TAXREP 23/13

(ICAEW REP 36/13)

ICAEW TAX REPRESENTATION

The Government's review of the balance of competencies between the United Kingdom and the European Union: call for evidence on taxation

Comments submitted on 22 February 2013 by ICAEW Tax Faculty in response to HM Treasury call for evidence, as above, published in November 2012

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on *The Government's review of the balance of competencies between the United Kingdom and the European Union: call for evidence on taxation* published by HM Treasury in November 2012.

2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

3. On 31 January 2013 we attended a meeting with HM Treasury jointly with other professional bodies and other commentators at which we were able to put forward some key comments and concerns and discuss aspects of the call for evidence paper.

4. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

5. ICAEW is a professional membership organisation, supporting over 140,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

6. Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.

7. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

MAIN POINTS

8. The design of the UK's tax system remains the responsibility of the UK government and parliament, because the EU has no specific competence in the area of direct taxation. This remains primarily within the competence of each member state, subject to our remarks about the influence of the Court of Justice of the European Union (CJEU).

9. Apart from the adoption of the VAT system when the UK joined the EU, there have been very few pan-EU tax measures because of the unanimity principle. The Common Consolidated Corporate Tax Base (CCCTB) project has been under active consideration for nearly ten years and is now with ECOFIN, but it is not clear when, if ever, this is going to be introduced. It will almost certainly require enhanced co-operation as a number of countries are opposed to it, including the UK. There is also currently a proposal, again using the enhanced cooperation procedure, for an FTT to be introduced in 11 countries, but again the UK is not going to participate and is concerned about the potential impact on the UK economy and the Financial Services sector in particular.

10. The UK benefits from EU-level action on taxation through solutions on cross-border tax issues; more consistent tax rules for British businesses operating across the continent; and the existence of a level playing-field on EU tax issues adjudicated by CJEU.

11. The UK sometimes does not benefit from EU-level action on taxation where the need for compromise has negative unintended consequences – for example, where lack of progress on charging VAT cross border has led to a higher level of fraud.

12. In deciding whether to pass more or fewer powers on tax to EU level, the UK must consider that while it may be necessary to occasionally compromise in the national interest, there is an increased need for cross-border tax collaboration in a globalising economy – for example on tax avoidance and evasion.

RESPONSES TO CONSULTATION QUESTIONS

Q1. What evidence is there that EU-level action on taxation advantages the UK?

13. In a globalising economy where the UK wishes to increase its exports, increasing collaboration on tax issues is necessary. The Prime Minister recognised this recently in seeking G8 agreement to tackle tax avoidance and evasion issues which, due to the global nature of modern business, cannot be tackled unilaterally at national level. This debate is also taking place at EU level, and EU initiatives, as well as work undertaken in other international forums such as the OECD, could play a major role in advancing this agenda.

14. The European Commission has used its "powers of persuasion" to encourage member states to collaborate and create fairer competition on tax issues in the EU. In 1997, member states agreed to set up the Code of Conduct Group (Business Taxation) which reported in 1999 and identified 66 harmful tax practices which were eliminated over the ensuing years. More recently in April 2009 the Commission issued a Communication on Good Governance in Tax Matters which recommended more transparency, exchange of information and, again, fair tax competition. The work of the code of conduct group helps to ensure a level playing field within the internal market for EU companies.

Q2. What evidence is there that EU-level action on taxation disadvantages the UK?

15. EU-level decisions on taxation will often require accommodation of the different views of the member states, including the UK, and seeking agreement can sometimes create less than optimum results. An example here is the failure to agree to charge VAT across borders. There have been very serious levels of 'missing trader' or 'carousel' VAT fraud, which has taken many years to bring down to more acceptable levels.

16. The lack of practical instructions from the CJEU on tax-related rulings has also caused uncertainty for UK courts and businesses. The CJEU upholds the principles of EU law, but it is then up to the UK courts to determine what the court's decision means in practice.

Some further comments on indirect taxation in the EU

17. The EU has had a profound and direct impact on the UK indirect taxation system. This is because, in order to join the Common Market in 1973, the UK had to introduce a VAT system (though significant derogations were secured, notably over zero rates on items like children's clothing). VAT has remained a fundamental part of the UK tax system. The current rate is 20%, and receipts from VAT represent nearly a fifth of total tax receipts. ICAEW has made a number of recommendations on how EU VAT should be reformed, including:

- Adopt the origin principle for all supplies within the EU.
- There should be only two VAT systems – domestic and international.
- Allow full input tax recovery relating to business or charitable activities.
- Abolish the concept of exemption - all supplies either positive rated or outside the scope with recovery.
- Substantially reduce the range of supplies not subject to VAT.
- Eliminate all reporting requirements other than VAT returns.

- Abolish the concept of input tax for public authorities – use alternative government funding to substantially reduce administration and compliance costs.
- All public transport to be outside the scope with recovery.

Some further comments on the CJEU

18. It is impossible to describe the influence of the EU in shaping UK tax policy without noting the impact of the CJEU's decisions. For instance, the UK has had to amend its cross-border loss relief provisions to reflect the CJEU decision on Marks & Spencer. (C-446/03). The UK domestic tax system must allow the possibility of relief for losses made by overseas subsidiaries in order to mirror the relief that is available if domestic subsidiaries make losses. The recent recasting of the Controlled Foreign Companies (CFC) regime owes something to the CJEU decision on Cadbury Schweppes. (C-196/04). The tax treatment of dividends was changed in 1999 and again in 2009, but the Hoechst/Metallgesellschaft cases (C-397 & 410/98) would have required a fundamental change in any event. The credit system spawned a considerable number of Group Litigation Order Classes (GLOs) as to the compliance with the EC treaty of the old ACT/imputation/tax credit system that was abolished in 1999.

19. At the start of the 2000s, there were a considerable number of CJEU cases which significantly affected what the UK Government could or could not do in relation to its domestic tax system.

20. In our annual publication TAXline Tax Planning 2005-06, in the edition published in autumn 2005, we wrote:

> "Ever since the Treaty of Rome in 1957, various freedoms have been enshrined within the framework of the EC Treaties. What was not apparent for a very long time was that these freedoms were going to have a profound impact on what was going to be acceptable direct tax policy in any one of the EU Member States. The fact that any changes to direct tax at an EU level required the unanimous approval of all the Member States, and any one Member State had an effective power of veto, lead the Member States to assume that domestic tax policy remained within their powers.
>
> However, the European Court of Justice, in applying the freedoms enshrined in the EC Treaty has increasingly shown that this domestic tax sovereignty may have less and less practical effect."

21. However, it should also be noted that at about that time, late 2005, the CJEU began to change its approach. Since then it has been more prepared to accept that domestic tax systems are generally compliant with the EU Treaty, but may then require some modification for the particular measures to be proportionate. This can be seen very clearly in the Marks & Spencer case. The Advocate General's opinion, delivered in April 2005, held that the UK system did not comply with the EU Treaty. The CJEU's final decision in December 2005 found that the UK system was compliant in general, but in order to be totally compliant needed some amendment to the UK law to allow the possibility of foreign subsidiary losses being used in the UK if there was no possibility they could be used abroad.

22. This rather more nuanced approach of the CJEU has actually led to quite considerable confusion about how the UK domestic tax system needs to be modified to comply with the EU Treaty. For instance, the FII GLO case has recently been referred to the CJEU for the third time, in addition to a very considerable number of hearings in the UK domestic courts. This case is about the different treatment of dividends from foreign subsidiaries, which were at that time taxable in the UK with relief for foreign tax suffered, compared with dividends from UK subsidiaries which were exempt. The CJEU ruled that the treatment of these two types of dividends needs to be equivalent, but more than six years later we are still not clear what this means in practice in relation to the UK tax system. This uncertainty is not good for taxpayers, and does not help the government which requires a stable source for its public finances.

23. Most recently in the 2013 UK Finance Bill draft clauses, the changes to the exit tax regime and the recognition of losses of UK permanent establishments are both being introduced to try to ensure that the UK domestic law reflects the terms of the EU Treaty.

Q3. What do you think are the main considerations in determining the appropriate level for decisions to be made on tax policy?
Q4. 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)?

24. We are not responding on these points.

Q5. How might the UK benefit from the EU taking more action on taxation? Please provide specific examples, identifying where possible the pros and cons.

25. More EU action on tax would be beneficial if it facilitated pro-growth cross-border cooperation, and further developed our capacity to agree international tax issues.

26. But this may open the UK up to the risk of more action on taxation by the EU that may not be in the UK's national interest, for example more requirements similar to the proposed financial transaction tax.

Q6. How might the UK benefit from the EU taking less action on taxation? Please provide specific examples, identifying where possible the pros and cons.

27. We are highlighting the Financial Transaction Tax draft directive proposals as an example of where the UK would benefit from the EU taking less action on taxation. We are very concerned by this development, which is not in the best interests of the EU or UK economies, will hit a financial services sector employing hundreds of thousands of British citizens right across the country, and damage a major sector of the UK economy.

28. The proposal could put the UK in a difficult position which could threaten the UK's ability to maintain mutual tax collecting agreements. As currently drafted, the directive would require the UK government to collect FTT on behalf of member states participating in the tax. It is not clear how these member states will secure UK agreement on this, and if the UK does not collect this levy or refuse to transfer the revenues, other member states may feel unable to engage in existing mutual tax collecting agreements in the same way.

Q7. 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?

29. The design of the UK's tax system remains the responsibility of the UK's government and parliament, because the EU has no specific competence in the area of direct taxation. This remains primarily within the competence of each member state subject to our remarks about the influence of the CJEU.

30. The vast majority of taxes in the UK are controlled domestically and not subject to EU legislation – such as national insurance and employment tax.

31. The UK government is also required to implement EU legislation (for instance, directives) agreed at EU level into national law. This means the domestic legislation is already in place.

32. VAT is UK law based on the provisions in the EU directives. If the UK's relationship with the EU on VAT changed, the UK would not need to pass a new VAT law, and the government would be able to freely adjust VAT law as it wished – this is not currently possible under EU rules.

33. The UK's double taxation agreements are mostly agreed bilaterally, based on the OECD Model Tax Convention, so we do not anticipate problems around double taxation if the UK's relationship with the EU changed.

Some caveats on the UK's tax autonomy

34. The EU can bring forward proposals in relation to direct taxation under Article 115 of TFEU "if such measures are necessary for the establishment and functioning of the internal market" – but such measures must be agreed by all the 27 member states. In the early 1990s, a number of directives were adopted including, for instance, the Parent Subsidiary and the Mergers Directive.

35. If all the member states cannot agree on a tax proposal, then as a result of the Nice Protocol of 2000, nine or more member states can take forward the proposal under the Enhanced Cooperation procedure. This is the decision-making process around the FTT proposals.

36. The other caveat is the requirement for the member states to "exercise their competence in areas of taxation consistently with the fundamental freedoms, avoid any discrimination on the grounds of nationality and comply with the rules on State aid." (Paragraph 3.21 of HM Treasury "Call for evidence" paper). We have discussed above some of the changes to the UK law as a result of decisions in the CJEU.

b) What action could best be taken at other international levels (by a different body or institution)?

37. A lot of the rules of international taxation are already promulgated by the OECD as a result of agreement by the OECD member countries which includes the UK. So the UK's treaty network is largely based on the OECD Model Double Tax Convention, and the UK has incorporated the OECD Transfer pricing guidelines into its domestic law.

Q8 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?

38. We are not responding to this question.

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APPENDIX 1

ICAEW 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 icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)