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JUDGMENT OF THE COURT (Eighth Chamber)

13 November 2014 (*)

(Failure of a Member State to fulfil obligations — Freedom of establishment — Free movement of capital — Articles 49 TFEU and 63 TFEU — Articles 31 and 40 of the EEA Agreement — National tax legislation — Attribution of gains to participators in close companies — Different treatment of resident and non-resident companies — Wholly artificial constructions — Proportionality)

In Case C?112/14,

ACTION for failure to fulfil obligations under Article 258 TFEU, brought on 7 March 2014,

European Commission, represented by R. Lyal and L. Armati, acting as Agents, with an address for service in Luxembourg,

applicant,

v

United Kingdom of Great Britain and Northern Ireland, represented by L. Christie, acting as Agent,

defendant,

THE COURT (Eighth Chamber),

composed of A. Ó Caoimh, President of the Chamber, E. Jaraši?nas (Rapporteur) and C.G. Fernlund Judges,

Advocate General: P. Mengozzi,

Registrar: A. Calot Escobar,

having regard to the written procedure,

having decided, after hearing the Advocate General, to proceed to judgment without an Opinion,

gives the following

Judgment

1 By its action the European Commission asks the Court to declare that, by adopting and maintaining tax legislation concerning the attribution of gains to participators in non-resident companies which provides for a difference in treatment between domestic and cross-border activities, the United Kingdom of Great Britain and Northern Ireland has failed to fulfil its obligations under Article 63 TFEU and Article 40 of the Agreement on the European Economic Area of 2 May 1992 (OJ 1994 L 1, p. 3, ‘the EEA Agreement’) or, in the alternative, under Article 49 TFEU and Article 31 of the EEA Agreement.

Legal context

2 Section 13 of the Taxation of Chargeable Gains Act 1992 ('the TCGA') provides that, where chargeable gains accrue to a company not resident in the United Kingdom which would be regarded as a close company if it were resident there ('non-resident close company'), those gains, or part of them, are immediately taxed in the United Kingdom. They are immediately attributed to participators in such a company who are United Kingdom residents, if they hold more than 10% of the company's shares and, consequently, rights to more than 10% of those gains, whether or not they actually receive the gains.

3 Section 414 of the Income and Corporation Taxes Act 1988 ('the ICTA') provides that a close company is a company which is under the control of not more than five participators, or of participators who are directors of the company. Section 417(1) of the ICTA defines a participator as a person having a share in a company or an interest in its capital or income, including a loan creditor.

4 Section 416 of the ICTA states that a person shall be taken to have control of a company if he exercises direct or indirect control over the company's affairs, in particular if he possesses the greater part of the share capital or of the voting power, or is entitled to receive the greater part of the income or assets of the company. That section also provides that, for the purpose of determining whether a particular person has such control, he is deemed to enjoy all the rights and powers of his associates and of any company which he or his associates control. Section 417(3) and (4) of the ICTA treats any partner or relative (spouse, brother or sister, relative in the ascending or descending line) as an associate.

5 Section 13 of the TCGA does not apply if the taxable gain results from the disposal of an asset used only for the purposes of a trade carried on by a non-resident close company outside the United Kingdom. Also, if within three years from the realisation of a taxable gain an amount in respect of the gain is distributed to a resident taxpayer, the tax already paid is applied for reducing the tax due from that taxpayer in respect of the distribution. The amount of tax paid at the time of accrual of a gain may thus be deducted from any tax owed by a participator in a non-resident close company because of a later disposal of his interest in the company. It is also possible that, because of a double taxation agreement, no tax is due.

Pre-litigation procedure

6 On 23 November 2009 the Commission sent a letter of formal notice to the United Kingdom. In the letter it drew the attention of the United Kingdom to the possible incompatibility with Articles 49 TFEU and 63 TFEU and the equivalent provisions of the EEA Agreement of certain rules on the attribution to taxpayers resident in the United Kingdom of gains realised by certain non-resident companies.

7 By letter of 18 January 2010, the United Kingdom expressed its disagreement with the Commission's position, stating the view that any restrictions affecting companies incorporated outside the United Kingdom were justified by the public interest in protecting the tax system of the United Kingdom from tax avoidance and were proportionate to that aim.

8 On 4 June 2010 the Commission sent the United Kingdom a supplementary letter of formal notice. In that letter it extended the scope of its original letter of formal notice to include the relevant United Kingdom legislation then in force. The United Kingdom replied by letter of 5 August 2010, maintaining its point of view.

9 On 17 February 2011 the Commission addressed a reasoned opinion to the United Kingdom in which it restated its position. The United Kingdom replied by letter dated 11 April 2011, in which

it stated that it would amend its legislation to make it compatible with EU law. Since the national legislation in question had not been amended by the time the period prescribed in the reasoned opinion expired, the Commission brought the present action.

The action

Arguments of the parties

10 The Commission submits, first, that the present case comes under Article 63 TFEU and Article 40 of the EEA Agreement on the ground, in particular, that the participation referred to in section 13 of the TCGA need not be a controlling holding. It asks the Court, in the alternative, to rule that that section is contrary to the articles of the FEU Treaty and the EEA Agreement which relate to freedom of establishment.

11 Next, as regards the existence of a restriction, the Commission observes that under section 13 of the TCGA the taxable gains made by a non-resident close company, including where the company is resident in another Member State of the European Union or in a Member State of the European Free Trade Association (EFTA) which is a party to the EEA Agreement, are immediately attributed for tax purposes to participators in that company who are resident in the United Kingdom and hold more than 10% of the company’s shares, the attribution taking place at the time when the company disposes of assets and makes a gain, which is included in the tax base of the participators concerned. In the Commission’s view, the participators are then liable to tax, either capital gains tax for a natural person or corporation tax for a company, even though they have not personally made any disposals and may never receive the proceeds of the disposal made by the company.

12 The Commission states that, by contrast, where a close company resident in the United Kingdom disposes of assets and makes taxable gains, tax is charged only in the event of a distribution of the gains to participators or if they dispose of their interests in the company. It points out, moreover, that that tax is based on the amount actually received by the participator, not on the amount of the gains made by the company itself.

13 The Commission concludes that section 13 of the TCGA is a restriction within the meaning of Article 63 TFEU and Article 40 of the EEA Agreement. While the Commission accepts that the tax burden on a resident participator may be reduced or even eliminated in certain circumstances, it submits that those mechanisms do not enable the restriction to be removed entirely.

14 Finally, as regards a possible justification for the restriction, the Commission acknowledges that section 13 of the TCGA is appropriate for achieving the objective of combating tax avoidance relied on by the United Kingdom, but considers that it goes beyond what is necessary for that purpose.

15 The United Kingdom points out that, in its reply to the reasoned opinion, it stated that the necessary measures would be taken to comply with it, but it would not be possible to amend the applicable legislation by 16 April 2011, the deadline for replying to the reasoned opinion. The United Kingdom notes that the national legislation was amended, with retroactive effect from 6 April 2012, and concedes that the version of section 13 of the TCGA which was in force on 16 April 2011 was incompatible with the Treaty, and that the action by the Commission is consequently well founded.

Findings of the Court

16 It must be observed, as a preliminary point, that section 13 of the TCGA applies where a

participator resident in the United Kingdom holds more than 10% of the shares of the non-resident close company in question. It can therefore apply both to holdings enabling their holder to exert a definite influence over the decisions of that company and determine its activities and to holdings acquired for investment purposes. It thus cannot be ruled out that that section may affect both freedom of establishment and free movement of capital (see, to that effect, judgment in *Commission* v *Belgium*, C?387/11, EU:C:2012:670, paragraphs 34 and 35 and the case-law cited). Accordingly, that section could be examined, first, in the light of Article 49 TFEU and Article 31 of the EEA Agreement and, secondly, in the light of Article 63 TFEU and Article 40 of the EEA Agreement.

17 However, since the Commission seeks primarily a declaration that the United Kingdom has failed to fulfil its obligations under Article 63 TFEU and Article 40 of the EEA Agreement, the Court should confine itself to examining the present case from the point of view of the provisions of the Treaty and the EEA Agreement on the free movement of capital, an examination from the point of view of freedom of establishment being necessary only if the failure to fulfil obligations alleged primarily is not established.

18 According to settled case-law of the Court, the measures prohibited by Article 63(1) TFEU as restrictions on the movement of capital include those that are such as to discourage non-residents from making investments in a Member State or to discourage that Member State's residents from doing so in other States (see, inter alia, judgment in *Commission* v *Finland*, C?342/10, EU:C:2012:688, paragraph 28 and the case-law cited).

19 In the present case, it is common ground that the effect of section 13 of the TCGA is that taxable gains made by non-resident close companies, including those resident in another Member State of the European Union, are immediately attributed for tax purposes to participators in those companies who are United Kingdom residents, if they hold rights over more than 10% of the gains. Those participators are then liable to tax on the amount of those gains, whether or not they have actually received them, the tax being calculated according to the gain made by the company itself. By contrast, for close companies resident in the United Kingdom, tax is charged only in the event of a distribution of the gains to the participators, or if the participators dispose of their interests in the company in question, the tax then being calculated, moreover, according to the amount actually received by the participator.

20 Consequently, in so far as that legislation is such as, first, to discourage residents of the United Kingdom, whether natural or legal persons, from contributing their capital to non-resident close companies and, secondly, to impede the possibility of such a company attracting capital from the United Kingdom, it constitutes a restriction of the free movement of capital, which is prohibited in principle by Article 63 TFEU.

21 That classification cannot be called in question by the fact that the tax burden on a participator in such a company may in some cases, set out in paragraph 5 above, be reduced or eliminated. It suffices to note here that those possibilities do not allow the restriction to be eliminated in all cases in which it occurs.

22 It must be examined, however, whether the restriction can be objectively justified by legitimate interests recognised by the law of the European Union.

23 According to settled case-law of the Court, the free movement of capital may be limited by national legislation only if it is justified by one of the reasons mentioned in Article 65 TFEU or by overriding reasons in the public interest as defined in the Court's case-law, to the extent that there are no harmonising measures at European Union level ensuring the protection of those interests (see, inter alia, judgments in *Commission* v *Germany*, C?112/05, EU:C:2007:623, paragraph 72

and the case-law cited, and *Commission* v *Portugal*, C?20/09, EU:C:2011:214, paragraph 59 and the case-law cited).

24 Thus the Court has repeatedly held that the objectives of combating tax evasion and tax avoidance may justify a restriction of the free movement of capital. That restriction must, however, be appropriate for attaining those objectives and not go beyond what is necessary for attaining them (see, inter alia, judgment in *Commission* v *Portugal*, EU:C:2011:214, paragraphs 60 and 61 and the case-law cited).

25 A national measure restricting the free movement of capital may thus be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and whose sole purpose is to avoid the tax normally payable on the profits generated by activities carried out on national territory (judgment in *Itelcar*, C?282/12, EU:C:2013:629, paragraph 34 and the case-law cited).

26 In the present case, the Commission does not dispute that section 13 of the TCGA may contribute to attaining the objective of combating tax avoidance. However, it submits that the provision goes beyond what is necessary for attaining that objective.

27 According to settled case-law of the Court, where rules are predicated on an assessment of objective and verifiable elements making it possible to identify the existence of a wholly artificial arrangement entered into for tax reasons alone, they may be regarded as not going beyond what is necessary to prevent tax evasion and tax avoidance, if, on each occasion on which the existence of such an arrangement cannot be ruled out, those rules give the taxpayer an opportunity, without subjecting him to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction (see, to that effect, judgment in *Itelcar*, EU:C:2013:629, paragraph 37 and the case-law cited).

28 It is clear, however, that section 13 of the TCGA is not confined specifically to targeting wholly artificial arrangements which do not reflect economic reality and are carried out for tax purposes alone, but also affects conduct whose economic reality cannot be disputed. The section applies generally to gains made on the disposal of assets by companies not resident in the United Kingdom controlled by no more than five persons, in particular without taking into account whether or not the taxpayer resident in the United Kingdom to whom the gain resulting from such a disposal is to be attributed is one of those persons, with its application being excluded only in a few circumstances, such as the disposal of an asset used exclusively for the purposes of a trade carried on by that company outside the United Kingdom. Furthermore, the section does not allow the taxpayer concerned to provide evidence to show the economic reality of his participation in the company in question.

29 It follows that section 13 of the TCGA goes beyond what is necessary for achieving its objective, as, moreover, is not contested by the United Kingdom.

30 In addition, since it is common ground that section 13 of the TCGA applies also to companies resident in a Member State of EFTA which is party to the EEA Agreement, and in so far as the provisions of Article 40 of the EEA Agreement have the same legal scope as the substantially identical provisions of Article 63 TFEU (judgments in *Commission* v *Belgium*, EU:C:2012:670, paragraph 88 and the case-law cited, and *Commission* v *Finland*, EU:C:2012:688, paragraph 53 and the case-law cited), all the foregoing considerations may, in circumstances such as those in the present case, be transposed *mutatis mutandis* to Article 40 of the EEA Agreement.

31 In those circumstances, having regard to all the foregoing, it must be held that, by adopting and maintaining tax legislation concerning the attribution of gains to participators in non-resident

companies which provides for a difference in treatment between domestic and cross-border activities, the United Kingdom of Great Britain and Northern Ireland has failed to fulfil its obligations under Article 63 TFEU and Article 40 of the EEA Agreement.

Costs

32 Under Article 138(1) of the Court’s Rules of Procedure, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party’s pleadings. Since the Commission has applied for costs and the United Kingdom has been unsuccessful, the United Kingdom must be ordered to pay the costs.

On those grounds, the Court (Eighth Chamber) hereby:

1. **Declares that, by adopting and maintaining tax legislation concerning the attribution of gains to participators in non-resident companies which provides for a difference in treatment between domestic and cross-border activities, the United Kingdom of Great Britain and Northern Ireland has failed to fulfil its obligations under Article 63 TFEU and Article 40 of the Agreement on the European Economic Area of 2 May 1992;**

2. **Orders the United Kingdom of Great Britain and Northern Ireland to pay the costs.**

[Signatures]

* Language of the case: English.