JUDGMENT OF THE COURT

16 July 1998

(Right of establishment — Corporation tax — Surrender by one company to another company in the same group of tax relief on trading losses — Residence requirement imposed on group companies — Discrimination according to the place of the corporate seat— Obligations of the national court)

In Case C-264/96,

REFERENCE to the Court under Article 177 of the EC Treaty by the House of Lords (United Kingdom) for a preliminary ruling in the proceedings pending before that court between

Imperial Chemical Industries plc (ICI)

and

Kenneth Hall Colmer (Her Majesty's Inspector of Taxes),

on the interpretation of Articles 5 and 52 of the EC Treaty,

THE COURT,

composed of: G.C. Rodríguez Iglesias, President, H. Ragnemalm, M. Wathelet (Rapporteur) and R. Schintgen (Presidents of Chambers), G.F. Mancini, J.C. Moitinho de Almeida, J.L. Murray, D.A.O. Edward, P. Jann, L. Sevón and K.M. Ioannou, Judges,

Advocate General: G. Tesauro,

Registrar: L. Hewlett, Administrator,

after considering the written observations submitted on behalf of:

— Imperial Chemical Industries plc (ICI), by Peter Whiteman QC and Christopher Vajda, Barrister, instructed by Hammond Suddards, Solicitors,

— the United Kingdom Government, by John E. Collins, Assistant Treasury Solicitor, acting as Agent, with Derrick Wyatt QC and Rabinder Singh, Barrister,

— the Commission of the European Communities, by Peter Oliver and Hélène Michard, of its Legal Service, acting as Agents,

having regard to the Report for the Hearing,

after hearing the oral observations of Imperial Chemical Industries plc (ICI), the United Kingdom Government and the Commission at the hearing on 14 October 1997,

after hearing the Opinion of the Advocate General at the sitting on 16 December 1997,

gives the following

Judgment

1. By order of 24 July 1996, received at the Court on 29 July 1996, the House of Lords referred to the Court of Justice for a preliminary ruling under Article 177 of the EC Treaty two questions on the interpretation of Articles 5 and 52 of the EC Treaty.

2. Those questions were raised in proceedings between Imperial Chemical Industries plc (hereinafter 'ICI') and the United Kingdom tax authorities (hereinafter 'the Inland Revenue') concerning the latter's refusal to grant to ICI tax relief in respect of trading losses incurred by a subsidiary of the holding company beneficially owned by ICI through a consortium.

3. ICI and Wellcome Foundation Ltd, both of which are companies resident in the United Kingdom, together form a consortium through which they beneficially own

49% and 51%, respectively, of Coopers Animal Health (Holdings) Ltd (hereinafter 'Holdings').

4. The sole business of Holdings is to hold shares in some 23 trading companies which are its subsidiaries and which operate in many countries. Of those 23 subsidiaries, 4 — including Coopers Animal Health Ltd (hereinafter 'CAH') — are resident in the United Kingdom, 6 in other Member States and 13 in non-member countries.

5. CAH incurred losses on its United Kingdom trade in the accounting periods ending in 1985, 1986 and 1987. ICI sought, pursuant to sections 258 to 264 of the Income and Corporation Taxes Act 1970 (hereinafter 'the Act'), to set 49% of CAH's losses for those periods (the proportion corresponding to its shareholding in Holdings) against its chargeable profits for the corresponding periods by way of tax relief.

6. As regards the conditions for and the detailed rules governing tax relief as claimed by ICI, the Act provides as follows:

Section 258:

'1. Relief for trading losses and other amounts eligible for relief from corporation tax may in accordance with the following provisions of this Chapter be surrendered by a company (called "the surrendering company") which is a member of a group of companies and, on the making of a claim by another company (called "the claimant company") which is a member of the same group, may be allowed to the claimant company by way of relief from corporation tax called "group relief".

2. Group relief shall also be available in accordance with the said provisions in the case of a surrendering company and a claimant company where either of them is a member of a consortium and the other is —

(a) a trading company which is owned by the consortium and which is not a 75 per cent. subsidiary of any company; or

(b) a trading company —

(i) which is a 90 per cent. subsidiary of a holding company which is owned by the consortium; and

(ii) which is not a 75 per cent. subsidiary of a company other than the holding company; or

(c) a holding company which is owned by the consortium and which is not a 75 per cent. subsidiary of any company:

[...]

5. For the purpose of this section and the following sections of this Chapter —

(a) two companies shall be deemed to be members of a group of companies if one is the 75 per cent. subsidiary of the other or both are 75 per cent. subsidiaries of a third company,

(b) ”holding company” means a company the business of which consists wholly or mainly in the holding of shares or securities of companies which are its 90 per cent. subsidiaries, and which are trading companies,

(c) ”trading company” means a company whose business consists wholly or mainly of the carrying on of a trade or trades.

[...]

7. References in this and the following sections of this Chapter to a company apply only to bodies corporate resident in the United Kingdom; and in determining for the purposes of this and the following sections of this Chapter whether one company is a 75 per cent. subsidiary of another, the other company shall be treated as not being the owner —

(a) of any share capital which it owns directly in a body corporate if a profit on a sale of the shares would be treated as a trading receipt of its trade, or

(b) of any share capital which it owns indirectly, and which is owned directly by a body corporate for which a profit on the sale of the shares would be a trading receipt, or

(c) of any share capital which it owns directly or indirectly in a body corporate not resident in the United Kingdom.

8. For the purposes of this and the following sections of this Chapter, a company is owned by a consortium if three-quarters or more of the ordinary share capital of the company is beneficially owned between them by companies of which none

beneficially owns less than one-twentieth of that capital, and those companies are called the members of the consortium.‘

Section 259:

'1. If in any accounting period the surrendering company has incurred a loss, computed as for the purposes of subsection (2) of section 177 of this Act, in carrying on a trade, the amount of the loss may be set off for the purposes of corporation tax against the total profits of the claimant company for its corresponding accounting period‘.

7.

The Inland Revenue refused ICI's application for tax relief on the ground that Holdings does not constitute a holding company within the meaning of section 258(5)(b) read together with section 258(7). Even though Holdings' sole business is to hold shares or securities of companies which are its 90% subsidiaries, and which are trading companies, the majority of its subsidiaries (19 out of 23) are not bodies corporate resident in the United Kingdom as required by the opening words of section 258(7) and therefore Holdings' main business cannot be recognised as that of a holding company within the meaning of subsection 5(b).

8.

Contesting that interpretation of the domestic legislation, ICI brought an action against the decision rejecting its claim. The High Court found in ICI's favour and its decision was subsequently affirmed by the Court of Appeal.

9.

On appeal, the House of Lords concluded that the Inland Revenue's refusal was justified in terms of the Act, but felt it necessary to consider the arguments, based on Community law, advanced by ICI to contest the refusal.

10.

In ICI's submission, the requirement that a holding company's business consist wholly or mainly in the holding of shares or securities of companies resident in the United Kingdom amounts to a restriction, in the form of a discriminatory tax regime, on freedom of establishment for companies and firms, and therefore infringes Articles 52 and 58 of the EC Treaty.

11.

It claims that the discrimination arises from the fact that tax relief for losses incurred by a resident company which is a subsidiary of a resident holding company is granted to a member of a consortium where all, or most of, the subsidiaries controlled by the holding company are resident, whereas, other things being equal, it will be refused where the holding company — because it has exercised its right to freedom of establishment conferred by the EC Treaty — controls mainly subsidiaries resident in other Member States.

12.

ICI maintains that, faced with such discrimination, it is the national court's duty, even in a case such as that before the House of Lords, where the holding company controls 23 subsidiaries, of which only 10 are resident in the United Kingdom or another Member State, to set aside the residence requirement laid down by the Act as being contrary to Community law.

13.

The House of Lords considered an interpretation of Community law to be necessary as regards both the compatibility of the residence requirement laid down

by the Act for the grant of tax relief as claimed by ICI with the rules of the Treaty and, should the Act prove to be contrary to Community law, the approach to be taken by national courts in such a situation. It therefore decided to stay proceedings and refer the following questions to the Court of Justice for a preliminary ruling:

'1. In a situation where:-

(i) a company (Company A) is resident in a Member State of the European Union

(ii) Company A is part of a consortium with another company (Company B) also resident in that Member State

(iii) Company A and B jointly own a holding company (Company C) also resident in the Member State

(iv) Company C has a number of trading subsidiaries, which are resident either in that Member State, other Member States of the European Union or elsewhere in the world, and

(v) Company A is precluded from being entitled to claim against its corporation tax liability relief in respect of trading losses incurred by a trading subsidiary (also resident in that Member State) of Company C because the national legislation, construed as a matter of national law, required that the business of Company C should consist wholly or mainly in the holding of shares in subsidiaries which are resident in that Member State:-

Does the requirement identified at (v) constitute a restriction on the freedom of establishment under Article 52 of the EC Treaty? If so, is such treatment nevertheless justified under Community law?

2. If the requirement under (v) is an unjustified restriction under Community law, does Article 5 of the EC Treaty require a national court to interpret the relevant national legislation, so far as is possible, so as to comply with Community law, even though neither Company A, Company B nor Company C is itself seeking to exercise any rights under Community law, and even if an interpretation of national legislation which would comply with Community law would have the effect of giving relief where the business of Company C consisted mainly in the holding of shares in subsidiaries established outside the EC/EEA? Or does Article 5 have the consequence only that the national legislation, despite its interpretation, takes effect subject to the requirements of Community law in a case where these requirements are in point?‘

Admissibility

14.

The United Kingdom Government has expressed doubts as to the relevance of the first question in determining the issue in the main proceedings. It argues that, even if the Act were found to entail a restriction on freedom of establishment, incompatible

with Article 52 of the Treaty, this would have no bearing on the determination of the proceedings. ICI would in any event be denied the tax relief provided for under the Act, since the majority of the companies controlled by Holdings (13 out of 23) are resident, not in other Member States, but in non-member countries.

15. According to established case-law, it is solely for the national courts before which proceedings are pending, and which must assume responsibility for the judgment to be given, to determine in the light of the particular circumstances of each case both the need for a preliminary ruling to enable them to give judgment and the relevance of the questions which they submit to the Court (see, *inter alia*, Case C-127/92 *Enderby* [1993] ECR I-5535, paragraph 10; Joined Cases C-332/92,C-333/92 and C-335/92 *Eurico Italia and Others* [1994] ECR I-711, paragraph 17; and Case C-146/93 *McLachlan* [1994] ECR I-3229, paragraph 20). A request for a preliminary ruling from a national court may be rejected only if it is manifest that the interpretation of Community law or the examination of the validity of a rule of Community law sought by that court bears no relation to the true facts or the subject-matter of the main proceedings (Case C-62/93 *BP Supergas* [1995] ECR I-1883, paragraph 10, and Case C-143/94 *Furlanis* [1995] ECR I-3633, paragraph 12).

16. However, that is not the situation in the present case. The House of Lords observes that opinion differs as to the proper construction of section 258(5), in terms of which, in order to qualify as a holding company within the meaning of the Act, it is necessary to hold shares wholly or mainly in companies which are resident in the United Kingdom, and, more specifically, as to the notion of control of a majority of subsidiaries resident in the United Kingdom, one interpretation of which makes it necessary to determine whether the Act is compatible with Article 52 of the Treaty.

17. In those circumstances, it is necessary to consider the questions referred by the House of Lords.

Substance

The first question

18. By its first question, the House of Lords asks essentially whether Article 52 of the Treaty precludes legislation of a Member State which, in the case of companies

established in that State belonging to a consortium through which they control a holding company, makes a particular form of tax relief subject to the requirement that the holding company's business consist wholly or mainly in the holding of shares in subsidiaries that are established in the Member State concerned.

19. Although direct taxation is a matter for the Member States, they must nevertheless exercise their direct taxation powers consistently with Community law (see Case C-279/93 *Schumacker* [1995] ECR I-225, paragraph 21; Case C-80/94 *Wielockx* [1995] ECR I-2493, paragraph 16; Case C-107/94 *Asscher* [1996] ECR I-3089, paragraph 36; and Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471, paragraph 19).

20. According to established case-law, the freedom of establishment which Article 52 grants to nationals of the Member States and which entails the right for them to take up and pursue activities as self-employed persons under the conditions laid down for its own nationals by the law of the Member State where such establishment is effected, includes, pursuant to Article 58 of the Treaty, the right of companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community, to pursue their activities in the Member State concerned through a branch or agency. With regard to companies, it should be noted in this context that it is their corporate seat in the above sense that serves as the connecting factor with the legal system of a particular State, like nationality in the case of natural persons (Case 270/83 *Commission* v *France* [1986] ECR 273, paragraph 18, and Case C-330/91 *Commerzbank* [1993] ECR I-4017, paragraph 13).

21. It should also be pointed out that, even though, according to their wording, the provisions concerning freedom of establishment are directed mainly to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in Article 58 (Case 81/87 *Daily Mail and General Trust* [1988] ECR 5483, paragraph 16).

22. It should be noted here that, under the legislation at issue in the main proceedings, companies belonging to a resident consortium which have, through a holding company, exercised their right to freedom of establishment in order to set up subsidiaries in other Member States are denied tax relief on losses incurred by a resident subsidiary where the majority of the subsidiaries controlled by the holding company have their seat outside the United Kingdom.

23. Such legislation, therefore, applies the test of the subsidiaries' seat to establish differential tax treatment of consortium companies established in the United Kingdom. Consortium relief is available only to companies controlling, wholly or mainly, subsidiaries whose seats are in the national territory.

24. It is therefore necessary to determine whether there is any justification for such inequality of treatment under the Treaty's provisions on freedom of establishment.

25. The United Kingdom Government maintains that, for the purposes of direct taxation, the respective situations of resident and non-resident companies are not, as a general rule, comparable. It puts forward two types of justification. First, the legislation at issue is designed to reduce the risk of tax avoidance arising, in the present case, from the possibility for members of a consortium to channel the charges of non-resident subsidiaries to a subsidiary resident in the United Kingdom and to have profits accrue to non-resident subsidiaries. The purpose of the legislation at issue is therefore to prevent the creation of foreign subsidiaries from being used as a means of depriving the United Kingdom Treasury of taxable revenues. A further objective is to prevent a reduction in revenue caused by the mere existence of non-resident subsidiaries, since the Inland Revenue cannot tax profits made by subsidiaries located

outside the United Kingdom in order to offset the revenue lost through the granting of relief on losses incurred by resident subsidiaries.

26. As regards the justification based on the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment.

27. Furthermore, the risk of charges being transferred, which the legislation at issue is designed to prevent, is entirely independent of whether or not the majority of subsidiaries are resident in the United Kingdom. The existence of only one non-resident subsidiary is enough to create the risk invoked by the United Kingdom Government.

28. In answer to the argument that revenue lost through the granting of tax relief on losses incurred by resident subsidiaries cannot be offset by taxing the profits of non-resident subsidiaries, it must be pointed out that diminution of tax revenue occurring in this way is not one of the grounds listed in Article 56 of the Treaty and cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment that is, in principle, incompatible with Article 52 of the Treaty.

29. It is true that in the past the Court has accepted that the need to maintain the cohesion of tax systems could, in certain circumstances, provide sufficient justification for maintaining rules restricting fundamental freedoms (see, to this

effect, Case C-204/90 *Bachmann* [1992] ECR I-249 and Case C-300/90 *Commission* v *Belgium* [1992] ECR I-305). Nevertheless, in the cases cited, there was a direct link between the deductibility of contributions from taxable income and the taxation of sums payable by insurers under old-age and life assurance policies, and that link had to be maintained in order to preserve the cohesion of the tax system in question. In the present case, there is no such direct link between the consortium relief granted for losses incurred by a resident subsidiary and the taxation of profits made by non-resident subsidiaries.

30. Consequently, the answer to be given to the first question must be that Article 52 of the Treaty precludes legislation of a Member State which, in the case of companies established in that State belonging to a consortium through which they control a holding company, by means of which they exercise their right to freedom of establishment in order to set up subsidiaries in other Member States, makes a particular form of tax relief subject to the requirement that the holding company's business consist wholly or mainly in the holding of shares in subsidiaries that are established in the Member State concerned.

The second question

31. By its second question the House of Lords essentially asks the Court to explain the scope of the duty to cooperate in good faith, laid down by Article 5 of the Treaty. More specifically, if it were to follow from the reply to the first question that the legislation at issue in the main proceedings is incompatible with Community law in not granting tax relief where the holding company owned by the consortium controls mainly subsidiaries having their seat in the Community, in a case where this condition is not fulfilled by subsidiaries resident in the United Kingdom, the House of Lords asks whether it must likewise disapply that legislation, or construe it in a way conforming with Community law, where the holding company controls mainly subsidiaries having their seat in non-member countries.

32. It must be emphasised that the difference of treatment applied according to whether or not the business of the holding company belonging to the consortium consists wholly or mainly in holding shares in subsidiaries having their seat in non-member countries lies outside the scope of Community law.

33. Consequently, Articles 52 and 58 of the Treaty do not preclude domestic legislation under which tax relief is not granted to a resident consortium member where the business of the holding company owned by that consortium consists wholly or mainly in holding shares in subsidiaries which have their seat in non-member countries. Nor does Article 5 of the Treaty apply.

34. 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.

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

Costs

36. The costs incurred by the United Kingdom Government and by the Commission, which have submitted observations to the Court, are not recoverable. Since these proceedings are, for the parties to the main proceedings, a step in the proceedings pending before the national court, the decision on costs is a matter for that court.

On those grounds,

THE COURT,

in answer to the questions referred to it by the House of Lords by order of 24 July 1996, hereby rules:

1. Article 52 of the EC Treaty precludes legislation of a Member State which, in the case of companies established in that State belonging to a consortium through which they control a holding company, by means of which they exercise their right to freedom of establishment in order to set up subsidiaries in other Member States, makes a particular form of tax

relief subject to the requirement that the holding company's business consist wholly or mainly in the holding of shares in subsidiaries that are established in the Member State concerned.

2. In circumstances such as those in point in the main proceedings, Article 5 of the EC Treaty does not require the national court to interpret its legislation in conformity with Community law or to disapply the legislation in a situation falling outside the scope of Community law.

Rogríguez Iglesias

Ragnemalm

Wathelet

Schintgen

Mancini

Moitinho de Almeida

Murray

Edward

Jann

Sevón

Ioannou

Delivered in open court in Luxembourg on 16 July 1998.

R. Grass — G.C. Rodríguez Iglesias

Registrar — President