THE ROLE OF EC LAW IN UK DIRECT TAX

by John Walters QC

This house believes that European Community Law should have a rôle in UK direct taxation - The Wyman Debate at the ICAEW

I was very pleased to be asked to speak in the Wyman Debate held on 7th July 1997 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales — the first of what is planned to be an series of annual debates named in recognition of Peter Wyman's work in spearheading the establishment of a Tax Faculty within the Institute. With Ian Barlow, Head of UK Tax at KPMG, I led the opposition to the Motion which was as follows : "This house believes that European Community Law should have no role in UK direct taxation". A vote of those present was taken both at the start and at the end of the debate and the Motion was defeated both times, and, I am glad to say, by a bigger majority at the end than at the beginning.

The Motion exposed the tension between the objectives of Community Law and the absence of any provision in the Treaty of Rome for a community policy on direct taxation. (As is well known, the common rules on taxation relate to indirect taxation.)

Our opposition to the Motion focused on the reason for the existence of Community Law — to achieve the objectives of the European Community, set out succinctly in Article 2 of the Treaty of Rome as its *task* "by establishing a common market and progressively approximating the economic policies of member states, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the States belonging to it." This task was redefined by the Treaty of Maastricht to include in addition the establishment of economic and monetary union.

The fact that the European Community's function is defined in terms of its *task* is interesting. It is unlike a legal polity whose function is defined by the subjects of legislation within its jurisdiction, such as we see in the federal constitutions of Australia and Canada for instance. Instead the Community has a *task* and by acceding to the Community, the UK has not only made a partial transfer of sovereignty but has. more importantly, made a *commitment to the accomplishment of the task*, that is, *a commitment to certain policies*.

These policies are expressed in the principles of the Community, which have always included "*the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital*"[1] and "*the approximation of the laws of Member States to the extent required for the proper functioning of the common market"*.[2] Member States have always bound themselves "*to abstain from any measure which could jeopardize the attainment of the objectives of the Treaty*".[3]

This is the nature of the Community which the UK joined and voted to stay in by the 1975 Referendum and it would be impossible as a practical matter to change the EC so that it did not have the objective of approximation or the means of Community Law to achieve it.

The Treaty fills out the general objectives of the Community by laying down *an objective of prohibiting any discrimination on grounds of nationality*.[4] There are particular objectives *to secure freedom of movement of workers by abolishing any discrimination on grounds of nationality as regards employment, remuneration and other conditions of work and employment*.[5] *Restrictions on freedom of establishment of nationals of one Member State in the territory of another member state are to be abolished*.[6] *Restrictions on the movement of capital and any discrimination based on nationality or place of residence or on the place of investment of capital are to be abolished*.[7] The Community has a specific objective of "*the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market*".[8]

Although within this scheme there is no provision for a community policy on direct taxation, *other* community policies, for example freedom of movement for workers and freedom of establishment have been interpreted by the European Court as requiring Member States to amend their direct tax law so that it is not discriminatory. *Ex p. Commerzbank*[9] is a case in point where the UK was involved.

Beyond that, Article 100 of the Treaty (which provides for directives to be issued at Community level for the approximation of laws of the Member States which directly affect the establishment or functioning of the common market) has been applied in the tax field in the case of the 1977 Directive on mutual assistance by the competent authorities of the member states in the fields of

[1] Treaty of Rome, Article 3(c)
[2] Treaty of Rome, Article 3(h)
[3] Treaty of Rome, Article 5
[4] Treaty of Rome, Article 7
[5] Treaty of Rome, Article 48
[6] Treaty of Rome, Article 52
[7] Treaty of Rome, Article 67
[8] Treaty of Rome, Article 100
[9] [1994] QB 219

direct and indirect taxation, and the two 1990 Directives on the taxation of cross-border mergers and the taxation of cross-border distributions.

So in this way as a practical matter Community law has been brought to bear on UK direct taxation. Should that be allowed? That was the question we debated. On our side, we said it should be allowed - and that the rôle of Community law in direct taxation is a direct result of the nature of the Community which Britain has joined.

We said that the burden was on our opponents (led by Michael Stern FCA, the MP for Bristol North West (1983-1997) and Simon McKie FCA), who said it should *not* have this rôle to establish a positive case **either** (a) for the UK leaving the Community; **or** (b) for direct taxation being left as an island among the domestic laws affecting the common market which enjoys some special immunity from the *incoming tide* of Community Law as it applies to establish the freedom of movement of persons, services and capital.[10]

These are not legal questions: they are political questions to be decided on the basis of political and economic considerations, not legal considerations. The legal consequences follow one way or the other from a decision on the political questions: If we leave the EC or designate direct taxation as an island immune from the general tide of Community Law then it follows that EC law will have no rôle in direct taxation — if, on the other hand, we stay in the EC and recognise that there is nothing about individual Member States' competence in the field of direct taxation which should allow it to undermine the successful establishment and functioning of the common market, then of course EC law will continue to have a rôle in UK direct taxation.

The political and economic case for remaining in the EC is overwhelming — our opponents did not suggest that we should leave. Ian Barlow dealt fully with the economic arguments. As for the political arguments, I made the point that the EC is a community, a new and different kind of political entity from either a superstate or federation like the USA on the one hand or a loose collection of nation states on the other. It is an experiment, embarked upon in the aftermath of two European wars of unprecedented ferocity, aimed to produce a new political structure in Europe for the post-imperial age. The new political structure is still being worked out. The political case for staying in the EC is that this is an experiment which we should be involved with. We are a European state. We have an interest in the prevention of future European wars. We have an incentive to be involved, on the inside, in the development of the Community.

If we stay in, why should direct tax be an island immune from the effects of the incoming tide of Community law? The preservation of national sovereignty

[10] Lord Denning's description in *Bulmer v Bollinger* [1974] Ch. 401,418

intact in this area should not be allowed to undermine the achievement of the whole objective of the Community — to the disadvantage of those within the Community who wish to use the freedoms which it exists to promote in order to expand and develop prosperity, both their own prosperity and prosperity generally within the Community.

Community activity in the direct tax area so far, both in the directives and in the case law, has shown a desire to implement the Community objectives on the establishment and functioning of the common market which overcomes the reluctance to avoid entering the sphere of direct taxation, which is left to the Member States.

Thus, where there has been a conflict between the two, we have seen the Community institutions, both in the directives and in the case law, decide to extend Community law into the direct tax field *in order to facilitate the functioning of the common market*. The justification for doing so has been quite clear: if the Community had shied away from the area of direct taxation in these instances, the common market would have been undermined.

So, in the *Schumacker* case[11], the European Court asked itself: "*How can there be the freedom of movement for workers, if a Member State can tax the income of non-resident individuals who are, economically speaking, in substantially the same situation as resident individuals, more severely than its own residents?* And, in the area of freedom of establishment, the European Court has asked itself (in the shareholders' tax credit case[12]: "*How can there be unrestricted freedom of establishment if the direct tax law of a Member State effectively obliges foreign companies to establish subsidiaries rather than operate through agencies and branches — by on the one hand levying direct tax on the same basis from its own residents and branches or agencies of non-residents situated on its territory, but nevertheless treating them differently with regard to shareholders' tax credit?"* And in *ex parte Commerzbank*[13] the European Court asked itself: "*How can there be freedom of establishment within the common market area, if UK law grants a repayment supplement to a UK-resident company which has overpaid tax, but not to a German-resident company in the same position?"*

[11] Finanzamt Köln-Altstadt v Schumacker (Case C–279/93) [1995] STC 306
[12] Commission v French Republic (Case 270/83) [1986] ECR 273
[13] [1994] QB 219

But this approach – striking down provisions of the direct tax laws of Member States on the grounds that they were discriminatory – has always been balanced with respect for the fiscal jurisdiction of the Member States where this respect can go hand in hand with the achievement of the Community's objectives. This is well illustrated by the recent (15th May 1997) judgment of the European Court in the case of *Futura* and *Singer* [14] on the interpretation of Article 52, the freedom of establishment article.

That case came from Luxembourg and concerned the Luxembourg branch (Singer) of a French Company (Futura). Luxembourg law allows residents of Luxembourg to deduct losses brought forward provided that they have kept proper accounts during the financial year in which the losses were incurred. Non-residents, including those, like Futura, having a branch in Luxembourg, are taxed on their income earned in Luxembourg. If they make losses, these may be carried forward and deducted from profits provided two conditions are satisfied, first, that the losses are "economically related" to income earned in Luxembourg and, secondly, that accounts complying with Luxembourg rules have been kept in Luxembourg in the loss making periods.

The European Court was asked whether either or both of these conditions was an infringement of Article 52 on freedom of establishment. The result was interesting. First, the European Court respected Luxembourg's competence to make its own direct tax rules on the ground that "*the effectiveness of fiscal supervision is an overriding requirement of general interest capable of justifying a restriction on the exercise of the fundamental freedoms guaranteed by the Treaty*[15]*"*. This led the Court to agree that Luxembourg could justifiably make a condition for the deduction of losses by a non-resident that they should be economically linked to income earned by the non-resident in Luxembourg. This application of "*the fiscal principle of territoriality*" did not entail any discrimination. On the other hand it struck down the rule that the non-resident must be required to have kept special branch accounts in Luxembourg during the period of the losses, because this imposed a discriminatory burden on non-residents, who were required to keep two sets of accounts (in the foreign country of residence, as well as in Luxembourg), whereas Luxembourg law only required Luxembourg-resident companies to keep one set of accounts. This case shows a balanced and sensitive approach by the Court to the demarcation between the harmonization of direct taxation, which has *not* taken place, and the functioning of a common market without discrimination which is the entire *raison d'être* of the Community.

So, on our side of the debate, we said that the issue comes down to the desirability of Britain's continued membership of the Community as it is developing. We said that membership is good for Britain, and that the objectives of the Community, besides being objectives which we <u>have in fact</u>

[14] Case C-250/95
[15] Judgment, paragraph 31

signed up to, are objectives which it was right for us to sign up to. The Community has set a *right balance* in promoting and bringing its objectives about, including its sensitive treatment of the direct tax area. Community law should have a rôle in UK direct taxation.