DOUBLE TAXATION - Relief - EC "Parent-Subsidiary" Directive - Dividends paid by UK corporation to Netherlands parent corporation - Tax credit abated by 5% of the aggregate of dividend and tax credit by operation of Double Taxation Treaty - EC Directive requires profits distributed to parent company by subsidiary to be exempt from withholding tax - Whether exemption extends to 5% abatement - Whether the 5% is a withholding tax on distributed profits - Whether UK's right to abate payment to parent corporation by 5% preserved by Directive - Whether Directive invalid because of lack of explanation and consultation - UK-Netherlands Double Taxation Convention art 10(3)(a)(ii) and (c) - Council Directive 90/435 EEC arts 5.1 and 7.2 - Questions referred to ECJ

THE SPECIAL COMMISSIONERS SpC 00231

OCÉ VAN DER GRINTEN NV Appellant

- and -

COMMISSIONERS OF INLAND REVENUE Respondents

Special Commissioner: STEPHEN OLIVER QC

Sitting in public in London on 24 and 25 January 2000

Graham Aaronson QC and Mark Barnes QC, instructed by KPMG, accountants, for the Appellant

Rabinder Singh, counsel, instructed by the Solicitor of Inland Revenue, for the Respondents

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INTERIM DECISION

1. Océ Van Der Grinten ("Océ NV") appeals against the refusal by the Board of Inland Revenue in a letter dated 26 April 1995 of Océ NV's claim for payment of an amount which Océ NV say should have been paid as tax credit under article 10.3(c) of the UK-Netherlands Double Taxation Convention, (1981) Cmnd 8268, ("the Treaty"). The point at issue is whether, as Océ NV argue, the Inland Revenue's claim to restrict their repayment

of the tax credit due to Océ NV, by 5% of the aggregate of the amount of two dividends received from its UK subsidiary, Océ UK Ltd ("Océ UK") and the amount of the tax credits on those dividends, violates their enforceable Community rights.

2. The Inland Revenue say that their refusal is based on the proper application of article 10.3(a)(ii) and (c) of the Treaty. Océ NV relies on article 5.1 of Council Directive 435 of 1990 ("the Directive"). That article, they say, has the effect of exempting them from the 5% restriction on the grounds that the restriction ranks as a "withholding tax" in article 5.1; and article 5.1 is not, they argue, disapplied by article 7.2. The Directive which is expressed to be "on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States contains a Recital in the following words-

"Whereas it is furthermore necessary, in order to ensure fiscal neutrality, that the profits which a subsidiary distributes to its parent company be exempt from withholding tax; ..."

Article 1 provides that "each Member State shall apply this Directive: ... - to distributions of profits by companies of that State to companies of other Member States of which they are subsidiaries."

Article 5 provides -

"1. Profits which a subsidiary distributes to its parent company shall, at least where the latter holds a minimum of 25% of the capital of the subsidiary, be exempt from withholding tax.

2.-4. ..."

Article 6 provides -

"The Member State of a parent company may not charge withholding tax on the profits which such a company receives from the subsidiary."

Article 7 provides -

"1. The term "withholding tax" as used in this Directive shall not cover an advance payment or pre-payment (précompte) of corporation tax to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company.

2. This Directive shall not affect the application of domestic or agreement-based provisions designed to eliminate or lessen economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipients of dividends."

3. The tax system in force at the time relevant to the present claims required companies resident in the United Kingdom paying dividends to their shareholders (wherever resident) to make a payment to the Inland Revenue, calculated by reference to the amount of the dividends, by way of advance corporation tax (ACT); see Income and Corporation Taxes Act 1988 section 14. The amount of such payment could subsequently be set off against the paying company’s general liability for corporation tax: section 239. The system is now

changed but those changes do not affect the present claims and the law as stated is that in force at the time relevant to the present claims: section 31 of Finance Act 1998 abolished ACT with effect from 1 April 1999. The corollary of that system was for a tax credit (representing part of the tax payable by the company) to be given to a United Kingdom resident shareholder: section 231(1) and (3). That shareholder would be taxed on the basis that he had received distributions of an amount equal to the value of the distribution plus the value of the tax credit: section 20. A similar credit was also given to a United Kingdom resident corporate shareholder to offset against its own liability for ACT on distributions that it might make: sections 231(1), 238(1) and 241(1). But neither of those benefits was available to a non-resident shareholder such as Océ NV under domestic law.

4. A number of Double Taxation Agreements between the United Kingdom and other countries provide for a measure of relief. Article 10 of the present Treaty provides that where a United Kingdom resident company has paid a dividend to a corporate shareholder resident in the Netherlands holding 10% or more of the shares in the paying company, that shareholder is to be "entitled to a tax credit equal to one-half of the tax credit to which an individual resident in the United Kingdom would have been entitled" (article 10.3(c)); article 10.3(a)(ii) directs, however, that -

> "... tax may also be charged in the United Kingdom and according to the laws of the United Kingdom on the aggregate of the amount or value of that dividend and the amount of that tax credit at a rate not exceeding 5%".

5. Article 10 of the Treaty is made part of the United Kingdom tax code without further action by section 788(3) which provides that such treaty arrangements "shall have effect in relation to income tax and corporation tax insofar as they provide ... for conferring on persons not resident in the United Kingdom the right to a tax credit under section 231 in respect of qualifying distributions made to them by companies which are so resident." The effect of the arrangements embodied in article 10 of the Treaty is that where a United Kingdom resident subsidiary pays a dividend to a Netherlands resident parent company the subsidiary pays ACT in the ordinary way and offsets it against its mainstream corporation tax liability; but under article 10 the parent is entitled, as a matter of UK tax law, to a tax credit of the amounts specified in paragraph 3.

6. In the present case the procedure provided for in the DTR (Taxes on Income) (General) (Dividend) Regulations 1973 (SI 1973 No.317) ("the General Regulations") has been adopted. Instead of Océ NV receiving the dividend and then claiming the tax credit from the Inland Revenue (i.e. half the tax credit to which a United Kingdom resident individual would have been entitled less 5% of the aggregate of the amount of the dividend and the amount of the tax credit), the General Regulations allow Océ UK to pay over to Océ NV the dividend plus the tax credit less the 5%. Océ UK is then able to set the amounts so paid against its own mainstream corporation tax liability. This was authorised by letter from the Inspector of Foreign Dividends of 24 November 1989 to Océ UK.

7. On 30 November 1992 and on 5 April 1993, Océ UK paid dividends to Océ NV, adding (under the terms of these arrangements) an amount representing the tax credit less the 5% deduction. The sums paid and deducted were as follows (£):

Date	(a) Dividend	(b)Tax credit	(c)5% of (a+b)	Net amount paid in addition to

				dividend: (b-c)
30 Nov 92	9,664,941.60	1,610,823.60	563,788.26	1,047,035.34
5 Apr 93	3,380,688.00	563,448.00	197,206.80	366,241.20
Totals	13,045,629.60	2,174,271.60	760,995.11	1,413,276.54

8. Océ NV appealed against the imposition of the 5% deduction claiming repayment of the sums deducted. Océ NV’s case is based on what they say is the proper application of the Directive.

9. The first issue is whether the 5% referred to in article 10.3(a)(ii) is a "withholding tax" on "profits that a subsidiary distributes to its parent". If it is, the second issue is whether the United Kingdom Inland Revenue’s right to require the deduction is nonetheless preserved by article 7.2 of the Directive. This only arises if the deduction is a withholding tax on profits that a subsidiary distributes in the first place. The third issue, which assumes that article 7.2 preserves the 5% from the effect of article 5.1, is whether article 7.2 is valid.

Issue 1 : is the 5% a withholding tax on the profits that Océ UK distributed to Océ NV?

10. Océ NV contend that the 5%, being a tax deducted at source, is a withholding tax on the distributed profits. It is a tax charged under the Schedule F charging provisions of section 20, i.e. a tax "chargeable … in respect of all dividends and other distributions … of a company registered in the United Kingdom"; by reason of article 10.3(a)(ii) the 5% is a "tax … charged … on the aggregate of the amount or value of that dividend and the amount of the tax credit".

11. The Inland Revenue contend that the 5% is not a withholding tax on "profits which a subsidiary company distributed to its parent company". The amount of the distribution may affect the calculation of the 5% under article 10(3)(a)(ii) but that amount is not affected by the charge. This is because a tax credit granted to a parent company is neither part of the profits of the subsidiary company nor is it distributed by a subsidiary company. The 5% is deducted from the credit payable to the parent. The subsidiary is not in any event chargeable to United Kingdom tax on the distribution and the amount of the dividend is not reduced or affected by the 5% reduction.

12. The operation of article 5.1 depends on three related issues. The first, a matter of United Kingdom law, is whether the 5% is a tax. The second, also a matter of United Kingdom law, is whether the 5% ranks as a tax on profits which a subsidiary such as Océ UK distributes to its Netherlands parent (such as Océ NV). The third, which arises if it is a tax on such profits, is essentially a matter of Community law and is whether the 5% is a withholding tax.

13. In the absence of article 10 the dividends of Océ UK would be charged to income tax in the hands of its non-resident parent. Dividends of a United Kingdom resident company

are charged to tax under Schedule F: see Rule 1 of the Schedule F in section 20(1). This provides :

"1. ... income tax under this Schedule shall be chargeable for any year of assessment in respect of all dividends and other distributions in that year of a company resident in the United Kingdom which are not specially excluded from income tax, and for the purposes of income tax such distributions shall be regarded as income however they fall to be dealt with in the hands of the recipient.

2. ... for the purposes of this Schedule and all other purposes of the Tax Acts any such distribution in respect of which a person is entitled to a tax credit shall be treated as representing income equal to the aggregate of the amount or value of that distribution and the amount of that credit, and income tax under this Schedule shall accordingly be charged on that aggregate."

Océ NV, because it is a non-resident company would, as I have already observed, have no entitlement to a tax credit under section 231. And because the dividends from Océ UK are distributions in respect of which it is not entitled to a tax credit, section 233(1(a) provides that no assessment to income tax at the basic rate may be made on these dividends. Given that the dividends are taxable income of Océ NV and so are chargeable to Netherlands tax in its hands (which I assume to be the case) there is still no double taxation of such dividends; this is simply because they are not charged to income tax in the UK.

14. Article 10.3(a)(ii) and 3(c) operate to give Netherlands corporation receiving the dividend from the United Kingdom corporation an entitlement to part of the tax credit, i.e. one half, while at the same time reducing the tax that would otherwise have been charged by virtue of section 20(1). (The charge under section 20(1) comes into play because section 233(1)(a) is disapplied on account of the entitlement to the tax credit.) That tax charge, being chargeable on all dividends and other distributions, will be imposed by operation of rules 1 and 2 of Schedule F. The terms of article 10.3 of the Treaty reflect this. Article 10.3 gives tax credits in the specific situations covered by subparagraphs (b) and(c) and contains the directions to pay them to the Netherlands resident shareholder. The words directing payment ("... shall ... be entitled ... to the payment of any excess of that tax credit over its liability to tax in the United Kingdom": see paragraph 3(c)) in terms recognize the liability of the recipient to tax. This must be referring to the recipient’s liability under Schedule F chargeable "according to the laws of the United Kingdom" (see paragraph 3(a)(ii)). The parties to the Treaty could have agreed that where the tax credit exceeded the recipient’s liability to tax the tax credit should be abated. But they did not; they specifically adopted a form of words in paragraph 3 that covered the three requisite aspects of relief, i.e. a reduced liability to tax under Schedule F, a reduced tax credit and payment of the excess to the Netherlands shareholder.

15. For those reasons I am satisfied that the 5% referred to article 10.3(a)(ii) is a tax. The decision of the Court of Appeal in Union Texas v Critchley [1990] STC 305 reinforces this conclusion. That decision was based on the somewhat different wording of the Double Taxation Convention with the United States. The relevant provision of that Convention provide for a tax credit "subject to the deduction withheld from such payment and according to the laws of the United Kingdom for an amount not exceeding 5% ... ." That wording would lend itself more strongly to the contention of the Inland Revenue in this case to the effect that there is no tax charged but simply an abated entitlement to a tax credit. Nonetheless the Court of Appeal regarded those words as imposing a charge to tax.

(I refer to page 311b-c, 311f-g and 313a-b).

16. Is the 5% tax a tax "on profits that a subsidiary distributes to its parent" : see the words of article 5.1 of the Directive? At the outset I agree as a matter of principle

with the argument for the Inland Revenue that, as a matter of both law and economic reality, the obligation on the subsidiary, such as Océ UK, to pay ACT in no way reduces its ability to declare a dividend of the whole of its distributable profits and pay them to its parent, such as Océ NV. Profits in article 5.1 of the Directive are, and here again I agree with the Inland Revenue, profits after corporation tax, being both ACT and mainstream corporation tax. Nonetheless the opening words of article 5.1 are, I think, capable of covering dividends such as those paid by Océ UK to Océ NV. Once it is recognized that the 5% is a tax, the answer follows from the United Kingdom domestic law which states in Rules 1 and 2 of Schedule F in section 20 that tax is to be "chargeable ... in respect of all dividends and other distributions ... of a company resident in the United Kingdom." This follows, in my view, despite the fact that the 5% might also be loosely described as a tax on the tax credit. The subsidiary's "profits" do not lose their character when distributed as dividends; the dividends are "profits that (the subsidiary) distributes to its parent".

17. Is the 5% tax a withholding tax? The term "withholding tax" appears to have different meanings in different countries and different languages. Withholding tax is not a term of art in the United Kingdom tax law. It appears in a number of statutes or statutory instruments (see e.g. Income and Corporation Taxes Act 1988 Schedule 23A paragraph 4(2)(a) and the Income Tax (Paying and Collecting Agents) Regulations 1996 Reg.8B (introduced by amendments in the 1997 Regulations)). It usually means the tax which is deducted at source by the payer of income and accounted for to the Inland Revenue in some means or other. No tax is, I recognize, deducted from the dividend itself. And yet the provisions for payment of the tax credit (in article 10.3(c)) require that the 5% be deducted or withheld either by the Inland Revenue on a claim or by the paying company under the General Regulations referred to above. Where an item of income is paid by a resident of one Member State to a recipient in another Member State, the term withholding tax is quite capable of referring to the tax on that income borne in the Member States of the payer. There is nothing in the Directive that appears to distinguish between those two situations. Moreover article 6 of the Directive contemplates that the expression "withholding tax" covers the tax imposed on the recipient by its own Member State.

18. The scope of the expression "withholding tax" is too vague to enable me to decide with the requisite level of confidence whether the 5% tax is within the expression "withholding tax" in the context of article 5.1. That question should, I think, be referred to the European Court of Justice under article 234 EC.

The second issue : given that the 5% tax is a withholding tax within article 5.1, is its imposition permitted by article 7.2?

19. The argument for Océ NV is that article 7.2 does not preserve the United Kingdom's right to impose the 5% tax. The provisions of the Treaty which authorise the imposition of the 5% tax on the aggregate of the dividend and the tax credit do not "eliminate or lessen economic double taxation of dividends". Instead, it is argued for Océ NV, they are calculated to impose or increase it. Moreover, its argued, article 7.2 does not simply refer to provisions relating to the payment of tax credit. It gives them as examples of provisions that are generally "designed to eliminate or lessen economic double taxation of dividends". The provisions relating to the payment of tax credit would only be "unaffected" insofar as they fall within the general description. In article 10.3(c) of the Treaty, however, the entitlement to a half tax credit is the precondition to the charge to tax.

20. The argument for the Inland Revenue is that the provisions of article 10(3)(a)(ii) of the Treaty fall fairly within article 7.2 of the Directive. They are, so the argument runs, provisions "relating to" the payment of tax credits; and they are "agreement-based" provisions and they are designed to eliminate or lessen double taxation of dividends.

21. The first issue raised by article 7.2 of the Directive is whether the relevant provisions of article 10.3 of the Treaty really "eliminate or reduce economic double taxation of dividends." Had there been no Treaty there would, as I observed in paragraph 13 above, have been no double taxation of the Océ UK dividends. This is because section 233(1)(a) excludes the dividends from charge to income tax. The Treaty has the effect of disapplying section 233(1)(a) because it gives the Netherlands recipient of the dividends (Océ NV) a partial tax credit; it leaves the UK revenue with the 5% tax charge on the aggregate of the amounts of the dividend and the tax credit and it compensates the recipient of the dividend (Océ NV) by entitling it to payment of the balance. This feature raises a real doubt as to the operation of article 7.2 in the present circumstances.

22. The second feature of article 7.2 is that tax credit and the payment of tax credits, are, at least so far as the United Kingdom tax law is concerned, an essential feature of the system of tax on dividends; they are not designed to eliminate or lessen double taxation of dividends, nor are they examples of provisions that do so. The construction of article 7.2 as advanced by the Inland Revenue would mean that it provides an exception to the exemption from withholding tax laid down by article 5.1 of the Directive wherever the charge to such tax is associated with payment of a tax credit. There is, in my view, a real doubt whether article 7.2 can be read as providing that result.

23. In this connection it is significant that nothing in the Recitals to the Directive give any indication of an intention to produce such an exception. The absence of any guidelines as to the purpose and extent of the exception makes it difficult to ascribe with confidence a purposive construction to article 7.2. All in all, therefore, I think there is sufficient doubt about the construction and application of article 7.2 to refer the matter as a separate question to the European Court of Justice.

Issue 3 : Is article 7.2 valid?

24. In view of my expressed doubts as to whether article 7.2 of the Directive, assuming it is valid, has the effect of preserving the United Kingdom’s right to maintain the 5% tax, the validity or otherwise of article 7.2 may become a determinative issue. The decision in Case 314/85 Foto-frost, [1987] ECR 4177, decides that once a question of validity has been identified as critical to a decision, a national court must refer that question to the European Court of Justice, unless it can confidently rule the measure to be valid. As will appear, I do not feel the requisite degree of confidence to decide whether article 7.2 is valid and I have therefore decided to refer the matter. For that reason I shall fully summarize the opposing arguments.

25. Océ NV’s argument starts by addressing what it sees as a lack of reasons. They point out that article 90 of the EC Treaty (now article 253 EC) provides the Directives (and other measures) shall state the reasons on which they are based. This, it is said, is one of the "essential procedural requirements" of the Treaty. It is designed to allow those affected to understand the reasons for it, and the court to carry out its function of legal review. Reference is made to case C-41/93 French Republic v Commission of the European Communities, [1994] ECR 1-1829, paragraph 34.

26. Océ NV go on to refer to the final recital of the Directive (set out at the start of this decision). This refers to the need to ensure a fiscal neutrality such that the profits which a subsidiary distributes to its parent should be exempt from withholding tax. Any exception from that, it is argued, would seem to require some explanation and no reason at all is

given for either or both of the exceptions introduced by article 7.2. That, it was said, must be fatal to such exception. In this connection it was observed that the Advocate General in case C-408/95 Eurotunnel v SeaFrance, [1995] ECR 1-6315, at 6360 had expressed the view that reasons should be stated even though the provision in question was being introduced by amendment.

27. The response for the Inland Revenue was that the requirement to give reasons for the relevant provisions of the Directive imposed by article 190 had been complied with. The Advocate General’s advice in the Eurotunnel appeal was not of itself authority for the proposition that an amendment made by the Counsel to a draft directive as it was being considered required for the reasons to be set out.

28. The other attack on the validity of article 7.2 was based on the lack of consultation with the European Commission, the Economic and Social Committee (ESC) and Parliament. It was pointed out that the Directive was based on article 100 of the EC Treaty (now article 94 EC). That article enables the Council to act unanimously upon a proposal from the Commission, after consultation with the Parliament and the ESC.. Article 190 of the EC Treaty (now article 253 EC), which has already been referred to above in connection with the requirement reasons, also requires directives and other measures to refer to any proposals or opinions that are required to be obtained pursuant to the Treaty.

29. Océ NV then observed that the Directive refers to the original proposal from the Commission (OJ 1969 C 39/7-2/2) and an amendment transmitted on 5 July 1985. The amendment, it was pointed out, does not relate to article 7. In the event, the proposal that went to the ESC and the Parliament was the original one, which did not include anything equivalent to the present article 7. Instead, it included some provisions concerned with the consolidation of profits. These were omitted on the recommendation of the ESC (OJ 1969 C 100.7) and Parliament (OJ 1970 C 51/6), but neither body made any recommendation relating to the current article 7. Océ NV stressed that the requirement to consult the Parliament is particularly important. Due consultation with the Parliament is "an essential factor in the institutional balance laid down by the Treaty", reflecting the fundamental democratic principle: see Eurotunnel paragraph 45. This, it was said for Océ NV, does not mean that the Council has to send a proposal back to the Parliament whenever it makes an amendment - but it does have to do so when the amendments departs substantially ("differs in essence") from the text on which Parliament has been consulted: see Eurotunnel at paragraph 46. Océ NV went on to point out that the Court has applied its principle to set aside Council regulations that significantly watered down the degree of liberalisation that had been proposed in the draft considered by the Parliament (e.g. in Case C-388/92 European Parliament v Council of the European Union [1994] ECR page 1-2067 and Case C-21/94 European Parliament v Council of the European Union [1995] ECR page 1-1827).

30. On the basis of those authorities it was submitted for Océ NV that a provision that allows the United Kingdom and France (and any other country adopting a similar system) to charge withholding tax on cross-border distributions, provided there was a tax credit, would be a substantial change. It would allow the maintenance in those countries of fiscal arrangements that put cross-border groups at a significant disadvantage. The whole purpose of the Directive was to eliminate such disadvantages (see Recitals 5 and 7) and to create conditions within the Community analogous to those of an internal market. This exception would leave the United Kingdom and France out of that internal market. It would, argued Océ NV, create, and will certainly perpetuate, some of the distortions that the Directive was supposed to eliminate.

31. The submission for the Inland Revenue was that the effect of the introduction of article 7.2 was not to change the "essence" of the draft Directive. On that basis there had been no obligation on the Council to consult the ESC and Parliament again.

32. In the light of the considerations summarized above it would not, in my view, be proper for me to decide the point one way or the other. I cannot with confidence decide on the validity of article 7.2.

Conclusions

33. For the reasons given above I conclude that the 5% charge allowed by article 10.3(a)(ii) of the Treaty is, as a matter of United Kingdom law, a tax on the profits distributed to the Netherlands parent.

34. I shall refer to the European Court of Justice the following questions:

(a) Whether such a charge is a "withholding tax" within article 5.1 of the Directive and if so

(b) whether it is saved by article 7.2, and if so,

(c) whether article 7.2 is invalid for want of reasoning or for failure to consult the ESC and Parliament with the result that it does not have the effect of preserving the right of the United Kingdom to charge the 5% tax.

35. In view of the need for a reference to the European Court of Justice before a final decision can be reached, I am releasing my reasoning in the form of an Interim Decision.

36. The parties have 28 days from the release of this Interim Decision to notify the Clerk to the Special Commissioners whether they wish to make submissions on the form of the reference and, if so, whether a further hearing is necessary.

STEPHEN OLIVER QC

SPECIAL COMMISSIONER

SC 3080/99