Three years after the ECJ’s decision in *The Test Claimants in the FII Group Litigation v HMRC*, the Court of Appeal has concluded that the key issue on the compatibility with the EC Treaty of the UK’s corporation tax treatment of domestic and foreign dividends until 1 July 2009 should be referred back to the ECJ for clarification. It has also taken a restrictive view of the ability of UK taxpayers to make claims for the repayment of tax suffered more than six years before the claim, countering the effect of earlier judgments. The uncertainty for taxpayers continues.

**Background**

The *FII Group Litigation* concerns the compatibility of certain historic aspects of the UK corporation tax treatment of domestic and foreign dividends with Article 43 (freedom of establishment) and Article 56 (free movement of capital) of the EC Treaty (now Articles 49 and 63 of the EU Treaty). In particular, the claimants challenged the rules in force in the UK until 1 July 2009 under which dividends paid by UK resident companies were exempt from tax, whilst dividends paid by non-resident companies were subject to corporation tax with credit given for any foreign taxes withheld from the payment and, subject to a 10 per cent holding requirement, for underlying tax on the profits out of which the dividends were paid.

In 2006, in a judgment that raised more questions than it gave answers, the ECJ concluded that Member States are not prevented from applying an exemption system to domestic dividends and an imputation system to foreign dividends provided, broadly, that the foreign dividends are not subjected to a higher rate of tax under that regime. In 2008, Mr Justice Henderson in the High Court took this to mean that the UK regime was contrary to EU law.

**Compatibility of UK rules with EU Law**

In a lengthy decision published this week, a 2:1 majority of the Court of Appeal rejected that interpretation of the ECJ’s decision, taking the view that the UK regime was compliant with EU law. However, given the significance of the decision and the failure of the ECJ to express itself clearly on the issue to

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date, the Court was unanimous in concluding that a further reference to the ECJ is required in order to obtain clarity.

The Court was clear that the issue is of significance only for dividends paid by EU/EEA resident companies: dividends paid from companies in other jurisdictions do not even fall within the ambit of the relevant EU rules.

The judgment considers a number of other aspects of the historic UK ACT and FIDs regimes, again concluding that further questions need to be asked of the ECJ in order to resolve the more difficult issues.

Conforming UK law to EU law

This case was a further example of the Court being asked to explore the extent to which it could conform domestic legislation in compliance with EU law. The Claimants argued that the Court was required to strike out the offending aspect of the domestic legislation - namely limiting tax credits to UK dividends. The Court rejected the Claimants’ argument on the grounds that such a construction went too far. Following its decision in Vodafone 2, the Court considered it was able, and indeed compelled, simply to read in words that extended the grant of credits to persons entitled to them by virtue of EU law.

This demonstrates the increasing willingness of the Courts to write into domestic legislation a shorthand fix that narrowly excludes or expands the scope of legislation to address particular EU law rights. The danger is that such a fix becomes a crutch and limits the incentive for Parliament to ensure that it enacts only EU compliant legislation from the start. The taxpayer, meanwhile, is required to pursue a costly challenge merely to clarify what the domestic legislation should always have said. Even once an infringement is found, a taxpayer must rely on remedies that are, on the basis of this judgment, increasingly limited.

Remedies for breach of EU law

Taxpayers have three potential remedies for a breach of EU law: a damages claim, a restitution claim for tax unlawfully demanded (a Woolwich claim) or a restitution claim for tax paid under a mistake of law.

To mount a successful damages claim a taxpayer has to be able to show a sufficiently serious breach of EU law i.e. a manifest and grave disregard. This is a high hurdle and one that was not cleared in the FII case.

The difference between Woolwich claims and mistake claims essentially lies in limitation periods. For Woolwich claims, the limitation period is 6 years from the date the tax was paid. For mistake claims, the 6 year period is extended and runs from date of discovery of the mistake (which could, for example, be as late as the date of a favourable ECJ judgment in relation to the issue), although in 2004 and 2007 legislation was passed to remove this extended period for claims in respect of tax matters. No transitional period was provided when this change was made and taxpayers have been arguing in EU cases that the absence of a transitional period means that the 2004 and
2007 changes are ineffective (technically, that they do not comply with the EU principle of effectiveness set out in the ECJ’s judgment in the *San Giorgio* case).

Taxpayers prefer mistake based claims because of the potential extended limitation period and because *Woolwich* claims have been understood to apply only where a demand for payment of tax was made, not relevant to self-assessed taxes.

The Court of Appeal held that domestic *Woolwich* claims could in fact be made in the absence of an unlawful demand and so provided an effective remedy for claims based on a breach of EU law. Accordingly, there was an effective remedy even without the ability to make mistake based claims, so an EU based challenge to the 2004 and 2007 legislation was misconceived.

It is implicit that the Court felt that the 6 year limitation period applicable to *Woolwich* claims did not jeopardise their status as an effective remedy. This will be very relevant to EU cases in other areas and is likely to be tested in future litigation.

The Court held that, even if on the further reference the ECJ confirmed that the UK’s rules did contravene EU law, a taxpayer’s right to recovery would be limited to tax paid directly on the foreign dividends; claims based on other losses suffered, for example by the use of group relief, would not be successful.

**What next?**

It remains to be seen whether there will be an appeal of this judgment direct to the Supreme Court or whether both parties will be content with a further reference to the ECJ on the substantive issues. In the meantime the uncertainty rumbles on.
This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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