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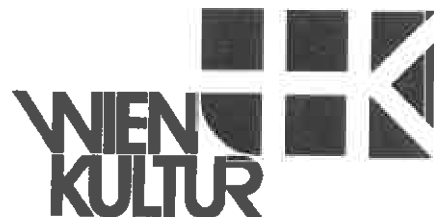

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UK Cases

Philip Baker

I. **Commission v the UK (Attribution of Gains of Foreign Companies) – Case C-112/14: Judgment of 13 November 2014**

II. **Commission v United Kingdom (Terminal Loss Relief) – Case C-172/13: Advocate General's Opinion of 23 October 2014**

III. **Commission v United Kingdom (Retrospective Curtailing of Recovery of Taxes Unlawfully Charged) – Case C-640/13: Judgment of 18 December 2014**

There are three cases concerning the UK that are discussed in this chapter. All of them are infringement actions and were previously discussed two years ago in the conference for that year.[1] Since that time there has been a judgment in one of the cases, an Advocate General's Opinion in another, and both domestic legislation, a related judgment and (subsequent to the conference) a judgment of the European Court in the third.

I. Commission v the UK (Attribution of Gains of Foreign Companies) – Case C-112/14: Judgment of 13 November 2014

This infringement action arose after a complaint to the Commission concerning s.13 of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992" – which is consolidating legislation, replacing original legislation dating back to 1965). In general, the United Kingdom's Capital Gains Tax Legislation does not impose a liability on non-residents; it would be relatively simple, therefore, to avoid the tax by having assets held by non-resident companies or non-resident trusts. In the case of companies, s.13 is an anti-avoidance measure designed to prevent this by automatically attributing any capital gains realized by closely held, non-resident companies to the participators in those companies and taxing them immediately on those gains. Though this is an anti-avoidance provision, it did not originally, or until recently, contain any opportunity for the participators to show that they were not seeking to avoid tax by the use of the non-resident company.

The immediate attribution of gains realized by the non-resident, closely held companies to their participators may be contrasted with the situation where the company realizing the gain is resident in the United Kingdom. In that situation, the company itself is liable to corporation tax on the chargeable gain, but there is no attribution to the participators unless and until there is a distribution to them. The legislation was, in effect, a form of controlled foreign corporation legislation for capital gains, but subject to no motive test at all.

By the time that the infringement action reached the European Court, the United Kingdom had changed the legislation with effect from 6 April 2012 (the amended legislation is discussed below). However, the amendment had not been made by the time that the period for responding to the Commission complaint had expired. The Court had to examine the situation, therefore, at the time that the period for compliance had expired. The UK Government admitted that, at that stage, the legislation failed to comply with European law. To that extent, therefore, the judgment was moot.

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1 See Baker in *Recent Developments in EU Direct Tax Cases 2012* (M. Lang et al eds 2013), pp. 247–248 and pp. 251–256.

The judgment is a relatively straightforward statement of well-established principles. The Court first considered the relevant freedom: the legislation originally applied to a shareholding of 5 % or above, but that had been raised to a shareholding of 10 % or above (that is, gains could be attributed to participators who held a 10 % interest or above). On that basis, the legislation could fall within the scope either of the freedom of establishment or the free movement of capital, since it could apply to situations where the participator had a controlling interest in the company, or where he had only 10 % and no controlling interest. However, the Commission had only challenged the United Kingdom with regards to the free movement of capital, and so the judgment focused on that freedom. The provision clearly restricted the exercise of that freedom.

The Court then went on to consider whether the restriction could be justified on grounds of combating tax evasion and avoidance. The Commission did not dispute that s.13 might contribute to attaining the objective of combating tax avoidance; however, it submitted that the provision went beyond what was necessary to attain that objective. The Court noted, however, that s.13 was not confined to targeting wholly artificial arrangements which did not reflect economic reality and were carried out for tax purposes alone, nor did it allow the tax payer concerned to provide evidence to show the economic reality of its participation in the non-resident company. On that basis, and with no real surprises, the Court concluded that s.13 went beyond what was necessary for achieving its objective.

In some senses, the issue of s.13 has moved on. In the Finance Act 2013 legislation was enacted which took effect from 6 April 2012 and which included two new defences to the s.13 charge. Prima facie, these two defences respond to the Court's decision that the original legislation lacked the possibility for the taxpayer to prove the economic reality of its participation in the non-resident company. The issue now is whether these amendments to the legislation go far enough as to cure the incompatibility. The two new provisions provide as follows:

> "(5) This section shall not apply in relation to –
> (ca) a chargeable gain accruing on the disposal of an asset used, and used only, for the purposes of economically significant activities carried on by the company wholly or mainly outside the United Kingdom, or
> (cb) a chargeable gain accruing to the company on a disposal of an asset where it is shown that neither –
> (i) the disposal of the asset by the company, or
> (ii) the acquisition or holding of the asset by the company,
> formed part of a scheme or arrangement of which the main purpose, or one of the main purposes, was avoidance of liability to capital gains tax or corporation tax..."

Thus the amendments in 2013 introduce two possible defences for the taxpayer otherwise liable to the tax.

The first of the defences applies if the taxpayer shows that the asset was used only for the purpose of "economically significant activities" carried on outside the United Kingdom. This concept of "economically significant activities" is a particularly United Kingdom Revenue Authority interpretation of the concept of establishment. It is defined in s.13A(4) TCGA 1992, which was also inserted by the Finance Act 2013. That paragraph defines these activities as follows:

> "activities which consist of the provision by the company of goods or services to others on a commercial basis and involves –
> (a) the use of staff in numbers, and with competence and authority,
> (b) the use of premises and equipment, and
> (c) the addition of economic value, by the company, to those to whom the goods or services are provided,
>
> commensurate with the size and nature of those activities."

This reflects a concept that establishment requires staff, premises and equipment and the addition of economic value to an extent commensurate with the activities concerned. This is very much a substance-oriented view of establishment, which would deny that a company had validly exercised its freedom of establishment if the company did not have significant staff, premises and equipment and add significant value. It remains to be seen whether this is too narrow a concept of establishment.[2]

The second defence requires the participator to prove that the acquisition or holding of the asset and its disposal did not form part of a scheme or arrangement of which one of the main purposes was the avoidance of liability to Capital Gains Tax or Corporation Tax.[3] This is relatively standard drafting by the United Kingdom for anti-avoidance legislation. The issue here is whether proving that no purpose of the arrangement was the avoidance of liability to tax is the same as identifying arrangements that are wholly artificial and entered into for tax reasons alone.

What is perhaps highlighted by the two defences to s.13 is the uncertainty over the scope of the justification of combating tax avoidance under European law. The phraseology of the Court in talking about "wholly artificial arrangements entered into for tax reasons only" suggests that it is only really abusive arrangements that can constitute the target of measures designed to combat tax avoidance. From the point of view of most governments, this concept of combating avoidance is far too narrow. What a challenge to the 2013 amending legislation might

2 It might be mentioned that, as part of the 2013 amendments the legislation was changed so that it only applies where the participant has a 25% or higher shareholding in the non-resident company: this change was clearly intended to ensure that only the freedom of establishment and not the free movement of capital could apply to s.13.

3 Just to clarify, s.13 applied to participators who were both individuals and companies. Individuals would pay Capital Gains Tax on the gains attributed to them, while companies would pay Corporation Tax on chargeable gains attributed to them.

usefully achieve is some clarity from the European Court as to the more precise scope of the justification of combating tax avoidance.

One final comment might be made on this case. The Commission commenced two infringement actions in parallel, one concerning s.13 TCGA 1992, and the other concerning the parallel provisions relating to Income Tax in the Transfer of Assets Abroad legislation. In both cases, the United Kingdom Government amended the legislation, but outside the time limit given by the Commission. The infringement action with regards to the capital gains legislation has been brought to a successful conclusion by the Commission, but the action relating to the income tax provisions appears to have been stalled.

II. Commission v United Kingdom (Terminal Loss Relief) – Case C-172/13: Advocate General's Opinion of 23 October 2014

The background to this case starts with the judgment of the European Court in the "Marks & Spencer" Case (Case C-446/03), which was delivered on 13 December 2005. The United Kingdom responded to that judgment by bringing in legislation originally contained in the Finance Act 2006 which amended the law with effect from 1 April 2006. It introduced new conditions for the use of losses from a non-UK subsidiary, the conditions now being found in s.111 of the Corporation Tax Act 2010. The Commission considered that the United Kingdom had not properly implemented the decision of the Court by introducing this legislation for two principal reasons. First, under the legislation it was virtually impossible to obtain group relief for the losses of the foreign subsidiaries because it was necessary to determine that there was no possibility of using the losses abroad at the end of the accounting period when the losses arose. This was so restrictive that it would only in practice be possible to use the losses if the local law did not allow any offset, or if the company was put into liquidation during the period when the losses arose. Secondly, the change to the law only applied as from 1 April 2006 and not to earlier periods.

The Advocate General's Opinion was issued on 23 October 2014. It is a long and detailed analysis which essentially calls for the abolition of the "Marks & Spencer exception", that is the exception where terminal losses can be used cross-border against profits. Not everyone will agree with the details of the Opinion. However, by the time of the publication of this chapter it is likely that the judgment of the European Court itself will have been issued, so one will know whether the Court has been persuaded to abolish the Marks & Spencer exception or not.

Perhaps one point might be made about this matter. Since the judgment of the European Court in December 2005, there have been nine hearings on the case at

various levels of courts in the United Kingdom.[4] These hearings ultimately concluded with a judgment of the Supreme Court on 22 May 2013[5] where it was unanimously held that it was not appropriate to determine whether or not there was no possibility of using losses at the end of the accounting period where the losses arose. The Supreme Court did so on the basis of the decision of the European Court in A Oy.[6] All of the UK courts proceeded on the basis that it was necessary to give workable effect to the judgment of the European Court in Marks & Spencer, consequently it was necessary to test the impossibility of the use of losses not at the end of the accounting period where they arose but when the claims to use the losses was made. Only that approach allowed the losses to be effectively utilized. The Advocate General, on the other hand, takes the opposite approach by maintaining that it is not in practice possible to determine the impossibility of utilizing the losses at the end of the accounting period in which they arose, consequently the exception should be abandoned. What is rather puzzling is that the Opinion appears to make no reference to the lengthy discussions of the issue by the domestic courts.

III. Commission v United Kingdom (Retrospective Curtailing of Recovery of Taxes Unlawfully Charged) – Case C-640/13: Judgment of 18 December 2014

This is another case with a long background. Unlike other countries where constitutional challenges to taxes are quite common, the United Kingdom has no long history of case law on the recovery of taxes unlawfully imposed. The remedies have had to be developed in the past few decades. One of those remedies is for taxes paid under a mistake of law, and the original limitation period for such actions was set out in s.32(1)(c) of the Limitation Act 1980. Under that paragraph, the limitation period did not begin to run until the mistake was discovered, which, in the case of tax imposed contrary to European law, would normally be at the time of the judgment of the European Court to that effect. This meant that for any tax that was imposed contrary to European law, the taxpayers concerned had a period of originally six years running from the time of the judgment of the European Court to bring a claim for repayment of the tax, and, at least in principle, they could claim back to the time that the United Kingdom joined the European Economic Community.

4 The judgment of the European Court was remitted to Park J., who directed that the matter should be sent back to the First Tier Tribunal for a finding of facts on the issue of the non-possibility of using the losses. That was challenged before the Court of Appeal who upheld the judgment, the matter then proceeding back to the First Tier Tribunal, and from there to the Upper Tribunal, to the Court of Appeal for the second time, and finally on to the Supreme Court (on two separate occasions).

5 [2013] UKSC 30.

6 ECJ 21 February 2013, C-123/11, *A* (not yet published).

This extended limitation period was curtailed by the UK in two stages. First, by s.320 of the Finance Act 2004 which disapplied the extended limitation period for claims brought after 8 September 2003. However, that curtailment of itself left the United Kingdom relatively exposed, so that in s.107 of the Finance Act 2007 ("FA 2007") the extended limitation period was disapplied even for claims brought before 8 September 2003 and with immediate effect (so that even existing claims were curtailed).

These two enactments which curtailed the claims for tax unlawfully imposed were challenged through the United Kingdom courts. On 23 May 2012, the UK Supreme Court ruled unanimously that s.107 FA 2007 was contrary to EU law, but, because there was a small amount of uncertainty, decided to refer the compatibility of s.320 of the Finance Act 2004 to the European Court.

On 12 December 2013 the European Court ruled in Case C-362/12 (Franked Investment Income (No 3)) that s.320 was contrary to the European principles of effectiveness, legal certainty and the protection of legitimate expectations. This was the response to the reference from the Supreme Court.

In the meantime, the Commission had brought an infringement action against the United Kingdom in respect of s.107 FA 2007. That is the case involved here.

One last step in the background: in the Finance Act 2014, the UK Government finally amended s.107 FA 2007 by adding a new subsection to the effect that the curtailment of the limitation period "does not have effect in relation to an action, or so much of an action, as relates to a cause of action, if the consequences of a mistake of law to which the action, or cause of action, relates is the charging of tax contrary to European Union law." That change took effect from the date that the Finance Act 2014 was passed, that is 17 July 2014. Thus the United Kingdom had again admitted that its legislation was not compatible with European law, but had amended the legislation beyond the time limit given by the Commission for making that amendment. Just as in the case of s.13 TCGA 1992 discussed above, the infringement action continued with regard to legislation that had already been amended only because the amendment was made too late.

The European Court has now decided that s.107 FA 2007, which curtailed (retroactively and without notice or transitional arrangements) the right of taxpayers to recover taxes levied in breach of EU law was a failure of the United Kingdom to comply with its obligations under Article 4(3) of the Treaty on the European Union. The enactment of s.107 was not only incompatible with the principle of effectiveness, but also breached the principle of the protection of legitimate expectations of taxpayers. The United Kingdom did not dispute the infringement. Though the legislation had subsequently been amended, on the date of expiry of the period prescribed in the reasoned opinion of the Commission for amendment of the law, the law had not yet been changed.