Taxing decisions

JON BOYLE AND PHILIP GILLETT LOOK AT RECENT HIGH-PROFILE TAX LAW CASES AND DRAW OUT THE LESSONS FOR TREASURERS LOOKING TO MAXIMISE TAX EFFICIENCY.

The objectives of organisation structure will generally be to maintain adequate amounts of capital, with appropriate buffers to finance growth and unforeseen events. To maximise flexibility and tax efficiency, most companies will aim, legitimately, to locate or accumulate surpluses in lower tax jurisdictions so they can then be readily deployed to meet emerging group requirements. To be competitive in today's international markets it is generally essential that such policies are followed. At the same time advice must be obtained which will, as far as possible, provide clarity and certainty of prospective tax treatment and availability of capital before decisions are taken.

Even within Europe, taxation rates differ substantially (see *Table 1*). The relatively low corporation rates applying in Ireland, for example, have encouraged numerous corporations to locate activities there in recent years, and the relatively favourable rates in Luxembourg and Holland have also proved attractive. The 29.9% corporation tax rate shown for Luxembourg in the table includes an effective municipal tax rate of just 6.75% applying to companies operating in the City of Luxembourg.

Executive summary

- Most companies seek legitimately to minimise their tax.
- Developments affecting EU and national tax law, including the Cadbury Schweppes case, the FII case and the Varney review, should be considered carefully by organisations reviewing their treasury, capital and organisation structures.

THE BACKGROUND EU tax developments and European Court of Justice (ECJ) judgements have followed the principle that as long as tax is not harmonised, domestic member state laws will be ineffective wherever they contravene the fundamental rights of the Treaty of Rome, the EU's founding treaty – that is, free movement of workers, freedom of establishment, freedom to provide services, and free movement of capital throughout the EU.

While corporate tax law is not harmonised, many tax cases have been considered by the ECJ where companies claim that their local tax law contravenes the EU treaty, often claiming that domestic law discriminates in favour of domestic companies compared with other EU companies. Recent months have seen the ECJ judgements in the Cadbury Schweppes case and the FII case, both of which have been referred to as landmark cases.

Early ECJ judgements in tax cases followed a relatively consistent pattern that is well illustrated by the 1998 case of ICI vs Colmer, a case on UK direct taxation. The judgement was best summed up by the counsel for the EU Commission, who stood up briefly at the oral hearing and asked three rhetorical questions:

- Is there any discrimination between taxpayers based on residence? To which he replied: "Of course there is.";
- Is there any justification for the discrimination? To which he replied: "Of course not."; and
- Does community law apply in these circumstances? To which he replied, in this case: "We think not."

The UK government's response to this judgement was to widen the definition of groups for tax purposes. However, later, in the Langhorst-Hohorst case, relating to German thin capitalisation rules, which then only applied to international situations, it was decided that community law applied in such a way that it was not permissible to have rules that applied internationally but not domestically. As a consequence of this, the UK introduced domestic transfer pricing rules to protect its own international transfer pricing rules, illustrating that the impact of an ECJ ruling can be an increase in domestic restrictions just as easily as a reduction in international restrictions.

There then followed a period of reasonable clarity and predictability about ECJ cases, almost all of which were decided in favour of the taxpayer, but recently this seems to have changed in favour of what might be seen as an element of pragmatism in relation to mitigating the financial impact on the country concerned – especially if this

would be very large (as in the case of the Italian 'IRAP' case). It is also important to understand that the ECJ can only strike down domestic legislation. It cannot create legislation. Replacement legislation can only be created by the member states.

Two recent cases are of significant potential interest to treasurers.

THE CADBURY SCHWEPPES CASE The September 2006 judgement on the Cadbury Schweppes case held that the UK's controlled foreign company (CFC) rules did not automatically breach the EU treaties, but could only be applied to attack "wholly artificial arrangements" that did not reflect economic reality. Companies conducting genuine economic activities within the EU and the European Economic Area (the EU plus Iceland, Liechtenstein and Norway) should not therefore be affected by the UK rules.

However, the UK Pre-Budget report in December introduced legislation such that, following the Cadbury Schweppes ruling, companies hoping to establish operations in low-tax jurisdictions can only claim exemption from the UK's CFC rules on profits specifically attributable to the activities of the individuals employed in such operations, and not profits attributable to any capital employed. This approach presents some interesting practical challenges but may just be a holding measure until a new CFC system can be devised.

THE FII CASE In December 2006 the judgement on the FII case ruled that:

- For shareholdings of more than 10%, a credit system existed, and therefore the existing UK system of taxing foreign sourced dividends did not contravene EU law on freedom of establishment providing there was a sufficiently favourable tax rate and credit system to mitigate double taxation. The ECJ left it to the UK courts to decide whether that was the case.

- Where holdings are less than 10%, the differential treatment of UK and foreign dividends was discriminatory.

Neither case has, as yet, produced a definitive response from the UK government. This leaves the question open of how the UK CFC regime will change as a result of the Cadbury Schweppes case, and what tests will be applied to determine whether an arrangement is wholly artificial. The current response looks like a holding measure pending more consultation with business on the future regime.

It also leaves open the question of whether there will be any changes to the way foreign dividends from EU companies, where less than 10% ownership is held, are taxed. The expectation is that we will move to an exemption regime for all foreign dividends, but if we do will there be a change to restrict the deductibility of interest, which is often seen as the natural corollary of an exemption regime? We are now promised a consultative document on these issues this Spring.

VARNEY REVIEW Finally there has been concern since the formation of HMRC that has variously been characterised as:

- a "growing atmosphere of mistrust as a result of a heavy focus on avoidance";
- a "new intensity of complaints about the British tax system"; and
- "increasing reviews in some cases resulting in companies contemplating migration of residence to other EU countries".

The response to this has been the Varney Review, which was published in November. It has been hailed by business as a genuine attempt to put its relationships with the UK tax authorities on a new footing, promising "a new approach to enquiries that will resolve contentious issues efficiently and quickly". Only time will tell.

Jon Boyle is Executive Director of Treasury and Head of Irish Office and of Institutional Cash Funds at Fidelity International.
jon.boyle@uk.fid-intl.com
www.fidelity.co.uk

Philip Gillett is Group VP for Tax and Treasury at ICI.
philip_gillett@ici.com
www.ici.com/home
Jon Boyle and Philip Gillett will be discussing international tax efficiency at The Treasurers' Conference 2-4 May 2007. More information at www.treasurersconference.com.

TABLE 1. Tax rates applying in some of the major European jurisdictions

	Germany	France	UK	Luxembourg	Netherlands	Ireland
Corporation tax	38.9%	35%	30%*	29.9%	25.5%	12.5%
VAT	19%	19.6%	17.5%	15%	15%	21%

* reducing to 28% in April 2008