THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW REPRESENTATION

TAXREP 30/10

DOUBLE TAX CONVENTIONS AND THE INTERNAL MARKET: FACTUAL EXAMPLES OF DOUBLE TAXATION CASES

Memorandum submitted in June 2010 to the European Commission by the Tax Faculty of the Institute of Chartered Accountants in England and Wales representing a response to the public consultation paper and online questionnaires published on 27 April 2010.

Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
www.icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX 877 London/City

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INTRODUCTION

1. We are writing to provide a response to the public consultation paper published on 27 April 2010 together with online questionnaires asking for factual examples of double taxation cases.

2. We have not provided factual examples as such but have set out below instances where our members have indicated that they, or their clients, suffer double taxation which is not mitigated by the terms of double tax conventions or domestic law.

3. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Appendix 1.

WHO WE ARE

4. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

5. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

6. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter TAXline to more than 11,000 members of the Institute who pay an additional subscription, and a free weekly newswire.

COMMENTS

Royalty withholding taxes not fully relieved

7. A number of the UK treaties with other EU member states allow for a withholding tax rate to be applied to royalties paid to UK resident companies. So for instance the reduced rates with Italy and Spain are 8 and 10% respectively.

8. Such royalties are then liable to UK corporation tax at 28% for large companies but the income chargeable is after deducting direct and indirect costs (section 44 of Taxation International and Other Provisions) Act 2010, formerly section 798A Income and Corporation Taxes Act 1988). These costs can amount to as much as 85% of the gross income leaving only 15% net income subject to the UK corporation tax rate of 28%.

9. This means in practice that the effective UK corporation tax rate on the gross royalty income is only about 4% (28% of 15% net income chargeable to tax) and that is the maximum amount of the, for example, Spanish withholding tax that can be used to set against the UK corporation tax.

10. In effect 6% of the Spanish withholding tax of 10% cannot be relieved against the UK corporation tax and represents double taxation.

11. To demonstrate what this means in practice we have an example of £1.7 million of Spanish royalty income on which a withholding tax of £170,000 is withheld. After deducting direct and indirect costs, income of £260,000 is taxable in the UK at a rate of 28% a UK corporation tax liability of £73,000. Only £73,000 of the Spanish withholding tax can be 'used' which means that £97,000 of the withholding tax is unused and represents double taxation.

Potential improvements to existing Directives

12. The existing Interest and Royalties Directive requires a direct holding in the relevant companies for them to be treated as associated under the current Directive. This means that where the shareholding is indirect the Directive does not apply and there can be withholding tax which may be unrelieved in the recipient company country of residence.

Transfer pricing

13. Even where there is a Double Tax Convention it is not always possible for transfer pricing disputes, for instance where a transfer pricing adjustment by one member state is not fully accepted by the other, to be resolved under the Competent Authority Procedures. There have, to our knowledge, only been a limited number of cases that have been dealt with under the EU Arbitration Convention which seems to suggest that there is a reluctance by member states to facilitate or participate in the potential Arbitration route with the consequence that there remains a considerable amount of double taxation arising from transfer pricing disputes.

Extra administration costs dealing with the international tax system

14. The administrative costs dealing with the tax system are in effect an additional form of taxation and in our view should be kept to the minimum possible.

15. We would recommend that the EU Commission should look at a new UK system which is being introduced with effect from September this year. This is a treaty passport for corporate interest payments. Under the new system overseas companies that lend money to UK companies can apply for a passport from the UK authorities which will eliminate the need to make multiple clearance applications in order for the borrower to pay interest under the reduced withholding tax available under the relevant double tax convention.

16. Similar arrangements in other countries are likely to deliver savings in administrative costs and streamline the international tax system.

Cross border losses

17. The absence of effective, immediate, relief for losses incurred by associated and subsidiary companies in other member states is another form of effective double taxation. Without effective relief for losses within a single group of companies the group will pay tax on profits when at the same time it may have losses in a group company resident in another member state.

18. We accept that it could be argued that the OECD separate enterprise working hypothesis supports the above tax treatment but in our view it does represent a form of double taxation and is an impediment to the proper functioning of the Single Market.

19. The Common Consolidated Corporate Tax Base (CCCTB) project that was put on hold in 2008, and which may be revived by the present EU Commission, would have the effect of giving relief for cross border losses and eliminate this particular source of double taxation.

Cross border dividend payments

20. A number of relatively recent European Court of Justice (ECJ) judgments have clearly demonstrated instances of double taxation as a consequence of 'the exercise in parallel by two Member States of their fiscal sovereignty'. The Damseaux C-128/08 judgement in July 2008 is a clear demonstration of this problem which the ECJ has stated it is not within the Court's competence to do anything about. The earlier Kerckhaert Morres C-513/04 judgment highlighted a similar problem.

21. Double taxation issues can also arise where the relevant bilateral Double Taxation Convention doesn't eliminate the withholding tax and the conditions to satisfy the Parent Subsidiary directive are not met and the dividend is then exempt from tax in the hands of the dividend recipient. The withholding tax is an additional cost for which there is no relief.

Relief for borrowing costs

22. The UK has a generous system of relief for interest payments but as part of its updating of its foreign profits tax regime it introduced in 2009 a world wide debt cap which has the effect of 'capping' tax deductible UK interest payments by reference to the world wide external debt of the particular group of companies

23. So in a simple example if the worldwide group has external borrowings of 100, and 150 is lent to the UK company in the group, then the interest deduction for tax purposes in the UK is restricted to interest on the 100 and there is no corresponding adjustment.

Exit taxes

24. Exit taxes may perhaps more properly be considered to be breaches of the EU Treaty rather than instances of double taxation but they do create an additional tax burden on cross border activities which undermine the benefits of the Single Market.

Problems with Permanent Establishments

25. Double Tax Conventions will generally deal with cost allocation issues that may arise between a Permanent Establishment and a Head Office. However, there can be problems when there are more than one Permanent Establishment. We have seen an example of a non EU parent company with Permanent Establishments in several EU member states where there are 'dealings' between those Permanent Establishments. At least one member state is querying the profit allocation in relation to these 'dealings'. There is no mechanism to resolve the problem of overlapping claims to the profits of the Permanent Establishments.

IKY
June 2010

E ian.young@icaew.com

- the title of the document and the reference number (Tackling Offshore Tax Evasion, TAXREP 16/10) are quoted.

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APPENDIX 1

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see http://www.icaew.com/index.cfm?route=128518).