HM Government

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

July 2013

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

Taxation

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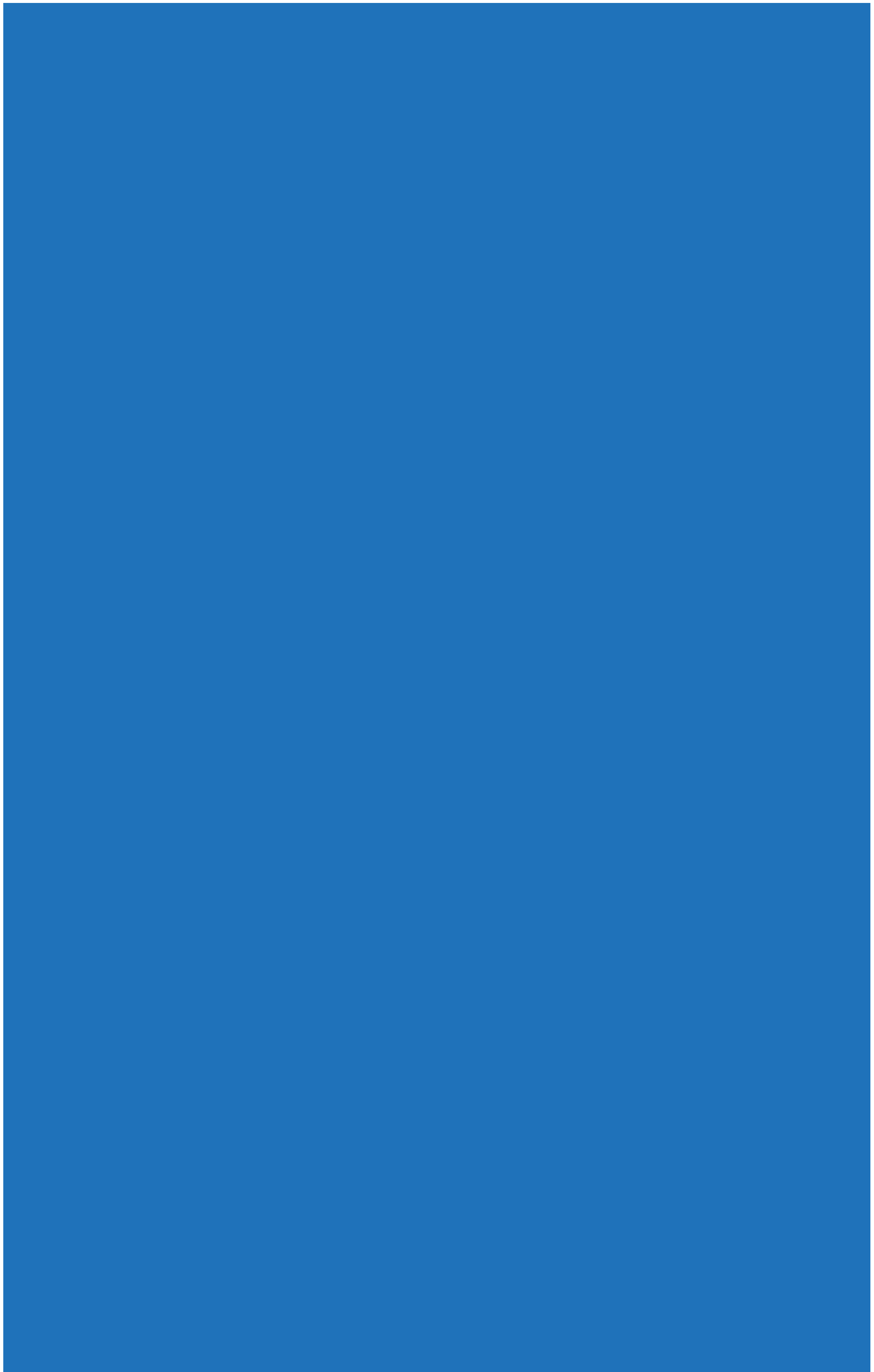

Executive summary

This report examines the balance of competences between the European Union and the United Kingdom in the area of taxation. It is a reflection and analysis of the evidence submitted by experts, non-governmental organisations, businesspeople, Members of Parliament and other interested parties, either in writing or orally, as well as a literature review of relevant material. Where appropriate, the report sets out the current position agreed within the Coalition Government for handling this policy area in the EU. It does not predetermine or prejudge proposals that either Coalition party may make in the future for changes to the EU or about the appropriate balance of competences.

The Balance of Competences Review aims to provide an analysis of what the UK's membership of the EU means for the UK national interest. As part of the review HM Treasury published a Call for Evidence on Taxation[1] to gather evidence and facilitate discussion with interested parties in order to inform this taxation report. The evidence received and discussions with interested parties focused around broad themes including:

- The considerations in determining the appropriate level for decisions on taxation to be made;
- The impact of the current balance of competence and its exercise on the national interest; and
- The future challenges the UK may face in relation to the balance of competence on tax, including proposals for changes to tax policy and legislation at the EU level.

The appropriate level for tax policy

Respondents identified decisions on taxation, in particular direct taxation, as primarily for Member States, especially where this concerned personal taxation.

They felt that tax policy measures to address obstacles to cross-border business, or administrative co-operation between Member States could be suited to action at the EU level where these obstacles could not be addressed by domestic action. Respondents also noted a role for tax policy at the international level would be preferable where this was necessary to facilitate global business, for example the creation and maintenance of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention to help address double taxation.

[1] The Government's review of the balance of competences between the United Kingdom and the European Union: call for evidence on taxation, HM Treasury, 30 November 2012.

The impact of the current balance of competence

Respondents recognised that the balance of competence on taxation is subject to an underlying tension between a level playing field within the internal market and a reduction in burdens for cross-border business activities on the one hand, and the ability of Member States to respond to specific national circumstances through design of their own tax systems on the other.

In recognition of this tension, respondents welcomed those indirect taxation measures which had facilitated, or addressed obstacles to, cross-border business activity. For example, respondents highlighted the use of a largely harmonised value added tax (VAT) regime as ensuring consistency in the internal market and enabling cross border-trade. On direct tax, respondents welcomed the limited EU tax legislation which they felt provided certainty of the tax treatment in specific cross-border situations. For example, respondents highlighted the benefits of the Mergers Directive[2] which provides a common system of taxation applicable to cross-border reorganisations of companies situated in two or more Member States.

Many respondents also highlighted as beneficial the removal of tax discrimination through enforcement of the fundamental freedoms and through representations by the European Commission when negotiating bilaterally with EU candidate countries, third countries, and at the international level in forums such as the World Trade Organisation (WTO).

While noting that unanimity voting on taxation has been essential in safeguarding the UK's interests, respondents acknowledged that unanimity voting could have some negative consequences because of the need to achieve agreement by all Member States. In particular, this had impacts on the probability of legislation finally being agreed, the nature of the legislation and the time frames for agreement. However, respondents clearly advocated the retention of unanimity voting and suggested other methods be used to address any downsides.

Where the UK would benefit from more or less EU-level action on taxation

The views expressed by respondents to the call for evidence and by those with whom the review was discussed were broadly similar. In particular, respondents and interested parties were content with the current balance of competence on taxation, taking account of the protections offered by unanimity voting. Whilst individual respondents suggested areas where existing measures could be updated to reflect modern business practice and development, no respondents identified any major gaps in the existing tax legislation. A number of respondents cited the proposed financial transactions tax as an area where they questioned the appropriateness and utility of EU-level action.

How tax policy and legislation could be improved

Many respondents sought improvements to the process of creating tax policy and legislation at the EU level. Respondents pressed for greater consultation by the European Commission with interested and affected parties, more detailed analysis of the effects of EU tax policy on Member States and greater accountability for impact assessments.

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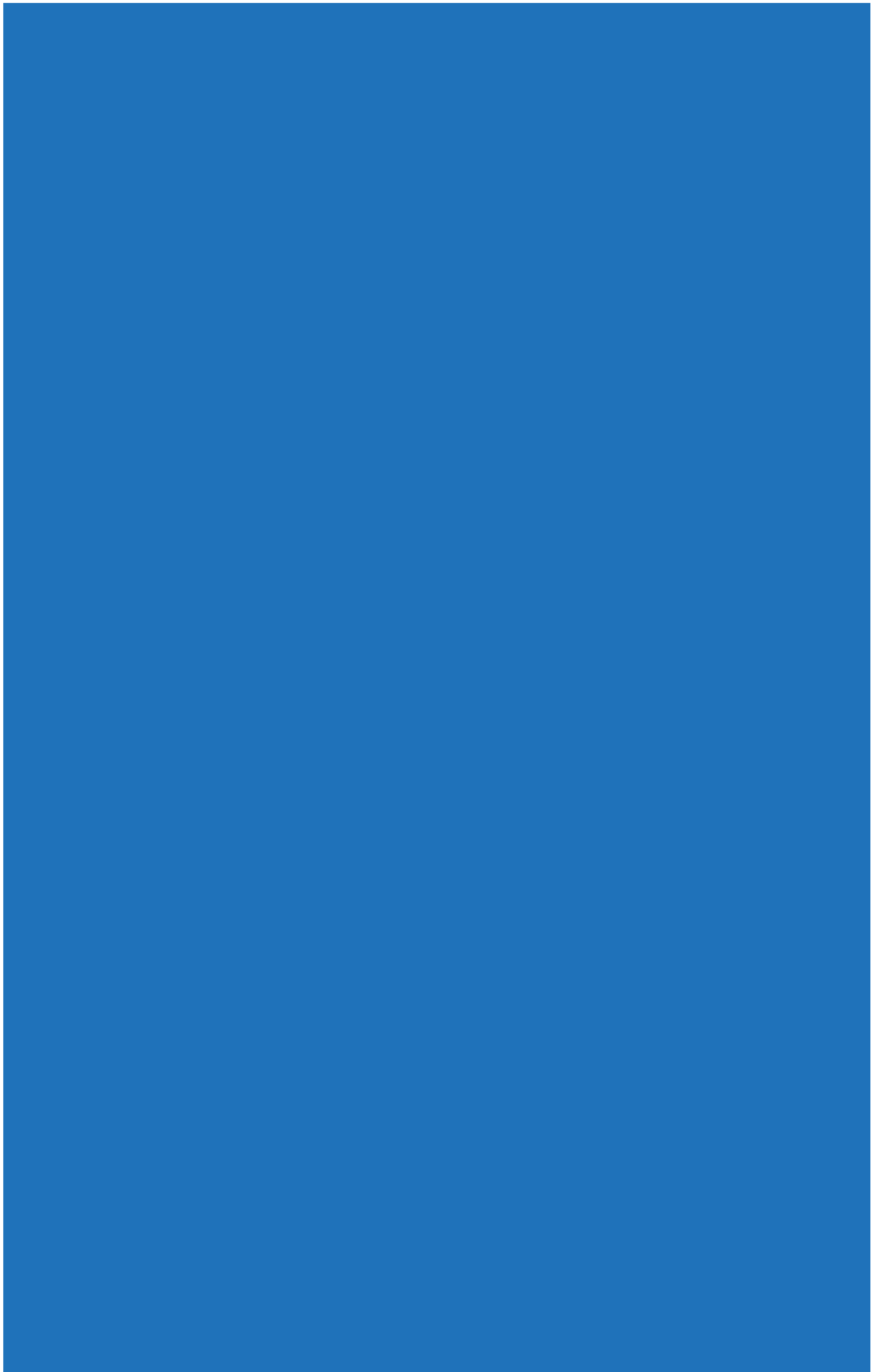
[2] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, as amended.

The future challenge the UK faces on the balance of competence on tax

Concerns expressed by respondents and interested parties focused on what they viewed as risks to the UK's tax sovereignty or national interests. These included the inclusion of tax or fiscal measures in non-tax proposals which are not assessed by tax experts and undermine unanimity; the use of enhanced co-operation on tax measures which could have extra-territorial effects; and the impact of rulings by the Court of Justice of the European Union (CJEU) on domestic tax measures and Member State competence.

The views generally expressed by respondents were that:

- Unanimity voting for taxation should be retained;
- Taxation is primarily a matter for Member States; and
- EU-level action is appropriate only where there is a clear internal market justification and the principles of subsidiarity and proportionality have satisfactorily been shown to be met.



Introduction

The Balance of Competences Review

The Foreign Secretary launched the Balance of Competences Review in Parliament on 12 July 2012, taking forward the Coalition commitment to examine the balance of competences between the UK and the EU. It will provide an analysis of what the UK's membership of the EU means for the UK national interest. It aims to deepen public and Parliamentary understanding of the nature of our EU membership and provide a constructive and serious contribution to the national and wider European debate about modernising, reforming and improving the EU in the face of collective challenges. It will not be tasked with producing specific recommendations nor will it look at alternative models for Britain's overall relationship with the EU.

The review is broken down into a series of reports on specific areas of EU competence, spread over four semesters between autumn 2012 and autumn 2014. The review is led by Government but also involves non-governmental experts, organisations and other individuals who wish to feed in their views. Foreign governments, including our EU partners and the EU institutions, have also been invited to contribute.

More information can be found on the review at www.gov.uk/review-of-the-balance-of-competences, including a timetable of reports to be published during the process.

This report follows HM Treasury's Call for Evidence on Taxation as part of the Balance of Competences Review. This was published on 30 November 2012 and invited evidence to be submitted by 22 February 2013. The analysis in this report draws on written evidence, seminars and discussions during the call for evidence period, and existing published material, including that which has been brought to our attention by interested parties, such as past select committee reports or reports of the European Commission.

This report begins with a summary in Chapter 1 of the existing balance of competence in the area of taxation. Further background detail can be found in the call for evidence published on HM Treasury's website: http://www.hm-treasury.gov.uk/int_balance_competences.htm.

Chapters 2 to 6 report on the evidence under the following broad themes set out in the call for evidence:

- The main considerations in determining the appropriate level for decisions on taxation to be made;
- The impact of the current balance of competence and its exercise on the national interest;

- Where the UK may benefit from more or less EU-level action on taxation;
- How tax policy and legislation at the EU level could be improved; and
- The future challenges and opportunities the UK may face in relation to the balance of competence on tax.

A list of evidence submitted can be found in annex A. Annex B sets out the meetings and events held or attended by the Treasury. A literature review of relevant material used to inform this report is included in annex C.

Competence

The term competence is normally used to describe the powers conferred on the EU by the Member States to undertake specific actions. The EU's competences are set out in the EU Treaties, which provide the legal basis for any actions taken by the EU institutions. The EU can only act within the limits of the competences conferred on it by the Treaties. This means there must be a legal basis for the EU to act.

There are different types of competence: exclusive, shared and supporting. Only the EU can act in areas where it has exclusive competence, such as the customs union and common commercial policy.

In areas of shared competence, such as the internal market, environment and energy, either the EU or the Member States may act. To the extent that the EU exercises its competence, then the Member States are not free to exercise their competence, but may do so again once the EU ceases to exercise the competence.

In areas of supporting competence, such as culture, tourism and education, both the EU and the Member States may act; but action by the EU does not prevent the Member States from taking action of their own and the Treaties explicitly prohibit harmonisation of laws.

Where the Treaties do not confer competence on the EU or the EU has not already acted, the competence remains with the Member States.[1]

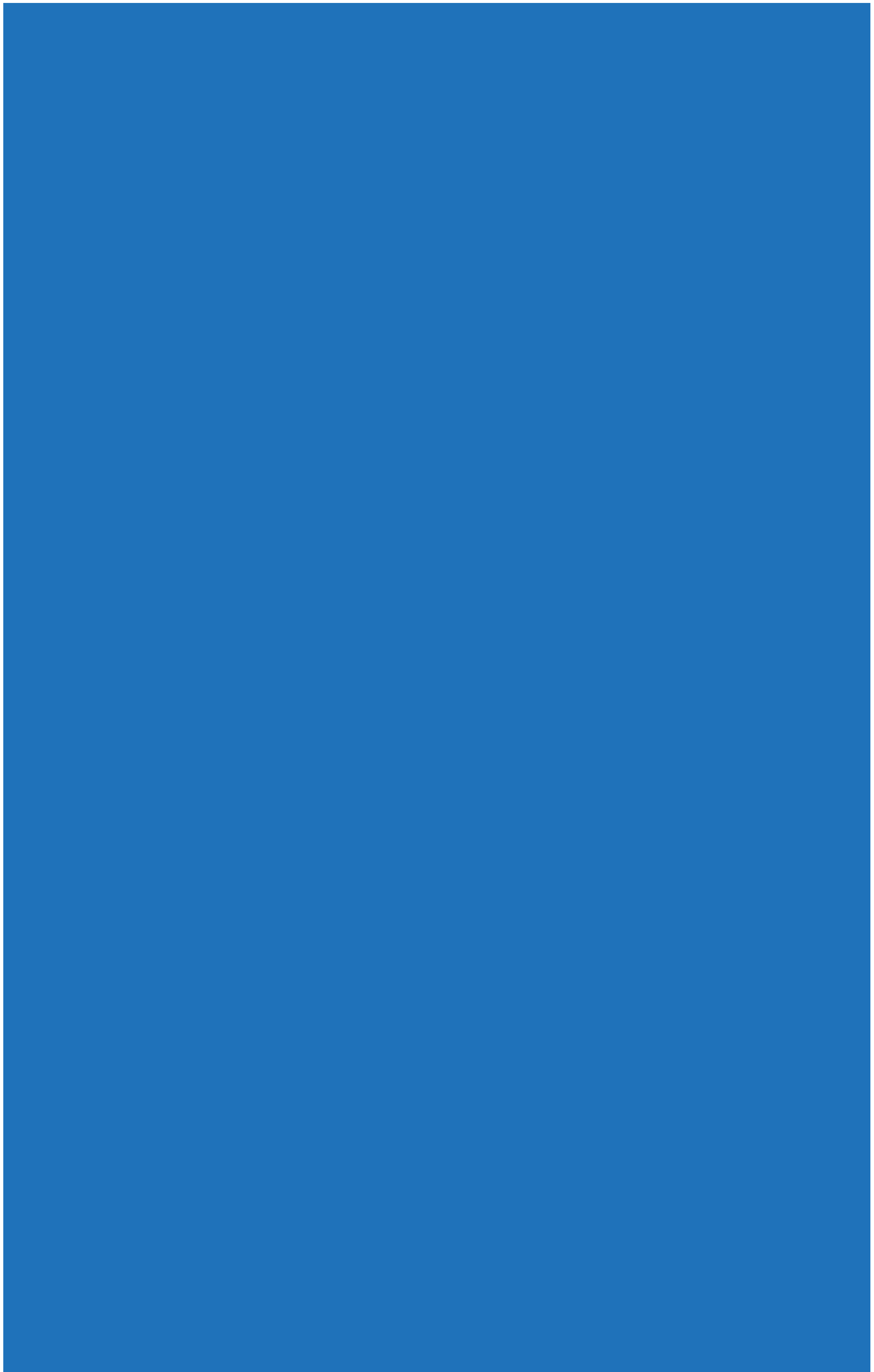
When the EU exercises its competence in the area of taxation, it must act in accordance with the general principles of EU law and fundamental rights, as set out in the Treaties. The EU must also act in accordance with other articles in the Treaties, including adhering to the principles of subsidiarity and proportionality under Article 5 of the Treaty of the European Union.

[1] Article 4(1) TEU.

Box A: Subsidiarity and proportionality

Under the principle of subsidiarity, where the EU does not have exclusive competence, it can only act if it is better placed than the Member States to do so, because of the scale or effects of the proposed action.

Under the principle of proportionality, EU action must not exceed what is necessary to achieve the objectives of the EU Treaties.



Chapter 1:
Tax at the EU level

1.1 Legislative proposals must have a legal base in the EU Treaties appropriate to the proposal.

Box 1.A: The Treaties of the European Union

The European Economic Community (EEC) was established by the Treaty of Rome in 1957. This Treaty has since been amended and supplemented by a series of Treaties, the latest of which is the Treaty of Lisbon.

The Treaty of Lisbon, which entered into force on 1 December 2009, re-organised the two Treaties on which the European Union is founded: the Treaty of the European Union (TEU) and the Treaty Establishing the European Community (TEC), which was re-named the Treaty on the Functioning of the European Union (TFEU).

The internal market

1.2 The internal market of the EU is an area without internal frontiers designed to ensure the free movement of goods, services, capital and freedom of establishment: the so-called fundamental freedoms.

Box 1.B: The fundamental freedoms

Article 21 TFEU (formerly Article 18 EC) on the free movement and residence of EU citizens[1].

Articles 45 – 48 TFEU (formerly Articles 39 – 42 EC) on the free movement of workers[2].

Articles 49 – 55 (formerly Articles 43 – 48 & 294 EC) on the freedom of establishment[3].

Articles 56 – 62 (formerly Articles 49- 55 EC) on the freedom to provide services[4].

Articles 63 – 66 (formerly Articles 56 – 59 EC) on the free movement of capital and payments[5].

1.3 The fundamental freedoms are the subject of separate reports as part of the Balance of Competences Review but are discussed in this report to the extent that they impact on the ability of Member States to exercise their competence over taxation policy.

1.4 Greater integration within the internal market reduces the autonomy of Member States to act independently, but can bring significant benefits as the barriers to trade between Member States are removed.

1.5 Action on taxation under both of the tax legal bases of the Treaty requires an internal market justification. For indirect taxation under Article 113 of the TFEU, the Treaty requires that the proposed action must be "necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition". For direct taxation Article 115 of the Treaty requires that for there to be harmonisation it must "directly affect the establishment or functioning of the internal market".

1.6 The EU today is a different place to that at the inception of the European Single Market 20 years ago. Commerce is now far more globalised. To ensure future economic growth, retaining the competitiveness of Member States and the EU is paramount.

1.7 Tax policy, in particular on indirect taxes, plays a part in ensuring the effective functioning of the internal market, for example the largely harmonised application of VAT which affects the pricing and competitiveness of products. However, any EU action on direct tax beyond administrative cooperation can have consequences for individual Member States' ability to shape their domestic tax systems to raise revenue and to support domestic growth.

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[1] The competence conferred under these Articles will be part of the Review on the Internal Market: Free Movement of Persons. This review began in the spring of 2013. Further information can be obtained by emailing FreeMovementofPersonsBoC@homeoffice.gsi.gov.uk.

[2] *Idem.*

[3] *Idem.*

[4] The competence conferred under these Articles will be part of the Review of the Internal Market: Free Movement of Services. This review will begin in the autumn of 2013. Further information can be obtained by emailing balanceofcompetences@bis.gsi.gov.uk.

[5] The competence conferred under these Articles will be part of the Review of the Internal Market: Free Movement of Capital. This review will begin in the autumn of 2013. Further information can be obtained by emailing BalanceofCompetences@hmtreasury.gsi.gov.uk.

1.8 The balance of competence on taxation is subject to an underlying tension between a level playing field within the internal market and a reduction in burdens for cross-border business activities on the one hand, and the ability of Member States to respond to specific national circumstances and national choices through design of their own tax systems and rates on the other. This in turn can have an impact on overall competitiveness both at the level of Member State and the EU as a whole.

1.9 While recognising these tensions, UK policy places priority on ensuring that the Government retains maximum flexibility to shape UK tax policy to suit UK economic circumstances. In line with the Coalition Agreement, the Government opposes any extension of EU competence in the area of taxation. The Government believes that tax matters should remain subject to unanimity and upholding the veto on tax is a priority. Under the terms of the European Union Act (2011), giving up the United Kingdom's national veto in a number of sensitive areas – including tax policy – would be subject to a referendum.

The exercise of competence on taxation

1.10 Assessing competence on taxation can be separated into three broad areas: indirect taxation, which is split between VAT, excise duties and other indirect taxes; direct taxation; and other issues, including the constraints on Member State competence such as having to exercise their competence in line with the fundamental freedoms.

1.11 For the purpose of this review, indirect taxation is broadly defined as a tax paid to the government on expenditure (including on imports) by consumers rather than on their income. The tax is often collected by the supplier of goods or services on behalf of the government. VAT and excise duties are the main indirect taxes in the UK.

1.12 For the purpose of this review, direct taxation is broadly defined as a charge on the income, profit or property of people or companies, who are responsible for paying the tax to the government. Income tax and corporation tax are the main direct taxes in the UK.

Indirect taxation

1.13 The European Commission can bring forward proposals for indirect taxation under Article 113 TFEU. Proposals under Article 113 are agreed by all 28 Member States acting in the Council of the EU by unanimity voting. Under unanimity voting a proposal can only be agreed where no Member State votes against it.

Article 113 TFEU provides:

The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the 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 and to avoid distortion of competition.

1.14 The EU has had an element of competence on indirect taxation since 1957, before the UK joined the EEC. This has been exercised and expanded over time with the consent of Member States to ensure the effective functioning of the internal market and improve trade.

VAT

1.15 In 1967, the Council of Ministers of the original six Member States of the EEC exercised the competence on indirect taxation to enact the First[6] and Second[7] VAT Council Directive on VAT, which required Member States to replace their domestic systems of turnover taxes with a common system of VAT. This was done in order to minimise tax differences, which were distorting competition and hindering trade.

1.16 The UK joined the EEC in 1973 and implemented the VAT Directives, having negotiated some significant derogations from them, notably our zero rates. In doing so the UK replaced selective employment tax and purchase tax and extended the scope of indirect taxation to services as well as goods.

1.17 The VAT regime is now largely harmonised to ensure consistency in the internal market. Member States have discretion (within a defined framework of minimum rates, subject to some derogations for the UK and one or two other Member States) over important areas, including VAT rates and how they control and collect VAT from their registered taxpayers.

Excise duties

1.18 The EU first exercised competence over excise in 1993 with the Directive on the general arrangements for products subject to excise duty[8]. This laid down the basic principles applicable for the holding, movement and monitoring of the products subject to excise duties, which are primarily tobacco, alcohol and energy. All EU Member States apply excise duties to these three product categories. The revenue from these excise duties accrues entirely to Member States.

1.19 The introduction of this Directive required Member States to remove their own domestic fiscal controls in this area. However, full harmonisation of the excise duty rates throughout the EU was not considered necessary for the proper functioning of the internal market. Instead, a series of minimum rates were agreed by Member States. For example, the Directive on the approximation of the rates of excise duty on alcohol and alcoholic beverages sets down these minimum rates for alcohol taxation.

1.20 Therefore, Member States retain competence to set excise duty rates at the levels they consider appropriate according to their national circumstances. In doing so it is necessary to take account of the risks that any significant disparity in the excise duty of any one product between different jurisdictions may have, for example in providing an incentive for criminal activity.

Other indirect taxes

1.21 Member States are able to maintain or introduce the following indirect taxes, provided that the collecting of those taxes, duties or charges do not, in trade between Member States, give rise to formalities connected with crossing of frontiers[9]:

- Taxes on insurance contracts;
- Tax on betting and gambling;
- Excise duties;

[6] Council Directive 67/227/EEC.

[7] Council Directive 67/228/EEC.

[8] Council Directive 92/12/EEC.

[9] Article 33 of the Sixth VAT Directive (now Article 401 of the Principal VAT Directives 2006/112) expressly provides for this.

- Stamp duties; and
- More generally, any taxes, duties or charges that could not be characterised as turnover taxes[10].

Current indirect tax proposals

1.22 The VAT Directive has been through several iterations[11] since its introduction to respond to developments, including the increased use of e-commerce. The European Commission proposals to modernise the VAT rules for financial services[12] and vouchers[13] are current examples of this process. In addition, a European Commission Communication[14] (White Paper) on the future of VAT in the EU was published at the end of 2011, following an EU-wide consultation.

1.23 The White Paper provides a high-level plan for development and reform of the EU VAT regime. It highlights future priority areas for the VAT regime, set against four broad themes: simpler; more efficient; more robust and fraud-proof; and tailored to the internal market.

1.24 There are two indirect tax proposals not relating to VAT that are under discussion by Member States. These are amendments to the Energy Tax Directive (ETD)[15] and a proposal for a financial transactions tax (FTT).

1.25 The ETD aims to update the existing rules on the taxation of energy products (e.g. gas, electricity, coal and road fuel) in the EU. This includes a number of elements, including revising the EU minimum rates for energy products. The proposal is currently under discussion between Member States.

1.26 The FTT proposal, initially presented under Article 113 of the TFEU, aims to create a common system of taxation for financial transactions. For example, this includes the sale or purchase of shares where one party to the transaction is in a Member State (see Box 5.A below).

1.27 Eleven Member States have taken forward the FTT under the enhanced co-operation procedure. The enhanced cooperation procedure is set out in the Treaties and it allows nine or more Member States wishing to take forward a proposal to apply to do so where agreement cannot be agreed amongst all 28 Member States, provided the requirements set out in the Treaties are met[16]. This includes respecting the competences, rights and obligations of those Member States which do not participate in it. The UK is not participating in the FTT under enhanced co-operation, and has submitted a legal challenge to the European Court of Justice (CJEU) against the decision authorising enhanced co-operation on a FTT.

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[10] A series of CJEU cases has established that taxes, duties and charges are to be regarded as being measures in the nature of turnover taxes if they exhibit the essential characteristics of VAT even if they are not identical to VAT at all points.

[11] The most recent iteration of the VAT Directive is the Principal VAT Directive (PVD) of 2006, *2006/112*. This was adopted under Article 93 TEC (now Article 113 TFEU).

[12] Commission proposal for a Council amending Directive 2006/112 regarding the VAT treatment of insurance and financial services, COM (2007) 747.

[13] Commission proposal for a Council Directive amending Directive 2006/112/EC on the common system of VAT as regards the treatment of vouchers, COM (2012) 206.

[14] COM (2011) 851.

[15] Proposal for a Council Directive amending Directive 2003/96/EC restructuring the Community framework for the taxation of energy products and electricity COM (2011) 169.

[16] Notably Articles 326-327 and 332 TFEU.

Direct taxation

1.28 In respect of direct taxation, Article 115 of the TFEU is used as the legal base for direct tax measures which are necessary for the functioning of the internal market. The internal market is defined as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties"[17]. Measures relating to direct tax should be adopted under Article 115 of the TFEU which requires unanimity voting and in consultation with the European Parliament. This is known as the special legislative procedure.

Article 115 TFEU provides:

Without prejudice to Article 114, the Council shall acting unanimously in accordance with a special legislative procedure and after consulting the European and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.

1.29 In contrast most measures necessary for the functioning of the internal market, are proposed using Article 114 of the TFEU. Legislation proposed under Article 114 is agreed by qualified majority voting (QMV) of the Member States and through co-decision with the European Parliament. This is known as the ordinary legislative procedure. Article 114 is discussed in the separate Single Market: Synoptic Report. The reason tax measures are not adopted under Article 114 is that Article 114(2) expressly precludes the application of Article 114 to fiscal measures.

1.30 While any harmonisation of taxation should be decided by unanimity, there are circumstances where tax measures have been agreed by QMV and co-decision. The CJEU, the judicial authority of the Union and the body charged with interpreting EU law, has said in a number of judgments that a measure may have a clear main purpose, and only incidentally pursue some secondary objective. In those circumstances, the only necessary legal basis is the one corresponding to the main purpose. The CJEU has expressed the principle as follows:

If examination of a Community [now EU] measure reveals that it pursues a twofold purpose or that it has a twofold component and if one of these is identifiable as the main or predominant purpose or component whereas the other is merely incidental, the act must be based on a single legal basis, namely that required by the main or predominant purpose or component[18]

1.31 Tax proposals are decided by unanimity with Finance Ministers deciding policy at the Economic and Financial Affairs Council (ECOFIN). Generally, non-tax proposals are decided outside of ECOFIN on a non-tax legal base through the ordinary legislative procedure, where the voting is by qualified majority. Therefore, there is a possibility that tax measures, which would be subject to unanimity voting were they introduced under Articles 113 or 115 of the TFEU, could be decided by QMV if contained within a non-tax proposal.

[17] Article 26(2) TFEU.

[18] See for instance *Commission v Council*, (Case C-155/91) [1993] ECR I-00939.

1.32 Competence on direct taxation remains primarily with Member States. Relatively few Directives have been adopted on direct tax. EU legislation to date on direct taxation has been aimed at removing particular tax obstacles, primarily for businesses, within the internal market rather than establishing broader common tax frameworks or rates. Three notable examples are:

- The Mergers Directive[19];
- The Parent-Subsidiary Directive[20]; and
- The Interest and Royalties Directive[21].

1.33 The Mergers Directive put in place a common system of taxation applicable to cross-border reorganisations of companies situated in two or more Member States.

1.34 The Parent-Subsidiary Directive abolished withholding taxes on dividend payments between group companies residing in different Member States and prevented double taxation of the parent companies on the profit of the subsidiaries.

1.35 The Interest and Royalties Directive put in place a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. The Directive sought to abolish, wherever possible, withholding taxes on interest and royalty payments between associated companies of different Member States.

1.36 At present there is one EU direct tax proposal under discussion by Member States. This is the European Commission proposal for a common consolidated corporate tax base (CCCTB)[22], which was introduced in 2011 under an Article 115 TFEU legal base. The CCCTB proposal aims to establish a single set of rules that companies operating within the EU could use to calculate their taxable profits. The UK will not agree to any proposal that would jeopardise our ability to shape our own tax policy and stop us from achieving our objective of creating the most competitive corporate tax regime in the G20.

Factors affecting the exercise of competence

1.37 Whilst direct tax remains primarily a Member State competence, Member States must exercise their competence consistently with EU law, meaning that when the UK makes changes to its system of taxation, it must not implement anything which is contrary to the Treaties, notably: Article 18 of the TFEU (formally Article 12 TEC) which contains a general non-discrimination provision; Article 110 of the TFEU (formally Article 90 TEC) which prohibits Member States directly or indirectly imposing internal taxation on the products of another Member State in excess of that imposed on similar domestic product; and the fundamental freedoms (see Box 1.B above).

1.38 The fundamental freedoms are directly applicable[23] and so can be invoked before national courts to challenge the validity of domestic legislation.

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[19] Council Directive 90/434/EEC 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, as amended.

[20] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended.

[21] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

[22] Proposal for a Council Directive on a Common Consolidated Corporate Tax Base COM (2011) 121.

[23] *Van Gend en Loos v Nederlandse Administratie der Belastingen* (Case 26/62) [1963] ECR 1 and subsequent cases.

1.39 The CJEU is the judicial authority of the Union and the body charged with interpreting EU law. It consists of three courts: the Court of Justice, the General Court and the Civil Service Tribunal.

Box 1.C: Types of action before the Court

Preliminary ruling requests

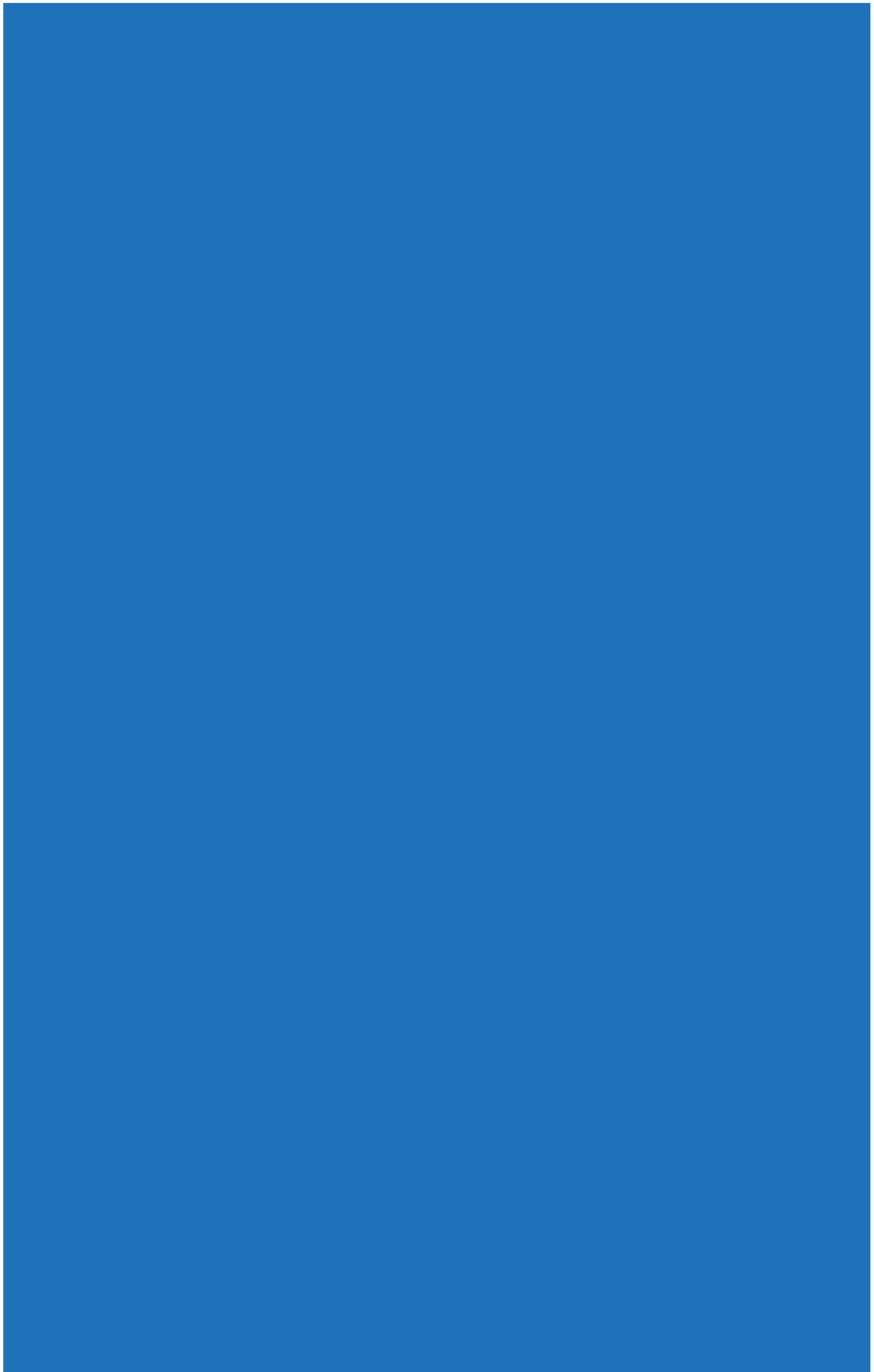
Where a domestic court wishes to clarify a point of EU law, it may, and in some cases must, ask the CJEU for advice. The CJEU will then give its interpretation of the relevant EU law, but it will not actually decide the substance of the case before the domestic court. This is known as a 'preliminary ruling'.

Actions for failure to fulfil an obligation

The European Commission is empowered to bring infringement proceedings against a Member State for failing to fulfil its Treaty obligations. This begins with a "Reasoned Opinion" by the Commission outlining the scope of the action and requesting the Member State to comply within a set time. The Commission may then refer the case to the CJEU. If the CJEU finds that the Member State has not fulfilled its obligations it is required to take the necessary measures to comply with the judgment. Failure to comply may result in a further European Commission request to the CJEU to impose a fine for non-compliance. A Member State may also bring an action for failure to fulfil an obligation against another Member State.

Actions for annulment

A challenge can be brought by a Member State or an institution as to the legality of EU of legislative acts as well as acts of the Council, the Commission and the European Central Bank.



Chapter 2: Considerations underpinning the level at which policy should be made

Summary

2.1 As part of the Call for Evidence respondents were asked at what level tax policy should be made, for example domestically at the Member State level, at the EU level or internationally in a forum such as the OECD. There was an understanding among respondents that action on taxation was necessary at a number of levels, but that many decisions on taxation should primarily be undertaken at the national level. This was particularly so for decisions relating to personal taxation which is seen as being a matter for Member States, taking into account their domestic circumstances, and social and economic objectives.

2.2 Most respondents started from the premise that action on taxation at the EU level should only be undertaken where there was a clear internal market justification for doing so. For example, the Chartered Institute of Taxation (CIOT) argued that harmonisation of tax rules at the EU level was desirable where it "helps to facilitate cross-border trade or the exercise of the fundamental treaty freedoms". Respondents felt that for EU-level action on taxation to be justified, the proposed action must also meet the principles of subsidiarity and proportionality (see Box 1.A above) and be demonstrated to be in the interests of Member States.

2.3 Respondents also considered certain action on taxation to be important at an international level in some cases, primarily for setting standards on internationally relevant taxation issues, such as transparency and matters affecting international business, and on tax evasion and avoidance.

Considerations for EU-level action on tax

2.4 The Call for Evidence asked respondents to identify what they believed the main considerations to be for deciding the appropriate level at which tax policy should be made.

2.5 Broadly, respondents felt EU-level action to harmonise rules could be desirable where:

- Such action was necessary to ensure the fundamental freedoms and the operation of the internal market;
- Member States could not achieve this through domestic action; and
- The proposed action does not unduly infringe Member States' ability to set their own domestic taxation policy and tailor their tax systems to support that policy.

2.6 The first consideration is reflected in the legal bases contained in the TFEU used for the

introduction of tax measures, namely Articles 113 and 115 as discussed in Chapter 1.

2.7 The second consideration is reflected in Article 5 of the TEU in the form of the principles of subsidiarity and proportionality. Under the principle of subsidiarity, where the EU does not have exclusive competence, it can only act if it is better placed than the Member States to do so, because of the scale or effects of the proposed action. Under the principle of proportionality, EU action must not exceed what is necessary to achieve the objectives of the EU Treaties.

2.8 In addition to these considerations on whether EU or international action was appropriate, respondents also noted a number of factors which they felt should be considered, including:

- Whether proper consultation with business and other stakeholders has been undertaken to understand the impact of measures proposed, with proposals then being refined accordingly; and
- The cost and complexity of achieving agreement to harmonised measures and the updating of such measures to take account of developments.

2.9 In considering the appropriateness and benefits of EU-level action on tax in a given situation, some respondents identified a number of existing measures which they felt met the above criteria and were best undertaken at the EU level. These included, a common system of VAT and the Interest and Royalties Directive as these facilitated cross border trade and addressed cross-border business problems in a way that could not have been achieved through domestic action alone.

International action on taxation

2.10 There was recognition among respondents that in certain circumstances international action on taxation was necessary. Many respondents also argued that global consideration of tax issues was becoming increasingly important, although there was no call for harmonisation of tax rates at an international level. For example, given the global nature of business, action to counter aggressive tax avoidance and tax evasion was seen as something best undertaken through wider international agreements. International agreements to prevent double taxation were also seen as important.

2.11 In a globalising economy, businesses look for tax cooperation and coordination above the Member State level to allow them to operate effectively across borders. The Institute of Chartered Accountants for England and Wales (ICAEW) noted that "[in] a globalising economy where the UK wishes to increase its exports, increasing collaboration on tax issues is necessary". This was representative of the views expressed by other respondents in written evidence and during the course of discussions. However, individual taxpaying citizens may prefer for tax sovereignty to be retained, with decisions affecting them, such as personal taxation, being decided at the national level.

2.12 Most respondents suggested that international standards on tax should be set at the widest level, with respondents generally identifying the OECD as the appropriate forum for this during the course of discussions.

Box 2.A: The Organisation for Economic Co-operation and Development

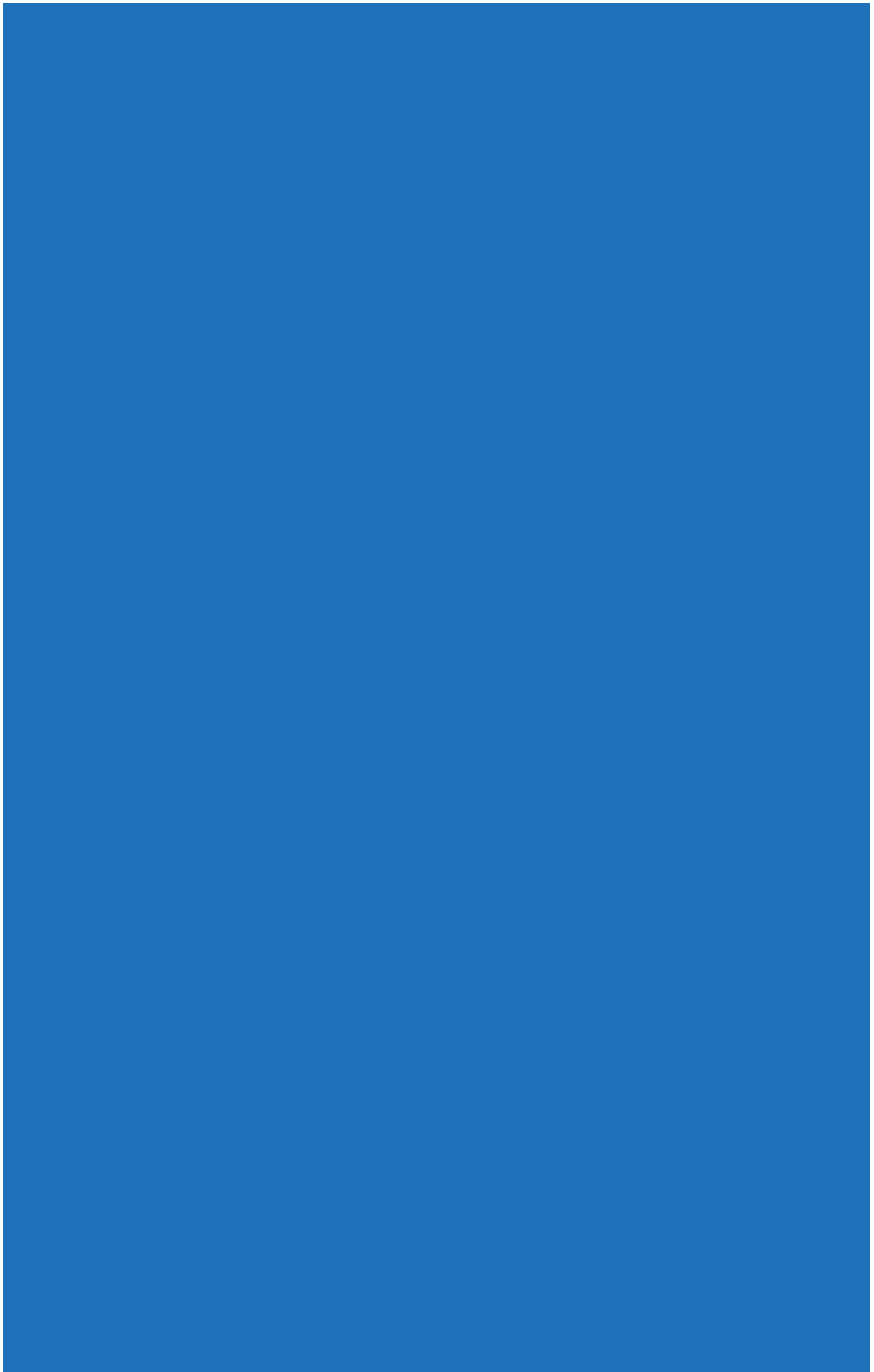
As a member of the OECD, the UK is subject to non-legislative agreements on taxation. Typically members of the OECD agree to adhere to minimum international standards on taxation, such as exchange of information under the Multilateral Convention on Mutual Assistance in Tax Matters, or standards contained within the OECD Model Tax Convention.

These obligations are not legally binding, but undertaken voluntarily by countries in order to achieve an international standard on taxation. The UK has incorporated some OECD standards into UK law. For example, the UK requires that legislation on transfer pricing is read in a manner which best secures consistency with the latest OECD Transfer Pricing Guidelines.

2.13 An example of international standards set by the OECD includes the OECD Model Tax Convention and the Model Agreement on Exchange of Information on Tax Matters. Compliance with the OECD level standards on transparency and exchange of information is monitored by the Global Forum on Transparency and Exchange of Information for Tax Purposes, through a peer review process.

2.14 The OECD also plays a role in double taxation agreements between Member States. Double taxation can have a number of harmful effects on the international exchange of goods and services, and the free movement of persons and capital. The OECD Model Tax Convention was presented in recognition of the need to clarify and help standardise the tax liability for taxpayers operating across borders. Although competence on the negotiation of double tax agreements lies with Member States, the OECD Model Tax convention serves as a guideline for these bilateral agreements.

2.15 An example of work currently being undertaken by the OECD on taxation is the project on base erosion and profit shifting (BEPS). The project, in response to international concerns on the allocation of profits by multinational companies, is looking at whether, and if so how, the current international tax rules need updating to reflect the allocation of taxable profits to locations where the actual business activity takes place. The OECD will report a comprehensive action plan to the G20 in July 2013 with options for addressing BEPS issues.



Chapter 3: The impact of the current balance of competence

3.1 As outlined in Chapter 2 the economic and commercial landscape has evolved significantly in recent years with, for example, the burgeoning use of digital commerce and the increasing globalisation of trade. On tax issues that require a coordinated international response, the UK has taken the lead, for example, through multilateral action in the G8, G20 and OECD. However, this review focuses solely on the current EU balance of competence on taxation.

3.2 The Call for Evidence asked for examples of how the current balance of competence on taxation advantages and disadvantages the UK. Respondents noted that the competence conferred under Article 113 and Article 115 of the TFEU has broadly been exercised to produce tax measures which have benefited the UK.

3.3 Unanimity voting on taxation has been essential in safeguarding the UK's interests, as recognised by respondents, who clearly advocated the retention of unanimity voting. Some respondents argued that unanimity voting could impede the timely and effective agreement of legislation, because of the need to achieve agreement by all Member States. Respondents also commented on the advantages and disadvantages of the constraints on Member States' competence arising from the enforcement of the fundamental freedoms and State Aid rules.

The effect of unanimity voting on tax

3.4 Unlike other policy areas which are decided by QMV, voting for taxation measures is by unanimity voting, which means every Member State has a veto over a tax proposal. The ability of Member States to veto tax legislation proposed under Articles 113 and 115 of the TFEU has shaped how the competence conferred under these articles has been used.

3.5 The Government believes that tax should remain subject to unanimity and upholding the Member State veto on tax is a priority.

3.6 Unanimity voting on tax was seen by most respondents as beneficial to the national interest because of the protection it offers against the imposition of disadvantageous tax measures. For example, the CIOT noted that unanimity voting can "act as a protection against disproportionate burdens being imposed on business and actions being taken contrary to a particular national interest".

3.7 However, some respondents including the Investment Management Association, the British Bankers Association and the Chartered Institute of Taxation felt that at the same time unanimity voting can have disadvantages by acting as a block on or delaying

necessary reforms which in turn leads to uncertainty. This view was also shared by interested parties during the course of discussions.

3.8 Unanimity was seen as blocking reforms in two ways:

- By reducing the capacity of EU Member States to respond to challenges through the adoption of new legislation or amending existing legislation; and
- By producing legislation that may be sub-optimal as a result of compromises necessary to secure agreement by all 28 Member States.

3.9 Examples submitted by respondents of where unanimity voting has been a hindrance included blocks to adoption of amendments to the Interest and Royalties Directive and the EU Savings Directive[1], neither of which have been adopted due to opposition from a small number of Member States. Respondents also highlighted the proposal on VAT treatment of Financial Services and efforts to introduce a standardised VAT return across all 28 Member States as being areas where useful measures have been hindered by unanimity voting.

3.10 The British Bankers Association noted that although a move to QMV might speed up the legislative process, it would come at a high cost:

"an important loss of sovereignty in the ability of individual Member States to control a fundamental tool of economic policy".

3.11 During the course of discussions some respondents questioned whether unanimity was in itself a strong enough safeguard to protect national interests on direct taxation, in light of the potential impact of CJEU rulings on taxation and the introduction of tax measures in non-tax proposals. The Institute of Directors noted in their response that "it is absolutely wrong to slide from unanimity to qualified majority, when a tax measure is incidental to a non-tax measure"[2]. In written evidence, one respondent concluded that some additional protection was needed, including identifying "a set of core elements of taxation policy which will, at all times, remain outside EU competence"[3]. Other responses suggested alternative reforms that could be made to better protect tax sovereignty, such as the creation of a specific, very narrow, direct tax legal base.

3.12 While most respondents agreed that maintaining the veto over tax policy was essential, some respondents, for example the National Farmers Union, could see the potential for areas of very specific indirect taxation which were "essential for the functioning of the internal market" to be decided by something less than unanimity, but acknowledged this did not necessarily mean it would be desirable.

3.13 Having considered the advantages and disadvantages of unanimity voting on tax, a majority of respondents felt that any EU action on tax should remain "strictly subject to unanimity"[4] and that unanimity on tax must remain universal. The reasons for advocating the retention of unanimity voting focused on the ability of Member States to ensure that tax measures at the EU level were in their interest and that a majority of Member States

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1 Council Directive 2003/48/EC of 3 June 2003 opn taxation of savings income in the form of interest payments.

2 Evidence submitted by the Institute of Directors.

3 Evidence submitted by HM Government of Gibraltar.

4 Evidence submitted by the Institute of Directors. See also evidence submitted by Her Majesty's Government of Gibraltar, page 8, "unanimity under Article 115 TFEU is a must". This was also the predominant view expressed during the course of discussions.

could not impose damaging tax measures on the minority[5]. Similarly, respondents felt strongly that Member States must retain the choice to decide between harmonisation and competition, and the ability to choose to introduce competitive business-friendly tax regimes, even where those Member States seeking to do so are in the minority[6].

3.14 Many of those respondents advocating the retention of unanimity did however request reforms to the legislative process to accelerate the process of getting unanimous agreement on tax proposals. Reforms to the legislative process are covered further in Chapter 5 below.

Simplification and facilitation of cross-border trade

3.15 Giving British business access to a well functioning internal market was seen as imperative by respondents. Having a well functioning tax and regulatory framework at the EU level was identified as necessary to achieve this and one of the key influencing factors for a business in determining where to invest. As such, tax measures seen as necessary for the functioning of the internal market, such as a common system of import duties and a common destination based system of VAT, were broadly welcomed and supported by respondents, with the benefits being easily identifiable for UK businesses and citizens.

3.16 Respondents welcomed existing tax measures, such as the Interest and Royalties Directive[7] and the Parent Subsidiary Directive[8] (see Box 3.A below), which they identified as reducing the burden on business and simplifying their cross-border operations. On the whole it was felt that the EU taxation measures in place had helped to simplify and facilitate cross-border trade, for example, as noted by ICAEW, by providing "consistent tax rules for business and solutions to cross border tax issues"[9] such as double taxation.

3.17 Existing EU direct tax measures including the Mergers Directive[10] and the Parent-Subsidiary Directive were identified by a number of respondents including the British Bankers Association and the Law Society as beneficial. These Directives benefit UK groups which trade in Europe or restructure their European business by removing tax liabilities which could otherwise have existed and made such trade or restructuring costly and less attractive to business.

5 See for example evidence submitted by the National Farmers Union: "qualified majority voting in this area would not be an appropriate system given that the intricacies and the full impact of proposals for some Member States may not be fully appreciated by the majority of Member States".

6 This was the view expressed during the course of discussion. For written evidence, see for example evidence submitted by the Institute of Directors.

7 Footnote 16 Chapter 1.

8 Footnote 15 Chapter 1.

9 Evidence submitted by the Institute of Chartered Accountants of England and Wales.

10 Footnote 14 Chapter 1.

Box 3.A: The benefits of the Parent-Subsidiary Directive

In their evidence, the Law Society noted that "the UK could be a natural location for an intermediate holding company for investors into Europe" due to a long-standing policy of not imposing withholding tax on dividends as well as other factors such as the ease of setting up a business.

However, prior to the introduction of the Parent-Subsidiary Directive, unless there was a Double Tax treaty in place which provided for no withholding tax, a UK resident company could not receive dividends from its subsidiaries based in another Member State on a tax-free basis. This adversely affected the attractiveness of the UK as a holding company jurisdiction.

The Parent-Subsidiary Directive abolished withholding taxes on dividend payments between group companies residing in different Member States and prevented double taxation of the parent companies on the profit of the subsidiaries. By abolishing withholding tax on dividends paid by qualifying subsidiaries the Directive "enhances the UK's relative competitive advantage" as a location for intermediate holding company investment.

3.18 Whilst recognising the benefits of the above mentioned Directives, PWC and the CIOT, amongst other respondents, noted that the benefits from these measures could have been greater had the measures not been limited due to political compromises in order to reach unanimous agreement. However, respondents also recognised that the requirement for the unanimous agreement of all Member States had helped the UK and other Member States protect their national interests.

Removal of tax discrimination and enforcement of the fundamental freedoms

3.19 Respondents noted the positive impact of EU action in relation to tackling tax discrimination in two areas, firstly through enforcement of the fundamental freedoms, and secondly through representations by the Commission when negotiating bilaterally with EU candidate countries, third countries, and at the international level in forums such as the WTO.

Enforcement of the fundamental freedoms

3.20 As mentioned above, Member States must exercise their competence consistently with EU law, meaning that when the UK makes changes to its system of taxation, it must do so in line with EU law. In practice this means that tax policy set by Member States must not discriminate directly or indirectly against a national of another Member State or against the Member State's own nationals who exercise the freedoms guaranteed by the Treaty[11].

3.21 The fundamental freedoms – notably the freedom of establishment[12], the freedom to supply services[13], and the freedom to move capital[14] – are prescribed by the EU Treaty and relate to cross-border movement between Member States[15] (see Box 1.B above).

[11] F.W.L *de Groot v Staatssecretaris van Financien* (Case C-385/00) [2002] ECR I-11819, Para 94.

[12] Articles 49-55 TFEU (formerly Articles 43-48 and 294 EC).

[13] Articles 56-62 TFEU (formerly Articles 49- 55 EC).

[14] Articles 63-66 TFEU (formerly Articles 56-59EC).

[15] Additionally, the free movement of capital also applies to movements between Member States and third countries.

3.22 EU level action to enforce the fundamental freedoms can be seen as a benefit to the UK where action is brought against a Member State whose national tax rules did not guarantee national treatment or when they discriminated on grounds of nationality against a UK citizen or UK business, as demonstrated in the case of *Royal Bank of Scotland v Greece*[16].

Box 3.B: Royal Bank of Scotland Plc v Elliniko Dimosio (Greek State)

The Royal Bank of Scotland (RBS) was resident in the United Kingdom and had a branch in Greece. Under Greek law the profits of the RBS branch in Greece were subjected to a higher rate of taxation than the profits of banks resident in Greece.

In its preliminary ruling, the ECJ (now CJEU) ruled that where there is no objective difference between two categories of companies a difference in treatment is not justified.

3.23 In explaining how the enforcement of the fundamental freedoms has been beneficial, the Investment Management Association (IMA) highlighted CJEU rulings, such as in the *Santander*[17] case where it was held that levying dividend withholding tax on dividend payments to recipients in EU Member States (where no dividend withholding tax is levied domestically) was in breach of the enforcement of the free moment of capital (under Article 63 TFEU). The IMA submitted that the fundamental freedoms "are beneficial to investors and savers in the UK. Where enforced, they ensure that UK persons can freely invest across borders without tax acting as a distortion or a barrier to investment".

3.24 British business can also benefit from the enforcement of the fundamental freedoms as it allows them to challenge UK tax measures which they feel do not guarantee national treatment. Cases cited by respondents to illustrate this include *Marks and Spencer*[18], *Cadbury Schweppes*[19] and *Philips Electronics*[20].

[16] *Royal Bank of Scotland Plc v Elliniko Dimosio (Greek State)* (Case C-311/97) [1999] ECR I-02651.

[17] *Santander Asset Management SGIIC SA v Directeur des residents á l'étranger et des services généraux and Others* Cases (C338/11 to C347/11) [2012].

[18] (Case C-446/03) [2005] ECR 1-10837,

[19] *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd. V Commissioners of Inland Revenue* (Case C-196/04) [2006] ECR I-7995.

[20] *HMRC v Philips Electronics UK Ltd* (Case C-18/11) [2012] BTC 438.

Box 3.C: Marks and Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)

Marks and Spencer had a number of subsidiaries in other EU Member States in which it made a loss. It argued that it could offset the losses of its subsidiaries against its profits in the UK under the UK's group relief rules. However, the rules did not permit such an offset where the loss-making subsidiary was not resident in the UK, or carrying out a trade in the UK. HMRC rejected the claim and Marks and Spencer appealed to the High Court. The High Court referred the question of whether the group relief rules breached the freedom of establishment to the ECJ (now CJEU) for a preliminary ruling.

The ECJ ruled that the UK group relief rules were largely consistent with EU principles as they applied to losses of subsidiaries in other countries. However, the rules were too restrictive in so far as they prevented the surrender of losses in circumstances where a subsidiary has exhausted all possibilities for using the loss relief in its state of residence and there was no possibility of relief in the country of residence of the subsidiary. As a result the UK was required to amend its cross-border loss relief rules.

The UK amended the Income and Corporate Taxes Act 1988 (ICTA) in Finance Act 2006 (FA06), Schedule 1 to reflect the ruling. On 27 September 2012 the European Commission formally announced that it was referring the UK to the CJEU under Article 258 TFEU because it considers that the UK has failed to properly implement the CJEU's ruling. This referral follows a Reasoned Opinion from the European Commission, which the UK responded to in September 2008.

3.25 Whilst the removal of discriminatory tax provisions at the national level can be beneficial, in their response Oxford University's Centre for Business Taxation argued that it "does not always contribute to the establishment of a more level playing field on an EU-wide scale"[21]. Where a ruling on a domestic tax system has ramifications for the domestic tax regimes in place in other Member States, there is a risk that they repeal measures which are beneficial to the internal market in order to avoid breaching EU law. As an example of this, one respondent highlighted the choice faced by Member States on whether to extend their group regime to cross-border situations or to abolish it in light of the Marks and Spencer ruling. The respondent points to the results of a study conducted by de la Feria and Fuest[22] which shows that different responses by Member States to the Marks and Spencer ruling "could increase the differences between Member States in the cost of capital and the levels of production"[23].

The effect of the fundamental freedoms on the exercise of Member State competence on tax

3.26 Although respondents noted that the enforcement of the fundamental freedoms has demonstrable benefits for them, many respondents also expressed concern over the way in which the freedoms are enforced with relation to taxation. Respondents including the ICAEW noted that there is a considerable volume of CJEU case law "which significantly affected what the UK Government could or could not do in relation to its domestic tax system"[24].

[21] Evidence submitted by Anzhela Yevgenyeva, Oxford University Centre for Business Taxation.

[22] Rita de la Feria and Clemens Fuest, "Closer to an Internal Market? The Economic Effects of EU Tax Jurisprudence" (2011) 12 CBT Working Papers.

[23] Evidence submitted by Anzhela Yevgenyeva, Oxford University Centre for Business Taxation.

[24] Evidence submitted by the Institute of Chartered Accountants of England and Wales.

3.27 A number of respondents pointed specifically to the effect on the UK tax regime of the ruling in Marks and Spencer[25], where the UK was required to amend its cross-border loss relief rules, (see Box 4.C above) to illustrate the effect that the fundamental freedoms and the jurisprudence of the CJEU can have on domestic tax systems.

3.28 PWC described the rulings of the CJEU as "a significant influence on the way EU tax competences have been clarified and applied"[26]. The Institute of Directors commented that decisions of the CJEU relating to taxation have been "a massive constraint on UK tax policy-making in recent years".

3.29 A number of respondents felt that certain rulings by the CJEU had undermined the sovereignty of Member States over their tax systems. For example, one respondent noted that:

> "in some cases, the Court comes very close to the borderline of its competence by taking 'quintessentially legislative' decisions, which can be seen as contradicting the spirit of the Member States' veto power guaranteed by the EU Treaties"[27].

3.30 This was felt most keenly where a ruling by the CJEU resulted in a taxation policy that respondents felt would not have been agreed if the policy had been voted on by all 28 Member States at Council using unanimity voting, as would have been the procedure for EU level legislation on a tax legal base.

3.31 While comments on the impact of the CJEU's jurisprudence largely related to its effect in the area of direct taxation where competence remains primarily with Member States, the impact was also noted in relation to indirect taxation. The British Bankers Association in their evidence commented that:

> "In the VAT area, the Court of Justice has increasingly been refining and restricting the extent of [Member States'] ability to apply and operate the tax in a manner appropriate to their national jurisdictions"

3.32 In addition to restricting Member States' ability to shape their tax system, EU litigation can lead to significant Exchequer cost and long periods of uncertainty for business. For example, where a Member State's tax measure is found to be in violation of EU law, the Member State concerned can be liable to repay the tax collected through this measure. This can result in a substantial cost, which may require revenue to be raised through alternative means. In addition, businesses or individuals may be left unsure of their tax liability, especially where legal proceedings are protracted or there are numerous referrals by a domestic court to the CJEU.

3.33 However, respondents including PwC did note a change in the approach of the CJEU since late 2005, with the CJEU now "more prepared to accept that domestic tax systems are generally compliant with the EU Treaty" but may require modification to make them proportionate[28].

[25] Footnote 16 above.

[26] See also Kaye, T.A,2005. *Tax Discrimination: a comparative analysis of U.S. and EU approaches* [pdf], page 20 Available at: <http://www.americantaxpolicyinstitute.org/pdf/Kayechapter_may_25rev.pdf> Accessed 31 March 2013.

[27] Evidence submitted by Anzhela Yevgenyeva, Oxford University Centre for Business Taxation.

[28] Idem.

3.34 Respondents also noted that in an effort to ensure that domestic tax measures comply with EU law relating to the fundamental freedoms and State Aid rules, tax legislation had become increasingly complex. The Law Society noted that attempts to draft EU compliant tax laws had led to:

"significant complexity in certain areas in the UK such as: the introduction of domestic transfer pricing; thin capitalisation rules; and expansion of dividend exemptions to non-UK dividends but with a series of complex exclusions to the exemptions that apply to both UK and non-UK dividends".

Removal of tax discrimination in third countries

3.35 In their evidence, the Scotch Whisky Association noted that one of the advantages to their members of EU-level action on taxation has been the removal of discriminatory tax measures in countries which gave favourable tax treatment to their domestic products. As an example of this they point to the removal of discriminatory tax measures as part of enlargement negotiations with countries including, amongst others, Poland, Romania and Turkey.

3.36 The Scotch Whisky Association also cited beneficial outcomes for their members from EU-level action on tax discrimination in third countries, through the use of the WTO dispute settlement mechanism.

3.37 In the WTO the EU acts for Member States for most purposes, including dispute settlement, because trade is an area of exclusive EU competence. The Scotch Whisky Association felt that action by the 28 Member States collectively as the EU at the international level carried more weight and expertise than an individual Member State, which in turn helped to secure the desired outcome, An example was the removal of tax discrimination against their members products in Japan, Korea, Chile and the Philippines.

Code of Conduct Group

3.38 Countries both within and outside of the EU have long recognised the difference between tax competition and harmful tax practices, for example in bilateral tax agreements, at the EU level and internationally at the OECD.

3.39 In 1997 Member States, with the encouragement of the UK, established the Code of Conduct Group for business taxation. By joining the Code Group Member States agreed to refrain from introducing any new harmful tax measures and to amend any laws or practices that are deemed to be harmful in respect of the principles of the Code[29].

3.40 In 1999, as part of the commitment to roll back harmful tax measures, the Code of Conduct Group identified 66 harmful tax measures in EU Member States and dependant or associated territories within its report[30]. The Group has since been monitoring the rollback of these measures and Member States' commitment not to introduce harmful tax measures.

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[29] The criteria for determining whether a measure is harmful can be found at: http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm.

[30] Report SN 4901/99 of 23 November 1999 Code of Conduct (Business Taxation).

3.41 The Code of Conduct is a voluntary political arrangement between Member States and has no effect on the balance of competence. However, Member States have committed to exercise their competence in accordance with the principles of the Code. In addition to each Member State, the UK's Crown Dependencies – Jersey, Guernsey and the Isle of Man have all voluntarily agreed to comply with the Code Group. The views of these jurisdictions are represented by the UK at the Code Group.

3.42 Some respondents including the ICAEW and the Law Society considered that the work of the Code of Conduct Group could contribute to ensuring a level playing field for companies operating within the internal market and reduce the potential for companies to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions. This view was shared by interested parties in the course of discussions who felt that commitment to the Code Group could usefully provide an indicator of a jurisdiction's good governance on tax matters for the purposes of discussions in international forums.

Derogations

3.43 A derogation is a provision in an EU legislative measure which allows for all or part of the legal measure to be applied differently, or not at all. Derogations can give Member States flexibility in how EU legislation is applied domestically. The UK has a number of derogations from EU legislation on VAT, notably those negotiated when joining the EEC in 1973, including our zero rates.

3.44 Member States can deviate from the common VAT rules through a number of routes. In some circumstances the VAT Directive allows for optional treatment, usually subject to meeting certain requirements. Examples include optional reverse charges[31] and the options to adopt the reduced rates listed in Annex III of the VAT Directive. Individual Member States may also derogate from the common rules through arrangements negotiated on accession, or through "stand still" arrangements which usually allow the retention of historic arrangements during the so-called "transitional period" or by applying to the European Commission for derogations to combat evasion, avoidance or for the simplification of the system.

3.45 In evidence respondents raised derogations from tax legislation as having both beneficial and detrimental effects. For example, derogations allow Member States flexibility in applying EU law to suit their domestic circumstance, but they have the potential to cause distortions when used inappropriately.

3.46 In evidence, the CIOT argued that:

"In principle, derogations from generally applicable legislation should be kept to a minimum and should not interfere with cross-border trade."

3.47 They argued that a lack of harmonisation on generally applicable legislation can result in double non-taxation or double taxation and protracted disputes with tax authorities.

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[31] Under Art 199 of Directive 2006/112/EC of 28 November 2006 on the common system of value added tax ("the Principal VAT Directive").

Reduced and zero rates

3.48 The most familiar UK derogation to most people in the UK is likely to be the zero VAT rate on certain foods, newspapers and journals. It is possible for the UK to apply a zero rate of VAT on these items because of special provisions included in Title V Chapter 4 of the Principle VAT Directive[32], which authorise specific treatments to apply until the "definitive arrangements"[33] for the EU VAT system are introduced. For the UK, Article 110 is a key provision as it provides the basis for the zero rate on the items mentioned above. Member States may continue to derogate from the Directive to apply a zero VAT rate or reduced rates lower that the minimum set down in the Directive[34].

3.49 In evidence, the Charity Finance Group (CFG) and the National Council for Voluntary Organisations (NCVO) identified zero and reduced rates as "extremely valuable to charities, allowing them to undertake activities which might otherwise be unaffordable". They acknowledged the benefits of a harmonised VAT system and the contribution it made to the efficient functioning of the internal market, welcoming moves to simplify and harmonise the VAT regime across the EU. However, they cautioned that moves towards harmonisation had "in some cases proved detrimental to the UK charity sector" and it was "essential that Member States are able to respond to national needs and circumstances" through the use of zero and reduced rates.

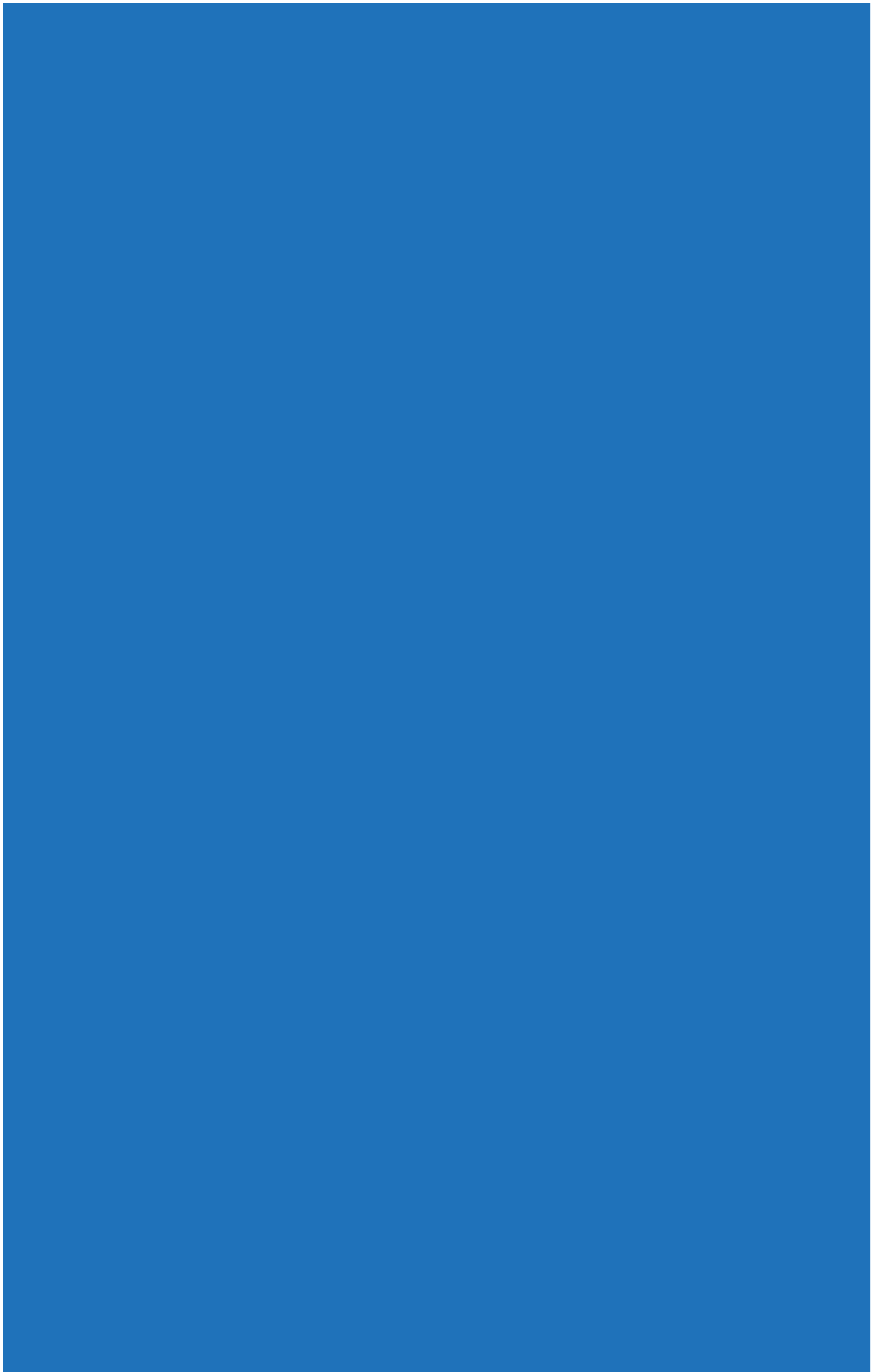
3.50 The existing legislation on reduced rates is currently under review and subject to public consultation by the European Commission. This is in line with the European Commission communication on the future of VAT[35], in which they set out what they identify as the fundamental characteristics that should underlie the new VAT regime, and their priority actions for creating a simpler, more efficient and more robust VAT system in the EU.

[32] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

[33] Referred to in Art 402(2) of the principal VAT Directive.

[34] Provided that they were in place on 1 January 1991 and were adopted for "a clearly defined social reasons and for the benefit of the final customer".

[35] Footnote 5, Chapter 2.



Chapter 4: More or less action on taxation

Summary

4.1 No respondents identified any significant gaps in EU-level legislation on taxation. A number of respondents noted that more action on taxation could be of benefit to the UK where the existing EU legislation is in need of modernisation or where improvements might be made to administrative co-operation. The Interest and Royalties Directive was cited as an example of where modernisation of the existing Directive would be of benefit. Respondents also noted areas where they would like less EU-level involvement on taxation, because they saw the action as unnecessary for the functioning of the internal market and not meeting the principles of proportionality and subsidiarity. Respondents also called into question measures which they felt would have a detrimental effect on growth.

More action

4.2 Respondents generally welcomed further action on taxation if it "facilitated pro-growth cross-border cooperation, and further developed our capacity to agree international tax issues"[1] to the extent that "it is required for the proper functioning of the single market"[2]. Respondents cautioned that this must also meet the tests set out in Chapter 2, for example, that any future action is clearly shown to be in the national interest. While respondents were content with the EU legislation that had been agreed, no responses identified any significant gaps needing to be filled at the EU level.

Updating existing measures

4.3 A common theme from the evidence received and discussions with interested parties was that more action was needed to keep EU-level taxation legislation up to date with modern business practices and advances in other areas of EU law. Respondents expressed concerns that legislation could become damaging to cross-border trade if it was not amended to reflect modern business practice. One respondent noted that, in cases where legislation is not amended to address emerging issues, the CJEU may fill the gap through individual rulings, taking control from Member States.

4.4 During the course of discussions a number of respondents cited the adoption of the amendment to the Interest and Royalties Directive, revisions to the Savings Directive, modernising the VAT regime and the administration of VAT as necessary actions.

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1 Evidence submitted by the Institute of Chartered Accountants of England and Wales.

2 Evidence submitted by the National Farmers' Union.

4.5 The CIOT highlighted that in responding to the European Commission Green Paper on the future of VAT many of their members had called for further harmonisation of the VAT structure, but also harmonisation of elements of the administration of VAT[3].

4.6 One specific area where respondents urged for EU legislation to be updated was on the VAT treatment of financial services[4]. The IMA highlighted that the proposal has "significant potential benefits to the investment management sector", including "giving UK funds and asset managers certainty on VAT treatment of the services they provide, and providing a level playing field for cross border provision of services".

4.7 Respondents also suggested a number of other areas where they felt action could have potential benefits, provided it met the criteria outlined in Chapter 2. These included the introduction of a standardised VAT return[5] and a harmonised tax framework for funds to help achieve the principle of tax neutrality for investor funds in line with the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive[6]. The UCITS Directive sets out a harmonised regulatory framework for investment funds that invest in certain classes of assets, providing high levels of investor protection and a basis for the cross-border sale of these funds.

4.8 Some respondents suggested that there was an imbalance of prioritisation and division of resources between implementing and reviewing existing legislation on the one hand and bringing forward new initiatives on the other. During discussions stakeholders cited the priority given to reaching agreement on the financial transactions tax compared with implementing the VAT Strategy as an example of this imbalance. While the suggested prioritisation may not be reflected in, for example, the number of people working on a given issue at the EU level, respondents felt it was reflected in the efforts made to reach agreement. Therefore, this could lead to resources being diverted from the more important issues from a business perspective, the more pressing issues such as implementing the VAT strategy.

3 Evidence submitted by the Chartered Institute of Taxation, page 2. See also Submission from the Chartered Institute of Taxation on the Commission's Green Paper on the future of VAT: Towards a simpler, more robust efficient VAT system: *http://www.tax.org.uk/Resources/CIOT/Documents/2011/05/EC_GreenPaper_VAT.pdf*.

4 *Proposal for a Council Directive as regards the VAT treatment of insurance and financial services*, COM (2007) 747 final.

5 See evidence of the British Bankers Association and evidence submitted by the Chartered Institute of Taxation.

6 See evidence submitted by the Law Society and the Investment Management Association.

Less action

4.9 On the whole respondents were supportive of existing tax measures, but were concerned about some of the proposed actions on taxation which they did not see as necessary for, or aiding, the functioning of the internal market. The most common measure cited as being unnecessary for the functioning of the internal market and disadvantageous to the UK was the proposed financial transactions tax.

4.10 Concerns were also raised about the impact of the rulings of the CJEU in relation to tax (see Chapter 1) with some respondents suggesting a lesser role for the CJEU in direct tax matters and others going further and suggesting an explicit limitation of the EU's power over direct taxation. This is discussed in Chapter 6.

The EU proposal for a financial transaction tax

Box 4.A: The financial transactions tax (FTT)

The FTT proposal, initially presented under Article 113 of the TFEU, aims to create a common system of taxation for financial transactions. This includes, for example, the sale or purchase of shares where one party to the transaction is in a Member State.

The Commission gave two justifications for the introduction of the proposed FTT:

- To ensure that the financial sector makes a fair contribution at a time of fiscal consolidation in the Member States, and
- A coordinated framework at EU level would help to strengthen the EU single market[9].

After some Member States made clear that they would not agree to adopt a FTT, 11 Member States are taking forward the proposal for a FTT under enhanced co-operation which was authorised by the Council in January 2013[10]. This has resulted in a revised proposal[11] which is currently under discussion. The UK is not participating in the FTT under enhanced co-operation and has submitted a legal challenge to the CJEU against the decision authorising enhanced co-operation. The case focuses on the extra-territorial aspects of the proposed tax.

4.11 The UK Government does not support the European Commission's proposal for the introduction of a FTT introduced through enhanced cooperation and will not participate in it. The UK believes that the proposal will damage economic growth, and lead to significant job losses across the EU. Although the UK will not participate, there is a risk that activity taking place in the UK will relocate elsewhere. In the case of the European Commission's proposal for a FTT, jurisdictions outside the EU may conceivably seek to block or refuse to comply with the extra territorial elements of the FTT as proposed.

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[7] Financial Transaction Tax: Making the financial sector pay its fair share, IP/11/1085.

[8] Council Decision of 22 January 2013 authorising enhanced co-operation in the area of financial transaction tax, (2013/52/EU).

[9] Proposal for a Council Directive Implementing Enhanced Cooperation in the Area of Financial Transaction Tax, COM(2013)71 final.

4.12 A number of respondents highlighted in evidence and during discussions that the FTT proposal was damaging to the UK's interests and an area where they felt the EU should not be taking action. Respondents felt strongly that the proposed tax measure was "not in the best interests of the EU or UK economies"[10]. This opinion was shared by a number of groups, including the House of Commons European Scrutiny Committee and City UK, who did not submit written responses to the questions raised in the taxation call for evidence document, but who asked for their work on the impact of the FTT to be considered as part of the review.

4.13 Prior to the FTT proposal being taken forward under enhanced co-operation, concerns had been noted about the disproportionate impact of the proposed tax on the UK. In their report "Towards a Financial Transactions Tax?" the House of Lords European Union Committee, having collected evidence from interested parties, noted that "revenue raised in the UK [from the FTT] would be 4.6 times higher than revenue raised in Germany and 10.9 times higher than revenue raised in France, and that 71.3% of overall revenue would be expected to come from the UK"[11].

4.14 Although the UK is not participating under the enhanced co-operation procedure in the FTT, respondents including the Northern Ireland Executive, the IMA, and City UK expressed concerns about the effect of the enhanced co-operation FTT on the UK, including that it would place requirements on non-participating Member States, for example, to collect revenues raised by the tax.

4.15 The ability of Member States participating in enhanced co-operation to place burdens on non-participating Member States led a number of respondents to question the use of enhanced co-operation on tax and whether reforms needed to be made. This is discussed in Chapter 6 below. To illustrate this concern in relation to the FTT, the City of London Corporation in their evidence to the Single Market Synoptic Review highlighted that the proposed 'residence principle', which applies if any one party to a qualifying transaction is based in a participating Member State. They suggest that this means that there is "the potential for such negative consequences to hit the UK even though the UK has exercised its right to opt-out of the FTT". City UK pointed to the results of a study which they and the City of London Corporation commissioned to assess the impact of the FTT on corporate and sovereign debt[12]. This study revealed that the cost is likely to be greater on non-participating Member States, like the UK, because debt securities represent a greater proportion of their corporations' capital structures.

4.16 On 18 April 2013 the UK submitted a legal challenge to the CJEU against the decision authorising enhanced cooperation on a FTT[13]. The case focuses on the extraterritorial aspects of the proposed tax.

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[10] Evidence submitted by the Institute of Chartered Accountants of England and Wales.

[11] House of Lords, European Union Committee, 2012. *Towards a Financial Transactions Tax*. (HL 287, 29th Report of Session 2010-12) together with Formal Minutes London: TSO (The Stationary Office), recalling evidence submitted to the Committee by John Vella, Clemens Fuest and Tim Schmidt-Eisenloh, Oxford Business School.

[12] London Economics, 2013. *Impact of the financial transactions tax on corporate and sovereign debt, A report conducted for the City of London*. London: http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/Impact-of-FTT-on-corporate-and-sovereign-debt-Final-PDF.pdf.

[13] Case C-209/13, *UK v Council*.

Limiting the EU's competence on direct tax

4.17 A number of respondents highlighted that Article 115 of the TFEU is not a specific legal base for direct tax measures in the way that Article 113 of the TFEU is specific to indirect taxation measures. There is no express provision in the TFEU for direct taxation.

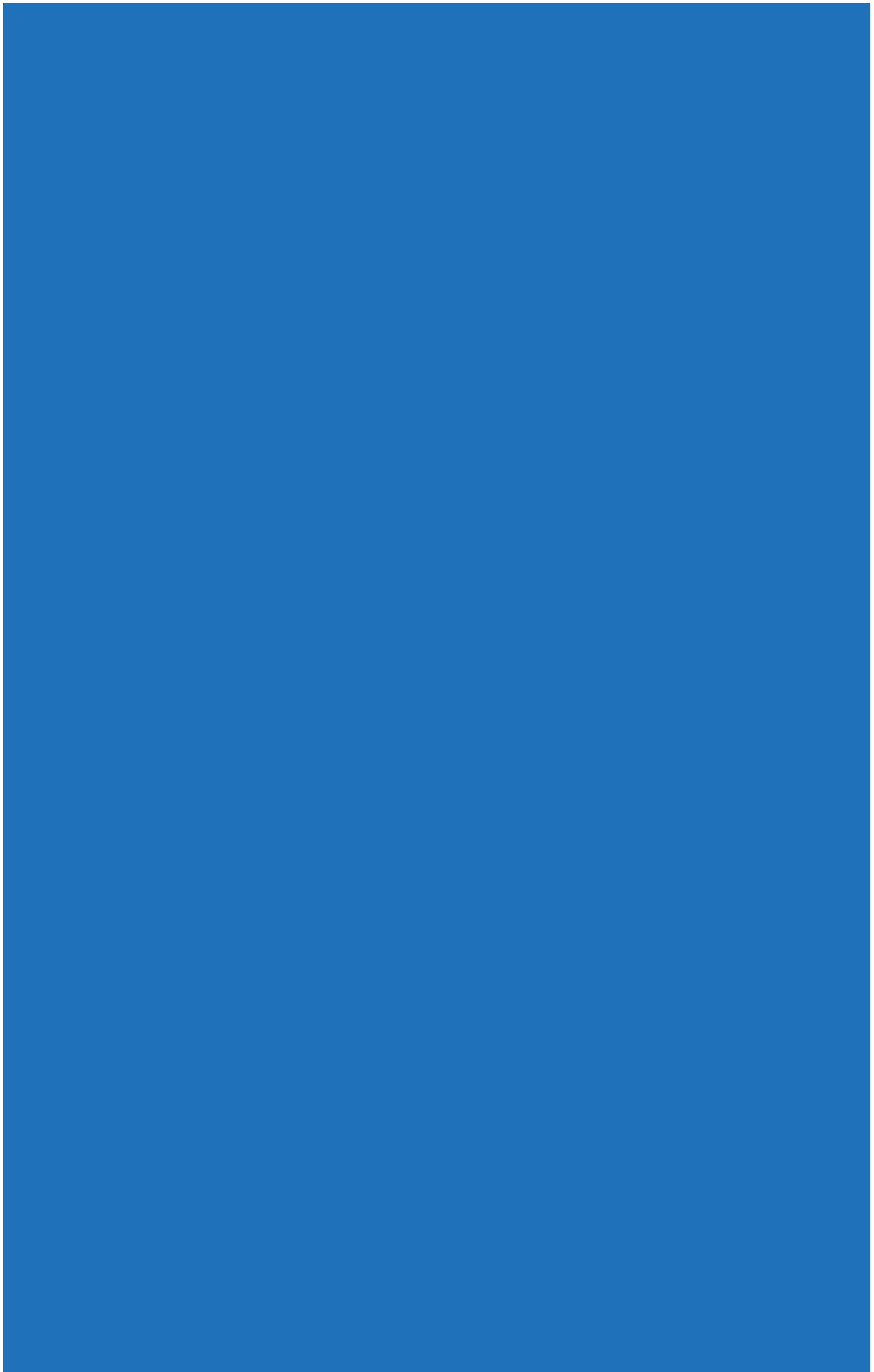
4.18 In response to concerns about: the impact of CJEU rulings on domestic tax regimes; concerns over the extent of the protection offered by unanimity voting; and the use of enhanced co-operation on tax measures with potential extraterritorial affects, some respondents could see merit in explicitly specifying the EU's competence on direct tax, either through the introduction of a specific direct tax legal base, or through explicitly limiting the EU's competence over direct tax.

4.19 One respondent suggested that competence on direct tax should be limited to "clearly defined areas, such as avoidance of double taxation or exchange of information"[14]. Another respondent explored the idea of excluding the application of the fundamental freedoms to direct taxation. The respondent concluded that this option "could endanger the integrity of the EU legal order, undermine the internal market and infringe the principle of the effective protection of rights under EU law"[15], bringing into question the desirability of this option. This concern was shared by other respondents, with the National Farmers' Union noting that limiting EU competence on tax too much presented a clear risk of having "a detrimental impact on the ability of UK businesses to access the single market putting them at a disadvantage to their European counterparts".

4.20 There was a general consensus during the course of discussions that competence on direct taxation should remain primarily with Member States, but that there was a need for limited action on direct taxation at the EU level to allow for the effective functioning of the internal market.

[14] HM Government of Gibraltar.

[15] Evidence submitted by Anzhela Yevgenyeva, Oxford University Centre for Business Taxation.



Chapter 5:
Reforming how tax policy and legislation is made at the EU level

Summary

5.1 While broadly satisfied with the current balance of competence on taxation, a significant number of respondents raised concerns about the legislative process. They identified their experiences of EU policy and legislation as a key factor in determining what future action on taxation they would wish to see taken at the EU level. For example, the CIOT noted that:

"while harmonisation may in theory be desirable, obviously its desirability in practice may depend on the precise form of the proposals and their impact on national interests. The development of proposals raises questions about the decision making process in the EU".

5.2 Many respondents suggested that the process of legislating and adjudicating on tax at the EU level needed reform to ensure a high quality and timely adoption of necessary tax legislation and to mitigate negative impacts on the national interest. Reforms suggested included: greater consultation; increased transparency at all stages prior to the adoption of legislation; full assessment of the impacts of proposed measures on individual Member States; and the use of enhanced review or sunset clauses in legislation. Similar comments were also made about tax measures taken forward through the enhanced co-operation procedure, which is discussed in Chapter 6 below.

Consultation

5.3 Under Article 17(2) of the TEU, the European Commission usually has the exclusive right to initiate legislative proposals. This "right of initiative" enables the European Commission to coordinate the EU's legislative programme, although the Council and the European Parliament may also ask the European Commission to put forward a proposal. One respondent suggested that "the Commission's right of initiative should perhaps be curtailed" so that it does not "lead to unnecessary interference"[1].

5.4 During the course of discussions other respondents expressed similar concerns about the volume of legislative initiatives on tax being suggested by the European Commission. Respondents proposed that refinement of the right of initiative could perhaps involve a stricter application of the principles of subsidiarity and proportionality, including in a form which could be challenged in the courts. Greater consultation prior to the introduction of a proposal was also suggested as a means of managing the large volume of material on tax resulting from the European Commission's right of initiative.

[1] See evidence submitted by the Institute of Directors.

5.5 The European Commission may issue a public consultation to seek the views of interested parties where it has identified an issue on which it may need to take action on, although this is not a requirement in order for the European Commission to introduce a proposal.

5.6 Increased and more transparent consultation by the European Commission as part of the legislative process was a common request in the evidence received[2] and during the course of discussions. Some respondents noted and welcomed the increase in public consultations undertaken by the European Commission in recent years in line with the European Commission's communication on consultation standards[3]. However some, including the British Bankers Association, felt that there was less consultation than in the UK policy-making process and there was room for further improvement. One example given of where policy would have benefited from greater consultation was on the proposed general anti-avoidance rule[4] contained within the European Commission's Recommendation on Aggressive Tax Planning[5].

5.7 The British Bankers Association argued that the role of business in the consultative process needed to be more clearly defined to achieve better quality tax proposals. The IMA went further, arguing that the European Commission did not have "an effective mechanism for consulting with the public and business on the impact of action on taxation".

5.8 Options suggested for improvement included "clear consultation documents, consult[ing] all relevant target groups, leave[ing] sufficient time for participation, publish[ing] the results and provid[ing] feedback"[6].

5.9 These suggestions were welcomed by interested parties when raised during the course of discussions who considered that while this was done to a high standard, in some instances, notably in relation to the VAT strategy, there were other instances where this was not done to a satisfactory extent. It was envisaged that greater consultation, although potentially time consuming, would result in a higher quality of proposal that functioned as intended, as well as helping to curtail initiatives that were not beneficial.

Impact assessments

5.10 Another concern amongst respondents was what they viewed as poor quality impact assessments for proposed tax measures at the EU level. Respondents noted that impact assessments were often incomplete and Oxford University's Centre for Business Taxation felt that "their conclusions at times do not sit comfortably with the content of the legislative proposal"[7]. Some respondents suggested that impact assessments should be carried out on a Member State by Member State basis[8], to ensure that the proposed measure did not create distortions. The British Bankers Association suggested that impact assessments could helpfully include a cost-benefit analysis.

5.11 PWC suggested that the appointment of an ombudsman to oversee the drafting of impact

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2 See evidence submitted by the British Bankers Association and evidence submitted by PriceWaterhouseCooper.

3 General principles and minimum standards for consultation of interested parties by the European Commission, COM (2002)704, final.

4 Evidence submitted by Anzhela Yevgenyeva, Oxford University Centre for Business Taxation.

5 Commission Recommendation of 6.12.2012 on Aggressive Tax Planning C(2012) 8806 final.

6 Evidence submitted by the British Bankers Association.

7 Evidence submitted by Anzhela Yevgenyeva, Oxford University Centre for Business Taxation.

8 See evidence submitted by the National Farmers Union, and evidence submitted by the British Bankers Association. This view was also expressed by a number of interested parties during the course of discussions.

assessments could help to improve their quality. Similar suggestions were made by stakeholders in the course of informal discussions, as well as the idea of an independent ombudsman to whom impact assessments could be referred to if it was felt that an impact assessment fell short of the necessary requirements and standards. A number of comments were made that the current process for the European Commission putting forward proposals was too political and their impact assessments and the views of stakeholders expressing concerns about a proposal were not given sufficient weight. Impact assessments with greater accountability could help to address this, as part of wider changes such as increased and more transparent consultation.

Sunset and review clauses

5.12 A number of respondents expressed a desire for more action to be taken to ensure that existing EU tax legislation was kept in line with modern business practice and evolving standards and to ensure that legislation worked as was intended (see Chapter 4 above). During the course of discussions interested parties considered a range of options of how this could be ensured. A number of groups suggested the inclusion of review or sunset clauses into legislation in order to require the European Commission and Member States to review legislation and choose whether to re-enact it after a given number of years.

5.13 PWC suggested that new tax legislation could include an initial review period of three years, with extensions being agreed every three to five years. While this could prompt Member States and the European Commission to review legislation and examine whether legislation is up-to-date, respondents also noted that it would increase the number of tax negotiations and potentially be used as an opportunity to extend EU competence on taxation.

5.14 PWC also suggested that reviews could potentially include opt-outs for Member States. An opt-out would ensure Member State tax sovereignty was protected by allowing a Member State to choose not to be bound by a tax measure when it was adopted. This option would have the advantage of protecting Member State tax sovereignty while not blocking progress for other Member States as can be the case where a veto is exercised under unanimity voting. When this idea was raised during the course of discussions, stakeholders noted the beneficial use of the UK's Justice and Home Affairs opt-out. However, some questioned whether a tax opt-out was necessary given the use of unanimity voting on tax, and the possibility for nine or more Member States to use the enhanced co-operation procedure to proceed with a tax measure that did not receive full support from all Member States. Interested parties also expressed concern that an opt-out (and the use of enhanced cooperation on tax) could lead to a more fractured internal market rather than aiding its functioning.

CJEU processes

5.15 In addition to concerns about the effect of the CJEU's rulings on domestic tax regimes discussed above, respondents also raised concerns about the decision-making process and how domestic courts respond to CJEU rulings. Respondents expressed concern that in some cases CJEU rulings had led to delays, uncertainty for tax payers and governments and the need for further litigation[9]. The Marks and Spencer case (see Box 3.C above) was highlighted by a number of respondents as an example where a CJEU ruling and the reaction of a domestic UK court have caused delay, uncertainty and significant cost. In this case, the UK amended its domestic law in response to a ruling by the CJEU.

5.16 Whilst recognising the problems caused in some instances by CJEU rulings and the

[9] Evidence submitted by the Law Society of England and Wales.

reactions of domestic courts to such rulings, the Law Society cautioned that:

"while certain CJEU decisions might be said to make a Member State's legislation less clear, the resulting doubt over the scope of the Member State's legislation has to be balanced against the need for a level playing field to be maintained and the value businesses attach to this".

Limitations placed on the CJEU and clarity of judgments

5.17 Respondents felt that one of the factors contributing to repeat referrals to the CJEU was the limitations placed on the Court on what it can take into account when forming its judgment. In evidence, the Law Society noted that proceedings before the CJEU "are inevitably limited by the facts and circumstances presented to the Court by the Commission [and] the parties in the reference".

5.18 A number of respondents also noted the limitations of what the CJEU can consider, expressing concern that the CJEU was left unable to take account of balancing factors in other parts of a domestic tax system, national circumstances or to accommodate the types of policy considerations that are seen as essential for complex tax policy decisions.

5.19 In evidence the CIOT noted that "the judgments of the CJEU are not always very clear" and this "frequently results in protracted litigation in national courts and multiple references at the same time". The ICAEW note that this results in uncertainty for tax payers and governments. As an example of this, the ICAEW highlighted the FII GLO case[10], which has recently been referred to the CJEU for a third time.

5.20 To help mitigate the uncertainty caused by a number of judgments which do not adequately take account of national circumstances or are unclear, some respondents favoured giving interested parties and Member States the opportunity to question or comment on judgments before they are finalised. The CIOT suggest that this should be done where "the questions put have not been answered in a manner capable of application nationally." Another respondent suggested introducing the possibility of responding to an Advocate General's Opinion could help to ensure the CJEU took "better account of the specific national legal context"[11].

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10 *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue* (Case C-446/04) [2006] ECR I-11753, (Case C-35/11) [2012], current reference Case C-363/12.

11 Evidence submitted by Anzhela Yevgenyeva, Oxford University Centre for Business Taxation.

5.21 Respondents recognised that this may lengthen the judicial process in the first instance, but shorten the overall process by reducing the need for further references to be made to the CJEU as well as reducing the uncertainty about the consequences of the ruling.

Retrospection of decisions

5.22 One of the concerns for Member States who face action before the CJEU on a domestic tax matter is the large liability they may incur as a result of a ruling. A Member State may be liable to repay taxes collected under a domestic tax law if that tax is found to contravene EU law. This liability may commence from where the tax measure was introduced, making it potentially very costly[12]. This liability will fall upon tax payers in the Member States. There is the possibility for an applicant to the CJEU seeking a judgment to ask for the effect of a ruling to have limited temporal effects, for example that the judgment has limited or no retrospective effect. An example of such a request can be seen in the joined cases of FIM Santander[13] where the French request for such a limitation was rejected by the CJEU.

5.23 Noting this concern of Member States, the Institute of Directors and other respondents suggested that the retrospection of decisions could be limited, for example, to a given number of years, to help Member States manage their liability. In concurrence with this, the Oxford University Centre for Business Taxation suggest that:

> "the limitation of retrospective effect could help Member States to manage the budgetary implications of case law: this possibility can be linked to a number of qualifying conditions, such as the uncertainty surrounding the application of EU law in a specific case".

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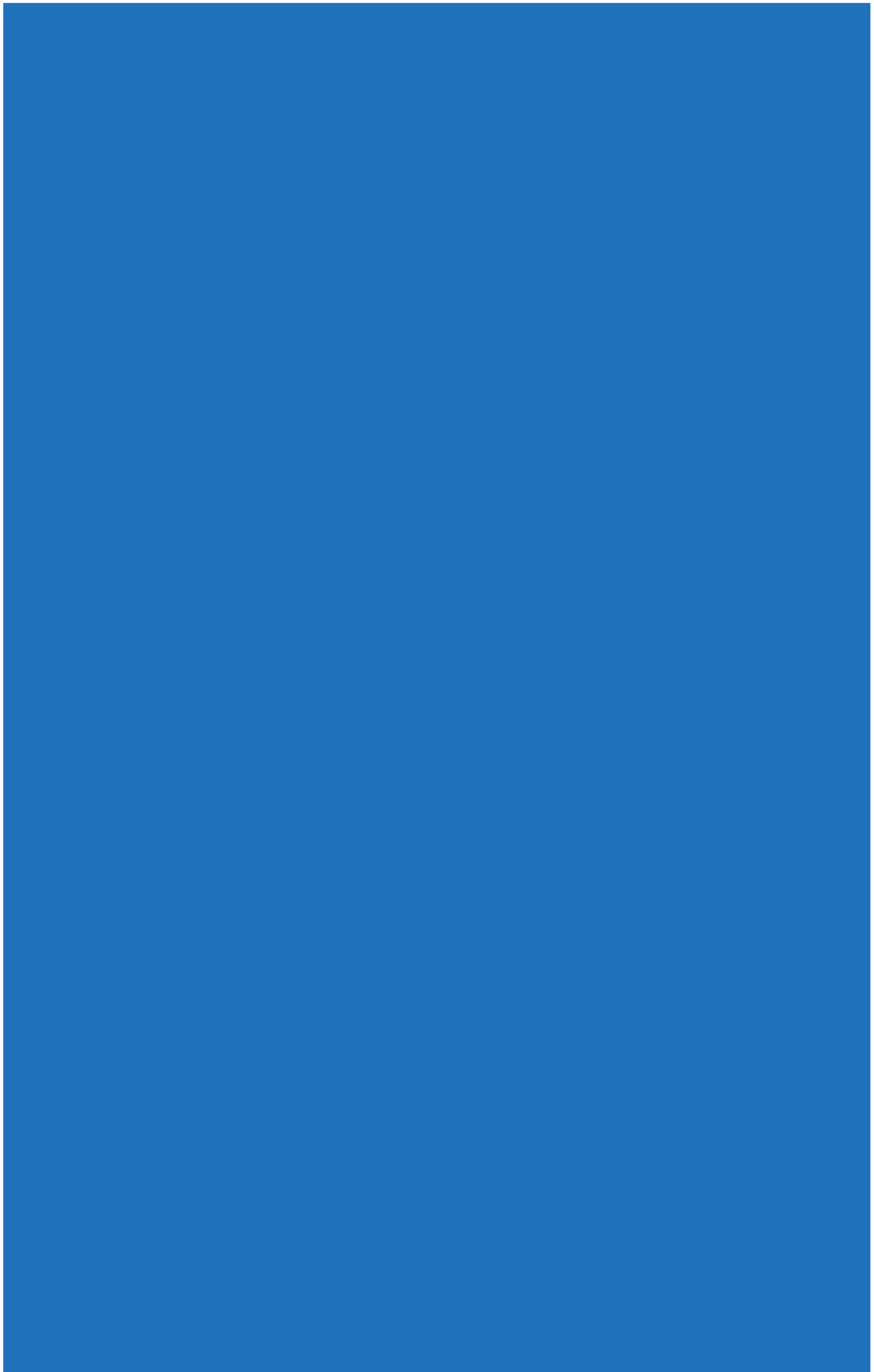
[12] However, there is a 10 year limitation period that relates to the recovery of unlawfully granted State aid, as set out in the implementing regulations 659/1999.

[13] C-338/11 to C-347-11.



Chapter 6: Future challenges

Summary

6.1 Interested parties were invited to provide evidence on the future challenges to the UK on the balance of competence on tax. One of the key themes from discussions was that certainty over the tax system was essential, particularly for businesses. In addition, the ability of Member States to retain control over the shape of their tax system was also seen as essential to protect national interests. Respondents also raised general concerns around potential future euro zone integration on tax and any “two-speed” Europe having potential spill over effects on the UK.

6.2 The future challenges identified by respondents were those which created uncertainty, such as CJEU rulings (discussed in Chapter 3) and those which posed a risk to individual Member States control of their tax systems, from undermining unanimity or the use of enhanced co-operation on tax.

6.3 Respondents proposed a number of actions to reduce uncertainty including reform of the CJEU process and recommended greater protection for Member State interests, through amendments to the enhanced cooperation procedure and maintaining the veto on taxation.

6.4 There was also a recognition among respondents that in certain future circumstances international action on taxation is likely to be necessary.

6.5 Work is ongoing in the OECD to address profit shifting by multi-national companies and erosion of the corporate tax base and the OECD will be presenting a comprehensive action plan for tackling these issues to the G20 in July 2013.

6.6 The EU will also have an important role in taking forward the recommendations from the action plan, particularly with regard to issues where they have already carried out work through bodies such as the EU Code of Conduct group.

6.7 In addition to tax avoidance, offshore tax evasion is also a global problem and is therefore most effectively tackled through a global solution. Recent developments in international tax transparency provide a real opportunity to secure a single global standard in exchanging tax information. The Government's approach has therefore been to press for a global standard in tax transparency through the G8 and the G20, with the EU fully supporting this process, before looking to implement this new standard in the EU. This approach is reflected in the recent May 2013 European Council conclusions.

Upholding unanimity voting on tax

6.8 Unlike many other policy areas, taxation is still subject to unanimity voting and is the preserve of Member States, with the European Parliament not having any decision making authority.

6.9 Having evaluated the pros and cons of unanimity voting and of the alternatives, respondents favoured the retention of unanimity voting on taxation. One area where respondents noted with concern that unanimity, and thus Member State control, could be undermined was where tax measures are contained in primarily non-tax dossiers which are subject to QMV.

6.10 To move from unanimity voting to QMV for measures which are primarily about taxation would require Treaty change that all Member States must agree. As such, the greater risk for respondents was on the potential loss of unanimity voting, and the inclusion of ancillary tax or fiscal measures in non-tax EU dossiers and so on a non-tax legal base.

6.11 For example, the European Emissions Trading Scheme Directive[1] was amended on an environment legal base[2] and the Eurovignette Directive[3] was updated on a transport legal base[4], but both contained fiscal elements.

6.12 During the course of discussions stakeholders expressed concern at the inclusion of tax or fiscal measures in non-tax dossiers. For example, in evidence the Institute of Directors argued that "it is absolutely wrong to slide from unanimity to qualified majority, when a tax measure is incidental to a non-tax measure".

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1 Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC.

2 Directive 2009/29/EC of the European Parliament and of the Council of 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community.

3 Directive 1999/62/EC of the European Parliament and of the Council of 17 June 1999 on the charging of heavy goods vehicles for the use of certain infrastructures.

4 Directive 2006/38/EC of The European Parliament and of the Council of 17 May 2006 amending Directive 1999/62/EC on the charging of heavy goods vehicles for the use of certain infrastructures.

Enhanced co-operation

6.13 The Treaties provide for "enhanced cooperation". Where Member States cannot agree to adopt a proposal, the enhanced co-operation procedure allows nine or more Member States wishing to take forward the proposal to apply to do so[5], providing the requirements set out in the Treaties are met[6]. This includes respecting the competences, rights and obligations of those Member States which do not participate in it.

6.14 In light of the process underway to strengthen the Economic and Monetary Union through closer financial, fiscal and economic integration (which will be the subject of a separate report in Semester 4 of the review), several respondents raised concerns about the use of enhanced co-operation on taxation. Respondents questioned the appropriateness of using enhanced co-operation on taxation and whether there were appropriate safeguards in place to protect non participating Member States. One respondent noted that enhanced co-operation on tax:

> "could well become the main competence concern the UK will have to face: having only a limited possibility of intervening in the process of enhanced cooperation, which undermines the value of unanimity"[7].

6.15 All respondents broadly concluded that they would like greater clarity of how the safeguards in the Treaty can be enforced. Some respondents went further and favoured reforms to the process of authorising enhanced co-operation with additional safeguards to protect the interests of non-participating Member States. A number of respondents noted that the Treaty provisions on enhanced co-operation had been rarely used and there was relatively little experience on the process and how the safeguards would operate in practice.

The appropriateness of using enhanced co-operation on tax

6.16 The TFEU does not exclude any area of taxation from the use of the enhanced co-operation procedure[8]. However, a number of stakeholders felt that tax at the EU level was "too close" to the functioning of the internal market for a subset of Member States to take forward a proposal without causing damage to the internal market. Comparisons were drawn between the two previous proposals on which enhanced co-operation has been used: on EU patents and on divorce law, both of which respondents identified as less fundamental to the functioning of the internal market.

Respecting the competences of non-participating Member States

6.17 During the course of discussions stakeholders also questioned the process of approving enhanced co-operation. It was noted that once Member States make a request to take forward a proposal under enhanced co-operation the voting by all 28 Member States to authorise enhanced co-operation is done under QMV rather than unanimity. Some stakeholders felt this undermined the veto on taxation measures and left non-participating Member States open to the possibility of being affected by taxation measures with extra territorial effect.

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[5] Article 20(2) TEU and Article 329(1) TFEU.

[6] Notably Articles 326-327 and 332 TFEU.

[7] Evidence submitted by Anzhela Yevgenyeva, Oxford University Centre for Business Taxation.

[8] Though the enhanced co-operation procedure cannot be used for areas of exclusive EU competence.

6.18 Although the Treaty requires that "any enhanced cooperation shall respect the competences, rights and obligations of those Member States which do not participate in it"[9], respondents questioned whether and to what extent the process of enhanced cooperation does fulfil this requirement and the mechanisms available for ensuring this requirement is met.

6.19 Using the enhanced cooperation on the FTT proposal as a case study, respondents questioned whether the process of enhanced cooperation satisfactorily protected the rights of non-participating Member States. A number of respondents including the British Bankers Association, the Institute of Directors, the Northern Ireland Finance Ministry and City UK felt that although the UK was not a participating Member State, the FTT may still have negative impacts on the UK (see Chapter 5).

6.20 One respondent concluded of the protections in the Treaty that "their interpretation and practical implementation, as well as the scope of their judicial review, needs clarification"[10].

6.21 Other respondents went further, suggesting that additional safeguards were needed to the process. For example, the Institute of Directors suggested that: "the enhanced cooperation requirement to 'respect the competences, rights and obligations of those Member States which do not participate in it' needs to be strengthened to give any non-participating state a right to block an enhanced cooperation measure if it would have any but the most trivial effect on its interests".

6.22 Another respondent noted that "whilst this alignment of taxation systems may be entirely reasonable there should be a requirement for Member States agreeing joint taxation measures to fully evaluate the impact on all other Member States"[11].

6.23 This respondent felt that where measures were found to create distortions to the internal market then the measure must be challenged.

6.24 On 18 April 2013 the UK submitted a legal challenge to the CJEU against the decision authorising enhanced cooperation on a FTT. The case focuses on the extraterritorial aspects of the proposed tax.

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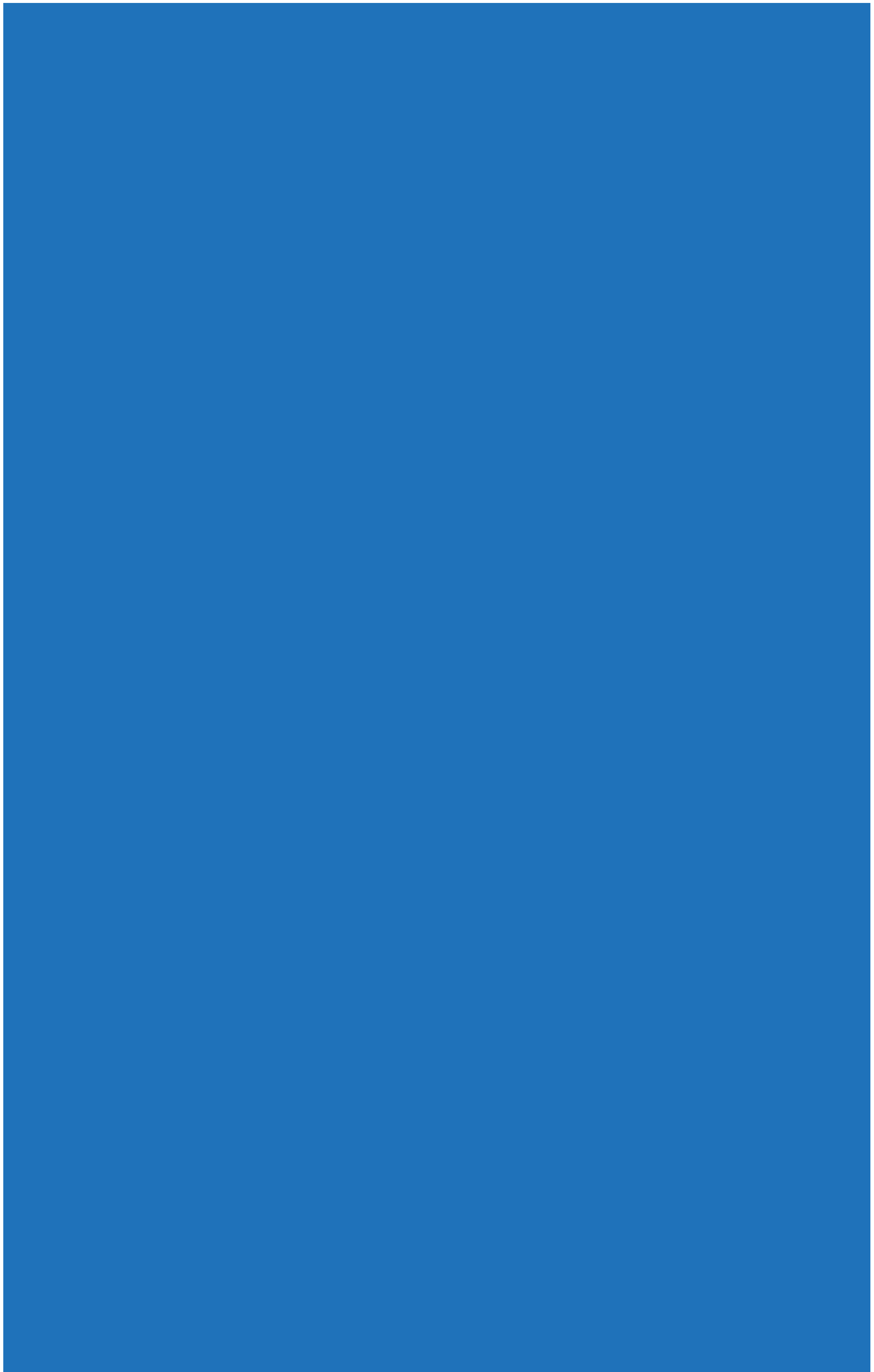
9 Article 327 of the TFEU.

10 Evidence submitted by Anzhela Yevgenyeva, Oxford University Centre for Business Taxation

11 Evidence submitted by the National Farmers Union.



Annex A: Submissions received to the Call for Evidence

The following formal responses to the call for evidence were received:

- Anzhela Yevgenyeva, Oxford University Centre for Business Taxation (OUCBT)
- British Bankers Association
- Charity Finance Group and the National Council of Voluntary Organisations
- Chartered Institute of Taxation (CIOT)
- Department for Finance and Personnel, Northern Ireland Executive
- HM Government of Gibraltar
- Imperial Tobacco
- Institute of Chartered Accountants of England and Wales (ICAEW)
- Institute of Directors
- Investment Management Association
- James Lynch-Staunton – individual
- National Farmers Union (NFU)
- PricewaterhouseCoopers (PWC)
- Scotch Whisky Association
- The Law Society of England and Wales
- The Wine and Spirit Trade Association
- UK Music

In addition to the formal submissions to the taxation Call for Evidence, the following response to other reviews have been considered:

- City of London Corporation – submitted to the Single Synoptic Review.

The following interested parties also asked for their relevant existing work to be considered:

- Dr Christiana HJI Panayi, Centre for Commercial Law Studies, Queen Mary, University of London – "*The Common Consolidated Corporate Tax Base and the UK*", Institute for Fiscal Studies, 2011.
- City of London – "*A financial transaction tax – review of impact assessment*".
- City of London Corporation and the City UK, Report prepared for the International Regulatory Strategy Group by London Economics "*The Impact of a Financial Transactions Tax on Corporate and Sovereign Debt*".
- Dr Tom O'Shea, Centre for Commercial Law Studies, Queen Mary, University of London – "*Balance of Competences on Taxation*" (presentation), first presented at the *Avoir Fiscal* EU Tax Conference 2013.

Annex B:
Engagement Events

To help inform the Taxation Report a number of meetings were held with interested parties to explore the issues raised in the Call for Evidence document.

These meetings included:

1 February 2013 – Balance of Competence Taxation Seminar at HM Treasury

External attendees:

Barclays

British Bankers Association

British Petroleum (BP)

Centre for Business Taxation, Said Business School, Oxford University

Centre for Commercial Law Studies, Queen Mary University of London

Chartered Institute of Taxation (CIOT)

CIVITAS

Ernst and Young

Institute of Chartered Accountants of England and Wales (ICAEW)

National Farmers Union (NFU)

PricewaterhouseCoopers (PWC)

Schroders

The Law Society of England and Wales

Tax Law Review

Tax Payers Alliance

15 February – Meeting with Dr Tom O'Shea

The Centre for Commercial Law Studies, Queen Mary, University of London

7 March – Meeting with Confederation of British Industry

25 March – Meeting with officials from Jersey and Guernsey

During the course of the Call for Evidence period the Balance of Competences Review was also discussed with interested parties including businesses, academic institutions, the Devolved Administrations, other Member States, and the European Commission as part of pre-standing meetings.

Annex C: Other sources used to inform the Taxation Report

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European Commission: Summary report of the outcome of the public.

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Kube, H, ‘Competence conflicts and solutions: national tax exemptions and transnational controls’ The Columbia Journal of European Law, Volume 9(1), 2002, pp.79-108.

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O’Shea, T, ‘Double Tax conventions and the European Union’, The EC Tax Journal, Volume 10, Issue 3, 2010, pp. 71-80.