nominal tax rate lower than the nominal tax rate applicable to the company receiving the dividend because the lower tax rate regime would pass to the parent company;
- b. When the company which receives the dividends is subjected to an imputation method which is able to take account of the effective level of taxation suffered by the subsidiary in the State of origin and "*the profits of the resident company which pays*

⁶¹ Report of the Committee of Independent Experts on Company Taxation to the Commission of the European Communities, Office for Official Publications of the European Communities, Brussels, 1992.

⁶² O'SHEA, T., *Dividend Taxation Post-Manninen: Shifting Sands or Solid Foundations?*, in *Tax Notes International*, 5 March 2007, pages 889.

⁶³ CRAIG, P. – DE BURCA, G., *EU Tax Law, Text, Cases and Materials*, Oxford, third edition, page 617.

⁶⁴ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 43.

dividends are subject in the Member State of residence to an effective level of taxation lower than the nominal rate of tax which is applicable there” because the company receiving the dividends would not join the lower tax regime.⁶⁵

The ECJ in the first judgement stated that the legislation in question “*does not contravene the principle of freedom of establishment*”⁶⁶ and the Court made it clear that the national court has to determine the “*highly exceptional circumstances*”⁶⁷ whether or not the foreign source dividends are suffering worse treatment than the domestic source dividends.

The Court, as affirmed by a Dutch professor, “*reluctantly admits getting it wrong in the first round*”⁶⁸ and, as well underlined by the Advocate General Jaaskinen in his opinion at paragraph 59, the “*application of the imputation method to foreign-sourced dividends as prescribed by the legislation at issue in the main proceedings does not ensure a tax treatment equivalent to that resulting from application of the exemption method to nationally-sourced dividends*”. However, seems to say the ECJ, due to the fact that the tax rates to which paragraph 56 of the first judgement referred relate to both the nominal rate of tax and the different level of taxation, “*the less favourable treatment of foreign-sourced dividends is a factual finding on how the United Kingdom system actually works*”.⁶⁹

It means that “*exemption and imputation methods do not immediately cease to be equivalent*”⁷⁰ but, due to the fact that the level of taxation of the profits of companies paying

⁶⁵ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 46.

⁶⁶ European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 57.

⁶⁷ European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 55.

⁶⁸ WATTEL, P., *Test Claimants in the FII Group Litigation (FII-2). Equivalence of the exemption and imputation methods. Dividends from third countries. Free movement of capital. Court of Justice (comments by Wattel)*, in *Highlight Insights on European Taxation*, n. 3/2013, page 20.

⁶⁹ Opinion of Mr Jaaskinen released on European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 59.

⁷⁰ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 5

dividends is lower than the statutory rates, foreign dividends are treated differently and it “*is not justified by a relevant difference in situation*”.⁷¹

It is indeed that a different treatment occurs whenever companies in the same situation are treated differently or whenever companies in different situation are treated equally. In our scenario, applying exemption method and imputation method to, respectively, domestic and foreign source dividends lead to different treatment not only when domestic legislation provides different nominal tax rates between companies paying dividends and companies receiving those dividends but also when the effective level of taxation of the profits is lower than the nominal tax rate. This is because the lower profits taxation would pass to parent company if exemption method is applied while the same treatment is not granted when imputation method occurs due to the fact that the profits already taxed, even at a lower rate, in the hand of the company paying dividends would suffer other burden of taxes consisted in paying taxes up to the UK nominal tax rate. In other words, granting exemption to domestic dividends which have suffered an effective taxation lower than the nominal tax rate consisted in giving a tax credit equal to the nominal rate of tax applicable, so the same tax treatment has to be granted to foreign sourced dividends. “*This is a key finding in this judgement*”⁷² due to the fact that the ECJ, comparing credit and exemption method, stated that exempt dividends means grant a tax credit equal to the nominal tax rate and, coming to our case, the national treatment,⁷³ which has to be grant to foreign dividends in the same situation of domestic source dividends, is a tax credit equal to the nominal tax rate applicable to the foreign company. It is indeed that the issue in the UK tax system was that the tax credit granted to foreign source dividend was calculated on the base of the effective level of taxation suffered by foreign companies.

⁷¹ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 50.

⁷² O’SHEA, T., *ECJ Reexamines the U.K. Dividend Rules*, in *Tax Notes International*, vol. 71, nr. 9/2013, page 818.

⁷³ For an excellent discussion on the national treatment which ensures not less favourable treatment to person who has exercised freedoms granted by EU law and he is in a similar situation in comparison with a person who has not exercised those freedoms see O’SHEA, T., *EU Tax Law and Double Tax Convention*, London, 2008, page 47.

For all those reason, the ECJ, clarifying the ruling given in FII GLO I (*id est*: Member State are able to adopt exemption method for domestic source dividends and imputation method for foreign dividends when two conditions are met: foreign dividends cannot suffer an higher rate of tax than the rate of tax applicable to domestic dividends and the Member State of the Parent company must grant an ordinary – equal to the tax paid by the distributing company – tax credit), stated that Articles 49 TFEU and 63 TFEU must be interpreted as precluding Member States to adopt exemption method to domestically sourced dividends and imputation method to foreign-sourced dividends when:

- a. company receiving the dividend cannot join a tax credit equal to the nominal rate of tax applicable in the State where the company paying dividends is established; and/or (when in calculation the tax credit the system is able to take in account the effective level of taxation paid by foreign companies);
- b. the effective level of profit taxation suffered by companies receiving dividends is lower than the prescribed nominal rate.

The ECJ, also, recognised, as analysed by the Advocate General in his opinion at paragraph 70, that granting a tax credit on the basis of nominal rate of tax applicable may still lead to less favourable treatment of foreign-sourced dividends because, *“it is true that calculation, when applying the imputation method, of a tax credit on the basis of the nominal rate of tax to which the profits underlying the dividends paid have been subject may still lead to a less favourable tax treatment of foreign-sourced dividends, as a result in particular of the existence in the Member States of different rules relating to determination of the basis of assessment for corporation tax. However, it must be held that, when unfavourable treatment of that kind arises, it results from the exercise in parallel by different Member States of their fiscal sovereignty, which is compatible with*

the Treaty".⁷⁴ This means that the UK is obliged to grant a tax credit equal to the nominal rate applicable to the foreign company paying the dividends and it might still result in a less favourable treatment of foreign sourced dividends due to the fact that the credit granted in UK does not cover the taxes paid abroad when the subsidiaries resident country applies an higher nominal tax rate. The latest less favourable treatment is not forbidden by the European Treaties because it "*is a merely an outcome of the higher rates of taxation imposed in the state where the dividends are paid and since it is a two-state problem that has not been resolve by income tax treaties rules*".⁷⁵

Coherence of a tax system

The court dismissed the justification provided by the United Kingdom Government who contended that the different tax treatment was justified by the need to ensure the cohesion of the national tax system.

The ECJ, in accordance with settled case-law, stated that such restriction of the freedom of establishment and of the freedom of free movement of capital is possible only if it "*justified by overriding reason in the public interest*".⁷⁶

A justification shall be "*necessary [and] its application [shall] be appropriate to ensuring the attainment of the objective question and not go beyond what is necessary to attain it*".⁷⁷

In the direct tax field there are five main justifications which have "*upheld by the Court: (i) the need to ensure the coherence of the national tax system; (ii) the need to ensure the effectiveness*

⁷⁴ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 64.

⁷⁵ O'SHEA, T., *ECJ Reexamines the U.K. Dividend Rules*, in *Tax Notes International*, vol. 71, nr. 9/2013, page 818.

⁷⁶ European Court of Justice, 23 October 2008, Case C-157/97, *Finanzamt für Körperschaften III in Berlin v. Krankenhaus Ruhesitz am Wannsee-Seniorenheimstatt GmbH*, paragraph 40.

⁷⁷ European Court of Justice, 30 November 1995, Case C-55/94, *Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*, paragraph 39.

of fiscal supervision; (iii) the need to prevent the risk of tax avoidance; (iv) the need to ensure the balanced allocation of taxing rights; and the need to ensure recovery of tax debt".⁷⁸

United Kingdom argued that the rules at issue in the main proceedings were necessary to "ensure the cohesion of the national tax system".⁷⁹

The need of safeguard the coherence of the tax system was for the first time accepted in *Bachmann*.⁸⁰

The ECJ defined the concept of coherence of the tax system as the need of a direct link between "the tax advantage concerned and the offsetting of that advantage by a particular tax levy".⁸¹ In other words, "the cohesion resulted from the logical balance between recognition of a tax advantage and right to tax income".⁸²

Since the first cases, the Court "appears to have been reluctant"⁸³ to accept the need of the coherence of the tax system as a justification for a restriction.

This reluctance should be read in the light of the case *Wielockx*⁸⁴ where the ECJ rejected the need of the coherence of tax system which was provided by the Netherlands as a justification due to the fact that Double Tax Treaties "might have affected it".⁸⁵ It is indeed that the coherence is no longer only a link between a tax advantage and a right to tax but "it is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States".⁸⁶ In other words, fiscal

⁷⁸ O'SHEA, T., *European Tax Controversies: A British-Dutch Debate: Back to Basics and is the ECJ Consistent?*, in *World Tax Journal*, vol. 5, n. 1/2013, page 122.

⁷⁹ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 56.

⁸⁰ European Court of Justice, 20 February 1979, Case 120/78, *hanns-Martin Bacmann v. Belgian State*, paragraphs 21-28. See, also, European Court of Justice, 28 January 1992, Case C-300/90, *Commission v Belgium*, paragraph 21.

⁸¹ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 58.

⁸² MULTARI, D.A., *Loss recapture rule and coherence of the tax system: the Bachmann theorem in the recent Krankenhaus case*, in Working Papers, Ials, University of London, available at http://ials.sas.ac.uk/postgrad/courses/docs/MA_Tax_Working_papers/MULTARI_PUBLICATION_FINAL%5B1%5D.pdf.

⁸³ O'SHEA, T., *German Loss Deduction and Reintegration Rules and the ECJ*, in *Tax analysts*, vol. 52, n. 11/2009, page 968.

⁸⁴ European Court of Justice, 11 August 1995, Case C-80/94, *Wielockx v. Inspecteur der Directe Belastingen*.

⁸⁵ O'SHEA, T., *Commission v. Denmark: Can Cohesion Work as a Justification?*, in *Tax Notes International*, vol. 45, n. 4/2007, page 45.

⁸⁶ European Court of Justice, 11 August 1995, Case C-80/94, *Wielockx v. Inspecteur der Directe Belastingen*, paragraph 24.

cohesion may not be invoked by Member States to justify fiscal disadvantage unless a “direct link” occurs between the fiscal advantage and the liability to tax⁸⁷ at the level of DTC.

In *Krankenheim*, which “represents an example of one of those direct link situation”,⁸⁸ the tax disadvantage may be justified by the need of the coherence of the tax system. The “deduction and recapture” granted by Germany to losses incurred by a PE of a German Company is found by the Court a corollary of the coherence of the tax system in the way that: “*the reintegration of the amount of the permanent establishment’s losses in the results of the principal company is the indissociable and logical complement of their having previously been taken into account*”.

In FII GLO II judgement the ECJ found a direct link “*between, on the one hand, the tax credit in the case of foreign-sourced dividends and the tax exemption for nationally-sourced dividends, and, on the other, the tax to which the distributed profits have already been subject*”.⁸⁹

Then, the Court applied the “two elements proportionality test”⁹⁰ and it stated that:

a. The restriction is suitable for the attainment of the coherence of the tax system due to the fact that there is a direct link between the tax advantage granted to companies receiving the dividends and the tax paid by the companies which distributed those profits; but

b. The restriction goes beyond what is necessary due to the fact that “*whilst application of the imputation method to foreign-sourced dividends may be justified in order to avoid economic double taxation of distributed profits, it is not necessary, in order to maintain the cohesion of the tax system in question, that account be taken, on the one hand, of the effective level of taxation to which the distributed profits have been subject to calculate the tax advantage when applying the imputation method and, on the*

⁸⁷ Also confirmed in European Court of Justice, 3 October 2002, Case C-136/00, *Danner case*, paragraph 33.

⁸⁸ O’SHEA, T., *German Loss Deduction and Reintegration Rules and the ECJ*, in *Tax analysts*, vol. 52, n. 11/2009, page 969.

⁸⁹ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 59.

⁹⁰ ZALASIŃKI, A., *Proportionality of Anti-Avoidance and Anti-Abuse Measures in the ECJ’s Direct Tax Case Law*, in *Intertax*, vol. 35, issue 5/2007, page 311.

*other, of only the nominal rate of tax chargeable on the distributed profits when applying the exemption method*⁹¹ and the ECJ continued stating that the relief method is granted to avoid economic double taxation of distributed profits irrespective of the effective level of taxation and on the assumption that those profits have been taxed at the nominal tax rate.

On this point, the ECJ concluded that for the purpose of ensuring the cohesion of the tax system would be appropriate to adopt an imputation method or a credit method which takes in account the nominal rate of tax to which the company paying the dividends would be subjected. In other words, the ECJ stated that *“for the purpose of ensuring the cohesion of the tax system in question, national rules which took account in particular, also under the imputation method, of the nominal rate of tax to which the profits underlying the dividends paid have been subject would be appropriate for preventing the economic double taxation of the distributed profits and for ensuring the internal cohesion of the tax system while being less prejudicial to freedom of establishment and the free movement of capital”*.⁹² It is indeed that, as explained above, the cohesion of the tax system would not be compromised by a tax credit equal to the nominal tax rate and, on the same time, the freedom of establishment and the free movement of capital are less prejudiced by a domestic less favourable treatment.

Significance of *Gilly, Kerckhart and Morres and Haribo*

The ECJ's outcome concerns the treatment of dividends in cross border situation. In fact, the UK legislation provided exemption method for domestic sourced dividends and imputation method for foreign sourced dividends. This system is, as already stated in FII GLO I and in other settled case law, compliant with the freedoms granted by EU Treaties unless the tax rate applied to foreign-sourced dividends is not higher and the tax credit is at least equal to the amount paid in the State of

⁹¹ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 60.

⁹² European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 64.

the subsidiary paying the dividends. Thus, in the FII GLO II the ECJ confirmed the principle stated in FII GLO I and it clarified that when worse level of taxation brings to a less favorable treatment. In particular, the ECJ stated that the equivalence of the two relief methods would be compromised only in two situations: “*first, if the resident company which pays dividends is subject to a nominal rate of tax below the nominal rate of tax to which the resident company that receives the dividends is subject, the exemption of the nationally-sourced dividends from tax in the hands of the latter company will give rise to lower taxation of the distributed profits than that which results from application of the imputation method to foreign-sourced dividends received by the same resident company, but this time from a non-resident company also subject to low taxation of its profits, inter alia because of a lower nominal rate of tax*”⁹³ and, “*second, exemption from tax of dividends paid by a resident company and application to dividends paid by a non-resident company of an imputation method which, like that laid down in the rules at issue in the main proceedings, takes account of the effective level of taxation of the profits in the State of origin also cease to be equivalent if the profits of the resident company which pays dividends are subject in the Member State of residence to an effective level of taxation lower than the nominal rate of tax which is applicable there*”.⁹⁴

The decision of the ECJ can be put together with other decisions.

In particular, the ECJ in *Gilly*, case concerning individuals, stated that “*the object of a convention such as that in issue is simply to prevent the same income from being taxed in each of the two States. It is not to ensure that the tax to which the taxpayer is subject in one State is no higher than that to which he or she would be subject in the other*”.⁹⁵ The ECJ continues “*if the State of residence were required to accord a tax credit greater than the fraction of its national tax*

⁹³ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 44.

⁹⁴ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 46.

⁹⁵ European Court of Justice 12 May 1998, Case C – 336/96, *Mr and Mrs Robert Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, paragraph 46.

corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income, which would entail a loss of tax revenue for it and would thus be such as to encroach on its sovereignty in matters of direct taxation”.⁹⁶ In other words, the ECJ stated that a Member State has to grant an ordinary tax credit and there is not any obligation for a Member State to give credit over and above the Member State’s tax rate.

Another important decision of the ECJ for understanding the present case is *Haribo*. In this case the ECJ referred to FII GLO I stating that “*the situation of a corporate shareholder receiving foreign-sourced dividends is comparable to that of a corporate shareholder receiving nationally source dividends*”.⁹⁷ Again, at paragraph 86 of *Haribo* the ECJ noted that the EU Law does not prohibit the so called asymmetrical choice if the “*tax rate applied to foreign-sourced dividends is not higher than the rate applied to nationally-sourced dividends and that the tax credit is at least equal to the amount paid in the State of the company making the distribution, up to the limit of the tax charged in the Member State of the company receiving the dividends*”.⁹⁸

The ECJ in FII GLO II decided in a slightly different ways in the sense that a Member State wishing to adopt asymmetrical relief methods has to grant a tax credit equal to its nominal tax rate. However, this outcome is not far away from settled cases law where the ECJ already refers to nominal tax rate at paragraph 99 in *Haribo* where the ECJ endorsed the Austrian indirect credit method for foreign sourced dividends due to the fact that for calculating the tax credit “*the profit of the company distributing dividends must be multiplied by the nominal rate of corporation tax applicable in the State where that company is established*”.⁹⁹ This paragraph has to be interpreted with the general guidelines given in paragraph 86 of the same judgment which stated that foreign

⁹⁶ European Court of Justice 12 May 1998, Case C – 336/96, *Mr and Mrs Robert Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, paragraph 48.

⁹⁷ European Court of Justice 10 February 2011, joined Cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08), Osterreichische Salinen AG v. Finanzamt Linz*, paragraph 59.

⁹⁸ European Court of Justice 10 February 2011, joined Cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08), Osterreichische Salinen AG v. Finanzamt Linz*, paragraph 86.

⁹⁹ European Court of Justice 10 February 2011, joined Cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08), Osterreichische Salinen AG v. Finanzamt Linz*, paragraph 99.

sourced dividends must not suffer an higher tax rate than the domestic source dividends. The result, and as clarified by the ECJ in FII GLO II, is that when exempting domestic source dividends a State accepts to grant a tax credit equal to the nominal tax rate irrespectively of the effective level of taxation suffered by the company paying the dividend. In other words, the eventual lower taxation granted to the subsidiary would be joined also by the parent company. It is indeed that in this situation the parent company receiving domestic source dividends would suffer an effective level of taxation lower than the nominal tax rate while parent company receiving foreign source dividends would suffer an effective level of taxation equal to the nominal tax rate due to the fact that it receives only a tax credit equal to the amount of taxes actually paid in the foreign country. The ECJ underlined in *Haribo* that the tax credit shall be calculated according to the nominal tax rate of the country where the subsidiary is resident and in FII GLO II the Court went a step forward highlighting that the tax credit should be equal to the nominal tax rate of the Member State where the parent company is resident. Doing so, the credit and exemption method of relief would lead to the same results due to the fact that the parent companies would join an eventual lower taxation in the State where the company paying the dividend is resident.

However, this approach would not bring to a full equivalence because in some circumstances the credit and exemption methods would lead to different conclusion. In particular the ECJ affirmed that whenever the country where the subsidiary is resident adopts a higher level of taxation it would lead to a less favorable treatment which is not prohibit under the EU law due to the fact that the direct taxes field is still a prerogative of Member State and, as stated by the ECJ in *Gilly*, a Member State cannot be asked to grant a tax credit greater than the fraction of its national tax corresponding.

In other words, the ECJ stated that “*such fiscal disadvantage results from the exercise in parallel by two Member States of their fiscal sovereignty*”¹⁰⁰ and it continued “*in the current state of the development of European Union law, the Member States enjoy a certain autonomy in this*

¹⁰⁰ European Court of Justice, 15 April 2010, Case C-98/08, *CIBA*, paragraph 25.

area provided they comply with European Union law, and are not obliged therefore to adapt their own systems to the different systems of taxation of the other Member States in order, inter alia, to eliminate the double taxation arising from the exercise in parallel by those State of their fiscal sovereignty”.¹⁰¹ This principle was affirmed by the ECJ in *Kerckhaert and Morres* where the ECJ stated that “the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue in the main proceedings result from the exercise in parallel by two Member State of their fiscal sovereignty”.¹⁰² It is indeed that “the unfavorable treatment referred to in paragraph 64 of FII GLO 2 has nothing to do with which state’s tax accounting rules must be applied to calculate the foreign nominal tax rate to be applied, since the UK is not obliged to grant anything more than an ordinary tax credit”.¹⁰³

This seems to be confirmed by *Meilicke II* case where the ECJ highlighted that “the obligation of a Member State to eliminate double taxation on a natural person benefiting ultimately from dividends of foreign origin is limited to the deduction of the corporation tax paid by the dividend-paying company on dividends distributed”¹⁰⁴ and the ECJ continued that “the calculation of the tax credit must be made in relation to the rate of corporation tax on the distributed profits applicable to the dividend-paying company according to the law of its Member State of establishment; however the amount to be imposed may not exceed the amount of the income tax to be paid on dividends received by the recipient shareholder in the member State in which that shareholder is fully taxable”.¹⁰⁵

Chapter 3 – Article 63 of TFEU and third Countries

¹⁰¹ European Court of Justice, 15 April 2010, Case C-98/08, *CIBA*, paragraph 28.

¹⁰² European Court of Justice, 12 December 2006, Case C-374/04, *Mark Kerckhaert, Bernadette Morees v. Belgische Staat*, paragraph 20.

¹⁰³ O’SHEA, T., *ECJ Reexamines the U.K. Dividend Rules*, in *Tax Notes International*, vol. 71, nr. 9/2013, page 818.

¹⁰⁴ European Court of Justice, 30 June 2011, *Wienand Meilicke, Heidi Christa Weyde, Marina Stoffer v. Finanzamt Bonn-Innenstadt*, Case C-262/09, paragraph 32.

¹⁰⁵ European Court of Justice, 30 June 2011, *Wienand Meilicke, Heidi Christa Weyde, Marina Stoffer v. Finanzamt Bonn-Innenstadt*, Case C-262/09, paragraph 34.

The second issue that the ECJ was asked to decide “*concerns dividends received by a UK parent company from subsidiary which is resident in a third country, i.e. a country other than a member state of the EU*”.¹⁰⁶ In other words, the question referred by the High Court concerns the relation between dividends received by UK companies from subsidiaries resident in third countries.

It is indeed, as explained by the Advocate General Jaaskinen at paragraph 103 of his opinion, this question “*will arise if, following the Court’s answer to Question 1 above, the national court finds that the United Kingdom rules taxing dividends received from companies resident in other Member States are contrary to Articles 49 or 63*”.

When the case returned to the High Court the Claimants “*submit that, if the tax legislation, like the Case V charge, is not aimed solely or primarily at establishment situations, Article 56 may be engaged in the case of a distribution by a Third Country subsidiary to its parent company in a Member State, regardless of the size of the parent’s shareholding and the extent of its control and influence*”.¹⁰⁷ On the other hand the UK Tax Authorities highlighted, citing *Burda* case, that article 63 was not applicable “*where a company has a shareholding in another company which gives it definite influence over that company’s decisions and allows it to determine that company’s activities, it is the provisions of the Treaty on the freedom of establishment that are to be applied*”.¹⁰⁸

The main differences between article 49 and article 63 of the TFUE may be found in the wording of those two articles. In particular, art. 49, expressly, refers to “*nationals of a Member State*” exercise the freedom of establishment “*in the territory of another Member State shall be prohibited*” and, on the other hand, art. 63 states that “*all restriction on the movement of capital between Member States and between Member State and third countries shall be prohibited*”. In

¹⁰⁶ High Court of Justice - Chancery Division, *The Test Claimants in The FII Group Litigation and The Commissioners for Her Majesty’s Revenue & Customs*, [2008] EWHC 2893 (Ch), paragraph 67.

¹⁰⁷ Court of Appeal (Civil division) on Appeal from the High Court of Justice (Chancery Division), paragraph 47.

¹⁰⁸ European Court of Justice, 26 June 2008, Case C-284/06, *Finanzamt Hamburg-Am Tierpark v. Burda GmbH*, paragraph 69.

other words, and coming to the question referred, applying article 63 to dividends instead of article 49 means that national treatment has to be granted to a company or individuals resident in a third country.

The ECJ made clear that the distinction between freedom of establishment and freedom of free movement of capital has to be found in the purpose of the national legislation.¹⁰⁹ In particular, as stated at paragraph 91 and 92 of FII GLO II, “*national legislation intended to apply only to those shareholdings which enable the holder to exert a definite influence on a company’s decisions and to determine its activities falls within the scope of Article 49 TFEU on freedom of establishment*” while “*national provisions which apply to shareholdings acquired solely with the intention of making financial investment without any intention to influence the management and control of the undertaking must be examined exclusively in light of the free movement of capital*”.

Thus, the ECJ underlined that the UK legislation at issue apply to both the mentioned scenarios and a purpose analysis for determining under which articles it falls is not possible.

In such circumstances, the ECJ may take account the factual circumstances disputed in the main proceedings.

The ECJ at paragraph 95 of its judgment FII GLO II highlighted that at paragraph 37 of FII GLO I it stated that the non-resident companies paying dividends were wholly owned by the UK parent which “*as the nature of the interest in question would confer on the holder definite influence*

¹⁰⁹ “Paragraphs 90-98 of the judgment contain a summary of the Court’s – until this case – settled case law on how to decide whether a case must be assessed under the free movement of capital rules (which also apply as regards third countries) or under the right of establishment rules (which does not extend to third country cases): (i) national legislation targeting groups of companies (controlling interests) must be assessed under the right of establishment; (ii) national legislation aimed at portfolio investors must be judged under the free movement of capital; (iii) general national legislation (equally affecting controlling interests and small investors) may fall under both sets of rules; (iv) in the latter case, the fact of the concrete case (definite influence or no definite influence?) determine which of the two freedoms applies (exclusively)” in WATTEL, P., *Test Claimants in the FII Group Litigation (FII-2). Equivalence of the exemption and imputation methods. Dividends from third countries. Free movement of capital. Court of Justice (comments by Wattel)*, in *Highlight Insights on European Taxation*, n. 3/2013, pages20.

over the decisions of the company paying the dividends and allow it to determine the company's activities, the provisions of the EC Treaty on freedom of establishment will apply".¹¹⁰

However, in a case as such as the one at issue it is not necessary to analyse the factual circumstances due to the fact article 49 on freedom of establishment applies only to Member State – Member State situation and its application is not extended to “*situations concerning the establishment of a company of a Member State in a third country or the establishment of a company of a third country in a Member State*”.¹¹¹ In particular, the ECJ made very clear that “*where it is apparent from the purpose of such national legislation that it can only apply to those shareholding which enable the holder to exert a definite influence on the decision of*” a company resident in a third country “*neither Article 49 TFEU nor Article 63 TFEU may be relied upon*”.¹¹²

However, in a case, as the one at issue in FII GLO II, where the national legislation, which relates to the tax treatment of dividends, does not apply “*exclusively to situations in which the parent company exercises decisive influence over the company paying the dividends must be assessed in the light of Article 63 TFEU. A company resident in a Member State may therefore rely on that provision in order to call into question the legality of such rules, irrespective of the size of its shareholding in the company paying dividends established in a third country*”.¹¹³

It is indeed that the ECJ, differently from question 1, has followed the Advocate General Jaaskinen who said at paragraphs 111-113 that there are two main ways for solving the question at issue:

- a. Interpreting art. 49 and art. 63 TFEU, in the context of third countries situation, as intra-EU situations. It means that whenever the influence over a company

¹¹⁰ European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 37.

¹¹¹ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 97.

¹¹² European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 98.

¹¹³ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 99.

resident in a third country is decisive, the application of art. 63 TFEU is not permitted and this situation is not covered by EU Treaties;

b. Interpreting art. 49 and art. 63 TFEU, in the context of third countries situation, as a extra-EU situations. It means that the distinction underlined in intra-EU situation between freedom of establishment and freedom of movement of capital does not find space in third-country relation and art. 63 TFEU applies also when there is decisive influence over the company paying the dividend.

In FII GLO II art. 63 can be extended to cover also the situations where participation in the company paying the dividend is more than a portfolio investment due to the fact that the legislation at issue “concern only the tax treatment of dividends which derive from investments which their recipient has made in a company established in a third country”¹¹⁴ and it does not “relate to the conditions for access of a company from a Member State to the market in a third country or of a company from a third country to the market in that Member State”.¹¹⁵

The ECJ concluded that “European Union law must be interpreted as meaning that a company that is resident in a Member State and has a shareholding in a company resident in a third country giving it definite influence over the decisions of the latter company and enabling it to determine its activities may rely upon Article 3 TFEU in order to call into question the consistency with that provision of legislation of that Member State which relates to the tax treatment of dividends originating in the third country does not apply exclusively to situations in which the parent company exercises decisive influence over the company paying the dividends”.¹¹⁶

The importance of *Holböck*, *Thin Cap GLO*, *A and B* and *Scheunemann*

¹¹⁴ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 100.

¹¹⁵ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 100.

¹¹⁶ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 104.

According to settled cases law, it is common ground that an infringement of Article 49 TFEU may fall also under Article 63, if applicable. In other words, infringement concerning “*tax treatment of dividends may fall within Article 49 TFEU on freedom of establishment and Article 63 TFEU on the free movement of capital*”.¹¹⁷ It is indeed that, as the free movement of capital is extended to third countries situation, it is very important to distinguish between the freedom granted by article 65 and all the others granted by EU Treaty but it “*is not always easy*”.¹¹⁸

The ECJ, in previous cases, underlined that for solving the question whether national legislation falls within the scope of one or of the other article the aim of the national legislation must be taken into consideration.

The ECJ, as well explained in FII GLO II paragraphs 91-91, distinguished between national legislations which:

- a. “*apply to holdings by nationals of the Member State concerned in the capital of a company established in another Member State, giving them definite influence on the company’s decisions and allowing them to determine its activities, come within the substantive scope of the provisions of the EC Treaty on freedom of establishment*”;¹¹⁹ by contrast
- b. Targets only portfolio investors come under the freedom of capital.

However, the two categories system had a short life due to the fact that Member States have adopted domestic legislation which targets all shareholders without any caring of the size of the holding.

When the national legislation is generic, *id est* potentially affecting both establishment and capital so it concerns only the tax treatment of dividends, the ECJ has to analyse the facts of the

¹¹⁷ European Court of Justice 10 February 2011, joined Cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08), Osterreichische Salinen AG v. Finanzamt Linz*, paragraph 33.

¹¹⁸ TERRA, B. – WATTEL, P., *European Tax Law*, The Netherlands, 2012, page 77.

¹¹⁹ European Court of Justice, 13 March 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, paragraph 27.

case for establishing which freedoms apply. In *Burda* the ECJ determined from which freedoms deciding the case by looking the facts of the dispute and it stated that “*the dispute before the referring court relates exclusively to the effect of the national legislation at issue in the main proceedings on the situation of a resident company which has distributed dividends to shareholders whose holding gives them definite influence over the decisions of that company and enables them to determine its activities*”.¹²⁰

It is indeed that the factual circumstances are decisive for understanding the freedom infringed but it seems that the ECJ went forward in FII GLO II when it stated that an analysis of the factual circumstances is not needed in all the case, as the one at issue, where the domestic legislation relates to tax treatment of dividends originated in third countries because art. 49 of the TFEU does not applied to third countries situation. It means that in such scenario the ECJ has to look only at the aim of the national legislation and if it does not apply exclusively to situations in which the parent company exercises decisive influence over the company paying the dividends the freedom granted by art. 63 must be extended to those dividends. On the other hand, if the purpose of the national legislation is only applicable to those shareholdings exercising a definite influence over a company resident in a third country neither Article 49 TFEU nor Article 63 TFEU may apply. The same way of thinking may be found in *Burda* where the ECJ stated that “*the present question must be answered solely in the light of the provisions of the Treaty on freedom of establishment*”¹²¹ because the national legislation relates exclusively to shareholders whose holding gives them definite influence.

It appears clear that the free movement of capital has not the same meaning in a third State context at it has in an intra-EU-context¹²² because “*a company resident in a Member State may*

¹²⁰ European Court of Justice, 26 June 2008, Case C-284/06, *Finanzamt Hamburg-Am Tierpark v. Burda GmbH*, paragraphs 72.

¹²¹ European Court of Justice, 26 June 2008, Case C-284/06, *Finanzamt Hamburg-Am Tierpark v. Burda GmbH*, paragraph 69

¹²² On that purpose, see TERRA, B. – WATTEL, P., *European Tax Law*, The Netherlands, 2012, page 73 who supported the opposite opinion.

therefore rely on that provision in order to call into question the legality of such rules, irrespective of the size of its shareholding in the company paying dividends established in a third country".¹²³

Indeed the ECJ in *A* case has already stated that "*the concept of restrictions on the movement of capital cannot be interpreted in the same manner with regard to relations between Member States and third countries as it is with regard to relations between Member States*".¹²⁴

It seems clear that the outcome of the *FII GLO II* judgement does not differ from ECJ's jurisprudence. In particular, the ECJ stated that the domestic legislation at issue does not require a factual circumstances analysis due to territorial limitation of the freedom of establishment. In other words, the ECJ simply affirmed that when only freedom of movement of capital applies there is any need to analyse the factual circumstances for understanding which freedoms apply because only freedom granted by art. 63 TFEU might apply. Then the ECJ confirmed its jurisprudence saying that if the domestic legislation targets only parent companies exerting definite influence over subsidiaries resident in third countries, the unfavourable treatment would not be covered by the EU Treaties. On the other hand, if the legislation does not target only the situation where the parent company has decisive influence over its subsidiaries but it concerns the tax treatment of dividends even in a portfolio situation.

Then, the ECJ stated that the risk of applying art. 63 to third countries may be concluding to an extension of the freedom of establishment to third countries. The ECJ concluded that "*such risk does not exist in a situation such as that at issue in the main proceedings*"¹²⁵ because "*the legislation of the Member State in question does not relate to the conditions for access of a company from that Member State to the market in a third country or of a company from a third*

¹²³ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 99.

¹²⁴ European Court of Justice, 18 December 2008, Case C – 101/05, *Skatteverket v. A*, paragraph 28.

¹²⁵ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 100.

country to the market in that Member State”¹²⁶ but “it concerns only the tax treatment of dividends”.¹²⁷

The referring to the market access is not very unusual¹²⁸ because in *Skatterket v. A* “The German, French and Netherlands Government argue that, unlike the liberalisation of the movement of capital between the Member States, which is intended to complete the internal market, the extension of the principle of free movement of capital to relations between Member States and third countries is linked to the completion of economic and monetary union. All those governments state that, in relations with third countries, compliance with the prohibition laid down in article 63 TFEU would lead to unilateral liberalisation on the part of the European Community without the Community securing a guarantee of equivalent liberalisation on the part of the third countries concerned and, in the relations with those countries, without measures for the harmonisation of national provisions, in particular on direct taxation”.¹²⁹ In other words, Member States were trying to convince the ECJ that one-sided liberalization would destroy the international principle known as reciprocity which has been expressly rejected by the ECJ in *Haribo*.¹³⁰ The latest case is also important because the ECJ explained possible justification of less favourable treatment of dividend paid by companies resident in third countries. In particular, at paragraph 56 the ECJ stated that “in so far as Article 65(1)(a) is a derogation from the fundamental principle of the free movement of capital, it must be interpreted strictly. It cannot therefore be interpreted as meaning that all tax legislation which draws distinction between taxpayers on the basis of their place of residence or the State in which they invest their capital is automatically compatible with the Treaty”.

¹²⁶ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 100.

¹²⁷ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 100.

¹²⁸ “Therefore, there was no trace in settled case law of the market access criterion the Court now stipulates in *FII – 2*” in WATTEL, P., *Test Claimants in the FII Group Litigation (FII-2). Equivalence of the exemption and imputation methods. Dividends from third countries. Free movement of capital. Court of Justice (comments by Wattel)*, in *Highlight Insights on European Taxation*, n. 3/2013, pages 22.

¹²⁹ European Court of Justice, 18 December 2008, Case C – 101/05, *Skatteverket v. A*, paragraph 29.

¹³⁰ European Court of Justice 10 February 2011, joined Cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08), Osterreichische Salinen AG v. Finanzamt Linz*.

However, as stated by the ECJ in FII GLO I, “*it may be that a Member State will be able to demonstrate that a restriction on capital movements to or from non-member countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States*”.¹³¹

It is clear that there is a distinction between freedom of establishment and free movement of capital and one of the justifications claimed by Member State is the protection of the economic Market.

Thus, in *Scheunemann* the ECJ applied the same principle but, on a first glance, it seems that the outcome of the case “*sharply contrasts*”¹³² with FII GLO II. However, the ECJ expressly stated that according to the national legislation at issue the possibility to receive a tax advantage “*is conditional upon having a direct holding of more than one quarter of the capital of the company*”.¹³³ It is indeed that the legislation at issue in *Scheunemann* cannot be covered by the freedom granted by article 63 TFEU due to the fact that the domestic legislations “*apply only to those shareholdings which enable the holder to exert a definite influence on a company’s decision and to determine its activities falls within the scope of Article 49 TFEU on freedom of establishment*”.¹³⁴

The two cases may be misconnected due to the fact that in both cases the test claimants had 100% holding in the capital and, indeed, “*it cannot be denied that he was able to exert a definite influence over its decisions and to determine its activities*”.¹³⁵

¹³¹ European Court of Justice, 12 December 2006, Case C – 446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, paragraph 171.

¹³² WATTEL, P., *Test Claimants in the FII Group Litigation (FII-2). Equivalence of the exemption and imputation methods. Dividends from third countries. Free movement of capital. Court of Justice (comments by Wattel)*, in *Highlight Insights on European Taxation*, n. 3/2013, pages 22.

¹³³ European Court of Justice, 19 July 2012, Case C-31/11, *Marianne Scheunemann v. Finanzamt Bremerhaven*, paragraph 25.

¹³⁴ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 91.

¹³⁵ European Court of Justice, 19 July 2012, Case C-31/11, *Marianne Scheunemann v. Finanzamt Bremerhaven*, paragraph 31.

However, the ECJ did not look at the factual circumstances¹³⁶ but, in both cases, it refers only to the aim of the legislation and it stated that the UK legislature in FII GLO II concerned “*only the tax treatment of dividends which derive from investments*”¹³⁷ while the German legislature in *Scheunemann* “*specified a shareholding threshold so high that the shareholder in the capital company is able to influence its management and control*”.¹³⁸

Concluding comments

FII GLO II concerns two main issues: treatment of dividends and third State Capital Movement. As mentioned above, UK system adopted an asymmetrical method relief: imputation method for cross-border dividends and exemption method for domestic source dividends. This legislation is not automatically incompatible with the EU Treaties but the two methods of reliefs would terminate to be equivalent whenever the effective level of taxation of domestic source dividends is lower than the nominal tax rate and whenever the effective level of taxation of the company residents in other member State is lower than the nominal tax rate. Indeed, the less favourable treatment suffered by foreign sourced dividends concern the impossibility of the parent company residents in UK to join the lower taxation granted to its subsidiaries.

The ECJ “suggested” that the UK should have granted a tax credit up to its nominal tax rate and this suggestion is justified because under the exemption method the UK legislation grants a credit up to the nominal tax rate irrespectively of the level of taxation incurred by the company paying the dividends. In other words, having an imputation system which calculates the tax credit taking in account the effective level of taxation incurred in the other State is contrary to the EU law if the effective level of taxation is lower than the nominal rate applicable in the parent company’s

¹³⁶ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 96.

¹³⁷ European Court of Justice, 13 November 2012, Case C – 35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paragraph 100.

¹³⁸ European Court of Justice, 19 July 2012, Case C-31/11, *Marianne Scheunemann v. Finanzamt Bremerhaven*, paragraph 29.

State due to the fact that the dividend would suffer another burden of taxation up to the nominal tax rate applicable in the parent company's State of residence.

It seems that the ECJ did not change its mind in relation to the case but it only clarifies when imputation method and exemption method are not equal and, also, it went forward underlying that in some circumstances the less favourable treatment is not covered by the EU law. It referred to the situation where two Member States in exercising their tax sovereignty adopt different nominal tax rate which may conclude to a less favourable treatment due to the fact that the parent company's state of residence is obliged to grant a tax credit up to its nominal tax rate and it is not obliged to give a credit for any extra amount paid by the subsidiary in its country.

The ECJ stated that this system would ensure the cohesion of the tax system while being less prejudicial to freedom of establishment and the free movement of capital.

The second main issue concerns the third state capital movement. It was not properly analysed by the ECJ in the first judgement and it was asked by the High Court to rule on the applicability of article 63 TFEUE to dividends received from a subsidiary resident in a third country over which the parent company exercises decisive influence.

The ECJ explained and summarised the previous settled cases law and it has reached the conclusion that:

- a. If the domestic legislation at issue targets the shareholding granting a definite influence over the company paying the dividend freedom of establishment would apply; conversely
- b. If the domestic legislation at issue targets only portfolio shareholding free movement of capital would apply;

c. If the legislation at issue targets both the mentioned situations which freedom applies has to be determined by analysing the aim of the domestic legislation or (as subsequent) by analysing the circumstances of the case;

d. If the legislation at issue concerns third countries dividends only free movement of capital may apply and:

i. if the domestic legislation applies only to definite influence shareholdings the less favourable treatment would not be covered by EU law;

ii. if the domestic legislation does not apply exclusively to situation of decisive influence the free movement of capital would apply.

Again, the outcome of the ECJ did not go far away for its previous cases.

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