The issue in the case was whether Her Majesty's Revenue and Customs ("HMRC") should close its enquiry into Vodafone's tax return for the period ending March 31, 2001. The purpose of HMRC's enquiry was to determine whether Vodafone should be held liable for tax on the profits of its wholly-owned subsidiary, Vodafone Investments Luxembourg Sarl ("VIL") under the controlled foreign companies legislation ("the CFC legislation").

Vodafone was an indirect, wholly-owned subsidiary of Vodafone Group plc. VIL, incorporated in Luxembourg, was a wholly-owned subsidiary of Vodafone. VIL was a resident for tax purposes in Luxembourg. VIL was incorporated as part of the project by which the Vodafone Group acquired the German company Mannesmann AG purchased in March 2000. VIL's accounts showed equity investments valued at 38 billion euros and debt investments amounting to 35 billion euros representing loans made by VIL to the Mannesmann Group and other telecommunications companies of which it was the holding company.

A UK resident company is subject to UK corporation tax on its worldwide profits. These profits include those of a permanent establishment outside the UK but do not generally include the profits of any of its subsidiary companies. The profits of such subsidiary companies are taxed under the laws of their countries of residence -- UK resident subsidiaries under UK corporation tax, foreign registered subsidiaries under the tax regimes of their countries of residence.

As an exception to this general rule, the profits of a controlled foreign subsidiary company ("a CFC"), where the CFC legislation applies, are apportioned among the persons and companies with an interest in it and taxed on those parties accordingly. The CFC legislation applies to certain CFCs which are resident outside the UK in countries where they are subject to a "lower level of taxation." A CFC is subject to a "lower level of taxation" in any accounting period where the tax paid by the CFC in the country of its residence for tax purposes is less than three quarters of the amount of the tax that would be payable had the subsidiary been resident in the UK.

Whether a resident of a Member State is entitled to enjoy the freedom of establishment provided for in Article 43 (EC Treaty) involves the balancing of two potentially conflicting rights and principles under European law. The first is the right under those articles to establish itself within the territory of another Member State freely and without disadvantage. The second principle is that Member States are entitled to enact legislation which restricts the enjoyment of Community rights in order to prevent abuse of those rights provided that such legislation is proportionate, i.e. does not go too far and thus penalize those who seek to enjoy a particular right, here the right of free establishment. A national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned. The court concluded that it is impossible to construe the U.K. CFC legislation so as to make it conform with the right of freedom of establishment under Article 43.

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