



EU Law and British Tax

Which comes first?

ALISTAIR CRAIG

CENTRE FOR POLICY STUDIES
57 Tufton Street London SW1P 3QL
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THE AUTHOR

ALISTAIR CRAIG is a Chartered Tax Adviser specialising in international corporate tax with a major accounting firm in the City of London. He is also an Approved Parliamentary Candidate for the Conservative Party. The views expressed in this pamphlet are entirely those of the author and should not be taken as representing the views of either his employer or of the Conservative Party.

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SUMMARY

- The EU has long had powers to legislate in the field of *indirect* tax (in particular on VAT and custom duties) (pp. 4-7).
- Despite repeated efforts by both the EU Commission and the EU Parliament, Member States have (largely) successfully maintained their exclusive control to legislate over *direct* taxes (in particular, income tax and corporation tax) (pp. 8-17).
- The European Court of Justice (ECJ) has, however, been able to use the powers that it is endowed with under the Single Market legislation to strike down various aspects of national corporation tax laws. So while Member States have so far retained the right to initiate tax law, the ECJ has developed the power to strike down those laws which it considers to be discriminatory under the Single Market legislation (pp. 18-36).
- As a result, ECJ judges have been able to reverse tax laws passed by the British Parliament. In particular, Britain, and the other Member States of the EU, have lost effective control over how they set their corporation tax laws (pp. 18-36).
- This is resulting in a major loss of tax revenues. Corporation tax raises £30 billion a year in the UK. It is estimated that the cost of those cases that have already been brought, or that are going through the courts, is in the region of £10 billion. And that if all the other potentially affected provisions of corporate tax law are also struck down, the loss to the UK Exchequer could be a further £8 billion annually (see Appendix).

- The British Government has so far failed to admit to the scale of the problem it faces. It has attempted to respond to adverse ECJ rulings through the use of *ad hoc* legislation. For example, the Treasury is considering adopting domestic thin capitalisation rules in the 2004 Finance Bill for all UK companies (irrespective of whether they had overseas subsidiaries). Such a move would result in a greatly increased compliance burden for UK companies, most of whom have never had to concern themselves with these rules. It would mean many man-hours lost in completing paperwork and dealing with enquiries from the Inland Revenue (p. 32).
- Attempting to address the problems caused by the ECJ rulings by adapting *ad hoc* solutions is likely:
 - to deny corporate taxpayers any sense of certainty;
 - to greatly increase the administrative burden on all UK companies; and
 - to undermine UK and EU competitiveness (pp. 35-36).
- Despite the British Government's claims that taxation is a "red-line" issue over which sovereignty will not be ceded in the IGC negotiations, the UK has already lost a large amount of control over corporation tax. It is unlikely for example that a future British Government, elected on a tax-cutting manifesto, could either implement radical cuts in British corporate tax rates, or introduce tax incentives.
- The draft Constitution contains proposals which will give the European Commission direct legislative influence for the first time over direct taxes (pp. 42-45). In addition, the European Commission has a publicly-declared agenda to achieve the "harmonisation" of corporate tax systems across the EU in the medium term (pp. 40-42).
- It is time for the British Government to admit that it has all but lost control over corporate tax. Options for reform are considered in Chapter 5 (pp. 36-39).

CHAPTER ONE

INTRODUCTION

The finance of this country is intimately associated with the liberties of the country. It is a powerful leverage by which English liberty has been gradually acquired. If these powers of the House of Commons come to be encroached upon, it will be by tacit and insidious measures, and therefore I say public attention should be drawn to this.

WILLIAM GLADSTONE spoke these words at Hastings on 17 March 1891. Today, the powers of the House of Commons are being encroached upon; and it is happening, as Gladstone foresaw, by “tacit and insidious” measures.

The ability of the British Parliament to set its own taxing laws and to raise its own revenues is now being fundamentally affected by judges in the European Court of Justice (ECJ) in Luxembourg. The ECJ is using EU legal principles to strike down national tax laws. As a result, the Exchequer has lost many billions of pounds in the past few years due to ECJ judgments. And it stands to lose billions more in the next few years.¹ British business also stands to lose out through facing significantly increased compliance and administration costs in the short to medium term.

The British Government is, at best, in denial of the problems it faces. At worst, it is guilty of deceiving the British people. In his Foreword to the Government’s White Paper² describing the

¹ See the Appendix for a necessarily very rough estimate of the cost to the UK Exchequer of these judgments.

² *A Constitutional Treaty for the EU – The British Approach to the European Union Intergovernmental Conference 2003*”, Cm 5394, September 2003.

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British negotiating position at the current Intergovernmental Conference (IGC) to discuss and finalise the draft EU Constitution,³ Tony Blair writes:

The Convention text spells out that the EU is a Union of nation States and that it only has those powers which Governments have chosen to confer upon it. It is not and will not be a federal superstate... And we could only accept a final text that made it clear that issues like tax, defence and foreign policy remain the province of the nation State.

However, the Treasury and Inland Revenue, in a recent consultation document on possible future reforms to the corporate tax system, did (briefly) acknowledge the threat that EU law poses to the British tax system, although they did not say how they intended to deal with it. They stated that:⁴

The corporation tax system has to... be kept robust against any legal challenges under EU law.

The situation is only going to get worse, unless radical action is taken. But the Government has failed to provide any indication of how it intends to reform our corporate tax laws to prevent more successful claims being made under EU law to strike them down. Its response, so far, has been denial at the highest levels; tacit acknowledgement at the lower levels; and “sticking plaster” proposals which will only make doing business in Britain more and more difficult.

Finally, the draft Constitution, and further European Commission proposals to align the corporate tax systems of the EU Member States more closely, will only increase pressures for tax harmonisation at the legislative level.

³ “Draft Treaty establishing a Constitution for Europe”, Convention on the Future of Europe, CONV 850/03, 18 July 2003.

⁴ HM Treasury/Inland Revenue, *Corporation tax reform – a consultation document*, August 2003.

INTRODUCTION

A succession of decisions taken by the ECJ has not only breached the principle that the British State has the monopoly power to levy taxes, but utterly destroyed it.

How will the Government replace the revenues lost due to ECJ rulings? How have we got ourselves into this position? And, more importantly, what can be done about it?

CHAPTER TWO

INDIRECT TAX AND THE EU

THERE IS A DISTINCTION to be drawn between EU legislative action in the field of direct taxation, such as income tax and corporate tax, and in the field of indirect taxation, including VAT and customs duties.⁵

Article 93 of the Treaty on European Union explicitly requires:

...harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market.

Harmonisation, or approximation, of tax laws has made most progress in the field of VAT and customs duties.

VAT

Most developed countries have a form of sales tax or VAT. VAT was a tax introduced in the UK by virtue of our membership of the EU (or EEC as it then was). VAT law is set by the EU legislative bodies, with the majority of VAT rules currently in force contained in the Sixth VAT Directive.⁶ The Directive sets out the broad principles of the tax, for example those transactions on which Member States should levy VAT.

⁵ 'Direct taxes' are taxes which are levied directly on individuals and organisations. They include: income tax, corporation tax, capital gains tax and inheritance tax. 'Indirect taxes' are taxes which are levied not directly from the taxpayer but through an intermediary. They include customs duties and sales taxes such as VAT.

⁶ 77/388/EEC, 17 May 1977.

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However, many differences still exist between Member States in their application of the VAT rules, particularly in the standard VAT rates which they apply to the majority of transactions, and also the rates which they apply to certain specific transactions.

The UK's VAT rules contain several derogations for specific transactions, for example in the rate applied to domestic fuel (5%, as opposed to the current standard rate of 17.5%) and zero rating (effectively not charging any VAT) for categories of goods and services such as:⁷

- Books
- Newspapers
- Food
- Children's clothing and shoes
- Public transport; and
- Medical care, medicines and dental care.

The European Commission has declared its wish to see these derogations ended:

The continued existence of a variety of derogations in both the VAT and excise duty fields is unhelpful.⁸

This policy still appears to be at the top of the Commission's agenda, as recently reported in *The Daily Telegraph*:⁹

At a meeting of finance ministers in Brussels yesterday, Mr Brown said the European Commission was still pushing to remove Britain's opt-out from charging VAT on children's clothes and shoes.

⁷ Along with Ireland, and Denmark in the case of books, the UK is alone in applying zero rating to these goods and services.

⁸ "Tax Policy in the European Union – Priorities for the years ahead", Commission Communication COM (2001) 260, p. 10.

⁹ *The Daily Telegraph*, 5 November 2003.

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These derogations are the exception to the rule that VAT is, effectively, a tax whose principles and application are decided at EU level. For example, the EU has set a minimum standard VAT rate of 15%, so the ability of a future tax-cutting British Government to reduce the UK VAT rate is curtailed in this respect.

Adherence to the VAT rules, subject to any derogations which were negotiated, such as those listed above, was part of the obligations Britain entered into when it joined the EEC in 1973. It can therefore be seen as part of the price Britain paid when joining the EU “club” in 1973 – indeed, VAT receipts have a key role to play in the contributions Member States make towards funding EU activities.

Since it is clear that the EU already has, and indeed has always had, a leading role in the formulation and application of the VAT rules (although Commission plans to further harmonise the tax to remove all derogations are less well known¹⁰), it is outside the scope of this pamphlet to explore this area in greater detail.

Customs duties

The EU has its own customs duty regime with all duties on exports and imports between Member States having been abolished. Imports from non-EU countries coming into the EU pay the same customs duties, regardless of whichever Member State they are shipped to. All customs duty revenues are paid directly to the EU, and do not impact on the national budgets of the Member States.

This is perhaps the most complete example of an integrated system of tax at the EU level. The widespread abolition of customs duties and tariffs within the EU trade area is also in line with World Trade Organisation (WTO) efforts to reduce and ultimately eliminate such barriers to free trade around the globe. The question of whether the EU could itself do more to encourage

¹⁰ See, for example, T Villiers, *European Tax Harmonisation – the impending threat*, CPS, 2001.

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free trade with non-EU countries, particularly in the developing world, for example by reforming the Common Agricultural Policy, is also not within the scope of this pamphlet.

EU measures in other areas of indirect taxation

There are a number of other areas where the EU has initiated, or at least proposed, legislative action to harmonise taxes across the Member States.

These include infrastructure charging in the field of transport taxation, the harmonisation of vehicle taxes in the EU (with the EU already setting a minimum level at which fuel excise duty can be imposed¹¹) and fuel taxes on domestic and cross-border flights within the EU.

It seems clear from all of these examples that the EU is gradually increasing its influence and power over the taxes which are levied on citizens of each of the Member States. In the case of indirect taxes, this has been done relatively openly.

¹¹ EU Directives 92/81/EEC and 92/82/EEC.

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CHAPTER THREE

DIRECT TAX AND THE EU

DIRECT TAX – and in particular, income tax and corporation tax – is repeatedly stated by British Government Ministers to be an area where national sovereignty is guaranteed, and where the EU has no legislative authority.

Income tax

Unlike Article 93 of the EC Treaty cited above, which explicitly declares that the harmonisation of indirect taxes is one of the aims of the EU, there is no similar explicit provision in the Treaty requiring the harmonisation of direct taxes, such as personal income tax. The absence of such a provision in the Treaty has led a number of EU supporters, down the years, to claim that the EU therefore has no intention to act in relation to personal income tax. This is not entirely correct.

The French Government attempted to insert such a provision into the Treaty of Nice during the negotiations leading up to the signing of the Treaty. However, they were unsuccessful due to resistance from other Member States, Britain prominent among them.

An early Commission attempt to legislate in the field of personal income tax,¹² which would have imposed a law on each Member State permitting them only to tax individuals resident in that Member State, was rejected by the various national governments back in 1980.

¹² “Directive on the Harmonisation of Income Tax Provisions with Respect to Freedom of Movement”, COM (79) 737.

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On occasion, some EU legislative bodies have tried to harmonise direct taxes by using existing legislation. As the European Parliament itself admitted:¹³

...action in this field [i.e. harmonisation of direct taxes] has necessarily been based on more general objectives.

In other words, having failed, so far, to implement direct legislation in the field of personal income tax because of political opposition, the EU intends to use the more “general objectives” of the Single Market to try to achieve a limited form of harmonisation in this area.

The Commission, in particular, has a clear desire to co-ordinate income taxes where there is a cross-border element involved – for example in the case of a worker resident in one Member State, but working in another. And the ECJ is using other Treaty articles, specifically those setting out the fundamental freedoms of the Single Market, such as the free movement of workers and freedom of establishment, to strike down national income tax laws.

A recent case¹⁴ involved an action brought by a French individual against the French Government in relation to a French residential “exit tax” which he suffered after he moved to Belgium. On referral from the relevant French national court to interpret the provision of the Treaty in point, the Advocate General to the ECJ found that the exit tax had infringed the individual’s freedom of establishment.¹⁵ Therefore, the likelihood is that this element of the French personal income tax system will be struck down when the ECJ delivers its judgment.

¹³ European Parliament Directorate General for Research: “Tax Competition in the European Union”, *Economic Affairs*, Series ECON 105 EN rev, 10-2000.

¹⁴ *Hugues de Lasteyrie du Saillant v Ministre de l’Economie, de Finance et de l’Industrie*, reported in *The Times*, 17 March 2003.

¹⁵ The Advocate General is an official of the court who gives a preliminary view on the legal position of a case. While the ECJ judges are not bound by his opinion, they nearly always follow it.

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Therefore, while most attempts at EU interference in the field of personal income tax have been successfully rejected by the Governments of the Member States, the ECJ is beginning to extend its influence into this area. However, relatively little progress has been made. Instead, it is in the area of corporate taxation that the Commission has been most active in attempting direct legislation.

Attempts to increase EU influence on corporate tax

As with income tax, there is no Treaty provision which permits the EU legislative bodies to act to harmonise corporate tax laws within the EU. Nevertheless, the Commission has introduced a series of Directives down the years to minimise corporate tax factors as an obstacle to doing business in the Single Market. A few of these have been enacted, but most of the more radical harmonising proposals have been resisted, so far, by the Member States.

The increasing pressures towards corporate tax harmonisation can be illustrated by the response to the decision by the Irish Government to set particularly low rates of corporation tax. In 1980, Ireland introduced a special 10% corporation tax rate for companies in certain economic sectors, most notably, although not exclusively, financial sector companies setting up businesses in the International Financial Services Centre (IFSC) in the Customs House docks area in Dublin.

The European Commission declared that this beneficial tax rate was an illegal state subsidy which took business away from the other Member States, and that it had to be removed.

The Irish Government, keen to preserve its attractiveness for inward investors, then introduced a flat-rate of 12.5% for corporation tax across the board, covering all sectors and companies which are subject to tax in Ireland. This rate is far below the EU average corporation tax rate of around 35% (the UK rate is comparatively low at 30%).¹⁶

¹⁶ It should also be noted that many of the accession countries who will join the EU in May 2004 are seeking to emulate this course of action.

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The European Commission has publicly condemned the Irish move on a number of occasions. The Governments of the other Member States, who were understandably afraid that they would lose tax revenues because companies would leave those states and set up businesses in Ireland, sided with the Commission. All of this led the Irish Finance Minister, Charlie McCreevy, to observe:¹⁷

We have no friends in Brussels regarding our corporation tax regime, or in any European capital.

The Commission has not limited itself to trying to influence Member States tax policy indirectly; it has also on occasion made attempts to introduce direct legislation in this area, despite the clearly expressed opposition of national governments. In the 1970s and 1980s, the Commission made a few ill-fated attempts at direct legislation, based on some early reports which recommended some degree of corporate tax harmonisation.¹⁸ A draft Directive was issued by the Commission in 1970 which proposed the closer alignment of corporate tax rates across the then Member States at levels between 45% and 55%. A Commission paper¹⁹ from 1980 also proposed various measures which could be undertaken to ensure that the complex and diverse tax systems of each Member State could be more closely brought together. None of these measures met with any success when put before the Member States themselves.

Later, at around the same time as the Single Market was being completed, the Commission recognised the necessity to push through a number of measures in the tax field, designed to ensure that differing corporation tax regimes did not act as a barrier to trade in the Single Market.

These measures included:

¹⁷ “Ireland fights the UK’s battle”, *The Sunday Telegraph*, 28 January 2001.

¹⁸ Neumark Report, 1962, and van den Temple Report, 1970.

¹⁹ *Report on the scope for Convergence of Tax Systems*, COM (80) 139.

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- The “**Parent/Subsidiary Directive**”²⁰ which tried to eliminate the double taxation of dividends paid from subsidiaries to their parent companies resident in other Member States;
- The “**Mergers Directive**”²¹ designed to facilitate business reorganisations and mergers; and
- The “**Arbitration Procedure Convention**”²² which introduced EU-wide arbitration procedures to settle disputes over the taxation of profits of associated companies resident in different Member States.

These measures have undoubtedly facilitated the cross-border operations of multinationals and other companies with a presence in more than one Member State. Although these measures involved a transfer of power from the Member States to the EU in relation to corporation tax, they were seen to be beneficial for companies doing business within the EU and were widely welcomed at the time. However, these limited measures were followed by proposals which would have involved a much greater loss of governmental control over corporation tax.

In 1992 the Commission published a paper, *The Report of the Committee of Independent Experts on Company Taxation* (known as “The Ruding Report”), which found that the differences in corporation tax rates and regimes across the Member States had the potential to “distort competition”, and hence be a barrier to free trade, within the Single Market.

²⁰ Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states (90/435/EEC).

²¹ Council Directive of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different member states (90/434/EEC).

²² EC Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436/EEC).

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This report recommended a number of steps to reduce the divergent treatment of companies under the various corporate tax regimes in the EU. But most importantly, and ambitiously, it also recommended the harmonisation of corporate tax rates between 30% and 40% across the EU.

This proposal did not succeed. While the Member States were prepared to concede a limited amount of tax sovereignty to facilitate cross-border business operations by means of the three measures listed above, they were not prepared to countenance a harmonisation of tax rates as this infringed too much on national fiscal decision-making powers.

At the same time as these three measures were successfully enacted, the Commission proposed another Directive. This measure related to the use of tax losses generated in one Member State by, for example a subsidiary, against taxable profits earned in another Member State by its parent company.²³ This concept was also too radical for the national Governments, who did not consider that their exchequers should provide tax relief for economic failures incurred in other countries. The proposal was therefore shelved.²⁴

In 1997, the Commission tried again, producing a “tax package”, consisting of three elements:

- a Code of Conduct on Business Taxation, designed to reduce and eliminate tax incentives and tax breaks offered to businesses in each of the Member States;
- a Directive to eliminate withholding taxes on payments of interest and royalties between associated companies resident in different Member States – this proposal was reintroduced after the Commission had withdrawn it in 1994; and

²³ COM (90) 595.

²⁴ However, there is currently a case before the ECJ which could bring about exactly this outcome. This is the clearest possible example of how, despite the opposition of the Member States to a proposed harmonisation measure, the result envisaged by the Commission could eventually come about because of an ECJ judgment. See Chapter 4.

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- a Directive to ensure the effective taxation of savings income across the EU.

After years of negotiations, the Directive on the taxation of savings income and ensuring exchange of information between national tax authorities in relation to bank accounts held in different Member States was only recently agreed.

The Code of Conduct on Business Taxation is an attempt by the Commission to get the Member States to agree to abolish certain tax breaks and incentives. The Commission chose this route rather than attempting full-scale harmonisation, which, as noted above, has been consistently rejected by national Governments.

Each of the Member States, including the newly-elected Labour Government in the UK, signed up to the principles of the Code of Conduct in 1997, and appointed a group of ministers and officials from each Member State, ultimately headed up by Treasury Minister Dawn Primarolo. The remit of this group was to examine in detail the national corporation tax regimes of each of the 15 Member States and to draw up a list of tax measures deemed to be “harmful” to the operation of the Single Market, which the Member States concerned would then agree to abolish.

In 1999, the Group reported back, listing 66 “harmful” legislative, regulatory or administrative measures, in the EU Member States and their dependent territories, which would apparently affect the choice of location of business activity for an inward investor in the EU. The measures cited offered significantly lower levels of corporation tax than those normally applicable in the Member State concerned (although no UK measures were found to be “harmful” at the time).

By the time the Code of Conduct was finally agreed in June 2003, most of the existing “harmful” tax measures had already been abolished, or were in the course of being abolished, and each Member State had given an undertaking not to introduce any new “harmful” measures.

The implications of the Code of Conduct for the UK are not clear. While its initial round of work covered “harmful” tax breaks

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and incentives, none of which were found to be present in the UK tax system, there is a risk that the scope of its work could be significantly extended. Dawn Primarolo has stated that: “Its work will never be finalised.”²⁵

This risk was acknowledged in a House of Lords Select Committee report issued after the Code of Conduct had been signed:²⁶

We remain unclear about the implications for the United Kingdom of having agreed to this Code, in particular in relation to national sovereignty and to the principle of unanimity in tax matters. However often the government repeats that the Code is not legally binding, it seems to us that agreeing to it has obviously created a moral if not legal obligation on the government to “roll back” tax measures which are ultimately deemed to be harmful and not to introduce any new measures of the same kind... there remains the risk that the process could lead to the UK being obliged – in practice if not in law – to adopt tax measures damaging to the interests of the economy or of its citizens.

One example of “the risk” that the UK faces is if a Government was elected on a manifesto of cutting taxes. Such a Government, even if it only wished to encourage investment to impoverished areas through tax reductions and incentives, would almost certainly fall foul of these rules.

Having abolished the opportunity for Member States to offer potential inward investors tax breaks and incentives, the Commission again set out plans to try to achieve greater overall harmonisation of the different corporation tax systems. In 2001, it produced a report²⁷ that proposed a series of potential short-term

²⁵ European Parliament Economic and Monetary Affairs Committee, 10 October 2000.

²⁶ House of Lords Select Committee, *Taxes in the EU – can co-ordination and competition coexist?*, HMSO, July 1999.

²⁷ *Towards an Internal Market without tax obstacles – a strategy for providing companies with a consolidated tax base for their EU-wide activities*, COM (2001) 582. This report was based on an earlier report on general EU tax policy, *Tax Policy in the European Union*, COM (2001) 260.

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measures and longer-term policy objectives designed to achieve greater harmonisation of corporate tax systems. This report opened with a clear acknowledgement of the Commission's ultimate aims:

...while important steps have been taken in other policy areas, little has happened here and Member States essentially operate the same company tax systems as they did before the set-up of the Internal Market. This mismatch in development needs to be addressed now and the imminent enlargement of the EU makes it all the more urgent.

Enlargement of the EU is thus being used as a pretext to argue for greater harmonisation of corporate tax systems.

It is true that the Commission has been at pains to stress, on a number of occasions, that its "approach does not infringe Member States' sovereignty to set corporate tax rates,"²⁸ and that "the level of taxation in this area is, however, a matter for Member States to decide, in accordance with the principle of subsidiarity."²⁹ However, Member States are not entirely free to set their own tax rates, at least not without the Commission voicing public disapproval. This was best seen in the case of Ireland, but can also be seen to some extent in the efforts of the Code of Conduct Group to get rid of "harmful" tax measures.

The pressure for harmonisation is only set to increase. Frits Bolkestein, the EU Commissioner for the Internal Market, Customs and Taxation recently wrote:³⁰

As an alternative to this "destructive" process [i.e. ECJ judgments], I favour closer co-operation between Member States and the Commission. Such co-operation could include guidelines for Member States' bilateral tax treaties on avoiding double taxation, Commission recommendations and codes of conduct agreed between governments, as well as directives to harmonise national legislation.

²⁸ COM (2001) 582.

²⁹ COM (2001) 260.

³⁰ Article in *The Financial Times*, 21 October 2003.

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British Ministers continue to declare their opposition to any tax harmonisation measures and publicly state that the veto over tax matters will be maintained in the Intergovernmental Conference negotiations on the proposed European Constitution. It would appear, however, that the Commission has already prepared the ground for greater corporate tax harmonisation. The latest manifestation of British opposition to these proposals was provided recently by Gordon Brown:³¹

My contention is that to move from trade bloc Europe to global Europe, we must explicitly reject old flawed assumptions that a single market should lead inexorably to tax harmonisation, fiscal federalism and then a federal state... just as Europe rejects a “one size fits all” plan for taxing savings which would have driven savings out of the EU, so too it must explicitly reject grandiose schemes for harmonising corporate and other taxes and support British proposals for tax competition.

One may applaud such good sense. But is it all too late?

³¹ Article in *The Daily Telegraph*, 5 November 2003.

CHAPTER FOUR

HOW THE ECJ IS CHANGING THE RULES

THE EUROPEAN COMMISSION has had relatively little success, to date, in introducing direct legislation in the field of corporation tax. However, the ECJ has gradually been striking down national corporation tax laws, using the powers it is endowed with under Single Market legislation, to remove certain elements of national tax systems when cases are brought before it. Over the past couple of years, its influence has grown to such an extent that it is now attacking fundamental tenets of the corporate tax systems of various Member States, including the UK on a number of occasions.

This is causing Member States to lose control over how they set corporation tax. It is also resulting in a major loss of corporation tax revenues to the UK Treasury.

Inland Revenue officials do not know how to respond to the threat. Ministers have said nothing on the issue, other than an elliptical comment in one Treasury publication and some as yet unformulated proposals to respond to recent ECJ judgments. And Parliament has not debated this issue with anything like the scrutiny it deserves. The Government seems to be hoping for the best, rather than properly considering how UK tax law can best be structured to ensure certainty for taxpayers and tax authorities alike.

Companies are now making claims for tax refunds, plus interest, from the UK Treasury which run into tens of billions of pounds, on the back of ECJ decisions. The companies are not to blame for this situation. Their task is to maximise returns for their shareholders. If the law is allowing them to claim substantial tax refunds, then they are under an obligation to act. Indeed, any

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company which did not act would be guilty of neglecting its shareholders' interests. No blame can attach to the companies or those who advise them.

However, it is more than likely that any short-term financial gains made by these companies will be more than offset by increased future administrative costs as national governments introduce "EU-compliant" laws. These laws will inevitably create more paperwork, regulation and red tape. At the end of the day, national governments and companies may both lose out unless a more comprehensive solution is found.

British Governments of all political colours, and the national Governments of many of the other Member States, never intended that the ECJ should have the power to strike down national tax laws. How has it been able to endow itself with this capability?

The Single Market and the ECJ's sphere of influence

When the Treaty of Rome, founding the then EEC, was signed in 1957, it contained a number of measures designed to ensure the free movement of goods, services, workers, capital and payments between Member States. Part of the freedom of movement of workers is the freedom of establishment, which allows companies resident in one Member State to set up a subsidiary, or branch operation (i.e. operating in unincorporated form) in another Member State. For example, the freedom of establishment is supposed to guarantee that a British company can set up an operation, in subsidiary or branch form, in Germany and benefit from the same rights and protections under German law as a German company would.

These "fundamental freedoms" essentially formed the basis for what later became the "Single Market". Goods, services, workers, businesses and financial capital could all move freely within the EU without suffering barriers to operation or discrimination on grounds of nationality or country of origin.

The role of the ECJ is to ensure that the principles of the "fundamental freedoms" are observed by national Governments

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throughout the EU in their making of national laws. The ECJ does this by ensuring the consistent interpretation of EU law throughout the Union. In effect, it obliges national courts to refer most cases where an interpretation of EU law is involved to the ECJ for clarification.

For example, a Dutch national living in Britain can bring a case against the British Government if he can claim that some particular aspect of British law infringes European law because it discriminates against him (i.e., it breaches one of the “fundamental freedoms”, which are designed to eliminate discrimination) as compared to that law’s treatment of a British national in the same or similar situation. The court may, and in some cases must, refer the case to the ECJ for “interpretation” where there is some doubt about the relevant European legal provisions.

The court would then refer a question, or series of questions, to the ECJ asking for clarification on the interpretation of EU law. The ECJ would hear representations from the parties to the case, the Commission and the national governments of any other Member States which wish to make representations. After receiving guidance from one of its officials, the Advocate-General, the ECJ then issues a ruling on the interpretation of EU law. The national court then rules on the case in hand ensuring that it adheres to the interpretation of EU law handed down by the ECJ.

Therefore, if the ECJ, in the example above, interpreted EU law in such a way that the British law concerned was clearly contrary to EU legal principles, the British court would have no option but to strike the national law down. It would then be up to Parliament to legislate to plug any perceived gaps in the British legal system brought about by the judgment.

The vast majority of the cases involving companies bringing complaints that they are subject to national laws which are not compliant with the principles of the Single Market have involved one particular provision, Article 43 of the EC Treaty. This Article states that:

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...restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. Freedom of establishment shall include the right to take up and pursue activities as self employed persons and to set up and manage undertakings, in particular companies or firms... under the conditions laid down for its own nationals by the law of the country where such establishment is effected.

This is intended to ensure that companies are not discriminated against by reason of their nationality from operating across the EU, for example by the imposition of regulations or administrative requirements which are more burdensome than those imposed on companies resident in the Member State concerned.

However, it is by using this Article that the ECJ has, in a series of decisions over the past few years, reduced the power of Member States to legislate their own company tax laws. In this respect, it is worth noting that Article 58 of the EC Treaty explicitly states that:

The provisions of Article 56 [which guarantees the fundamental freedom of free movement of capital between Member States without restrictions] shall not be without prejudice to the rights of Member States to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested.

In other words, Member States are free to apply their own tax laws to ensure that non-residents, or those whose capital is located elsewhere, are taxed differently to residents or those whose capital is invested in that Member State. This is a clear acknowledgement that Member States should continue to have complete sovereignty in matters of taxation, at least in relation to free movement of capital.

However, the same Article left a gap which the ECJ has effectively turned into a gaping hole:

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The provisions of this Chapter [including the words cited above] shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.

That is to say, even though the Treaty explicitly states that tax remains the preserve of the Member States, the “freedom of establishment” principle in Article 43 can be invoked to overturn a national tax law which is held to be incompatible with the freedom of establishment.

The gradual growth of the ECJ’s influence on national taxes

The 1970s and 1980s saw very few cases brought before the ECJ dealing with the compatibility of national tax systems with the provisions of the Single Market.³²

It is only in the last 15 years that a succession of cases has seen the ECJ increase its influence in this area, becoming ever more ready to strike down national tax measures which it deems an impediment to the operation of the Single Market because they breach one of the “fundamental freedoms”, most often the freedom of establishment.

Even up until 1990, the caution with which the ECJ acted in this area was obvious, given the reaction it knew would be provoked if it ruled against a national tax measure. Indeed, one of the first high profile cases to come before the ECJ concerning direct taxation, *Bachmann*³³ in 1990, saw a victory for the Belgian Government, relying on a defence of protection of national tax revenues and the maintenance of the integrity of the Belgian tax system.

The case concerned a German national working in Belgium, who paid life insurance and sickness premiums to German

³² One of the few cases that were brought, *Commission v France* (Case 270/83, judgment of 28 January 1986) concerning a feature of the French tax regime called *avoir fiscal* did however provide an early warning of how the ECJ intended to tackle national tax measures which were in breach of one of the “fundamental freedoms”.

³³ *Bachmann*, Case C-204/90.

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insurance companies, and claimed a tax deduction for the payments in his Belgian tax return. The Belgian tax authorities refused to allow him the deduction, citing a national law that only payments to Belgian insurance companies could be claimed as a tax deduction.

When the case eventually reached the ECJ, the Belgian Government argued that if the national tax rule was, in fact, in breach of the EU freedom to provide services, the rule could nevertheless be justified on the grounds that it “maintained the coherence of the [Belgian] tax system”. The Advocate-General to the ECJ disagreed.

Nevertheless, the ECJ judges ruled in favour of the Belgian Government, agreeing with the argument that the Belgians should not be required to allow a tax deduction for the payments when they would not be able to tax either the profits of the German insurance companies to whom the payments were made (those companies not being subject to tax in Belgium), nor would they be able to tax any subsequent pay-out to the German national, on the assumption that he would eventually return to his home country.

This can be summarised as the “fiscal cohesion” defence: even if our national tax rule may be in breach of an EU fundamental freedom, such as the freedom of establishment or the freedom to provide services, its maintenance is justified to allow us to tax, and provide tax relief to, people on an equal basis. That is, we will not allow a tax deduction if we cannot tax profits related to it in some way. If national tax authorities are not allowed to observe this principle, then there is a likelihood of a net outflow of tax revenues.

Clearly, Member State Governments saw their chance to use the “fiscal cohesion” defence to protect their sovereignty over their national tax systems. The ECJ seemed to have accepted the argument, consistent with Article 58 of the Treaty itself, that the Single Market provisions should not be used to strike down national tax laws, as these are intended to remain within the sphere of influence of the Member States.

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However, the legal position did not remain like this for long. In a succession of cases following *Bachmann*, the ECJ consistently refuted defences of national tax measures based on the principle of “fiscal cohesion”. Time and again, government lawyers, more often than not British government lawyers, have argued that fiscal cohesion is a valid justification for a measure which is otherwise in breach of Single Market provisions. Time and again, the ECJ has rejected that defence in a few short sentences in each judgment. It is clearly a principle which the ECJ has decided is of very little merit nowadays.

The beginning of the end for national tax sovereignty?

The first major defeat for Member State Governments came in 1996, with the case of *ICI v Colmer*.³⁴ This case concerned the UK’s corporation tax “group relief” rules. These allow the losses of one UK company to be offset against the profits of another UK company in the same group for tax purposes, thereby reducing the overall tax payable on a group basis.

Imagine that Company A has profits of 100. Company B, which is owned by Company A, has losses of 50. The group therefore has an overall profit of 50. In the absence of group relief, Company A would pay tax of 30 (assuming a tax rate of 30%, the current rate of UK corporation tax) on its profits of 100 and Company B would not pay any tax – but neither would it be entitled to a tax refund. The effective rate of tax on the group profits of 50 would therefore be 60%.

However, the group relief rules allow Company B to surrender its loss of 50 to Company A, so that Company A’s taxable profit is reduced to 50 and the tax it has to pay is only 15 (i.e. 30% of 50). This allows the tax rules to match the overall economic position.

The group relief rules only apply, broadly, to profits and losses made by UK companies subject to tax in the UK. Before the *ICI* case, the rules also stipulated that group relief was only available

³⁴ *ICI v Colmer*, Case C-264/96.

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to companies whose ultimate parent company was also UK resident. This was the law as decided by Parliament.

However, ICI brought a case against the British Government arguing that a certain section of the group relief legislation, the “consortium relief” rules, was discriminatory and in breach of the EU freedom of establishment. Consortium relief is a variation of the group relief principle which allows profits and losses to be offset between parties in a joint venture relationship. Before the ECJ got involved, the rules only applied where the business of a holding company consisted “wholly or mainly” in the holding of *UK resident* subsidiaries.

ICI, the holding company in the consortium concerned, had 23 subsidiaries, 11 of which were EU resident, of which, in turn, 4 were UK resident. As the business of the holding company was clearly not “wholly or mainly” consisting of the holding of UK subsidiaries, constituting a mere 4 out of 23, consortium relief in respect of their taxable profits and losses was denied.

ICI argued that this was a discriminatory measure in breach of the freedom of establishment. The ECJ agreed with this argument, ruling that the consortium relief rules were indeed in breach of EU law. The fiscal cohesion defence, advanced successfully by the Belgians in *Bachmann*, was rejected by the ECJ in *ICI* in a few words as being “devoid of substance”.

The British Government was therefore obliged to change its consortium relief and group relief rules to make them “EU-compliant”. The Irish, whose tax system is similar in many respects to the British system, were obliged to do the same to their equivalent rules.

It is impossible to say how much this ruling cost the UK Exchequer. But what seems certain is that the case marked a watershed moment in UK legal history – the first time our direct tax rules, legislated in Parliament, were overturned by the ECJ. The ECJ effectively signalled the beginning of the end for the concept that the Member States retained total sovereignty over their direct tax affairs.

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Outside academic and professional circles interested in tax matters, the judgment received relatively little publicity. Few people envisaged that this would be only the first in a long line of cases in the past few years which have seen the ECJ strike down a number of national tax measures with fundamental consequences for tax policymakers and national exchequers in all the Member States.

In 1998, *The Economist* published an article entitled “Europe – no tax without misrepresentation.”³⁵ This dealt with the media controversy in the UK at that time concerning comments made by various European finance ministers about the need to provide greater impetus towards the harmonisation of corporate and income tax systems across Europe.³⁶

Gordon Brown had sought to calm the controversy in the British media, claiming that he would not give up the veto, and could not be forced to do so. *The Economist* seemed, partly at least, to accept this argument, stating that “...for all the sound and fury this provoked in the British newspapers, there are few firm proposals on the table [for corporate or income tax harmonisation].”

But, in the article, the true situation was acknowledged. *The Economist* noted the case of *Jessica Safir*³⁷ in which the ECJ judged that the Swedish rules governing the taxation of life assurance businesses were against EU law because they discriminated against life assurance companies from other Member States. *The Economist* stated:

The same principle – that the court can overrule national sovereignty in tax matters, where it clashes with other aspects of European law [such as

³⁵ *The Economist*, 5 December 1998.

³⁶ The French and German Governments had just issued a joint statement calling for “rapid progress towards tax harmonisation in Europe.” Oskar Lafontaine and Dominique Strauss-Kahn, the then finance ministers of these two countries, stated that they thought the national veto on tax should be abolished.

³⁷ *Jessica Safir*, Case 118/96, judgment of 28 April 1998.

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the Single Market provisions] – could theoretically be applied to other taxes too. And not even Mr Brown can veto judgments of the court.

In fact, in the *ICI* case, the court had already applied the principle to other taxes, and forced a change in the British and Irish corporation tax laws.

The ECJ steps up another gear

The case which, to date, has had arguably the biggest effect on the financial position of the British Exchequer, and also removed the basis for any claims that the British Government still maintained total control over its tax system, was yet to come.

Two cases, which were decided in one judgment because their facts were so similar, *Hoechst*³⁸ and *Metallgesellschaft*³⁹, were brought before the ECJ in 1998. This case concerned the compatibility of the UK's Advance Corporation Tax (ACT) rules with European law.

Under the ACT system, a UK company which paid a dividend to its parent company had to pay 20% of the dividend to the Inland Revenue as advance corporation tax. This tax could, depending on the circumstances, be refunded later in the year (but not in all cases). Clearly, this could be a major cash flow disadvantage to companies considering how to repatriate profits to their parent company by way of a dividend.

The Government catered for this by introducing the concept of a “group income election”, under which a UK parent company and its UK subsidiary could elect to form a “group” for ACT purposes, so there was no need to account for the payment to the Inland Revenue. However, it was not possible to make a group income election with a foreign parent company.

Hoechst was a German-parented group. Therefore, its UK subsidiary had to account for ACT when making dividend payments back to its German parent. Hoechst brought a case

³⁸ *Hoechst*, Case C-410/98.

³⁹ *Metallgesellschaft*, Case C-397/98.

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against the UK Government arguing that, because the UK subsidiary of a UK parent company would have been able to enter into a group income election and so avoid the need to pay ACT, the rules were effectively discriminating against non-UK parented groups, something which they felt was in breach of the principle of freedom of establishment.

The ECJ ruled that the ACT rules were indeed contrary to EU law, stating that the German group had been put at a disadvantage because it was effectively having to pay its corporation tax earlier than a UK-parented group would have had to. Therefore, Hoechst's UK subsidiary was entitled to compensation, effectively being interest on the money it had foregone by making the early payment of tax.

Again, the ECJ dismissed the UK Government's "fiscal cohesion" defence in a few short paragraphs. As one tax author writing about the *Hoechst* case said:⁴⁰

Commentators take the view that, in practice, the "fiscal cohesion" principle has been qualified to such an extent that its scope is now extremely limited to the point where the principle is almost irrelevant.

Claims for repayments of ACT, plus interest, are making their way through the High Court at present. Hundreds of companies have signed up to "Group Litigation Orders" to reclaim many millions of pounds from the UK Exchequer. Again, it must be emphasised that the outflow of money from the Exchequer is not the fault of these claimants – they are duty bound to their shareholders to recoup their overpaid tax. It was the ECJ judgment which led to this somewhat chaotic situation.

Interestingly, in 1999, the Government anticipated the result of the *Hoechst* case in advance (the judgment was issued in 2000), by abolishing altogether the requirement for UK companies to pay ACT on their dividends. It replaced it with a system whereby companies pay their entire corporation tax liability in quarterly

⁴⁰ E O'Grady, "ECJ leads the way towards tax unification", *Tax Notes International*, 30 June 2003.

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instalments (this was introduced at the same time as Gordon Brown's £5 billion tax on UK pension funds by abolishing the ACT credit to which they had previously been entitled).

However, the UK corporate sector, despite many of its constituent companies obtaining, or being in the process of obtaining, ACT refunds from the Inland Revenue, has arguably not benefited at all from the change of law imposed by the ECJ. One firm of accountants has stated:⁴¹

...it wasn't a win for UK plc and has arguably increased the overall tax burden on corporate profits.

In the end, it looks as if nobody wins. UK companies end up paying more tax and higher increased administration costs (because of the need to carry out instalment payments forecasts for each quarter). The Government may have seen an increase in corporation tax revenues with the introduction of the quarterly payments system over the past few years, but could lose billions in the form of tax and interest repayments as the claims are processed in the High Court.

By the time *Hoechst* had been decided, it was becoming clear that the ECJ had crossed the Rubicon. It now seemed ready to strike down, as the cases were brought before it, every single national tax law which breaches one of the Single Market's "fundamental freedoms". As one analyst put it:⁴²

It is clear from those cases that in its effort to uphold the fundamental principles of Community law, the ECJ has established a *notably low threshold for a taxpayer to pass* in order to demonstrate that a national rule has breached a fundamental freedom. The taxpayer is not required to show an absolute restriction on the exercise of a particular freedom, but merely that the law in question "limits", "discourages", "hinders" or generally makes less attractive the exercise of a fundamental freedom. *In sharp contrast, the governments of the Member*

⁴¹ Ernst & Young, *Damned if we don't? How EU law is challenging and changing the British tax system*, March 2003, page 5.

⁴² E O'Grady, op cit.

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States are required to meet a very high standard to justify a domestic tax law on the basis that it is in the public interest [author's own emphasis].

It would seem that there is no argument which national governments can put forward in defence of national tax sovereignty which will be accepted by the ECJ if the court can find any justification at all in a taxpayer's case to strike down the national law in question. The burden of proof appears to have swung against the Member States to such an extent that there seems little point in advancing a fiscal cohesion defence, or similar argument. If the national tax law is, *prima facie*, contrary to the Single Market provisions, the ECJ will not accept that any valid defence exists. It is difficult to draw any other conclusion from the case law.

Well down the road to chaos

The next major milestone in the ECJ's attack on the notion of national tax sovereignty came at the end of 2002, with its judgment in the case of *Lankhorst-Hohorst*.⁴³ This case concerned the German "thin capitalisation" rules.

These are rules which many countries, including the UK, have in place to protect their corporation tax revenues from flowing out of the country in the form of excessive interest payments being made to foreign companies intra-group. Essentially, they stop foreign parent companies funding their UK subsidiaries entirely by way of debt (as opposed to equity investment), interest payments on which are generally deductible for tax purposes in the hands of the UK subsidiary. The "thin capitalisation" rules prevent excessive interest deductions by imposing an "arm's length" (i.e. market) rate of interest which will be allowed as a deduction – beyond the arm's length amount, no deduction will be allowed. These rules are widely seen as one of the cornerstones of revenue protection for national governments.

⁴³ *Lankhorst-Hohorst*, Case C-324/00.

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The German thin capitalisation rules were the subject of the challenge in *Lankhorst-Hohorst*. A loan made from a Dutch parent company to its German subsidiary had to be on arm's length terms. However, a loan from a German parent to its German subsidiary did not need to be on such terms. Therefore, the Dutch group in *Lankhorst-Hohorst* claimed that this rule was tantamount to discrimination and therefore in breach of the freedom of establishment principle.

The German Government, supported in court by the British Government, argued that these rules were necessary to combat tax evasion, to ensure the "cohesion" of the German tax system and to protect government revenues. The ECJ rejected all of these arguments and declared the thin capitalisation rules to be in breach of EU law.

The German Government decided, perhaps in view of the severe budgetary constraints that it was already under, that it simply could not afford to lose billions in tax refunds and interest payments, without enacting something to replace the lost revenues. It therefore introduced domestic thin capitalisation rules with immediate effect – i.e. a loan from a German parent to a German subsidiary would also have to meet the arm's length criteria.

Undoubtedly, this places a significant additional administrative burden on the German corporate sector, both large and small companies alike, as considerable paperwork is required to prove to the tax authorities that the arm's length principle is being respected. Companies which were not previously subject to the rules will have to learn to comply with them. The tax authorities will also have to deal with more cases. Overall, it adds yet another layer of regulation to business in Germany.

As noted above, many countries, including the UK, have thin capitalisation rules which are similar in concept and application to the German model. It is almost certain that, were the UK rules to be challenged in the High Court (and a case is being brought at the moment), the court would be bound to declare the UK thin

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capitalisation rules in breach of EU law following the principle established in the *Lankhorst-Hohorst* case.

Estimates of the effect of such a judgment on UK corporation tax revenues are hard to pinpoint with any accuracy, but most commentators are agreed that claims would run into several billions of pounds.⁴⁴ One leading firm of accountants has observed:

And so one case leads to another, and the UK tax system unravels...⁴⁵

The Government has been slow to respond to the *Lankhorst-Hohorst* judgment. Yet most international tax professionals have been debating its potential ramifications endlessly. Finally, the Treasury decided to float the idea of introducing the concept of domestic thin capitalisation rules in the UK in the 2004 Finance Bill.

Again, this would result in a greatly increased compliance burden for UK companies, most of whom have never had to concern themselves with these rules. It would mean many man-hours lost in completing paperwork and dealing with enquiries from the Inland Revenue.

Measures introduced in such circumstances are clearly not good for British, or for EU, business. If the Government had taken a longer-term view of the likely impact of EU law on the British tax system, it is possible that Ministers would have been able to formulate a more comprehensive solution, better adapted to the needs of British business, rather than take short-term measures in response to a court case which are unlikely to have a beneficial effect for taxpayers or tax authorities.

It is also arguable that the introduction of domestic thin capitalisation rules would itself be contrary to EU law. National governments are not supposed to introduce new rules which make it more difficult to do business in the Single Market. So, the Government would be unable to apply the rules as they currently

⁴⁴ See the Appendix for a necessarily rough estimate of the impact on the UK Exchequer.

⁴⁵ Ernst & Young, *op cit*, page 5.

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stand, and unable to impose new ones to take their place. While companies would benefit, corporation tax revenues would decrease rapidly and the UK Government would have abandoned, definitively, its pretence that it has the ability to make and enforce its own tax rules.

All hell breaks loose

In the wake of *Lankhorst-Hohorst*, tax advisers have begun to draw up long lists of national tax measures which would be struck down by the ECJ were they to be the subject of litigation. There are a number of UK measures, which are key features of the UK corporation tax system, which feature in these lists. These include:

- the taxation of overseas dividends received by UK parent companies: currently, these are fully taxed in the UK, whereas UK to UK dividends are not taxed;
- Controlled Foreign Company (CFC) rules: anti-avoidance measures introduced to prevent the use of artificial tax havens to shelter low-taxed profits from UK tax;
- transfer pricing rules: similar to thin capitalisation, these rules impose arm's length principles to all cross-border intra-group transactions, for example pricing on products, but do not apply to transactions within the UK (the UK Government is now considering introducing domestic transfer pricing provisions in the Finance Bill 2004, something which would potentially impose a significant and costly administrative burden on UK business); and
- group relief rules (dealt with in more detail below).

If any, or all, of these measures are the subject of successful claims before the ECJ, the UK Government will face a substantial bill for repayment of taxes and interest thereon. The squeeze on revenues would be such that tax rates could almost certainly not remain at their present levels in the short to medium term.

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The most immediate claim facing the UK Government is in the area of group relief, whose broad principles were outlined in the earlier discussion of the *ICI* case. Marks & Spencer has brought a case before the High Court reclaiming approximately £30 million in taxes from the Inland Revenue on the grounds that its inability to offset losses made from its failed expansion into continental Europe against its UK profits is a breach of the freedom of establishment.

The principle is very simple. The UK group relief rules allow profits and losses made by UK resident subsidiaries in the same group (which can be headed by an EU parent company following the *ICI* decision) to be offset against each other, so that the tax result mirrors the group's overall results. They do not allow losses made by overseas subsidiaries to be offset against UK profits.

So, if M&S sets up a store in Manchester operated by a subsidiary company, which makes a loss for tax purposes, that loss can be offset against a profit made by a similar subsidiary company operating a store in, say, Edinburgh. If M&S operated a loss-making store in Paris through a branch of a UK company rather than a separate French-incorporated subsidiary, those losses should also be available to reduce the taxable profits made in Edinburgh. However, if M&S chose (for legal or commercial reasons) to operate its store in Paris via a French-incorporated subsidiary, those losses would not be available to offset against the profits of the Edinburgh store.

M&S claims that the UK group relief rules, by restricting the ability to offset profits and losses to UK residents and their overseas branches, are contrary to the freedom of establishment principle. Effectively, the company is claiming that the UK tax system should provide tax relief for failed overseas business ventures.

If the claim is successful – and on the evidence of recent cases it is more than likely that it will be – the financial implications for the UK Treasury of this case alone are significant. M&S are reclaiming £30 million – many other companies are prepared to

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reclaim many times that amount, and the total will run into billions of pounds.

Some of the recent speculation and comment in certain sectors of the British press concerning these developments has been misguided. One example of this was a piece in *The Observer* in June 2003 about the M&S case which stated that:⁴⁶

In what could be one of the most significant legal disputes in recent British corporate history, more than 40 of the UK's most powerful firms are preparing to take the beleaguered Inland Revenue to Europe's Court of Justice to recoup billions of pounds in tax. If successful, the group action could seriously affect Gordon Brown's spending plans. And it would be yet another vivid example of how multinationals run rings round the Revenue by avoiding tax with the help of armies of highly paid tax planners.

What M&S, and the other companies who have signed up to the claim, are doing cannot be defined as tax avoidance. As stated earlier, they are simply reclaiming what is their due under the law, as decreed by the ECJ. And it is not the companies who are running rings around the Inland Revenue and the UK Government, but the judges in the ECJ. They have consistently outflanked the national governments of the Member States, rejecting their arguments in defence of national tax sovereignty out of hand. Where the Commission has been afraid to act by way of direct legislation, because it knows the Member States will not accept the proposals, the ECJ has stepped into the breach, using Single Market provisions in a way in which they were probably never intended to be used (at least as far as most politicians in this country are concerned).

Business has not benefited either. While there may be some short-term financial gain for companies reclaiming tax, there will be much more to pay in terms of increased administrative costs, thanks to the greater regulatory burden which Governments have been obliged to impose in the wake of ECJ judgments.

⁴⁶ "Corporate tax avoidance is costing us billions", *Observer*, 29 June 2003.

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As well as the financial chaos which these judgments have brought, the effect in political terms should not be forgotten. The national Governments of each EU Member State, with the UK being a prime example, have lost control over their own corporate tax systems. They no longer seem free to legislate and tax companies according to their own democratic mandates and political priorities. Instead, they are being forced to react, often in panic, to ECJ judgments. In one recent case, *Bosal*, the Dutch Government had to rush legislation out the day after an adverse judgment to bring its tax laws into line with the principles of the ECJ judgment. This is not a satisfactory way to conduct the affairs of government. Neither does it give any certainty to taxpayers, who are facing a constantly changing set of rules. In applying the Single Market provisions to direct tax laws, the ECJ is creating turmoil and playing havoc with the EU Member States' corporate tax systems.

CHAPTER FIVE

WHAT CAN BE DONE?

GOVERNMENTS OF THE MEMBER STATES – and in particular, that of the UK – have failed to anticipate the likely direction of EU law and to provide for it in advance.

The Government continues to maintain publicly that the UK still enjoys total sovereignty over its tax system. It has failed to provide any comprehensive legislative solution to deal with the fact that many aspects of UK tax law are contrary to the Single Market provisions; and that these will be struck down by the ECJ if litigated. The Government has failed to face up to reality.

Proposals to reform our corporation tax system are now essential. So what are the options open to the UK Government? Some of them are radical and innovative, others less so. The options can be split into the following categories:

Accepting the political thrust of the ECJ's decisions and the wishes of the EU legislative bodies and arguing for corporate tax harmonisation, in some form, across the EU Member States.

To do this, the Government would have to perform a spectacular political U-turn. It would be highly damaging politically.

Maintaining the current “sticking plaster” approach in response to future ECJ judgments.

This is unlikely to be acceptable to corporate taxpayers and would not lead to long-term stability. At the very least, the Government must enter into discussions with business and industry representatives as soon as possible to decide what short-term

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action should be taken in relation to those areas of tax law which are currently the subject of litigation before the courts.

Negotiating some kind of tax “carve-out” from the provisions of the EU Treaty, or expressly limiting the powers of the ECJ in this field of policy, through unanimous agreement with the other Member States.

Such a carve-out was suggested during the course of the negotiations leading up to the Nice Treaty. This suggestion was supported by a number of the larger Member States, but ultimately failed due to lack of widespread support. Achieving such an agreement will be even more difficult post-enlargement, but some commentators believe that it may be possible if it is part of a determined attempt by the Government to introduce a non-discriminatory tax system designed to be robust against ECJ challenge. This option should at least be discussed as a concept between Ministers of the various Member States.

Systematically going through the potentially affected provisions in the UK corporate tax code and amending them to make them “EU-compliant”.

Such amendments could either be “negative” (i.e. abolishing such concepts as group relief altogether – this might maintain revenues in the short term, but would make the UK significantly less advantageous as an investment location) or “positive” (i.e. extending group relief and similar concepts to all EU companies). This latter option could also be accompanied by a reduction in the current UK corporation tax rate of 30%, in the hope that increased tax revenues from more economic activity taking place in the UK would offset the loss of revenue resulting from the extension of these reliefs. However, without further work to quantify the precise financial effects, it could only ever be a hope that a decrease in one source of revenue would be matched by an increase in another. There is a risk that the short-term costs of any revenue mismatch could be extremely costly for the Government.

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Looking at the reasons why reliefs, exemptions and restrictions in the UK tax code which may be contrary to EU law were introduced in the first place, and determining if the goal they were intended to achieve, or the mischief they were intended to tackle, could instead be dealt with in some other, non-discriminatory way.

This may involve changing some of the fundamental principles behind the UK tax system, moving to an income source basis of taxation rather than taxing a company on the basis of where it is resident.

Radically reforming the UK's current system of corporate tax, which taxes UK resident companies (or UK branches of overseas companies) on their UK profits as they arise, and on profits from overseas subsidiaries only once they are paid to the UK by way of dividend.

This system could be replaced by a system of worldwide tax consolidation, again perhaps accompanied by a reduction in the UK corporation tax rate. A number of countries, for example Denmark, already have such a system. The implementation of such a system should make the UK more attractive, at least from a tax perspective, as a location for inward investment, and if properly introduced would minimise the risk of any future challenge under EU law. The major disadvantage of this proposal would be the effect it has on the UK's current network of double taxation treaties.

Leaving the EU.

This would clearly be a massive step, with political and economic implications far beyond just tax. The question is whether the broader benefits conferred by EU membership outweigh the disadvantages, which of course include the effect EU law is currently having on our tax system. It would be preferable to find an option, such as one of those listed above, which did not involve such upheaval across all of Britain's international relationships and obligations. But, as with any problem or crisis involving Britain's dealings with her fellow Member States and the EU bodies, the option is always there if required.

CHAPTER SIX

TAX AND THE EU CONSTITUTION

BRITISH GOVERNMENT MINISTERS have been at pains to emphasise that tax is one of the few issues where the UK Government will veto all attempts to introduce Qualified Majority Voting (QMV) at the EU level in the new Constitution. Indeed, the Prime Minister has stated that he will not cede powers over tax in his Foreword to the Government's White Paper:

And we could only accept a final text that made it clear that issues like tax, defence and foreign policy remain the province of the nation State.⁴⁷

But it is the case that the pressures in the EU for tax harmonisation are still growing. And the Constitution, as presently drafted, does contain a number of draft clauses which could have a serious effect on our ability to control our own tax system.

Calls for tax harmonisation

While the proposed Constitution does not contain any specific proposal relating to tax harmonisation, many in the EU would like it to do so. Supporters of federal integration, such as the European Commission President Romano Prodi, have gone on record as stating that the draft document does not go anywhere near achieving federal goals. In calling the draft “unworkable” and “absurd”, Mr Prodi called for the end of the national veto in

⁴⁷ Foreword, *A Constitutional Treaty for the EU – the British Approach to the European Union Intergovernmental Conference 2003*, Cm 5934 [author's own emphasis].

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all remaining policy areas, including taxation.⁴⁸ Indeed, in its formal Opinion to the IGC, the Commission again reiterated its view that tax harmonisation is necessary in the field of corporate tax to enable the Single Market to operate more effectively. The Opinion stated:⁴⁹

In certain fields, the Constitution will need to be revised to enable the Union to operate effectively... more precise demarcation of the Union's authority should, in some cases, enable unanimous voting to be dispensed with. For example... taxation in connection with the operation of the internal market i.e. modernising and simplifying existing legislation, administrative co-operation, combating tax fraud or tax evasion, and measures relating to tax bases for companies, but not including tax rates.

There can be little doubt that a “more precise demarcation” of the Union's, or more correctly the Commission's, powers in this area would lead to the accrual of more powers to the EU legislative body. Despite the widespread opposition amongst the Member States to such tax harmonisation proposals, it is notable that the Commission has started, as it often does when seeking to obtain powers in a specific policy area, by identifying a number of “non-core” areas where it argues that greater co-operation is necessary. There are many instances of Member States being persuaded by such arguments. Indeed, the Commission is at pains to stress that the removal of unanimity does not, in its view at least, mean that Member States will see powers taken away from them in relation to corporate tax. In its opening remarks to its representations to the IGC, the Commission states:

It is important to stress that QMV does not imply harmonisation of taxes across Europe. Nor does it mean an increase in taxation. QMV in taxation is aimed at ensuring the compatibility of the Member States' tax systems with each other and with the Treaties.

⁴⁸ *The Daily Telegraph*, 18 September 2003.

⁴⁹ COM (2003) 548.

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It is not clear how ensuring that 15 diverse corporate tax systems are “compatible” with each other does not necessarily imply some degree of harmonisation.

The “co-ordination” of economic and employment policies

Article I-14(1) of the draft Constitution states:⁵⁰

The Union shall adopt measures to ensure co-ordination of the economic policies of the Member States, in particular by adopting broad guidelines for these policies. The Member States shall co-ordinate their economic policies within the Union.

Assuming the Constitution is enacted into law in its current form, Britain will then be under an obligation to “co-ordinate” its economic policy. This provision would effectively hand control of our broad economic policy guidelines to the EU. It includes tax policy as it is one of the major “planks” of wider economic management, in line with “broad guidelines” to be set by the Union (guidelines which will presumably be developed and driven by the Commission).⁵¹

As David Heathcoat-Amory MP, one of the British Parliament representatives at the Convention which drafted the Constitution, has observed:⁵²

The compulsory co-ordination of economic and employment policies of all member states is a significant transfer of responsibility and decision-making from national governments to the Union, going far beyond the existing EU treaties. It would certainly cover the overall level of taxation, interest rates and public expenditure in each country, as well as pensions policy and employment taxes.

⁵⁰ The European Convention, *Draft Treaty establishing a Constitution for Europe*, CONV 850/03, 18 July 2003. All future references to the draft Constitution are to the document of this date.

⁵¹ Note that the word “shall”, in a legal context, indicates “must”, or “have a duty to”.

⁵² D Heathcoat-Amory, *The European Constitution and what it means for Britain*, CPS, 2003.

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Imagine a future British Government, elected on a manifesto of cutting taxes, deregulating and reducing unnecessarily high levels of public spending. Its economic policies would clearly, in those circumstances, not be “co-ordinated” with those of the Union. What would happen? Would the Union attempt to impose its policies against the preferences of the British people? Would they attempt to censure, or fine, us in some way?

“Administrative co-operation” in relation to company taxation

Article III-63 of the draft Constitution provides that:

Where the Council of Ministers, acting unanimously on a proposal from the Commission, finds that measures on company taxation relate to administrative co-operation or combating tax fraud and tax evasion, it shall adopt, by a qualified majority, a European law or framework law laying down these measures, provided they are necessary for the functioning of the internal market and to avoid distortion of competition.

The effect of this provision is to introduce QMV (i.e. the abandonment of the unanimity requirement) in relation to company taxation where “administrative co-operation, or combating tax fraud and tax evasion” are concerned.

These terms are undefined. What is meant by “administrative co-operation” is extremely unclear and is capable of very wide interpretation.

In a similar way to the Code of Conduct on Business Taxation, this may be seen as another way for the EU to side-step significant opposition from the Member States. By gaining powers in a seemingly harmless area such as “administrative co-operation” or the tackling of tax fraud or tax evasion, the EU can then spread its influence ever more gradually in this area.

If this provision is signed into law, the British Government will have given the EU the “foot in the door” in relation to direct legislative authority on company taxation. This would be the first time a British Government expressly agreed to abandon the veto in relation to direct taxation.

TAX AND THE EU CONSTITUTION

It is worth noting that the Government maintained its position when questioned about it recently in Parliament. In response to the question “To ask the Chancellor of the Exchequer what plans the EU has for the harmonisation of company tax within the EU”, Dawn Primarolo responded in a written answer:⁵³

The Government’s view is that fair tax competition is the way forward for Europe, not proposals for tax harmonisation. The Government will not support any action at European level that will threaten jobs or the competitive position of British business.

In response to a supplementary question dealing specifically with how the Chancellor defined “administrative co-operation” and “combating tax fraud and tax evasion” in Article III-63 of the draft Constitution, the written response was:

The draft EU Constitutional Treaty provided by the Convention on the Future of Europe does not contain definitions of these terms. Any changes to the provisions of the existing EU Treaties, including those contained in Article III-63 of the draft Treaty, require the unanimous agreement of all Member States. The Government has made it clear in its White Paper... that it will insist that tax matters continue to be decided by unanimity.

The statement of intent therefore seems clear. The Government has stated that “tax matters”, which must be construed as including “administrative co-operation” and “combating tax fraud and tax evasion” will not become the subject of QMV procedures, and will remain subject to the unanimity requirement.

The effect on Britain’s international tax agreements

Britain concludes a number of double taxation treaties with other countries across the world, designed to ensure that individuals and companies operating in each of the signatory states to a treaty do not suffer double taxation by virtue of each country applying

⁵³ House of Commons written answer, 29 October 2003, *Hansard*, Column 243W.

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its domestic tax laws in isolation. These treaties are essential to facilitate cross-border transactions by reducing the tax burden that would otherwise make such transactions uneconomic.

Britain has possibly the widest network of double taxation treaties in the world, individually designed and negotiated to obtain the best deal for UK individuals and companies living, working or operating overseas. However, under the terms of the draft Constitution, we could also be granting powers to the EU in this area. Article I-12(2) of the draft Constitution states:

The Union shall have exclusive competence for the conclusion of an international agreement when its conclusion is provided for in a legislative act of the Union, is necessary to enable it to exercise its internal competence, or affects an internal Union act.

This is further expanded by Article III-225 of the draft Constitution:

The Union may conclude agreements with one or more third countries or international organisations where the Constitution so provides or where the conclusion of an agreement is necessary in order to achieve, within the framework of the Union's policies, one of the objectives fixed by the Constitution...

What this appears to mean is that the Union shall equip itself with the power to conclude international agreements, such as double taxation treaties, but also agreements in the fields of foreign affairs, defence, and many others, a function previously enjoyed by the Governments of the Member States.

The inevitable consequence of this, from a tax point of view, is that the interests of British individuals and companies will no longer be paramount to the teams of specialists negotiating these agreements. Instead, the most important consideration will be the implications at an EU level. This would be a significant reduction of Britain's influence in the international tax field and would mean that our interests are subsumed into the broader EU context. Again, Ministers have made no specific objection to this provision.

CHAPTER SEVEN

CONCLUSIONS

Little progress for the EU for direct tax harmonisation through legislation

DESPITE NUMEROUS ATTEMPTS, the European Commission has not been as successful in introducing harmonisation in the field of direct taxation as it has been in other areas. Nevertheless, it has made some progress with initiatives like the Code of Conduct on Business Taxation. A large number of policy documents and initiatives discussing the introduction of a single corporate tax system for the EU has been published at various times. Most of these are currently waiting to be implemented if the Member States agree, at some stage, to allow the Commission to assume direct legislative authority in this area.

The ECJ uses single market legislation to strike down national tax laws

While little progress has been made on the legislative front, the ECJ has invoked Single Market provisions to strike down a whole succession of national tax laws. This has had serious financial repercussions for national exchequers, running into the billions. And as the caseload of the ECJ grows, so will the damage to national finances. The British Government could well find itself having to raise tax rates, either corporate or individual, to meet the shortfall which will be caused by the ECJ judgments.

The failure of the British Government to respond

The British Government had the chance to act earlier to introduce reforms which could have avoided the recent chaos and

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uncertainty. Many companies and advisers were well aware of the logical conclusion of the ECJ's enforcement of Single Market principles. However, the Government decided to ignore the signs and do nothing, and is now paying the price.

The threat of increased regulatory cost on business

Those companies which have claimed tax refunds, and compensatory interest, may gain in the short term. But in the medium term, businesses are certain to lose out as Governments are forced to introduce ever more rules and regulations to ensure that their national tax systems are "EU-compliant".

The need to overhaul corporation tax

Eventually, the British Government may be forced to radically overhaul its corporation tax system in a way not seen for over 100 years. This would be a massive legislative exercise, but it may be necessary to ensure that the system becomes immune to the chaos and sudden financial outflows which characterise the current *status quo*. Some ways in which this may be achieved have been suggested above. It is now time for the Government to take a strategic lead.

More powers to the EU under the draft Constitution

Finally, the draft European Constitution, although apparently disappointing to supporters of a more integrated Europe because of its apparent lack of federalist proposals and containing no plans for a unified corporate tax system, does in fact contain a number of measures which would give the EU even more power, and direct legislative influence for the first time, over the UK's corporation tax system.

APPENDIX

ESTIMATES OF IMPACT OF ECJ'S CORPORATE TAX JUDGMENTS

IT IS NOT POSSIBLE to assess with any real accuracy the cost to the UK Exchequer of the various ECJ rulings on corporation tax. The following paragraphs try to estimate the possible exposure of the UK Treasury and while they do not claim any great scientific exactitude, they are probably as accurate as anyone can estimate at this stage of proceedings.

1. The historical cost of the ECJ judgments

The table below suggests that the probable total cost of all those cases which have already been decided, or which are presently the subject of active litigation, is possibly in excess of £10 billion.

	Lower estimate	Higher estimate
"Hoechst" ACT cases: ⁵⁴	£3 billion	£4.5 billion
French & German tax credit claims: ⁵⁵	£1 billion	£2 billion
Surplus ACT claims	£500 million	£1 billion
M&S group relief cases	£3 billion	£4 billion
Total	£7.5 billion	£11.5 billion

⁵⁴ There are three classes of Hoechst cases. The cost of Class I cases (where most of these claims are being settled currently) is about £500 million; the cost of Class II cases (these claims have not yet been heard): between £500 million and £1 billion; and the cost of Class III cases (which are under appeal in the UK at the time of writing): between £2 billion and £3 billion.

⁵⁵ French and German companies are making claims on the back of a decision in favour of a Dutch parent company with UK subsidiary.

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2. The potential cost of the ECJ judgments

Corporation tax raises about £30 billion each year for the UK Exchequer. Around 80% of total Corporation Tax receipts are paid by about the top 20% of corporate taxpayers (mainly banks, retailers and oil companies).

If all of the provisions which have been identified as potentially subject to future litigation are indeed struck down, and are not replaced by the Government, then the cost could be around £8 billion to £10 billion per year.

The system would basically become a free-for-all and most companies would seek to exploit the opportunities presented to remove as much profit as possible from the UK tax net.

Clearly, however, it is unlikely to cost as much as this because the Government would be expected to introduce some form of replacement legislation (even if of the “sticking plaster” variety) to prevent revenue loss on such a massive scale. But the costs are likely to be there in some shape or form, as will the amount of red tape unless a more strategic approach is taken.

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