JUDGMENT OF THE COURT (Grand Chamber)

13 March 2007 *

In Case C-524/04,

REFERENCE for a preliminary ruling under Article 234 EC from the High Court of Justice of England and Wales, Chancery Division (United Kingdom), made by decision of 21 December 2004, received at the Court on 31 December 2004, in the proceedings

Test Claimants in the Thin Cap Group Litigation

v

Commissioners of Inland Revenue,

THE COURT (Grand Chamber),

composed of V. Skouris, President, P. Jann, C.W.A. Timmermans, A. Rosas, K. Lenaerts (Rapporteur), P. Kūris and E. Juhász, Presidents of Chambers,

* Language of the case: English.

J.N. Cunha Rodrigues, R. Silva de Lapuerta, K. Schiemann, J. Makarczyk, G. Arestis and A. Borg Barthet, Judges,

Advocate General: L.A. Geelhoed,
Registrar: L. Hewlett, Principal Administrator,

having regard to the written procedure and further to the hearing on 31 January 2006,

after considering the observations submitted on behalf of:

— Test Claimants in the Thin Cap Group Litigation, by G. Aaronson QC, P. Farmer and D. Cavender, Barristers,

— the United Kingdom Government, by C. Jackson and C. Gibbs, acting as Agents, and by D. Anderson QC, D. Ewart and S. Stevens, Barristers,

— the German Government, by M. Lumma and U. Forsthoff, acting as Agents,

— the Netherlands Government, by D.J.M. de Grave, acting as Agent,

— the Commission of the European Communities, by R. Lyal, acting as Agent,

after hearing the Opinion of the Advocate General at the sitting on 29 June 2006,

gives the following

Judgment

1 This reference for a preliminary ruling concerns the interpretation of Articles 43 EC and 49 EC, together with Articles 56 EC to 58 EC.

2 The reference has been made in proceedings between groups of companies ('the claimants in the main proceedings') and the Commissioners of Inland Revenue concerning the tax treatment of interest paid by United Kingdom-resident

companies in respect of loans granted by a company belonging to the same group ('the related company') which is not resident in that Member State.

National legal framework

3 The relevant provisions of the legislation in force in the United Kingdom are contained in the Income and Corporation Taxes Act 1988 ('ICTA'), initially in the version which applied prior to 1995 and, subsequently, in the version as amended, in particular, by the Finance Act 1995 and the Finance Act 1998.

The national provisions prior to the amendments made in 1995

4 Under section 209(2)(d) of ICTA, any interest paid by a United Kingdom-resident company on a loan was treated as a distribution of profits by that company to the extent that the interest represented more than a reasonable commercial return on the loan. That rule applied both when the loan was granted by a United Kingdom-resident company and when it was granted by a non-resident company. The amount by which the interest exceeded a reasonable commercial return was not deductible

from the borrowing company's taxable profits, but was treated as a distribution, that is to say, as a dividend. Because of this, the borrowing company became liable to advance corporation tax (ACT) under section 14 of ICTA.

5 In addition, under section 209(2)(e)(iv) and (v) of ICTA, any interest paid by a United Kingdom-resident company to a non-resident company belonging to the same group of companies, other than interest already treated as such under section 209(2)(d), was treated as a 'distribution', even where the interest represented a reasonable commercial return on the loan in question. That rule applied to loans made by a non-resident company to a resident subsidiary of which the former owned 75% of the capital or where both the companies were 75% subsidiaries of a non-resident third company.

6 However, under section 788(3) of ICTA, the national provisions referred to above did not apply where a double taxation convention ('DTC') was in place which prevented the application of those rules and thus ensured that, subject to certain conditions, the interest was allowed as a deduction for tax purposes. Depending on the conditions governing the deductibility of the interest, the DTCs concluded by the United Kingdom of Great Britain and Northern Ireland can be categorised as falling into one of two categories.

7 Under the first category of DTCs, such as those concluded with the Federal Republic of Germany, the Kingdom of Spain, the Grand Duchy of Luxembourg, the Republic of Austria and Japan, interest is deductible if, taking into account the amount of the loan in question, the amount of the interest corresponds to what would have been agreed at arm's length between the parties or between the parties and a third party.

8 The second category of DTCs, such as those concluded with the French Republic, Ireland, the Italian Republic, the Kingdom of the Netherlands, the United States of America and the Swiss Confederation, involves a more general enquiry into whether the amount of the interest exceeds, for any reason, what would have been agreed at arm's length between the parties or between the parties and a third party. That enquiry extends to the question whether the amount of the loan itself exceeds what would have been lent at arm's length.

9 Section 808A of ICTA, which was inserted by section 52 of the Finance (No 2) Act 1992, and applies to interest paid after 14 May 1992, provides that account is to be taken, as regards the second category of DTC, of all factors, including whether, had the relationship been one at arm's length, the loan would have been made at all, and, if so, how much would have been lent and the rate of interest which would have been agreed upon.

The amendments made to the legislation in 1995

10 Under the Finance Act 1995, which has effect generally in relation to interest paid after 28 November 1994, section 209(2)(d) of ICTA remained unaltered. However, section 209(2)(e)(iv) and (v) were replaced by section 209(2)(da), under which interest paid between members of the same group of companies is treated as a 'distribution' to the extent to which it exceeds the amount that would have been paid at arm's length between the payer and the payee of the interest. That rule applies to loans made by a company to another company in which the former owns 75% of the capital or where both the companies are 75% subsidiaries of a third company.

11 However, under section 212(1) and (3) of ICTA, as amended, section 209(2)(da) does not apply if the payer and the payee of the interest are both liable to corporation tax in the United Kingdom.

12 Section 209(2)(da) of ICTA was amplified by section 209(8A) to (8F). Section 209(8B) of ICTA specifies the criteria to be used in determining whether interest payments are to be treated as distributions. Section 209(8A), in conjunction with section 209(8D) to (8F) of ICTA, determines the extent to which companies can be grouped together for the purposes of assessing the level of their borrowing on a consolidated basis.

The amendments made to the legislation in 1998

13 Schedule 28AA, added to ICTA by the Finance Act 1998, lays down rules on transfer pricing, which also apply to interest payments between companies. Transactions between two companies under common control are subject to those rules if the terms under which they were entered into differ from what they would have been if the companies had not been under common control and if those terms give one of the affected parties a potential advantage in relation to United Kingdom tax legislation. The concept of 'common control' includes both the direct or indirect participation of a company in the management, control or capital of the other company concerned and the direct or indirect participation of a third person in the management, control or capital of both the other companies concerned.

14 Until those rules were amended in 2004, no potential advantage for one of the companies concerned was deemed to arise under that legislation where the other party to the transaction was also liable to tax in the United Kingdom and certain other conditions were satisfied.

15 In 2004, those rules were amended so as to apply where both parties to the transaction are liable to tax in the United Kingdom.

The main proceedings and the questions referred for a preliminary ruling

16 The main proceedings are part of a group litigation concerning the rules on thin capitalisation ('Thin Cap Group Litigation'), consisting of a number of claims for restitution and/or compensation brought by groups of companies against the Commissioners of Inland Revenue in the High Court of Justice of England and Wales, Chancery Division, following the judgment in Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779.

17 Each of the cases selected by the national court as test cases for the purposes of the present reference for a preliminary ruling involves a United Kingdom-resident company which is at least 75% owned, directly or indirectly, by a non-resident parent company and has been granted a loan either by that parent company or by another non-resident company which is at least 75% owned, directly or indirectly, by that parent company.

18 The test cases involve, first, loans granted to a United Kingdom-resident company by a company established in another Member State, each of the companies belonging to the same group of companies, the ultimate parent company of which is also established in that other State. That applies to some of those test cases, namely those involving the Lafarge and Volvo groups, in which the lending company and the parent company are established in the same Member State, that is to say, in this case, France and Sweden respectively.

19 Secondly, some of the test cases involve a United Kingdom-resident company which belongs to a group of companies headed by a parent company established in a non-member country, namely the United States of America, and which was granted a loan by another company in the same group which is, for its part, resident either in another Member State (the first type of Caterpillar group claim, which involves a loan granted by a lending company established in Ireland), or in a non-member country (the second type of Caterpillar group claim, which involves a loan granted by a lending company established in Switzerland), or in another Member State but operating through a branch resident in a non-member country (the PepsiCo Group Claim, where the company granting the loan has its seat in Luxembourg, but operates through a branch established in Switzerland).

20 According to the order for reference, some of the claimant companies converted part of those loans to equity in order to prevent the interest payments under the loans being re-characterised as a distribution under the legislation in force in the United Kingdom. Some of the claimant companies have concluded an agreement with the United Kingdom tax authorities as to how that legislation should be applied, laying down the terms upon which the tax authorities would assess loans to be granted within the group of companies in future years.

21 Following the judgment in *Lankhorst-Hohorst*, the claimants in the main proceedings brought claims for restitution and/or compensation for the con-

sequential tax disadvantages which they claim to have suffered as a result of the application of the United Kingdom legislation, which include, in particular, the additional corporation tax paid following the decision of the United Kingdom tax authorities to disallow interest paid as a deduction against their taxable profits and/or to limit such deductions, and the additional tax arising as a result of those companies having converted loans to equity.

22 In those circumstances, the High Court of Justice of England and Wales, Chancery Division, decided to stay the proceedings and to refer the following questions to the Court for a preliminary ruling:

'(1) Is it contrary to Articles 43 [EC], 49 [EC] or 56 EC for a Member State ("the State of the borrowing company") to keep in force and apply provisions such as those in sections 209, 212 and schedule 28AA of [ICTA] ("the national provisions") which impose restrictions upon the ability of a company resident in that Member State ("the borrowing company") to deduct for tax purposes interest on loan finance granted by a direct or indirect parent company resident in another Member State in circumstances where the borrowing company would not be subject to such restrictions if the parent company had been resident in the State of the borrowing company?

(2) What difference, if any, does it make to the answer to Question 1:

(a) if the loan finance is provided not by the parent company of the borrowing company but by another company ("the lending company") in the same

company group sharing a common direct or indirect parent company with the borrowing company and both that common parent and the lending company are resident in Member States other than the State of the borrowing company?

(b) if the lending company is resident in a Member State other than that of the borrowing company but all common direct or indirect parent companies of the borrowing company and the lending company are resident in a third country?

(c) if all the common direct or indirect parent companies of the lending company and the borrowing company are resident in third countries and the lending company is resident in a Member State other than that of the borrowing company, but advances the loan finance to the borrowing company from a branch of the lending company situated in a third country?

(d) if the lending company and all the common direct or indirect parent companies of the lending company and the borrowing company are resident in third countries?

(3) Would it make any difference to the answers to Questions 1 and 2 if it could be shown that the borrowing constituted an abuse of rights or was part of an artificial arrangement designed to circumvent the tax law of the Member State

of the borrowing company? If so, what guidance does the Court of Justice think it appropriate to provide as to what constitutes such an abuse or artificial arrangement in the context of cases such as the present?

(4) If there is a restriction on the movement of capital between Member States and third countries within Article 56 EC, did that restriction exist on 31 December 1993 for the purposes of Article 57 EC?

(5) In the event that any of the matters referred to in Questions 1 or 2 are contrary to Articles 43 [EC], 49 [EC] or 56 EC, then in circumstances where the borrowing company, or other companies in the borrowing company's group ("the Claimants") make the following claims:

(a) a claim for the repayment of the additional corporation tax paid by the borrowing company as a result of the disallowance, as a deduction against its profits chargeable to corporation tax, of interest paid to the lending company, where those interest payments would have been regarded as allowable deductions from the borrowing company's profits if the lending company had also been resident in the State of the borrowing company;

(b) a claim for repayment of the additional corporation tax paid by the borrowing company where the full amount of interest on the loan has

actually been paid to the lending company but the claim for a deduction in respect of that interest has been reduced because of the national provisions or the tax authority's application of them;

(c) a claim for the repayment of the additional corporation tax paid by the borrowing company where the amount of interest on loans from the lending company, allowable as a deduction against the borrowing company's profits, has been reduced because equity capital has been subscribed rather than loan capital, or has been substituted for existing loan capital, because of the national provisions or the tax authority's application of them;

(d) a claim for the repayment of the additional corporation tax paid by the borrowing company where the interest on loans from the lending company allowable as a deduction against the borrowing company's profits has been reduced by reducing the rate of interest chargeable on the loan (or making the loan interest free) as a result of the national provisions or the tax authority's application of them;

(e) a claim for restitution or compensation in respect of losses, or other tax reliefs or credits, of the borrowing company (or which were surrendered to the borrowing company by other companies in the borrowing company's group which were also resident in the State of the borrowing company) used by the borrowing company to offset the additional corporation tax liabilities referred to in paragraphs (a), (b) or (c) above, where such losses, reliefs and

credits would otherwise have been available for alternative use or to be carried forward;

(f) a claim for repayment of unutilised advance corporation tax paid by the borrowing company upon interest payments to the lending company which were re-characterised as distributions;

(g) a claim for restitution or compensation in respect of amounts of advance corporation tax paid in the circumstances referred to in paragraph (f) above but which were subsequently set off against the borrowing company's corporation tax liabilities;

(h) a claim for compensation for costs and expenses incurred by the Claimants in complying with the national provisions and the Revenue authority's application of them;

(i) a claim for restitution or compensation for the loss of return upon loan capital invested as equity (or converted to equity) in the circumstances described in (c); and

(j) a claim for restitution or compensation for any tax liability incurred by the lending company in its State of residence upon the deemed or imputed

receipt of interest from the borrowing company which was re-characterised as a distribution under the national provisions referred to in Question 1,

are such claims to be regarded, for the purposes of Community law, as:

— claims for restitution or repayment of sums unduly levied which arise as a consequence of, and adjunct to, the breach of the abovementioned Community provisions; or

— claims for compensation or damages; or

— claims for payment of an amount representing a benefit unduly denied?

(6) In the event that the answer to any part of Question 5 is that the claims are claims for payment of an amount representing a benefit unduly denied:

(a) are such claims a consequence of, and an adjunct to, the right conferred by the abovementioned Community provisions; or

(b) must all or some of the conditions for recovery laid down in Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and Factortame* [[1996] ECR I-1029] be satisfied; or

(c) must some other conditions be met?

(7) Does it make any difference whether as a matter of domestic law the claims referred to in Question 6 are brought as restitutionary claims or are brought or have to be brought as claims for damages?

(8) What guidance, if any, does the Court of Justice think it appropriate to provide in the present cases as to which circumstances the national court ought to take into consideration when it comes to determine whether there is a sufficiently serious breach within the meaning of the judgment in [*Brasserie du Pêcheur and Factortame*], in particular as to whether, given the state of the case-law on the interpretation of the relevant Community provisions, the breach was excusable?

(9) As a matter of principle, can there be a direct causal link (within the meaning of the judgment in [*Brasserie du Pêcheur and Factortame*]) between any breach of Articles 43 [EC], 49 [EC] and 56 EC and losses falling into the categories identified in Question 5(a)-(h) that are claimed to flow from it? If so, what

guidance, if any, does the Court of Justice think it appropriate to provide as to the circumstances which the national court should take into account in determining whether such a direct causal link exists?

(10) In determining the loss or damage for which reparation may be granted, is it open to the national court to have regard to the question of whether injured persons showed reasonable diligence in order to avoid or limit their loss, in particular by availing themselves of legal remedies which could have established that the national provisions did not (by reason of the application of double taxation conventions) have the effect of imposing the restrictions set out in Question 1? Is the answer to this question affected by the beliefs of the parties at the relevant times as to the effect of the double taxation conventions?'

The questions referred for a preliminary ruling

Questions 1 and 3

23 By Question 1, the national court essentially asks whether Articles 43 EC, 49 EC or 56 EC preclude legislation of a Member State which restricts the ability of a resident company to deduct, for tax purposes, interest paid on loan finance granted by a direct or indirect parent company which is resident in another Member State, where

that resident company would not have been subject to such a restriction if the interest had been paid on loan finance granted by a parent company which was resident in the first Member State.

24 This question should be considered together with Question 3, by which the national court essentially asks whether the answer to Question 1 would differ if it can be shown that the borrowing constitutes an abuse of rights or is part of an artificial arrangement designed to circumvent the tax law of the Member State in which the borrowing company is resident.

25 It should be noted at the outset that, although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law (see, inter alia, Joined Cases C-397/98 and C-410/98 *Metallgesellschaft and Others* [2001] ECR I-1727, paragraph 37; Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, paragraph 29; and Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, paragraph 36).

The freedoms of movement which apply

26 In so far as the national court seeks a ruling from the Court on the interpretation both of Article 43 EC relating to freedom of establishment and of Article 49 EC relating to the freedom to provide services, together with Article 56 EC relating to the free movement of capital, it is necessary to determine whether national legislation, such as the legislation at issue in the main proceedings, is capable of coming within the scope of those freedoms.

27 In accordance with settled case-law, national provisions which apply to holdings by nationals of the Member State concerned in the capital of a company established in another Member State, giving them definite influence on the company's decisions and allowing them to determine its activities, come within the substantive scope of the provisions of the EC Treaty on freedom of establishment (see, to that effect, Case C-251/98 *Baars* [2000] ECR I-2787, paragraph 22; Case C-436/00 *X and Y* [2002] ECR I-10829, paragraph 37; and Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* [2006] ECR II-7995, paragraph 31).

28 In the present case, as the Advocate General noted in points 33 and 34 of his Opinion, the national provisions at issue providing for the re-characterisation as a distribution of interest paid by a resident company ('the borrowing company') in respect of a loan granted by a non-resident company ('the lending company') apply only to situations where the lending company has a definite influence on the borrowing company or is itself controlled by a company which has such an influence.

29 In the first place, in the case of the legislation in force prior to the amendments made in 1998, the relevant provisions of ICTA applied to loans granted by a non-resident company to a resident subsidiary of which the former company owned 75% of the capital or where each of the companies was a 75% subsidiary of a third company.

30 In the second place, in the case of the amendments made in 1998, the legislation at issue applies only where the two companies in question are subject to common

control in the sense that one of them participates directly or indirectly in the management, control or capital or the other company concerned or a third party participates directly or indirectly in the management, control or capital of both the other companies concerned.

31 As the Commission of the European Communities has pointed out, legislation such as the legislation at issue in the main proceedings, which is directed against thin capitalisation of resident companies by a related non-resident company, concerns only situations in which the latter company enjoys a level of control over other companies belonging to the same group which allows it to influence the financing decisions of those other companies, in particular the decision as to whether those companies are to be financed by way of loan or equity capital.

32 Moreover, the order for reference shows that the cases selected as test cases in the proceedings before the national court involve United Kingdom-resident subsidiaries which are at least 75% owned, directly or indirectly, by a non-resident parent company or by another non-resident company which is also at least 75% owned, directly or indirectly, by that parent company.

33 Legislation such as the legislation at issue in the main proceedings, which is targeted only at relations within a group of companies, primarily affects freedom of establishment and should, accordingly, be considered in the light of Article 43 EC (see, to that effect, *Cadbury Schweppes and Cadbury Schweppes Overseas*, paragraph 32, and Case C-446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, paragraph 118).

34 If, as submitted by the claimants in the main proceedings, it were to be accepted that that legislation has restrictive effects on the freedom to provide services and the free movement of capital, such effects must be seen as an unavoidable consequence of any restriction on freedom of establishment and do not justify an independent examination of that legislation in the light of Articles 49 EC and 56 EC (see, to that effect, Case C-36/02 *Omega* [2004] ECR I-9609, paragraph 27; *Cadbury Schweppes and Cadbury Schweppes Overseas*, paragraph 33; and Case C-452/04 *Fidium Finanz* [2006] ECR I-9521, paragraphs 48 and 49).

35 The questions referred should therefore be answered in the light of Article 43 EC alone.

Whether there is a restriction on freedom of establishment

36 Freedom of establishment, which Article 43 EC grants to Community nationals and which includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, under the conditions laid down for its own nationals by the law of the Member State where such establishment is effected, entails, in accordance with Article 48 EC, for 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 European Community, the right to exercise their activity in the Member State concerned through a subsidiary, branch or agency (see, inter alia, Case C-307/97 *Saint-Gobain ZN* [1999] ECR I-6161, paragraph 35; *Marks & Spencer*, paragraph 30; and *Cadbury Schweppes and Cadbury Schweppes Overseas*, paragraph 41).

37 In the case of companies, their registered office for the purposes of Article 48 EC serves, in the same way as nationality in the case of individuals, as the connecting factor with the legal system of a State. Acceptance of the proposition that the Member State in which a subsidiary seeks to establish itself may freely apply different treatment merely by reason of the fact that the registered office of its parent company is situated in another Member State would deprive Article 43 EC of all meaning (see, to that effect, Case 270/83 *Commission* v *France* [1986] ECR 273, paragraph 18; Case C-330/91 *Commerzbank* [1993] ECR I-4017, paragraph 13; *Metallgesellschaft and Others*, paragraph 42; and *Marks & Spencer*, paragraph 37). Freedom of establishment thus aims to guarantee the benefit of national treatment in the host Member State, by prohibiting any discrimination based on the place in which companies have their seat (see, to that effect, *Commission* v *France*, paragraph 14, and *Saint-Gobain ZN*, paragraph 35).

38 In the present case, the national provisions regarding thin capitalisation provide that, in some circumstances, interest paid by a company to another company belonging to the same group in respect of a loan granted by the latter is to be treated as a distribution, thereby prohibiting the borrowing company from deducting the interest paid from its taxable profits.

39 The documents before the Court show that the fact that interest paid to a related company is treated as a distribution is capable of increasing the liability of the borrowing company to tax, not only because taxable profits cannot be reduced by the amount of the interest paid, but also because, by treating that interest as a distribution, that company may be liable to advance corporation tax when that transaction takes place.

40 It must be held that the national provisions relating to thin capitalisation give rise to a difference in treatment between resident borrowing companies according to whether or not the related lending company is established in the United Kingdom.

41 As regards, first, the national legislation which was in force until 1995, it is true that interest paid by a resident company was, in principle, treated as a distribution to the extent to which it represented more than a reasonable commercial return on the loan in question, whether or not the lending company was resident. However, where a resident company paid interest to a related non-resident company, apart from cases governed by a DTC which prevented the application of the national legislation, that interest was always treated as a distribution, even if it represented a reasonable commercial return on that loan.

42 With regard, secondly, to the national legislation as in force between 1995 and 1998, the provision which treated interest paid by one company to another belonging to the same group of companies as a distribution to the extent to which that interest exceeded the amount that would have been paid at arm's length between the payer and the payee of the interest, or between those parties and a third party, did not apply when both the borrowing company and the lending company were subject to tax in the United Kingdom.

43 Similarly, under the legislation in force between 1998 and 2004, interest paid between companies in the same group was governed by the rules on transfer pricing when it was payable pursuant to a transaction entered into on terms which differed

from what they would have been if those companies had not belonged to the same group and if the terms under which the transaction was entered into had given one of the parties involved a potential advantage in relation to United Kingdom tax legislation. The effect of that legislation is that such an advantage was deemed not to exist where certain conditions were satisfied, in particular the fact that the other party to the transaction was also liable to tax in the United Kingdom.

44 In so far as a company is liable to tax in the United Kingdom if it is resident in that Member State or carries on an economic activity there through a branch or agency, the provisions in force between 1995 and 2004 primarily imposed restrictions on loans granted by non-resident parent companies.

45 It follows that, even prior to 1995 and, in any case, between 1995 and 2004, when interest was paid by a resident company in respect of a loan granted by a related non-resident company, the tax position of the former company was less advantageous than that of a resident borrowing company which had been granted a loan by a related resident company.

46 As regards the compatibility of that difference in treatment with the Treaty provisions relating to freedom of establishment, the German and United Kingdom Governments submit, in the first place, that those provisions do not apply to a national rule which is concerned only with exercising fiscal competence, as allocated in accordance with internationally-recognised principles in the DTCs concluded by the United Kingdom.

47 Those Governments refer in that regard to the principle that States may allocate profits of companies belonging to the same group on the basis of the 'arm's-length' principle or 'arm's-length comparison' laid down, in particular, in Article 9 of the Model Tax Convention on Income and Capital of the Organisation for Economic Cooperation and Development (OECD). The German Government adds that, under that principle, it is the State in which the lending company is resident which has the right to tax the interest received where the transaction in question is entered into on arm's-length terms, whereas, should those terms not apply, the right to do so belongs to the State in which the borrowing company is resident.

48 As regards the implementation of that principle, the United Kingdom Government states that most of the DTCs which that Member State has concluded contain a provision permitting the respective competent authorities to agree a compensating adjustment, whereby any increase in taxable profits in the State of the borrowing company is matched by a corresponding reduction in taxable profits in the State in which the lending company is established.

49 It must be pointed out in that regard that, in the absence of any unifying or harmonising Community measures, Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation (Case C-336/96 *Gilly* [1998] ECR I-2793, paragraphs 24 and 30; Case C-470/04 *N* [2006] ECR I-7409, paragraph 44; and Case C-513/04 *Kerckhaert and Morres* [2006] ECR I-10967, paragraphs 22 and 23). In that context, it is for the Member States to take the measures necessary to prevent double taxation by applying, in particular, the apportionment criteria followed in international tax practice, including the model conventions drawn up by the OECD (see, to that effect, *Gilly*, paragraph 31; *N*, paragraph 45; and *Kerckhaert and Morres*, paragraph 23).

50 However, the national provisions at issue in the main proceedings are not based on a mere allocation of powers between the United Kingdom and the countries with which it has concluded DTCs.

51 Although, prior to the amendments to the legislation made in 1995, those national provisions stipulated that, save where there was a term to the contrary effect in a DTC, interest paid by a resident company in respect of a loan granted by a related non-resident company was to be treated as a distribution, in so doing, those provisions represented a unilateral choice on the part of the United Kingdom legislature. The same was true, prior to the amendments made in 1998, of interest paid in such circumstances which exceeded what would have been paid on an arm's-length basis and, following the amendments to the legislation made in 1998, of transactions entered into between two companies under common control if the terms under which they were entered into differed from what they would have been if those companies had not been under common control, in particular where those terms gave one of the parties concerned a potential tax advantage in relation to the legislation in force in the United Kingdom.

52 Rather than seeking to avoid the double taxation of profits arising in the United Kingdom, those provisions reflected the choice made by that Member State to organise its tax system in such a way as to prevent those profits from being untaxed in that State through a system of thin capitalisation of resident subsidiaries by related non-resident companies. As the Advocate General stated at points 55 and 56 of his Opinion, the unilateral nature of the provisions treating certain interest paid to non-resident companies as a distribution is negated neither by the fact that, in giving effect to such treatment, that Member State did so on the basis of

internationally-recognised principles nor even by the fact that, in the case of lending companies that are resident in certain other countries, that State sought to couple the application of its national legislation with DTCs containing clauses designed to prevent or to mitigate the double taxation that might arise from such treatment.

53 Moreover, even if, in some cases, the application of the provisions at issue in the main proceedings did no more than implement criteria laid down in DTCs, the fact remains that, in exercising the powers of taxation allocated under them, the Member States are obliged to comply with the rules of Community law (see, to that effect, *Saint-Gobain ZN*, paragraphs 58 and 59, and Case C-385/00 *De Groot* [2002] ECR I-11819, paragraph 94) and, more particularly, the freedom of establishment which Article 43 EC guarantees.

54 As regards, lastly, the fact that, under the provisions of a DTC, an increase in taxable profits resulting from a re-characterisation of interest may be matched by a corresponding reduction in taxable profits in the State in which the lending company is resident, it is true that, since the tax regime resulting from a DTC forms part of the legal framework applying in the main proceedings and has been presented as such by the national court, the Court must take it into account in order to provide an interpretation of Community law that is relevant to the national court (see, to that effect, Case C-319/02 *Manninen* [2004] ECR I-7477, paragraph 21; Case C-265/04 *Bouanich* [2006] ECR I-923, paragraphs 51 to 55; *Test Claimants in Class IV of the ACT Group Litigation*, paragraph 71; and Case C-170/05 *Denkavit Internationaal and Denkavit France* [2006] ECR I-11949, paragraph 45).

55 However, the documents before the Court do not show that where, under the legislation in force in the United Kingdom, interest paid by a resident company to a related non-resident company falls to be treated as a distribution, the application of that national legislation coupled with the relevant provisions of a DTC generally allows the increase in the charge to tax arising from the adjustment made to the taxable profits of the borrowing company to be offset. In that regard, the claimants in the main proceedings do not share the United Kingdom Government's view that, by reason of the DTCs which the United Kingdom has concluded with other Member States and the application of Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (OJ 1990 L 225, p. 10), the tax disadvantage inflicted on a group of companies as a result of the application of the national provisions relating to thin capitalisation has always been matched by a corresponding advantage.

56 Even if it were to be accepted that a tax advantage granted in the State in which the lending company is resident might be capable of offsetting the charge to tax arising for the borrowing company from the application of the legislation of the State in which it is resident, the documents before the Court do not show that, by virtue of the application of the legislation in force in the United Kingdom, coupled with the DTCs concluded by that Member State, any upward adjustment to the taxable profits of the borrowing company to which the re-characterisation of the interest paid to a related non-resident company may give rise is offset by the grant of a tax advantage to the latter company in the State in which it is resident.

57 In the second place, the United Kingdom Government argues that the difference in treatment arising under the legislation at issue in the main proceedings does not constitute a direct and certain obstacle to the exercise of freedom of establishment, since it has neither the object nor the effect of making it less attractive for companies established in other Member States to exercise freedom of establishment in the United Kingdom.

58 According to that Government and the German Government, rather than giving rise to discrimination, the legislation in force in the United Kingdom merely distinguishes between situations which are not comparable. Those Governments state that it is only in a multinational context that a group of companies may, by financing a United Kingdom-resident subsidiary by loan, rather than equity, capital, organise a 'transfer of profits' to another State where those profits will be subject to a lower rate of tax, with the result that the profits made by the resident subsidiary will avoid being taxed in the United Kingdom. Furthermore, only a foreign parent company has the choice of establishing itself in the State in which interest is taxed at a particularly low rate, or is exempt from tax.

59 In that regard, it must be held, first, that the difference in treatment to which the subsidiaries of non-resident parent companies are, by virtue of legislation such as the legislation at issue in the main proceedings, subjected in comparison with subsidiaries of resident parent companies is capable of restricting freedom of establishment even if, from a tax perspective, the position of a multinational group of companies is not comparable to that of a group of companies, each of which is resident in the same Member State.

60 It is true that, within a group of companies, the risk that the financing of a subsidiary will be structured in such a way that profits are transferred to a State where they are subject to a lower rate of tax does not normally arise if all of the companies in question are subject, in the same Member State, to the same rate of tax. However, that does not mean that the rules adopted by a Member State for the specific purpose of dealing with the situation of multinational groups may not, in some cases, constitute a restriction on the freedom of establishment of the companies concerned.

61 Secondly, it must be held that a difference in treatment between resident subsidiaries which is based on the place where their parent company has its seat

constitutes a restriction on freedom of establishment, since it makes it less attractive for companies established in other Member States to exercise freedom of establishment and they may, in consequence, refrain from acquiring, creating or maintaining a subsidiary in the Member State which adopts that measure (see *Lankhorst-Hohorst*, paragraph 32).

62 Contrary to what the United Kingdom Government submits, in order for such legislation to be considered to be a restriction on freedom of establishment, it is sufficient that it be capable of restricting the exercise of that freedom in a Member State by companies established in another Member State, and it is not necessary to establish that the legislation in question has actually had the effect of leading some of those companies to refrain from acquiring, creating or maintaining a subsidiary in the first Member State.

63 It follows that the difference in treatment which applies to resident borrowing companies by virtue of the national provisions relating to thin capitalisation at issue in the main proceedings on the basis of the registered office of the related lending company constitutes a restriction on freedom of establishment.

The justification for the restriction on freedom of establishment

64 Such a restriction is permissible only if it is justified by overriding reasons of public interest. It is further necessary, in such a case, that its application be appropriate to

ensuring the attainment of the objective in question and not go beyond what is necessary to attain it (*Marks & Spencer*, paragraph 35, and *Cadbury Schweppes and Cadbury Schweppes Overseas*, paragraph 47).

65 The United Kingdom Government, supported by the German Government, argues that the national provisions at issue in the main proceedings are justified by both the need to ensure the cohesion of the national tax system and that of preventing tax avoidance. According to the United Kingdom Government, the true position is that these are two aspects of the same objective, which is to ensure fair and coherent tax treatment.

— The need to ensure the cohesion of the national tax system

66 As regards, in the first place, the need to ensure the cohesion of the national tax system, the United Kingdom Government submits that, by ensuring that 'covert' dividend payments are taxed once only, in the appropriate tax jurisdiction, the national legislation guarantees, through the DTCs that have been entered into, that any increase in taxable profits in the United Kingdom is offset by a corresponding reduction in the taxable profits of the lender in the State in which it is resident. By contrast, in *Lankhorst-Hohorst*, no equivalent provision existed in the DTC concluded between the Federal Republic of Germany and the Kingdom of the Netherlands.

67 The German Government adds that, where the borrowing company and the lending company are resident in the same Member State, the tax advantage to which an

interest payment gives rise, that is to say, the deduction of that payment from the taxable profits of the borrowing company, is always offset by a corresponding tax disadvantage to the lending company, in the form of the taxation of the interest received. The fact that there is no entitlement to such an offset where the lending company is resident in another Member State leads the Member States to allocate their taxing powers according to whether the transaction in question was entered into on an arm's-length basis.

68 In that respect, it should be pointed out that, in paragraphs 28 and 21 respectively of the judgments in Case C-204/90 *Bachmann* [1992] ECR I-249 and Case C-300/90 *Commission* v *Belgium* [1992] ECR I-305, the Court recognised that the need to maintain the cohesion of a tax system can justify a restriction on the exercise of the fundamental freedoms guaranteed by the Treaty. However, for an argument based on such a justification to succeed, a direct link must be established between the tax advantage concerned and the offsetting of that advantage by a particular tax levy (see, to that effect, Case C-484/93 *Svensson and Gustavsson* [1995] ECR I-3955, paragraph 18; *Manninen*, paragraph 42; and Case C-471/04 *Keller Holding* [2006] ECR I-2107, paragraph 40).

69 As was stated in paragraphs 55 and 56 of this judgment, even if it were to be accepted that a tax advantage granted in the State in which the lending company is resident might be capable of offsetting the charge to tax arising for the borrowing company from the application of the legislation of the State in which it is resident, the Governments which have submitted observations have not shown that, by virtue of the application of the legislation in force in the United Kingdom, coupled with the DTCs concluded by that Member State, any upward adjustment to the taxable profits of the borrowing company to which the re-characterisation of interest paid to a related non-resident company may give rise is offset by the grant of a tax advantage to the latter company in the State in which it is resident.

70 In those circumstances, the restriction on freedom of establishment constituted by the national provisions at issue in the main proceedings cannot therefore be justified by the need to ensure the cohesion of the tax system.

— The grounds based on the fight against abusive practices

71 As regards, in the second place, the issues relating to the fight against tax avoidance, the United Kingdom Government states that, unlike the German legislation at issue in *Lankhorst-Hohorst*, the national provisions relating to thin capitalisation are targeted at a particular form of tax avoidance, which consists in the adoption of artificial arrangements designed to circumvent the tax legislation in the State in which the borrowing company is resident. The provisions in force in the United Kingdom go no further than is necessary in order to attain that objective, inasmuch as they are based on the internationally-recognised arm's-length principle, they treat as a distribution only that proportion of the interest which exceeds what would have been paid under a transaction entered into on an arm's-length basis and they are applied with flexibility, particularly as they provide for an advance clearance procedure.

72 It must be pointed out that, according to established case-law, a national measure restricting freedom of establishment may be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned (see, to that effect, Case C-264/96 *ICI* [1998] ECR I-4695, paragraph 26; *Lankhorst-Hohorst*, paragraph 37; *Marks & Spencer*, paragraph 57; and *Cadbury Schweppes and Cadbury Schweppes Overseas*, paragraph 51).

73 The mere fact that a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty (see, to that effect, Case C-478/98 *Commission* v *Belgium* [2000] ECR I-7587, paragraph 45; *X and Y*, paragraph 62; Case C-334/02 *Commission* v *France* [2004] ECR I-2229, paragraph 27; and *Cadbury Schweppes and Cadbury Schweppes Overseas*, paragraph 50).

74 In order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory (*Cadbury Schweppes and Cadbury Schweppes Overseas*, paragraph 55).

75 Like the practices referred to in paragraph 49 of the judgment in *Marks & Spencer*, which involved arranging transfers of losses incurred within a group of companies to companies established in the Member States which applied the highest rates of taxation and in which the tax value of those losses was therefore the greatest, the type of conduct described in the preceding paragraph is such as to undermine the right of the Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardise a balanced allocation between Member States of the power to impose taxes (*Cadbury Schweppes and Cadbury Schweppes Overseas*, paragraph 56).

76 As the United Kingdom Government observes, national legislation such as the legislation at issue in the main proceedings is targeted at the practice of thin capitalisation, under which a group of companies will seek to reduce the taxation of profits made by one of its subsidiaries by electing to fund that subsidiary by way of loan capital, rather than equity capital, thereby allowing that subsidiary to transfer profits to a parent company in the form of interest which is deductible in the calculation of its taxable profits, and not in the form of non-deductible dividends. Where the parent company is resident in a State in which the rate of tax is lower than that which applies in the State in which its subsidiary is resident, the tax liability may thus be transferred to a State which has a lower tax rate.

77 By providing that that interest is to be treated as a distribution, such legislation is able to prevent practices the sole purpose of which is to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory. It follows that such legislation is an appropriate means of attaining the objective underlying its adoption.

78 It remains necessary to determine whether or not that legislation goes beyond what is necessary to attain that objective.

79 As the Court held in paragraph 37 of its judgment in *Lankhorst-Hohorst*, that requirement is not met by national legislation which does not have the specific purpose of preventing wholly artificial arrangements designed to circumvent that legislation, but applies generally to any situation in which the parent company has its seat, for whatever reason, in another Member State.

80 By contrast, legislation of a Member State may be justified by the need to combat abusive practices where it provides that interest paid by a resident subsidiary to a non-resident parent company is to be treated as a distribution only if, and in so far as, it exceeds what those companies would have agreed upon on an arm's-length basis, that is to say, the commercial terms which those parties would have accepted if they had not formed part of the same group of companies.

81 The fact that a resident company has been granted a loan by a non-resident company on terms which do not correspond to those which would have been agreed upon at arm's length constitutes, for the Member State in which the borrowing company is resident, an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State. In that regard, the question is whether, had there been an arm's-length relationship between the companies concerned, the loan would not have been granted or would have been granted for a different amount or at a different rate of interest.

82 As the Advocate General stated at point 67 of his Opinion, national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement, entered into for tax reasons alone, is to be considered as not going beyond what is necessary to prevent abusive practices where, in the first place, on each occasion on which the existence of such an arrangement cannot be ruled out, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that arrangement.

83 In order for such legislation to remain compatible with the principle of proportionality, it is necessary, in the second place, that, where the consideration of those elements leads to the conclusion that the transaction in question represents a purely artificial arrangement without any underlying commercial justification, the re-characterisation of interest paid as a distribution is limited to the proportion of that interest which exceeds what would have been agreed had the relationship between the parties or between those parties and a third party been one at arm's length.

84 In the present case, the documents before the Court show that, prior to the amendments made in 1995, the legislation in force in the United Kingdom provided that interest paid by a resident subsidiary in respect of a loan granted by a non-resident parent company was treated, in its entirety, as a distribution, with no assessment of whether the loan satisfied a relevant criterion, such as that of being granted at arm's length, and without that subsidiary being given any opportunity to provide evidence as to any valid commercial justifications there may have been for the loan.

85 However, those documents also show that that legislation did not apply in cases involving a DTC which prevented the application of those rules and thus ensured that the interest in question was allowed as a deduction for tax purposes, provided that the rate of interest did not exceed what would have been agreed upon on an arm's-length basis. Under such a DTC, only that proportion of the interest which exceeded what would have been paid on an arm's-length basis was treated as a distribution.

86 Whilst a tax regime such as the regime which arises, in cases to which they apply, under the DTCs concluded by the United Kingdom appears initially to be based on a consideration of objective and verifiable elements which make it possible to determine whether a purely artificial arrangement, entered into for tax reasons

alone, is involved, it is for the national court to determine, should it be established that the claimants in the main proceedings benefited from such a regime, whether that regime gave them an opportunity, if their transactions did not satisfy the conditions laid down under the DTC in order to assess their compatibility with the arm's-length criterion, to provide evidence as to any commercial justification there may have been for the transactions, without being subject to any undue administrative constraints.

87 The same applies to the national provisions in force after the legislative amendments introduced in 1995 and 1998. It is a matter of agreement that, under those provisions, it is only interest which exceeds what would be paid on an arm's-length basis that falls to be re-characterised as a distribution. Whilst, at first sight, the criteria laid down by those provisions appear to require a consideration of objective and verifiable elements in order to determine whether a purely artificial arrangement, entered into for tax reasons alone, is involved, it is for the national court to determine whether those provisions allow taxpayers, where the transaction does not satisfy the arm's-length criterion, to produce evidence of the commercial justifications for that transaction, under the conditions referred to in the preceding paragraph.

88 Contrary to what the Commission submits, where a Member State treats all or part of the interest paid by a resident company to a non-resident company belonging to the same group of companies as a distribution, after having determined that a purely artificial arrangement, designed to circumvent its tax legislation, is involved, that Member State cannot be obliged to ensure in such a case that the State in which the latter company is resident does everything necessary to avoid the payment which is treated as a dividend being taxed, as such, at group level both in the Member State in which the former company is resident and in the Member State in which the latter company is resident.

89 In so far as, in such a case, the Member State in which the former company is resident may lawfully treat interest paid by that company as a distribution of profits, it is not, in principle, for that State to ensure that profits distributed to a non-resident shareholder company are not subject to a series of charges to tax (see, to that effect, *Test Claimants in Class IV of the ACT Group Litigation*, paragraphs 59 and 60).

90 It is only where a Member State decides to exercise its powers of taxation not only, as regards resident subsidiaries, in relation to profits made in that State but also, as regards non-resident companies receiving distributions, in relation to the income which the latter receive from those subsidiaries, that that State is obliged, in order for the latter companies not to be confronted with a restriction on freedom of establishment which is prohibited, in principle, by Article 43 EC, to ensure that, under the procedures laid down by its national law in order to prevent or mitigate a series of liabilities to tax, non-resident companies receiving distributions are subject to the same treatment as resident companies which receive such distributions (see, to that effect, *Test Claimants in Class IV of the ACT Group Litigation*, paragraph 70, and *Denkavit Internationaal and Denkavit France*, paragraph 37).

91 Furthermore, as was noted in paragraph 49 of this judgment, in the absence of any unifying or harmonising Community measures, Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation.

92 The answer to Questions 1 and 3 must therefore be that Article 43 EC precludes legislation of a Member State which restricts the ability of a resident company to

deduct, for tax purposes, interest on loan finance granted by a direct or indirect parent company which is resident in another Member State or by a company which is resident in another Member State and is controlled by such a parent company, without imposing that restriction on a resident company which has been granted loan finance by a company which is also resident, unless, first, that legislation provides for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allows taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question and, secondly, where it is established that such an arrangement exists, such legislation treats that interest as a distribution only in so far as it exceeds what would have been agreed upon at arm's length.

Question 2

93 By Question 2, the national court essentially asks whether the answer to Question 1 would be different if the loan finance was provided to a resident company, not by a parent company which is resident in another Member State, but:

— by another company belonging to the same group of companies, where that company and the parent company of that group are resident in another Member State;

— by another company belonging to the same group of companies which is resident in another Member State, where the common parent companies of the borrowing company and the lending company are resident in a non-member country; or

— by another company belonging to the same group of companies which is resident in another Member State but provides the loan through a branch situated in a non-member country, where the common parent companies of the borrowing company and the lending company are resident in a non-member country; or

— by another company belonging to the same group of companies which is, together with the common parent companies of the borrowing company and the lending company, resident in a non-member country.

94 In that regard, it must be noted, first of all, that, as was stated in paragraph 61 of this judgment, national legislation such as the legislation at issue in the main proceedings which, in treating interest paid by a resident subsidiary to a parent company as a distribution, applies a difference in treatment between resident subsidiaries which is based on the place where their parent company has its seat, constitutes a restriction on freedom of establishment, since it makes it less attractive for companies established in other Member States to exercise freedom of establishment and they may, in consequence, refrain from acquiring, creating or maintaining a subsidiary in the Member State which adopts such a measure.

95 It follows that legislation of this kind constitutes a restriction on freedom of establishment which is prohibited, in principle, by Article 43 EC, both where a

resident borrowing company is granted a loan by a company which is established in another Member State and has a direct or indirect holding in the capital of the borrowing company, conferring on it definite influence on the decisions of that company and allowing it to determine its activities, and where a borrowing company is granted a loan by another non-resident company which, irrespective of where it is resident, is itself controlled by a company which is resident in another Member State and which has, directly or indirectly, such a holding in the capital of the borrowing company.

96 The answer given to Question 1 therefore also applies to the situation referred to in the first indent to Question 2.

97 As regards the situations referred to in the second, third and fourth indents to Question 2, it must be noted, as was stated in paragraph 36 of this judgment, that Article 43 EC, read in conjunction with Article 48 EC, entails, for 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, the right to exercise their activity in the Member State concerned through a subsidiary, branch or agency.

98 Article 43 EC has accordingly no bearing on the application of national legislation such as the legislation at issue in the main proceedings to a situation in which a

resident company is granted a loan by a company which is resident in another Member State and which does not itself have a controlling shareholding in the borrowing company and where each of those companies is directly or indirectly controlled by a common parent company which is resident, for its part, in a non-member country.

99 Where, in such a situation, the Member State which has adopted that legislation treats interest paid by the borrowing company as a distribution, that measure affects freedom of establishment, not as regards the lending company, but only as regards the parent company which enjoys a level of control over each of the other companies concerned allowing it to influence the funding decisions of those companies. In so far as that related company is not established in a Member State for the purposes of Article 48 EC, Article 43 EC is not applicable.

100 For the same reasons, Article 43 EC has no bearing on the application of that legislation to a situation in which both the lending company and the common parent company are resident in a non-member country, nor does it have any bearing on a situation in which a lending company which is resident in another Member State and does not itself control the borrowing company grants the loan through a branch established in a non-member country, where the common parent company is also resident in a non-member country.

101 As regards the other provisions of the Treaty relied on by the claimants in the main proceedings, it must be pointed out that, as was stated in paragraphs 33 and 34 of this judgment, legislation such as the legislation at issue in the main proceedings, which is targeted only at relations within a group of companies, primarily affects

freedom of establishment. Even if it were to be accepted that such legislation might have restrictive effects on the freedom to provide services and the free movement of capital, such effects must be seen as an unavoidable consequence of any restriction on freedom of establishment and do not justify an independent examination of that legislation in the light of Articles 49 EC and 56 EC.

102 The answer to Question 2 must therefore be that Article 43 EC has no bearing on legislation of a Member State, such as the legislation referred to in Question 1, where that legislation applies to a situation in which a resident company is granted a loan by a company which is resident in another Member State or in a non-member country and which does not itself control the borrowing company and where each of those companies is controlled, directly or indirectly, by a common parent company which is resident in a non-member country.

Question 4

103 By Question 4, the national court essentially asks whether, if legislation such as the legislation at issue in the main proceedings were to constitute a restriction on the free movement of capital between Member States and non-member countries within the terms of Article 56 EC, such a restriction falls to be treated as existing on 31 December 1993 for the purposes of Article 57(1) EC.

104 It must be stated at the outset, as is clear from paragraphs 33, 34 and 101 of this judgment, that legislation such as the legislation at issue in the main proceedings must be examined in the light of Article 43 EC and not Article 56 EC.

105 It is therefore unnecessary to reply to Question 4.

Questions 5 to 10

106 By Questions 5 to 10, which should be considered together, the national court essentially asks whether, in the event that the national measures referred to in the preceding questions are incompatible with Community law, claims such as those brought by the claimants in the main proceedings in order to remedy such an incompatibility must be classified as actions for restitution of sums unduly levied or advantages unduly refused or, conversely, as claims for compensation in respect of damage suffered. In the latter case, it asks whether it is necessary to satisfy the conditions laid down in the judgment in *Brasserie du Pêcheur and Factortame* and whether account must be taken, in that regard, of the form in which such claims must be brought under national law.

107 As regards the application of the conditions under which a Member State is liable to make reparation for the loss and damage caused to claimants as a result of an infringement of Community law, the national court asks the Court to provide guidance as to the need for a sufficiently serious breach of that law and the need for a causal link between the breach of the obligation imposed on the Member State and the loss and damage suffered by the injured parties.

108 Lastly, the national court asks whether, in determining the losses which are to be reimbursed or in respect of which compensation is to be provided, it is appropriate to have regard to the question whether the injured parties showed reasonable diligence in order to avoid their loss, in particular in bringing actions before the courts.

109 It must be stated in that regard that it is not for the Court to assign a legal classification to the actions brought before the national court by the claimants in the main proceedings. In the circumstances, it is for the latter to specify the nature and basis of their actions (whether they are actions for restitution or actions for compensation for damage), subject to the supervision of the national court (see *Metallgesellschaft and Others*, paragraph 81, and *Test Claimants in the FII Group Litigation*, paragraph 201).

110 However, the fact remains that, according to well-established case-law, the right to a refund of charges levied in a Member State in breach of the rules of Community law is the consequence and complement of the rights conferred on individuals by Community provisions as interpreted by the Court. The Member State is therefore required in principle to repay charges levied in breach of Community law (*Test Claimants in the FII Group Litigation*, paragraph 202 and the case-law cited there).

111 In the absence of Community rules on the refund of national charges levied though not due, it is for the domestic legal system of each Member State to designate the courts and tribunals having jurisdiction and to lay down the detailed procedural rules governing actions for safeguarding rights which individuals derive from

Community law, provided, first, that such rules are not less favourable than those governing similar domestic actions (principle of equivalence) and, secondly, that they do not render virtually impossible or excessively difficult the exercise of rights conferred by Community law (principle of effectiveness) (*Test Claimants in the FII Group Litigation*, paragraph 203 and the case-law cited there).

112 In addition, where a Member State has levied charges in breach of the rules of Community law, individuals are entitled to reimbursement not only of the tax unduly levied but also of the amounts paid to that State or retained by it which relate directly to that tax. As the Court held in paragraphs 87 and 88 of the judgment in *Metallgesellschaft and Others*, that also includes losses constituted by the unavailability of sums of money as a result of a tax being levied prematurely (*Test Claimants in the FII Group Litigation*, paragraph 205 and the case-law cited there).

113 However, contrary to what the claimants in the main proceedings contend, neither the reliefs or other tax advantages waived by a resident company in order to be able to offset in full a tax levied unlawfully against an amount due in respect of another tax, nor the loss and damage suffered by such a company because the group to which it belongs saw itself as having to substitute financing by way of equity capital for loan capital in order to reduce its overall charge to tax, nor the expenses incurred by the companies in that group in order to comply with the national legislation at issue, can form the basis of an action under Community law for the reimbursement of the tax unlawfully levied or of sums paid to the Member State concerned or withheld by it directly against that tax. Such expenditure is the result of decisions taken by those companies and does not constitute, on their part, an inevitable consequence of the decision by the United Kingdom to treat certain interest paid to non-resident companies as a distribution.

114 That being the case, it is for the national court to determine whether the expenditure referred to in the preceding paragraph represents, in the case of the companies concerned, financial losses suffered by reason of a breach of Community law for which the Member State in question is responsible.

115 While it has not gone so far as to rule out the possibility of a State being liable in less restrictive conditions on the basis of national law, the Court has held that there are three conditions under which a Member State will be liable to make reparation for loss and damage caused to individuals as a result of breaches of Community law for which it can be held responsible, namely that the rule of law infringed must be intended to confer rights on individuals, that the breach must be sufficiently serious, and that there must be a direct causal link between the breach of the obligation resting on the State and the loss or damage sustained by the injured parties (see *Brasserie du Pêcheur and Factortame*, paragraphs 51 and 66; Case C-224/01 *Köbler* [2003] ECR I-10239, paragraphs 51 and 57; and *Test Claimants in the FII Group Litigation*, paragraph 209).

116 It is, in principle, for the national courts to apply the criteria for establishing the liability of Member States for damage caused to individuals by breaches of Community law, in accordance with the guidelines laid down by the Court for the application of those criteria (*Test Claimants in the FII Group Litigation*, paragraph 210 and the case-law cited there).

117 In the main proceedings, the first condition is plainly satisfied as regards Article 43 EC. That provision confers rights on individuals (see *Brasserie du Pêcheur and*

Factortame, paragraphs 23 and 54, and *Test Claimants in the FII Group Litigation*, paragraph 211).

118 As regards the second condition, it should be pointed out, first, that a breach of Community law will be sufficiently serious where, in the exercise of its legislative power, a Member State has manifestly and gravely disregarded the limits on its discretion. Secondly, where, at the time when it committed the infringement, the Member State in question had only considerably reduced, or even no, discretion, the mere infringement of Community law may be sufficient to establish the existence of a sufficiently serious breach (*Test Claimants in the FII Group Litigation*, paragraph 212 and the case-law cited there).

119 In order to determine whether a breach of Community law is sufficiently serious, it is necessary to take account of all the factors which characterise the situation brought before the national court. Those factors include, in particular, the clarity and precision of the rule infringed, whether the infringement and the damage caused were intentional or involuntary, whether any error of law was excusable or inexcusable, and the fact that the position taken by a Community institution may have contributed to the adoption or maintenance of national measures or practices contrary to Community law (*Test Claimants in the FII Group Litigation*, paragraph 213 and the case-law cited there).

120 On any view, a breach of Community law will clearly be sufficiently serious if it has persisted despite a judgment finding the infringement in question to be established,

or a preliminary ruling or settled case-law of the Court on the matter from which it is clear that the conduct in question constituted an infringement (*Test Claimants in the FII Group Litigation*, paragraph 214 and the case-law cited there).

121 In the present case, in order to determine whether a breach of Article 43 EC committed by the Member State concerned was sufficiently serious, the national court must take into account the fact that, in a field such as direct taxation, the consequences arising from the freedoms of movement guaranteed by the Treaty have been only gradually made clear, in particular by the principles identified by the Court since delivering judgment in Case 270/83 *Commission* v *France*. Until delivery of the judgment in *Lankhorst-Hohorst*, the problem raised by the current reference for a preliminary ruling had not, as such, been addressed in the Court's case-law.

122 As regards the third condition, namely the requirement for a causal link between the breach of the obligation resting on the State and the loss or damage sustained by the injured parties, it is for the national court to assess whether the loss and damage claimed flows sufficiently directly from the breach of Community law to render the State liable to make it good (*Test Claimants in the FII Group Litigation*, paragraph 218 and the case-law cited there).

123 Subject to the right of reparation which flows directly from Community law where those conditions are satisfied, it is on the basis of the rules of national law on liability that the State must make reparation for the consequences of the loss and damage caused, provided that the conditions for reparation of loss and damage laid down by

national law are not less favourable than those relating to similar domestic claims and are not so framed as to make it, in practice, impossible or excessively difficult to obtain reparation (*Test Claimants in the FII Group Litigation*, paragraph 219 and the case-law cited there).

124 It should be made clear that, in order to determine the loss or damage for which reparation may be granted, the national court may inquire whether the injured person showed reasonable diligence in order to avoid the loss or damage or limit its extent and whether, in particular, he availed himself in time of all the legal remedies available to him (*Brasserie du Pêcheur and Factortame*, paragraph 84).

125 In that regard, the Court held in paragraph 106 of the judgment in *Metallgesellschaft and Others*, with respect to tax legislation which did not afford the possibility of benefiting from the group taxation regime to resident subsidiaries of non-resident parent companies, that the exercise of rights conferred on private persons by directly applicable provisions of Community law would be rendered impossible or excessively difficult if their claims for restitution or compensation based on infringement of Community law were rejected or reduced solely because the persons concerned had not applied for a tax advantage which national law denied them, with a view to challenging the refusal of the tax authorities by means of the legal remedies provided for that purpose, invoking the primacy and direct effect of Community law.

126 Similarly, the application of the provisions relating to freedom of establishment would be rendered impossible or excessively difficult if claims for restitution or compensation based on infringement of those provisions were rejected or reduced solely because the companies concerned had not applied to the tax authorities to be

allowed to pay interest on loans granted by a non-resident parent company without that interest being treated as a distribution when, in the circumstances at issue, national law, combined, where appropriate, with the relevant provisions of the DTCs, provided for such treatment to apply.

127 It is for the national court to determine whether, should it be established that the national legislation at issue in the main proceedings, combined, where appropriate, with the relevant provisions of the DTCs, did not satisfy the conditions set out in paragraph 92 of this judgment and thus constituted an obstacle to the freedom of establishment prohibited by Article 43 EC, the application of that legislation would, on any basis, have led to the failure of the claims of the claimants in the main proceedings before the United Kingdom tax authorities.

128 The answer to Questions 5 to 10 must therefore be as follows:

— In the absence of Community legislation, it is for the domestic legal system of each Member State to designate the courts and tribunals having jurisdiction and to lay down the detailed procedural rules governing actions for safeguarding rights which individuals derive from Community law, including the classification of claims brought by injured parties before national courts and tribunals. Those courts and tribunals are, however, obliged to ensure that individuals have an effective legal remedy enabling them to obtain reimbursement of the tax unlawfully levied on them and the amounts paid to that Member State or withheld by it directly against that tax. As regards other loss or damage which a

person may have sustained by reason of a breach of Community law for which a Member State is liable, the latter is under a duty to make reparation for the loss or damage caused to individuals under the conditions set out in paragraph 51 of the judgment in *Brasserie du Pêcheur and Factortame*, but that does not preclude the State from being liable under less restrictive conditions, where national law so provides.

— Where it is established that the legislation of a Member State constitutes an obstacle to freedom of establishment prohibited by Article 43 EC, the national court may, in order to establish the recoverable losses, determine whether the injured parties have shown reasonable diligence in order to avoid those losses or to limit their extent and whether, in particular, they availed themselves in time of all legal remedies available to them. However, in order to prevent the exercise of the rights which Article 43 EC confers on individuals from being rendered impossible or excessively difficult, the national court may determine whether the application of that legislation, coupled, where appropriate, with the relevant provisions of DTCs, would, in any event, have led to the failure of the claims brought by the claimants in the main proceedings before the tax authorities of the Member State concerned.

The application for a limitation on the temporal effects of the judgment

129 At the hearing, the United Kingdom Government requested the Court, if it were to interpret Community law as precluding national legislation such as the legislation at issue in the main proceedings, to limit the temporal effects of its judgment, even as regards legal proceedings brought before the date on which this judgment is delivered. That Government estimates the cost of an interpretation of Community law which is unfavourable to it at EUR 300 million.

130 It is clear that the United Kingdom Government has not, in the present case, stated the basis on which it reaches its estimate of the costs of the effects of this judgment, nor even whether that amount relates only to the financial consequences arising under the main proceedings or also to those which would flow from this judgment in other cases.

131 In addition, the amount put forward by that Government proceeds on the hypothesis that the answers given by the Court would, in their entirety, be those proposed by the claimants in the main proceedings, which, however, it is for the national court to determine.

132 In those circumstances, the Court does not have sufficient information before it to consider the application made by the United Kingdom Government.

133 It is therefore not appropriate to limit the temporal effects of the present judgment.

Costs

134 Since these proceedings are, for the parties to the main proceedings, a step in the actions pending before the national court, the decision on costs is a matter for that court. Costs incurred in submitting observations to the Court, other than the costs of those parties, are not recoverable.

On those grounds, the Court (Grand Chamber) hereby rules:

1. **Article 43 EC precludes legislation of a Member State which restricts the ability of a resident company to deduct, for tax purposes, interest on loan finance granted by a direct or indirect parent company which is resident in another Member State or by a company which is resident in another Member State and is controlled by such a parent company, without imposing that restriction on a resident company which has been granted loan finance by a company which is also resident, unless, first, that legislation provides for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, to be established and allows taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question and, secondly, where it is established that such an arrangement exists, such legislation treats that interest as a distribution only in so far as it exceeds what would have been agreed upon at arm's length.**

2. **Article 43 EC has no bearing on legislation of a Member State, such as the legislation referred to in Question 1, where that legislation applies to a situation in which a resident company is granted a loan by a company which is resident in another Member State or in a non-member country and which does not itself control the borrowing company and where each of those companies is controlled, directly or indirectly, by a common parent company which is resident in a non-member country.**

3. **In the absence of Community legislation, it is for the domestic legal system of each Member State to designate the courts and tribunals having**

jurisdiction and to lay down the detailed procedural rules governing actions for safeguarding rights which individuals derive from Community law, including the classification of claims brought by injured parties before national courts and tribunals. Those courts and tribunals are, however, obliged to ensure that individuals have an effective legal remedy enabling them to obtain reimbursement of the tax unlawfully levied on them and the amounts paid to that Member State or withheld by it directly against that tax. As regards other loss or damage which a person may have sustained by reason of a breach of Community law for which a Member State is liable, the latter is under a duty to make reparation for the loss or damage caused to individuals under the conditions set out in paragraph 51 of the judgment in Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and Factortame* [1996] ECR I-1029, but that does not preclude the State from being liable under less restrictive conditions, where national law so provides.

Where it is established that the legislation of a Member State constitutes an obstacle to freedom of establishment prohibited by Article 43 EC, the national court may, in order to establish the recoverable losses, determine whether the injured parties have shown reasonable diligence in order to avoid those losses or to limit their extent and whether, in particular, they availed themselves in time of all legal remedies available to them. However, in order to prevent the exercise of the rights which Article 43 EC confers on individuals from being rendered impossible or excessively difficult, the national court may determine whether the application of that legislation, coupled, where appropriate, with the relevant provisions of double taxation conventions, would, in any event, have led to the failure of the claims brought by the claimants in the main proceedings before the tax authorities of the Member State concerned.

[Signatures]