



The Law Society
of England and Wales

Review of the Balance of Competences between the United Kingdom and the European Union – Taxation

Written response by the Law Society of England and Wales

February 2013



Review of the Balance of Competences between the United Kingdom and the European Union – Taxation

Response by the Law Society of England and Wales

Introduction

- I. The Law Society of England and Wales is the independent professional body, established for solicitors in 1825, that works globally to support and represent its 166,000 members, promoting the highest professional standards and the rule of law. The Law Society welcomes the opportunity to comment on the consultation paper.
- II. The Tax Law Committee of the Law Society places great weight on the UK tax regime being stable and predictable, and tax law (whether statutory or case law) being accessible. Indeed with the possible exception of the first principle, a good starting point in assessing the impact of the EU on the UK tax system is whether EU action has furthered or detracted from the principles for corporate tax reform published by HMRC/HMT in 2010: namely stability, aligned with modern business practice; avoiding complexity; and maintaining a level playing field.

Question 1 - What evidence is there that EU-level action on taxation advantages the UK?

1. A number of EU measures in the field of taxation have been of benefit to the UK, in particular the Parent-Subsidiary Directive, Mergers Directive, Interest and Royalties Directive and progress towards increasing cooperation between national governments, for example with regard to information exchange and mutual assistance in the recovery of tax liabilities.
2. The UK has a long-standing policy of not imposing withholding tax on dividends, not an approach shared by all Member States. That, coupled with the relative ease with which businesses can be established in the UK and the increasing use of English as an international business language, means that the UK could be a natural location for an intermediate holding company for investors into Europe. The enactment of the Parent-Subsidiary directive, providing for no withholding tax to be imposed on dividends paid by qualifying subsidiaries, enhances the UK's relative competitive advantage.
3. Whilst a decision upholding a challenge to HMRC's legislation might have an impact on tax receipts and/or require refunds with interest or damages to be paid, the ability of the taxpayers concerned to enforce their rights under the Treaties could be seen to be of a longer term benefit to the UK.
4. Another benefit that has accrued from EU action has been the enactment of the Arbitration Convention which provides a means by which double taxation is avoided (by virtue of the fact that Member States seeking to bring profits into charge in more than one country are bound within time limits to reach agreement) is avoided. This is an improvement over the position under many double tax treaties where there is no timetable and little scope for the affected taxpayer(s) to influence the contracting states in reaching agreement on what measures to take.

5. While the impact on the UK's competitiveness position of the Mergers Directive has not been as marked as that of the Parent-Subsidiary Directive, we suspect that it has helped facilitate the reorganisation of businesses and operations in Continental Europe of UK-headquartered groups.
6. It continues to be a principle of international law, subject to any contrary agreement reached between contracting states, that one country will not enforce another country's revenue laws. The Mutual Assistance Directive enables the UK to require another Member State to enforce a UK tax liability in that Member State (and similarly the UK to enforce a tax liability of another Member State). This, together with the Savings Directive, may have assisted HMRC in reducing evasion.
7. The agreements reached between countries as regards phasing out of tax practices under the Code of Conduct group may have reduced the scope of Member States to reduce tax on favoured types of business (e.g. headquarters of companies) by what could be regarded as "aggressive" special tax regimes and so reduce the potential that, in aggregate, all Member States seeking to rely on tax incentives harm their respective tax bases in a "race to the bottom".
8. One might argue that there has been some "levelling off" of differences between Member States' tax systems given the recent jurisprudence of the CJEU, which perhaps means that taxpayers know where they stand with greater certainty when they operate from a number of Member States or are seeking to relocate or establish subsidiaries or branches in other Member States.
9. Whilst harmonisation is a sensitive topic, and even matters such as the Common Consolidated Corporation Tax Base (CCCTB) can elicit much debate, this form of "harmonisation of approach" between Member States and their tax authorities could be seen to have certain benefits for individuals and businesses. State Aid restrictions and the Code of Conduct have also gone to create a more level playing field between Member States.

Question 2 - What evidence is there that EU-level action on taxation disadvantages the UK?

10. Where the UK's tax legislation has been found to be incompatible, particularly where it is perceived to be anti-avoidance legislation, one perspective might be that this may put the UK tax base at risk. However, given that the CJEU has merely identified that the legislation in question contravenes the obligations to which the UK subjected itself when it joined the EU, the tax in question should not have been assumed to be available to the UK exchequer. Essentially what the CJEU does is to assess the degree of interference with one or more of the four freedoms resulting from the measure in question and evaluate whether such interference goes beyond the minimum level of interference needed to achieve the UK's policy, taking account of alternatives open to the UK.
11. One of the principal concerns is a perception that the Court may be placing less emphasis on its *Bachmann* principle of cohesion of the tax system as it seeks to ensure that taxpayers have an "effective" remedy for infringements of EU law. This focus on effective remedies can lead to unwinding assessments and revisiting tax liabilities incurred many years previously, and in our view has caused significant uncertainty, both for taxpayers and the wider public finances.

There is a perception that the CJEU focuses principally on the measure(s) alleged to restrict the four freedoms without taking into account whether there are countervailing benefits in the tax regime which partly or fully compensate for the restrictive measure.

12. We recognise that the CJEU is making a decision in principle which is then referred to the domestic courts to apply in the context of the Member States concerned. But nonetheless, the proceedings before the CJEU may in fact deal only with certain aspects of a country's taxation system without taking account of balancing factors in other parts of the tax system. On a reference from a national court or in an action brought by the European Commission against a Member State, there is no general right to intervene before the CJEU. Thus the CJEU proceedings are inevitably limited by the facts and circumstances presented to the Court by the Commission, the parties in the reference, and the United Kingdom government should it choose to exercise its right to intervene. This compares with the more considered and integrated tax system that might be expected to result from legislation which has benefitted from broad consultation both on policy and implementation. Of course, we recognise that any adverse "knock-on" consequences of CJEU judgments may also be attributed to the "fault" of the relevant Member States not taking active steps to review whether their domestic legislation is compliant with the EU principles but instead hoping to preserve taxing rights which they could not expect to preserve.
13. There can be circumstances where CJEU decisions may affect more than one Member State – for instance where a decision on one Member State's regime may have an effect on another State's (other States') regime(s). So, for instance, any Member State that had provided a VAT exemption for claims handling in the insurance sector (as the UK had done) could find that the domestic legislation exempted activities required under the VAT Directive to be liable to VAT following *Arthur Andersen & Co*. We are also conscious that, while certain CJEU decisions might be said to make the UK (or any other Member State's) tax law less clear, the resulting doubt over the scope of the UK's (or another Member State's) legislation has to be balanced against the need for there to be a level playing field across the EU – and the value to UK business of such a level playing field being established and maintained. On some occasions, uncertainty has also been exacerbated in the UK by the rather narrow way in which HMRC has sought to implement decisions of the CJEU, requiring individual taxpayers to litigate further, either in the domestic courts or before the CJEU again.
14. A related point is that CJEU intervention in tax issues may overlay tax legislation in individual Member States and so generate uncertainty, perhaps exacerbated by the sometimes Delphic nature of judicial pronouncements of the CJEU and inconsistency in the approach to particular tax issues as decisions come before different Advocates-General and judiciary of the CJEU.
15. This is not helped by a perception that, unlike a decision in the UK courts, which would distinguish or otherwise "explain away" a previous decision which the court in question was choosing not to follow, the CJEU on occasions just does not refer to a previous decision on the legal issue in question, or takes it on itself to rephrase the carefully worded questions put to it by the local referring Court. However, such uncertainty can also arise in cases heard before the domestic courts as different tiers of judges reach, possibly conflicting, decisions.

16. In one regard, it could be said that EU level action on taxation potentially disadvantages the UK (but if it does so, it affects other Member States too). We refer to the need in certain circumstances for proposed tax measures to be approved by the Commission from a State Aid perspective. On the other hand, certain Member States might be viewed as innately more pre-disposed than the UK to provide aid to “national champions” or enterprises associated with a Member State (e.g. airlines). On that basis, the need for Commission approval may in fact assist enterprises from Member States such as the UK which wish to do business in such “intervention-minded” Member States. Again, this concerns the level playing field provided by EU law and defended by the CJEU to the benefit of UK business.
17. The European Commission will on occasion take steps to challenge a Member State’s approach to taxation by issuing a reasoned opinion to the State concerned in effect asking the State to justify its legislation or, if not, to change it. Where the State disagrees with the Commission the dispute is referred to the CJEU. This has happened to the UK on several occasions, whether in relation to VAT - for instance whether zero-rating was limited to transactions where there was a social purpose in not imposing VAT - or direct tax, such as the UK’s group relief rules.
18. A consequence of challenge is that additional tax may be due (e.g. as a result of the restriction of zero-rating) which may benefit the State concerned but also restrict its scope to adjust its tax regime to take account of social or economic factors.
19. The response of tax authorities to “CJEU-proof” legislation and/or draft legislation in a compliant fashion has led to significant complexity in certain areas in the UK such as: the introduction of domestic transfer pricing; thin capitalisation rules; and expansion of dividend exemptions to non-UK dividends but with a series of complex exclusions to the exemptions that apply to both UK and non-UK dividends etc. It has also led to the introduction of certain tax provisions which require an accompanying understanding of EU law, e.g. the proposed s.742A(3) ITA 2007 where, under the amended transfer of assets abroad rules, it will be necessary to assess whether an individual’s liability to tax under those rules would constitute an unjustified and disproportionate restriction on a freedom protected under Title II or IV of the TFEU.
20. It might also be argued that the judgments given by the CJEU are not always sufficiently clear in order to be helpful to national courts that have to apply the principles to the case before them. However, we appreciate that the CJEU needs to adopt judgments that can be applied in a multitude of different legal systems, and that this constrains the degree of precision that it can provide. We also note a trend towards giving stronger guidance as to the conclusions that the national courts may wish to reach, but this is not always the case. Finally, it can sometimes be difficult to identify broader principles from a judgment, which leads to the risk of multiple references on similar matters – but again we recognise that the CJEU may in such cases deliberately be seeking to develop its case-law gradually, so as to ensure that all relevant factors are taken into account and to avoid unnecessary disturbance to national legal systems and tax regimes.
21. We also consider that part of the problem in this regard may in fact lie with the UK interpretation. A good example is the manner in which EU VAT legislation

has often been transposed into UK law, using terms not readily apparent from the original text and with additional contributions from the draftsman that years later get struck down when a case is brought. This type of issue is presumably why there has been a move towards implementing regulations, to try and create a more level playing field and remove Member States' ability to implement directives in the manner in which they wish to read them, pending a challenge.

22. There are also examples of EU legislation that has proved complex but of limited effect. One example is the EU Savings Directive (EUSD) , which whilst it has limited "retail" avoidance by taxpayers banking in their next door Member State and not declaring the resulting income, is very straightforward to circumvent for those who can. The ongoing EUSD review and proposals to tighten up the approach and mechanisms adopted are a clear statement that the Directive originally adopted in 2003 has not fully achieved its objective.

Question 3 - What do you think are the main considerations in determining the appropriate level for decisions to be made on tax policy?

23. A key consideration in determining the appropriate level for decisions to be made on tax policy is the extent to which action at the level of a Member State or at the level of the EU will best achieve the goals of a Member State, consistent with the obligations to which the Member State has subjected itself. For example, the UK government perceives it to be in the UK's interest for its citizens (individual or "corporate") to be able to trade freely with persons based in, and to invest in, inter alia, other Member States.
24. This would suggest that while there can be drawbacks in having to negotiate with 26 other Member States, if changes are to be made to the VAT system applicable throughout the Union, it might still be preferable to a regime where any individual Member State had a freer hand to introduce changes to VAT/turnover taxes in its own country, but which may (in)advertently favour persons based in that Member State or disadvantage those based outside the State.
25. Indeed, it is clear from the Commission's papers on more streamlined VAT regimes in Member States, that there can be drawbacks – different forms and different interpretations of underlying legislation – if each Member State can determine its own VAT regime.
26. Conversely, there would seem to be no reason why the UK should not have the freedom to introduce a tax on, or remove tax from, an asset or activity where the incidence of that tax had no actual or potential impact on persons in other Member States which was less favourable than its impact, actual or potential, on UK based persons.
27. Where policy is determined at Member State level, rather than EU level, relevant local factors might be given more weight by HM Treasury than they would by the Commission. It could also be that taking decisions locally gave certain groups greater influence on tax policy than if decisions on policy were made at an EU level – so for instance tax policy in Member States with highly developed financial services groups might differ from tax policy in Member States with substantial manufacturing capacity or a significant proportion of their population still involved in agriculture. It may be debateable whether this approach is consistent with the single market, but equally each Member State is likely to be in the best position to

determine the scope of tax measures that best suits its economy and provides resources for its planned expenditure.

28. To the extent that it is seen to be necessary, in the interests of the single market, for tax policies in specific areas to be developed at EU level, this tension would best be resolved by ensuring that it is the Member States (and not just the Commission in isolation) that are responsible for that development, and that it is the broad parameters of the policy that are set at EU level. Member States should then be afforded a significant degree of latitude in developing systems and operational procedures more attuned to the needs of the local population/tax-paying community unless in relation to any particular Member State the Commission can demonstrate such latitude is being exploited in ways that undermine the rationale for developing EU level tax policy in the particular case.
29. While there could be advantages in seeking to reach, e.g. via a forum such as the OECD, agreement with the widest number of countries on fundamental tax issues exercising many countries' exchequers, such as how to secure a fair allocation of profits from international business using the internet to sell remotely, it is possible that certain countries may perceive that their interests are served well by the current international tax architecture.
30. Accordingly, it may be easier to reach agreement with a small number of Member States which obtain a significant proportion of their tax revenues from corporate income tax. So HMT will doubtless be considering whether active participation in the design of the CCCTB would assist the likelihood of the UK receiving an appropriate share of the profits realised for such businesses, particular if such businesses "play off" Member States to produce tax incentives that operate as a "race to the bottom". Against that having a harmonised tax base could reduce the scope for targeted incentives such as the patent box. That of course is affected by whether the UK's economy is better served by a less highly taxed, broader base with less incentives or a tax regime with higher rates (not least because tax incentives are less valuable as rates fall).
31. This characteristic of the VAT regime should be noted in the context of proposals for the CCCTB. The draft directive does not contain much of the detail that would be required for a properly functioning tax system. Differences in local implementation would undermine a great deal of the purpose behind it. Without significant fleshing out of the rules, business will be left in a position of considerable uncertainty.

Question 4 - Are there any other impacts of EU action on taxation that should be noted, including as regards the process for taking action (for example unanimity versus qualified majority voting)?

32. From a VAT perspective there is an argument that implementation of a Directive by enactment of legislation locally gives scope for differences between Member States (whereas production of regulations with direct effect gives less scope for differences between Member States) that may impede intra-EU trade. However, it is imperative that the development of regulations involves representatives of the business community or other sectors potentially affected to ensure that regulations are sufficiently precise and attuned to the operational requirements of those who have to self-assess liabilities.

Question 5 - How might the UK benefit from the EU taking more action on taxation? Please provide specific examples, identifying where possible the pros and cons.

33. Concern has recently been expressed that despite a significant level of sales taking place involving UK resident individuals, certain (principally US-headquartered) multi-nationals have been paying no or little UK corporation tax. This stance, on the limited information available, would seem to be justified based on the structures used by the groups (e.g. sales companies located in lower tax jurisdictions) using UK resident companies either to perform low risk activities meriting limited remuneration on normal transfer pricing methodologies or to carry on activities that are merely introductory and which are asserted not to constitute permanent establishments of overseas resident companies. It would appear too, from the published material that levels of royalties paid on respect of intellectual property or other “intangibles” are difficult for HMRC to challenge.
34. The Commission has proposed the possible adoption of a CCCTB which, in very broad terms, would allocate profits and losses made by relevant corporate groups among Member States by reference to certain factors – e.g. sales, employees etc.
35. To the extent that (i) the issue identified in paragraph 33 above was a perceived “mis-allocation” of profits among Member States, and (ii) agreement could be reached on the relative weighting of the factors (as that would influence the level of tax revenues allocated to each State) this might address the issue identified in paragraph 33.
36. However, to the extent that the perceived mischief identified in paragraph 33 resulted from the level of royalties attributable to intangibles or other services provided from lower or no tax countries located outside the EU e.g. Bermuda or Switzerland, the adoption of the CCCTB by all Member States would at best only ameliorate the problem.
37. In addition the UK (and clearly certain other Member States, such as Ireland and Luxembourg) has concluded that there are benefits to individual countries of having a competitive tax system. To the extent that the CCCTB limited the scope for introducing tax incentives in a particular country (because the tax base was determined by the CCCTB, not local rules on profit computation), this would mean that the UK (and other countries) could only compete on the tax rate or quality of tax administration.
38. Overall, the Society suspects it is likely that co-ordination among Member States on cross-border tax issues reduces the burdens on business (if the alternative is conflicting regimes, uncertainty or tax authorities trying to enhance their jurisdictions’ tax “take” at the expense of other countries).
39. HMRC may also believe less tax is lost to evasion as a result of co-operation.
40. There are also a number of missed opportunities where developments in EU financial regulation have not been matched in relation to EU taxation. As an example, through the various UCITS directives, but particularly UCITS IV, funds in one Member State can be managed from another; funds can more easily merge cross border; and “master-feeder” structures can be adopted that allow

more straightforward marketing of funds to investors across Europe. However, although these are all now possible as a regulatory matter, the tax rules of each jurisdiction have hampered taxpayers' ability to take advantage of the increased flexibility. For example, a corporate fund managed cross border may be treated as subject to tax in the jurisdiction in which the manager is resident. Equally, a cross-border reconstruction under which an investment in a local fund is exchanged for an investment in a fund in another Member State may give rise to tax liabilities and/or result in a worse tax position going forward, where the same position would not apply in a purely domestic transaction. Whilst, arguably, this may amount to a breach of one of the fundamental freedoms, a better approach would be to adopt a "UCITS Tax Directive" setting out on an EU wide basis the rules that are to apply.

41. The Common Customs Tariff (CCT) is, of course, a tax raised on the import of goods into the EU. The Society expresses no view as to whether the tax, once collected, is distributed fairly between the member states. The following points are based on practitioners' experience of customs cases:
- a) The CCT has been subject in some cases to serious abuse and avoidance. This particularly applies to abuse of the system of tariff preferences for developing economies;
 - b) Where abuse has been uncovered enforcement has sometimes been weak and has resulted in failure to collect duties which should have been paid (examples include tuna from various then 'Lomé' countries, orange juice imported from countries having association agreements and misuse of the local content rules in relation to electronic products);
 - c) In addition to strengthening the systems for enforcement of the CCT rules, improvements could also be made to the automatic acceptance of Certificates of Origin issued by the country of export which are very often just a rubber stamp.
42. More generally, the CCT is, of course, an essential part of a common trading zone which the EU is. A common external tariff is essential for the trading zone to work. We would simply question whether steps should be taken to improve enforcement to make sure that tariffs due are actually paid and collected.

Question 6 - How might the UK benefit from the EU taking less action on taxation? Please provide specific examples, identifying where possible the pros and cons.

43. The Society is not convinced that the proposals on the Financial Transaction Tax are in accordance with the Treaties, or that they will enhance the single market in financial services. The extra-territorial effect proposed by the tax will have an adverse effect on Member States not imposing the FTT (which include the UK) and indeed outside the EU. However, the existence of the Mutual Assistance Directive probably results in the effects for non-participating Member States being worse than for non-Member States.
44. The Society notes that there may be some residual concerns over whether enforcement in the UK of judgments or claims for tax of other countries is retrograde. For example where there are differences in the threshold test for

liability which dictates when it can be enforced on an EU wide basis. The Society's perception is that such enforcement usually follows a procedure not dissimilar from that in the UK courts, and any occasional "hard cases" may in fact serve to reduce the scope for evasion across the EU as a whole.

Question 7 - How could action on taxation be undertaken differently? For example: (a) Could more action be taken at the national level? If so, what domestic legislation would be needed on taxation in the absence of EU legislation, for example to take account of issues around international trade and cross-border transactions? (b) What action could best be taken at other international levels (by a different body or institution)?

45. The Society is concerned that although legislation in Member States has moved towards greater compliance with EU law, the approach of tax authorities has not and can vary significantly between Member States. In the VAT arena, various current or proposed measures such as the one-stop shop and simplified/aligned VAT reporting/invoicing will go some way to assist, but there is more that needs to be done.
46. As a longstanding member of the OECD, and significant past contributor to OECD working parties, the UK might well conclude that the OECD would be an institution through which policy making and recommendations might be made and/or influenced.
47. As with any organisation where members have widely differing interests, with businesses at different levels of sophistication and with different degrees of dependency on domestic and international markets, it may be hard to achieve consensus on important tax matters. For example, were the United States to perceive that "playing off" the tax regimes of European countries and/or the current US regime for the taxation of companies with overseas operations gave US headquartered groups a substantial competitive advantage, it might be difficult to reach agreement on changes to the tax treatment of corporate income.

Question 8 - What future challenges and opportunities might the UK face on the balance of competence on taxation? What impact might different scenarios for the future development of the EU have on the national interest?

48. The Society has no comment on this question.

Question 9 - Are there any general points on competence you wish to make that are not captured above?

49. The Society considers that it would be difficult to give a definitive answer to the question of whether EU action on taxation matters has been good or bad for the UK - in part because the answer depends on the capacity in which one is judging the impact. From the point of view of a specific taxpayer, substantive challenges to tax rules may be viewed as an advantage; as a general taxpayer, the decrease in tax revenue might be viewed as a disadvantage.
50. Possibly a distinction can also be drawn between the ability to claim repayments of tax as a result of an EU challenge which would be disadvantageous to the general taxpayer and the ability to force the government to make the rules EU compliant for the future. The latter situation may provide advantages to both the

general and individual taxpayer as it enhances the ease, and therefore attractiveness, of doing business in the UK - for example, in the case of the dividend exemption recently introduced in the UK corporate tax regime at least in part to address the non EU compliant differential treatment from a tax perspective of companies receiving UK source and overseas source dividends.

51. When the UK acceded to the Union it accepted that action could be taken to enable individuals and businesses to exercise the four internal market freedoms – of goods, services, persons and capital. The Society notes that some action on taxation at EU level is necessary to ensure smooth operation of the internal market.
52. A significant body of case law has developed in the CJEU, particularly since 1997, calling into question the compatibility of individual Member States' tax regimes with the four freedoms.
53. A substantial amount of that case law has resulted from UK taxpayers challenging provisions in the UK tax regime – whether charges; the regime for taxation of dividends; cross-border loss relief; the UK CFC regime; or Stamp Duty Reserve Tax. Successful challenges initiated from other Member States have also contributed. Even if particular statutory provisions have not been challenged by taxpayers, individual advisors may have suggested to HMRC (or its predecessor bodies) that UK domestic legislation was incompatible with the EU law, and so caused potential charges not in fact to be imposed or enforced.
54. Further, the European Commission has, whether of its own motion or prompted by complaints by taxpayers, on several occasions challenged the compatibility of UK domestic legislation with EU law for example, in relation to the UK VAT grouping rules, section 13 Taxation of Chargeable Gains Act 1992 and section 720 Income Tax Act 2007.
55. Given that that the UK is a relatively open economy enabling both external businesses to invest in the UK and UK-headquartered businesses to invest outside the UK, these developments have the consequence of requiring the UK to treat inbound and outbound investment in a similar manner compared to purely domestic investment, i.e. maintaining a level playing field. While this clearly limits the ability of the UK to design its own tax system, overall it may prove to be a catalyst for a more open system that is attractive to investment.

For further information please contact:

Mickaël Laurans

The Law Societies' Brussels Office

T: +32 2 743 85 85

E: mickael.laurans@lawsociety.org.uk