Case Notes

Vodafone 2 v HMRC: the roaming boundaries of European Community law

By far the greater part of the High Court judgment in *Vodafone 2*[1] is concerned with the question of whether the motive test in the UK's controlled foreign companies (CFC) legislation[2] can be construed in a manner compatible with Article 43 of the EC Treaty (freedom of establishment). The judge found that it could not be. The last few paragraphs of the judgment then address a different point altogether: the relationship between domestic law and directly effective provisions of European Community law (in this case Article 43 of the EC Treaty). The issue is dealt with briefly by the judge but it is central to the importance of European Community law in practice. The judge's decision on this second issue has proved controversial and, in the writer's view, rightly so. It is understood that HMRC are to appeal the decision.

The background: Cadbury Schweppes

The background to the decision in *Vodafone 2* is the European Court of Justice (ECJ) decision in *Cadbury Schweppes*.[3] Here, the ECJ held that the UK's CFC rules constituted a restriction on the freedom of establishment under Article 43. However, they could be justified on the basis of preventing tax avoidance, although that justification would only be available if the rules were disapplied in relation to subsidiaries through which the UK parent was actually established in the relevant member state[4] and carrying on genuine economic activities there (even if the subsidiary had been set up in that member state to save tax).[5] The question remitted back to the UK courts in *Cadbury Schweppes* was whether the UK's CFC motive test could be interpreted so as to disapply a CFC charge in these circumstances.[6] Very broadly speaking, the motive test provides protection from the CFC rules where the reduction of UK tax was not the reason behind the existence of the CFC and the transactions undertaken by it.

To hold the UK's motive test as providing protection for the company in the circumstances required by the ECJ under Article 43 (actual establishment and the existence of genuine economic activities) was always going to require the principle of conforming interpretation known as the *Marleasing*[7] principle to be taken to its very limit. The *Cadbury Schweppes* criteria of "actual establishment" and "genuine economic activities", which were considered by the ECJ in *Cadbury Schweppes* to be quite separate from the question of whether the CFC had been incorporated to save tax, find no place in

1 *Vodafone 2 v HMRC* [2008] EWHC 1569 (Ch); [2008] STC 2391.
2 ICTA 1988, s.748(3).
3 Case C-196/04 *Cadbury Schweppes Ltd v IRC* [2006] STC 1908.
4 The analysis in this article is confined to the European Union rather than to (non-EU) EEA countries.
5 Case C-196/04 *Cadbury Schweppes Ltd v IRC* [2006] STC 1908 at [55].
6 This is incidentally also the question referred back to the UK courts by the ECJ in Case C-201/05 *The Test Claimants in the CFC and Dividend Group Litigation v HMRC* [2008] STC 1513.
7 Based on Case C-106/89 *Marleasing SA v La Comercial Internacional de Alimentacion SA* [1990] ECR I-4135 and introduced in the United Kingdom in the European Communities Act 1972, s.2.

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the language of the motive test. Read literally, it can be failed, resulting in a CFC charge, even when those factors are present.

The first issue: interpretation of the motive test

The question of whether the CFC rules were in breach of Article 43 also fell for consideration in *Vodafone 2*. As a result the High Court has now answered the question remitted back to the UK courts by the ECJ in *Cadbury Schweppes*.

The *Vodafone 2* case concerned the legitimacy of HMRC's enquiry into the accounting period of Vodafone 2 (Vodafone) for the year ended March 31, 2001. The enquiry was stated to be for the purposes of establishing whether Vodafone was liable to a charge under the UK's CFC legislation in respect of the profits of its wholly owned Luxembourg subsidiary.

The judge held that the UK's CFC rules could not be construed so as to be compatible with the exercise of Community law rights (the first issue). The motive test was failed as a result of a subjective intention to avoid tax. Thus it did not apply to prevent a CFC charge where there was a subjective intention to avoid tax but the subsidiary was nonetheless actually established in the member state and carrying on genuine economic activities there. Neither normal English law principles of construction nor the *Marleasing* principle permitted a charge to be avoided in such circumstances. As a result the UK's CFC code was in breach of Article 43.

Why did this issue fall for determination in *Vodafone 2*? Had the judge found that the motive test *could* be read as compatible with Article 43, then this would have resulted in the disapplication of the CFC regime in relation to Vodafone, assuming it could show that it was indeed exercising its right of establishment in the EU through the Luxembourg subsidiary, i.e. if, through the subsidiary, Vodafone was actually established in Luxembourg and carrying on genuine economic activities there.

However, if the motive test could *not* be construed as compatible with Article 43, the CFC regime would also have been disapplied in relation to Vodafone: this time as a consequence, not of the motive test, but of the direct effect and supremacy of Community law, as a result of which measures of domestic law which offend directly effective provisions of Community law are disapplied to give effect to Community law. However, this of course assumes that Vodafone qualified for the protection of Article 43 in the first place, which in turn assumes that, through the subsidiary, Vodafone was actually established in Luxembourg and carrying on genuine economic activities there.

Therefore the question of whether the motive test was capable of being read as compatible with Article 43 would not, one would have thought on the facts of the case, been one which affected the substantive rights of either party. In both cases one would have expected that the company would have been required to cross the "actual establishment/genuine economic activities" hurdle.[8]

The approach of the judge in relation to the second issue (the second issue being, in essence, whether, given his conclusion on the motive test, that was the end of the matter and the enquiry should be closed) is however far more radical.

[8] The difference may though have been relevant in determining the procedure for demonstrating this, i.e. whether through a continuation of the enquiry process or a Special Commissioners' hearing to have the enquiry closed.

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The second issue: closure of the enquiry

After finding that the CFC code could not be construed so as to be compatible with Article 43, the judge then turned to the submission of Counsel for HMRC that the enquiry should nevertheless be allowed to continue (the second issue). HMRC argued that it was necessary to determine whether Vodafone was indeed exercising, through its Luxembourg subsidiary, a right of establishment protected by the EC Treaty. Unless Vodafone was exercising an EC Treaty right, it should not receive EC Treaty protection. Simply incorporating a subsidiary in another member state did not necessarily mean that the freedom of establishment was being exercised. That is because, as the ECJ in *Cadbury Schweppes* put it:

> "the concept of establishment within the meaning of the Treaty provisions on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period. Consequently it presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there".[9]

Accordingly, Counsel for HMRC argued that it was necessary to determine whether these criteria were met before Vodafone could escape a CFC charge.

It can be observed in passing that there may well have been a faint air of unreality to the argument that Vodafone was not exercising its right of establishment in the EU through its Luxembourg subsidiary. The subsidiary appears to have had net assets of 3 billion Euros and was the holding company of a large number of telecommunications companies in the Vodafone group; and it would have been surprising for it not to have been managed where it was supposed to be managed, in Luxembourg. This may well have influenced the judge's approach. Nevertheless it is understood that, during the Special Commissioners' hearing at least, submissions were made by Counsel for HMRC on the question of whether establishment in Luxembourg was present on the facts. So there may have been room for argument. In any event the judge did not comment on whether the *Cadbury Schweppes* criteria for establishment within Article 43 were satisfied on the facts, nor, importantly, did he remit the question to the Special Commissioners. His reasoning, if correct, is, furthermore, of application to more than just Vodafone.

The judge rejected the argument for HMRC, holding that the enquiry should be closed irrespective of whether Vodafone was in fact truly exercising its right of establishment through its Luxembourg subsidiary. He put it thus:

> "The CFC legislation and the motive test are of potentially wide application throughout the UK business world. To adapt the speech of Lord Hope in [the *Fleming*][10] case, the nature of the defect [in the UK CFC legislation] is such that a single solution is required that can reasonably be applied to all taxpayers. That can only be done by Parliament, or possibly by appropriate executive steps as was suggested by the House of Lords in the *Fleming* case. . .
>
> In my judgment the CFC legislation, which depends on Section 747 and Section 748 for its effectiveness, must be disapplied so that, pending such amending legislation

[9] Case C-196/04 *Cadbury Schweppes plc v IRC* [2006] STC 190 at [54].

[10] *Fleming (trading as Bodycraft) v HMRC; Condé Nast Publications Ltd v HMRC* [2008] UKHL 2; [2008] STC 324.

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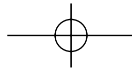

or executive action, no charge can be imposed on a company such as Vodafone under the CFC legislation. It follows that HMRC's enquiry into Vodafone's tax return for the Accounting Period has no legitimate purpose and should be closed."

It is not clear whether the disapplication of the CFC code was considered by the judge to extend to companies in respect of all overseas subsidiaries (that would be a "single solution") or in respect of EU subsidiaries only (that would apply to companies "such as" Vodafone, but would not, in all senses at least, be a "single solution").

However the decision is, even on the latter basis, a surprising one. Would, for instance, a UK company which had suffered an apportionment in respect of an EU subsidiary through which it had not truly been exercising its right of establishment now have a claim in respect of tax previously paid under the CFC code? That would seem to follow from the judge's reasoning.[11]

Disapplication of domestic law

Domestic law which is in conflict with directly enforceable Community law rights must be disapplied so as to give effect to those rights. This flows from European Communities Act 1972 section 2 and the principle of direct effect.[12] Where, by contrast, there are no directly effective Community law rights to protect, there is no basis for a disapplication of UK domestic law. As a result a statutory provision may, so to speak, be switched on and off according to whether it enters into conflict with Community law—the uncertainty which results for users of the legislation is for the Member State to sort out. The ECJ said as much in *ICI v Colmer*[13]:

> "Accordingly, when deciding an issue concerning a situation which lies outside the scope of Community law, the national court is not required, under Community law, either to interpret its legislation in a way conforming with Community law or to disapply that legislation. Where a particular provision must be disapplied in a situation covered by Community law, but that same provision could remain applicable to a situation not so covered, it is for the competent body of the State concerned to remove that legal uncertainty in so far as it might affect rights deriving from Community rules.
>
> Consequently, in circumstances such as those in point in the main proceedings, Article 5 of the Treaty does not require the national court to interpret its legislation

[11] The notion that the CFC legislation should not be applied to Vodafone irrespective of whether it was exercising Community law rights where the CFC code could not be construed in a manner which was compliant with *Cadbury Schweppes* is also a feature of the dissenting Special Commissioner's reasoning in the Special Commissioners' decision in *Vodafone 2* [2008] STC (SCD) 55 at [103]. The presiding Special Commissioner, John Walters Q.C., who exercised his casting vote, considered the motive test capable of being construed in accordance with *Cadbury Schweppes* so the point did not arise.

[12] *R v Secretary of State for Transport, ex p Factortame Ltd (No.2)* [1991] 1 AC 603 and Case 106/77 *Amministrazione delle Finanze dello Stato v Simmenthal SpA* [1978] ECR 629; [1978] 3 CMLR 263, ECJ: "Any national court must, in a case within its jurisdiction, apply Community law in its entirety and protect rights which the latter confers on individuals and must accordingly set aside any provision of national law which may conflict with it, whether prior to or subsequent to the Community rule."

[13] Case C-264/96 *Imperial Chemicals Industries plc (ICI) v Colmer (Inspector of Taxes)* [1998] STC 874 at [34] and [35].

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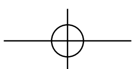

in conformity with Community law or to disapply the legislation in a situation falling outside the scope of Community law."

That of course is far from the "single solution" which the judge was looking for in the *Vodafone 2* case. Indeed it is this legal uncertainty (the switching on and off of a provision of the domestic code without that being made explicit on the face of the legislation) which the judge was attempting to resolve. The manner in which it was resolved by the judge was a permanent switching off of the CFC regime, at least where an EU subsidiary is involved, irrespective of whether rights protected by Community law were being infringed by the regime.

The basis for disapplication of the CFC code

While the abolition of the CFC regime (in so far as it applies to EU subsidiaries or perhaps more widely) may be an appropriate solution for Parliament to enact, it is less easy to see the basis for it as a judicial solution. A disapplication by a court of domestic legislation in this context can only be justified by provisions of Community law which override domestic law. However it is hard to identify the relevant Community law principle which could have had that effect here.

In giving effect to Community law rights, domestic case law suggests that the relevant provisions of national law take effect "as if enacted as being without prejudice to" the directly enforceable Community rights in question.[14] A process of "moulding" or "adapting" consequential provisions may be appropriate[15] as a result. That was not the rather more heavy-handed approach adopted by the judge. He considered the CFC code to be disapplied in a manner which made the question of enforceable Community rights irrelevant.

Moreover, it seems tolerably clear from the decision of the ECJ in *The Test Claimants in the CFC and Dividend Group Litigation v Commissioners of the Inland Revenue*[16] that a CFC regime is in principle acceptable if the regime gives the company in question the opportunity to produce evidence that the CFC is actually established in the European Union and that its activities are genuine and if the charge is disapplied by domestic law in those circumstances. So requiring Vodafone to demonstrate that it was exercising its freedom of establishment would not of itself have given rise to a breach of Article 43.

It may of course be that the effect of reading a provision of national law as being "without prejudice to directly enforceable Community rights" would effectively remove the provision from the statute book for all practical purposes (in so far as directly enforceable Community law rights are concerned). That might happen for instance because the provision offends Community law directly. In that case the question may arise as to whether the court is empowered to substitute an alternative provision rather than merely to modify what is there—the principle of legal certainty, which does in this

[14] Per Lord Nolan in *ICI v Colmer (Inspector of Taxes)* [1998] STC 874 at [23] and Lord Bridge in *R v Secretary of State for Transport Ex p. Factortame Ltd* [1990] 2 AC 85 at [140].

[15] Per Lord Nicholls in *Re Claimants under Loss Relief Group Litigation Order* (sub nom *Autologic Holdings plc v IRC*) [2005] UKHL 54; [2005] STC 1357 at [17].

[16] *ICI v Colmer (Inspector of Taxes)* [1998] STC 874 at [85]; Case C-201/05 *Test Claimants in the CFC and Dividend Group Litigation v HMRC* [2008] STC 1513 at [85].

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context find a basis in the ECJ's case law,[17] may militate against this: taxpayers would not have been in a position to know in advance what that alternative provision would have been. If the factor of legal certainty results in the court being unable to substitute an altogether new provision for the offending one, the latter simply falls away—again, however, only in so far as directly enforceable Community law rights are concerned.

The case of *Fleming* cited by the judge in *Vodafone 2* is a case in point. This concerned the absence of transitional provisions in changes to the value added tax (VAT) time limit rules which, as Lord Walker put it, resulted in an "infringement of directly enforceable Community rights".[18] The case involved directly enforceable Community rights only, however, since it concerned claims for repayment of VAT under the VAT Directive. So the falling away of the offending provisions of national law applied in all cases. *Fleming* was therefore, it is submitted, an imperfect analogy for the judge to draw on in *Vodafone 2*.[19]

Where no directly enforceable Community rights are relevant to the application of a provision of national law, it is irrelevant to the application of that provision that uncertainty results from the fact that, in some other cases (where directly enforceable Community rights are in point), the provision can be disapplied. That uncertainty may be unwelcome but it is an issue for Parliament, rather than the courts, to resolve.

The judge may therefore have taken things one step too far in "switching off" the CFC regime irrespective of whether an enforceable Community right was being exercised. The legal uncertainty in the CFC regime which the judge highlighted and which he rightly saw as important given that "the CFC legislation and the motive test are of potentially wide application throughout the UK business world"[20] remains until it is fixed by Parliament.

At some point Vodafone should therefore, in the writer's view, have been required to demonstrate that it was exercising a right of establishment protected by the EC Treaty before the CFC legislation was disapplied in relation to it, whether this was through an enquiry on the basis of "remoulded" CFC legislation which exempts cases where a genuine right of establishment in the EU is being exercised[21] or a further Special Commissioners' hearing.

New section 751A

One has considerable sympathy for the doubts expressed by the judge as to the effectiveness of new ICTA 1988 section 751A, introduced by FA 2007, as an appropriate legislative solution to the legal uncertainty in the CFC regime discussed above. In particular, the

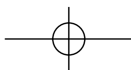
[17] Where directly enforceable EU-protected rights are in point. See for instance Case C-62/00 *Marks & Spencer plc v Customs & Excise Commissioners* [2002] STC 1036 at [39].

[18] At [26].

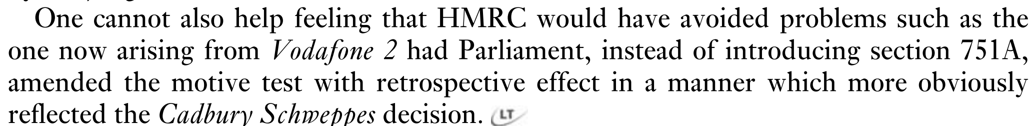
[19] The point is well made by P. Davison, Freshfields Bruckhaus Deringer, in a *Letter to the Editor*, Tax Journal, Issue 946, 3.

[20] At [89].

[21] It is not clear whether that was how HMRC were genuinely proposing to approach things, although it might have been given that HMRC considered the motive test to be *Cadbury Schweppes*-compliant. Account must however be taken of HMRC's controversial views as to what establishment protected by Art.43 requires in practice, as one can glean from new ICTA 1988, s.751A, intended to make the CFC regime *Cadbury Schweppes*-compliant, and HMRC statements in relation to that provision. This would not have made the CFC legislation compliant with the EC Treaty (see Case C-33/03 *EC Commission v United Kingdom* [2005] STC 582 at [25]) but one would have nevertheless expected that to make the procedural imposition on Vodafone more likely to have been palatable to the court.



division of profits, under section 751A, into good and bad depending on whether they are "created directly by qualifying work", which HMRC considers to give rise to a dichotomy between profits generated from labour and profits generated from capital, does not, as interpreted by HMRC at least, have a firm basis in the ECJ's jurisprudence.[22] A point for consideration however is whether *Marleasing* principles might find the post-FA 2007 regime more fertile territory for their application than the pre-FA 2007 regime considered by the judge.



One cannot also help feeling that HMRC would have avoided problems such as the one now arising from *Vodafone 2* had Parliament, instead of introducing section 751A, amended the motive test with retrospective effect in a manner which more obviously reflected the *Cadbury Schweppes* decision.

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