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Applying CJEU Case Law in Tax Treaties with the UK: The Indirect Effect of the EU/UK Trade Agreement

Dennis Weber (Editor) (Amsterdam Centre for Tax Law (ACTL) of the University of Amsterdam; Loyens & Loeff) and Jorn Steenbergen (Loyens & Loeff) · Thursday, June 3rd, 2021

The Trade Agreement between the EU and the UK rules out any direct effect. However, the Trade Agreement could have an indirect effect. EU Member States should interpret the capital ownership provisions in their bilateral tax treaties with the UK in line with the Trade Agreement and its provision on national treatment. On the basis of this indirect effect of the Trade Agreement, the expanded scope of group regimes for intra-EU situations on the basis of CJEU case law, would also apply in relation to UK situations.

Introduction

On January 1, 2021, the United Kingdom (**UK**) left the European Union. On December 24, 2020, the EU and the UK entered into a Trade and Cooperation Agreement (**TCA**).[1] One of the goals of the TCA is to create a level playing field for open and fair competition.[2]

The TCA contains multiple provisions that are relevant for both direct and indirect taxes. One of the most interesting provisions from a direct tax side is Article 129 TCA, which contains a national treatment clause. As explained later, this provision appears to offer starting points for applying certain freedom of establishment case law of the Court of Justice of the European Union (CJEU) in relation to the UK, after the Brexit. This could especially be beneficial for tax group regimes (consolidation regimes/loss relief regimes), whose scope has been increased under CJEU case law.

National Treatment under TCA

Article 129 TCA prohibits EU Member States from treating an UK entity, which intends to establish or has established an enterprise in the Netherlands through capital participation, less favorable with respect to its operations than Dutch investors in similar situations.

Similarly, Article 129 TCA prohibits EU Member States from treating the subsidiaries of an UK entity less favorable than subsidiaries of an entity of a Member State. An entity resident in a Member State may not be treated less favorable because its shares are held by a UK entity. As such, Article 129 TCA prohibits a less favorable treatment of both UK investors and their subsidiaries on the territory of an EU Member State.

A similar provision on national treatment is part of the freedom of establishment in Article 49 TFEU. Freedom of establishment includes the establishment and management of companies, and in particular of corporations, in accordance with the provisions established by the laws of the country of establishment for its own nationals. This raises the question whether the CJEU case law on the national treatment under Article 49 TFEU can be extended to the national treatment under Article 129 TCA.

According to settled case law, the CJEU case law on fundamental freedoms can only be applied to the other agreements (such as the TCA) if the purpose and scope of the agreement corresponds to the purpose and scope of the TFEU.[3] As the purpose of the TFEU is to create an internal market, it seems to have a more far-reaching objective than the TCA. Nonetheless, the CJEU has also applied its case law on fundamental freedoms to agreements which purpose was not to establish an internal market. In contrast, the TCA does go further than a bilateral tax treaty with third states, which only aim to further develop economic relations and improve cooperation in tax matters. Indeed, according to its preamble, the TCA aims (among other things) to create a level playing field. Article 129 TCA addresses the liberalization of investment and therefore contributes to the creation of a level playing field more similar to the TFEU than to bilateral treaties.

It can be argued that EU Member States should interpret the national treatment provision in Article 129 TCA in line with Article 49 TFEU. This means that, among others, the judgments in the cases *Papillon*, *SCA*, and *B. et al.* are to be applied by analogy to the interpretation of Article 129 TCA.[4] It was in those cases that the CJEU expanded the scope of group regimes on the basis of national treatment provision laid down in Article 49 TFEU. As such, the expanded scope of group regimes for intra-EU situations that is currently in place in (among others) the Netherlands and Luxembourg, would also apply in relation to UK situations (i.e. a limited extra-EU scope).

Indirect effect

It must be noted that Article 5 TCA explicitly excludes any direct effect of the TCA. Nonetheless, the fact that the TCA does not confer individual rights on taxpayers does not relieve the court to interpret existing treaties with the UK in accordance with the provisions of the TCA.

First, it is relevant that the TCA is an agreement concluded by the EU. As a result, the TCA is part of EU law. By virtue of the principle of loyalty contained in Article 4(3) TEU, all authorities of the Member States, including courts, must ensure compliance with EU law in the exercise of their powers. Existing provisions must be interpreted in line with EU law as far as possible. Therefore, existing treaty provisions too must be interpreted in line with EU law as far as possible.

Secondly, generally every tax treaty is subject (whether on the basis of common law or not) to the Vienna Convention on the Law of Treaties (**VCLT**). Under the VCLT, treaties must be interpreted in good faith in accordance with the ordinary meaning of the terms of the relevant treaty in their context and in light of the object and purpose of the treaty. In addition to the context, every relevant rule of international law that can be applied to the relations between the parties must be taken into account. As such, Article 31(1)(c) VCLT provides that tax treaties should be read in conjunction with other applicable international rules.

Hence, both the principle of loyalty to the EU and the VCLT provide that the TCA should be taken into account when interpreting bilateral tax treaties concluded between EU Member States and the UK. If these bilateral tax treaties offer the possibility to be interpreted in line with the TCA, then the provisions should be interpreted accordingly.

Capital Ownership

Article 129 TCA could be seen to have an indirect effect with regard to existing bilateral treaties between EU Member States and the UK. More specifically, Article 129 TCA should be taken into account when interpreting the capital ownership provision in existing bilateral tax treaties between EU Member States and the UK.

The capital ownership provision of Article 24(5) OECD Model states that a domestic enterprise whose capital is wholly or partially owned or controlled directly or indirectly by residents of the other contracting state may not be subject to other or more burdensome taxation or connected requirements than a similar enterprise whose capital is owned by residents of the taxing country.

The provision is similar to that of Article 129 TCA, as it both deals with the national treatment of companies owned by foreign shareholders. Since bilateral tax treaties should be interpreted in accordance with the TCA, the capital ownership provision should be interpreted in accordance with Article 129 TCA. The concrete consequence is that the national treatment also prevents restrictions on group regimes, as also follows from *SCA*, *X BV & X NV*, and *D. et al.*[5]

Remarkably, UK courts apply a similar interpretation to the capital ownership provision as the CJEU does in the aforementioned cases. This follows from the British *FCE Bank* case. Here the court ruled that not allowing a group regime between subsidiaries, held by a non-resident parent company, is a more unfavorable treatment than fully domestic situations. According to the court, the capital ownership provision prohibits such unfavorable treatment.[6] A similar reasoning follows from the British *Felixstowe Dock* case.[7] The latter case also concerned the disallowance of a group regime between the resident subsidiaries of a Luxembourg parent company. According to the court, the impossibility of transferring losses between two resident sister companies constituted a difference in treatment that falls within the scope of the capital ownership provision (Article 26(4)) of the UK-Luxembourg Tax Treaty.[8]

Conclusion

The indirect effect of the TCA is that the extended scope of group regimes under EU law would also apply in relation to the UK. By taking into account the TCA, the capital ownership provision would preclude legislation of a Member State under which a domestic or EU parent company can apply the group regime to domestic sub-subsidiaries held through a domestic or EU company, but cannot apply the group regime where it holds that sub-subsidiary through a company tax resident in the UK. Further, the capital ownership provision would preclude legislation of a Member State under which application of the group regime is granted to a resident or EU parent company which holds resident subsidiaries, but is precluded for resident sister companies the common parent company of which is tax resident of the UK.

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[1] Trade and Cooperation Agreement between the European Union and the European Atomic Energy Community, of the one part, and the United Kingdom of Great Britain and Northern Ireland, of the other part, *OJ* L 149/20, 30-4-2021, p. 10-2359.

[2] Recital 9 of the preamble to the TCA.

[3] CJEU 30 September 1987, C-2/86 (*Demirel*), CJEU 31 January 1991, C-18/90, (*ONEM v. Kziber*), CJEU 16 June 1998, C-162/96, (*Racke*), CJEU 2 March 1999, C-416/96, (*El-Yassini*), CJEU 27 September 2001, C-63/99 (*Gloszczuk*).

[4] CJEU 27 November 2008, C-418/07 (*Papillon)*, CJEU 12 June 2014, C-39/13, C-40/13 and C-41/13, (*SCA*), CJEU 14 May 2020, C-749/18 (*D. et. al.)*.

[5] Such an interpretation is also in line with the OECD Commentary on Article 24, from which it follows that the purpose of Article 24 OECD Model Convention is to prevent differences in tax treatment, not just differences in actual taxation.

[6] Revenue and Customs Commissioners v FCE Bank plc. [2012] BTC 462. See: https://library.croneri.co.uk/cch_uk/btc/2012-btc-462: *The purpose and effect of art. 24(5) are to outlaw the admittedly discriminatory tax treatment to which (but for the convention) FCE would be subject as the directly held subsidiary of a US-resident company as compared with the more favorable tax treatment to which it would be entitled if it were the directly held subsidiary of a UK-resident company. That shows, in my judgment, that the only reason for the difference in treatment in the present case is the fact of FMC?s US residence.*

[7] The Felixstowe Dock and Railway Company Ltd & Ors v Revenue & Customs, [2011] UKFTT 838 (TC), 19 Dec. 2011. See for a detailed analysis of the case Bruno da Silva, Felixstowe Dock and Railway Company Ltd. & Ors v Revenue & Customs: UK group relief: Non Discrimination in Tax Treaties and EU Law, Highlights & Insights on European Taxation 2013/2.1.

[8] The Dutch Supreme Court ruled contrary to *Felixstowe Dock*. The case concerned two Dutch subsidiaries of an Israeli parent company. The taxpayer invoked the capital ownership provision in the treaty between the Netherlands and Israel. According to the Dutch Supreme Court, the Dutch fiscal unity legislation did not discriminate with regard to foreign capital ownership, as a purely domestic fiscal unity was only possible if the parent company was part of the fiscal unity. (HR 15 December 2017, no. 16/02919, *BNB* 2018/57 (concl. A-G Wattel, m.nt. S. Douma).

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