Chartered Institute of Taxation

Excellence in Taxation

Reform of two anti-avoidance provisions: (i) the attribution of gains to members of closely controlled non-resident companies, and (ii) the transfer of assets abroad
Response by the Chartered Institute of Taxation (CIOT)

1 Introduction

1.1 We set out below our initial comments on the consultation document published on 30 July 2012 regarding reform of two anti-avoidance provisions: (i) the attribution of gains to members of closely controlled non-resident companies, and (ii) the transfer of assets abroad. These comments focus on the application of EU law to the provisions.

1.2 In our view, the current proposals do not fully address the EU law issues raised by infraction proceedings in relation to either the attribution of gains rules (section 13) or the transfer of assets code. The response to address the freedom of establishment issue is inadequate and no attempt has been made to address the freedom to move capital issue, which, in our view, is relevant to both sets of provisions.

1.3 In addition to the EU law implications, we are disappointed that the opportunity has not been taken for a fuller review of these provisions, which are old and out of date in their current form. We intend to submit further comments in due course dealing with the non-EU aspects of the proposed changes and setting out some suggestions as to how the rules can be improved more generally.

1.4 We suggest that the immediate changes required to ensure that the provisions are compliant with EU law (intended for Finance Bill 2013) should be viewed as an interim step and the opportunity be taken to undertake a full review in 2013 and beyond. A precedent for this approach is the reform of the CFC rules: interim measures were introduced in Finance Act 2011, before the substantive reform enacted in Finance Act 2012.

2 Application of EU law

2.1 The proposals in the consultation document are a response to the infraction notices (in the form of reasoned opinions) received from the EU Commission in February 2011. Although the document says that the proposals include other improvements to

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the transfer of assets code and section 13, these are disappointingly limited. We will be responding to the more general changes in a separate paper.

2.2 The Commission considers that the difference in tax treatment between domestic and cross-border transactions as a result of section 13 and the transfer of assets code restricts two fundamental principles of the EU's Single Market: freedom of establishment (article 49 of the Treaty of the Functioning of the European Union (TFEU)) and the free movement of capital (TFEU Article 63). The Commission further considers that these rules are disproportionate in that they go beyond what is reasonably necessary in order to prevent abuse or tax avoidance and any other requirements of public interest.

2.3 The CIOT agrees that both the transfer of assets code and section 13 restrict the freedom of establishment and the free movement of capital. It is, however, important to identify which of these two freedoms are engaged and address each separately in relation to each of the two sets of rules. In our view, both treaty provisions could apply to each of the transfer of assets code and section 13.

2.4 In this connection, we draw your attention to the ECJ judgement in *Glaxo Wellcome v Finanzamt* (Case C-182/08). At paragraph 50 of the judgement it is said:

> 'In addition, since the purpose of the legislation at issue in the main proceedings is to prevent non-resident shareholders from obtaining an undue advantage directly through the sale of shares with the sole objective of obtaining that advantage, and not with the objective of exercising the freedom of establishment or as a result of exercising that freedom, it must be held that the free movement of capital aspect of that legislation prevails over that of freedom of establishment.'

2.5 The CIOT considers that this reasoning applies to the transfer of assets code. As its name implies, that code is directed at transfers of assets, as a result of which income arises to non resident persons. It does not refer to companies specifically and nor does it refer to business profits. As a result, the CIOT's view is that capital is the principle freedom engaged by the transfer of assets code. However, the freedom of establishment will remain relevant and potentially engaged. The fact that there is no *de minimis* exemption to the transfer of assets code is another reason why both Treaty freedoms are engaged.

2.6 Section 13 is subject to a *de minimis* exemption in that shareholders with less than 10% of the company are excluded. But otherwise it applies regardless of the size of participation. The recent case of *Scheunemann v Finanzamt Bremerhaven* (Case C 31/11) has indicated that the threshold for definite influence is 25%. If this is correct, with the current lower *de minimis* of 10%, section 13 engages both capital and establishment freedoms.

2.7 The distinction between capital and establishment is important. One reason for this is that the capital movement freedom extends to movements to or from countries outside the EU, whereas establishment does not. In this context it is worth noting that British Overseas Territories count as third countries (*Prunus v Directeur des services* [2011] STC 1392).

2.8 The CIOT agrees with the Commission's view that the transfer of assets code and section 13 are disproportionate. The CIOT is well aware that prevention of abuse and the need to ensure a balanced allocation of taxing rights can justify anti-avoidance legislation and thus permit the freedoms to be overridden. But anti-avoidance legislation can be so justified only if and insofar as it 'specifically targets wholly

artificial arrangements which do not reflect economic reality and whose only purpose is to obtain a tax advantage' (see, for example, *Glaxo Welcome v Finanzamt* Case C-182/08, at paragraph 89).

2.9 The CIOT considers the concept of 'wholly artificial arrangements' is of fundamental importance. Originally formulated in relation to establishment (*Cadbury Schweppes plc v H M Revenue & Customs (HMRC)*, C 196/04), it applies to capital (*Glaxo Welcome*, supra), and also to other freedoms (see, for example, *SIAT v Belgium*, Case C - 318/10).

2.10 The CIOT notes that paragraph 2.14 of the Consultative Document makes reference to the analysis of *Cadbury Schweppes* in Annex I of the CFC consultative document issued in June 2011. The CIOT broadly agrees with the following conclusion at paragraph 1.10 of that Annex:

> 'the term 'wholly artificial arrangements' is to be taken to refer to arrangements that do not relate to genuine economic activities pursued through an actual establishment in the host Member State.'

2.11 However, it is to be pointed out that that summary is based on the reasoning in *Cadbury Schweppes* and that that reasoning is itself founded on the objectives of the freedom of establishment, specifically the need to assist economic and social interpenetration within the EU. This is as referred to in paragraph 2.9 of the present consultation. But these issues are, in the view of the CIOT, immaterial to freedom of movement of capital: for that freedom has a different underlying rationale. However, as noted above, the restriction of anti-avoidance legislation to wholly artificial arrangements applies just as much where freedom to move capital is engaged as where freedom of establishment is engaged. *Glaxo Wellcome* indicates that with capital, the issue is simply whether the legislation is targeted solely on arrangements which do not reflect economic reality and whose sole objective is to secure the tax advantage at issue (see especially paragraphs 92 and 93 of the judgement).

2.12 We recognise that in recent judgements the ECJ has held that anti-avoidance legislation can more readily be justified in relation to third country capital movements than within the EU. This is because of the different legal context which operates as regards third countries. In particular, the differences in treatment in these cases have been justified by difficulties in obtaining information and the legislation being considered has been drafted on a basis that makes it clear that this is the justification for the difference in treatment. However, the nature of the UK provisions does not suggest that they could be easily justified on this basis. Further, the different legal context is far from meaning that anti-avoidance legislation directed at third countries will be per se upheld (*Santander v Directeur* Cases C-338/11 to C-347/11). In particular, it will not be upheld insofar as it goes further than is necessary to achieve the objective by which it is justified (*Haribo v Finanzamt Linz* (2011), Case C- 436/08).

2.13 The CIOT is also aware that the so-called 'standstill' is widely held to preclude the application of the capital movement freedom to the transfer of assets code and section 13 in relation to movements involving third countries. However, this point is not conclusive, as the standstill only applies to certain types of capital movement, most notably direct investment. It does not apply to gifts and endowments, which are an apt description of many transactions within the transfer of assets code. A further point is that the standstill does not apply to restrictions enacted after 1993, and so would not save post 1993 amendments to section 13 and the transfer of assets code.

2.14 In the context of gifts and inheritances a point also worth making is that the ECJ has decided both a usufruct and a gift to a Liechtenstein foundation are movements of

capital (*Schröder v Finanzamt Hameln* C-450/09; *Ospelt v Schössle Wesseberg Familier Stiftung* C-452/01). It is therefore difficult to argue that a gift into trust is not a movement of capital, albeit that there is as yet no decision of the ECJ on the point.

3 Problems with the proposals in consultation document

3.1 The amendments for which draft legislation is published in the consultation document will, if enacted, come into force on 6 April 2012 and are the amendments designed to make the transfer of assets code and section 13 compliant with EU law. In our view, the changes proposed will not make the relevant provisions compliant with EU law. The provisions will continue to deter UK-residents from exercising the free movement of capital and/or the freedom of establishment where the transaction is neither artificial nor designed to circumvent UK tax legislation. The provisions will continue to go beyond what is permissible by way of protecting the tax base from artificial tax avoidance.

3.2 In assessing the proposed amendments, an important preliminary point is that the transfer of assets code already has a purpose or motive defence (ITA 2007 ss 736-42) whereas section 13 does not. With transfer of assets, therefore, the issue is whether the existing defence goes far enough – that is whether it confines the transfer of assets code to wholly artificial arrangements with no purpose other than the avoidance of tax. The CIOT believes the defence does not have this effect and this, plainly, is the view of the Commission. With section 13, by contrast, this issue does not arise at all, for currently section 13 has no motive defence.

3.3 Two other distinctions between the codes must be kept in mind. The first is that the transfer of assets code applies only to individuals: in other words the transferor charge applies only if a UK resident individual has power to enjoy the income of an overseas entity or receives a capital sum from it. Section 13, by contrast, applies to all forms of UK taxpayer. The second point of distinction is that the transfer of assets code applies regardless of the form the overseas entity takes: it can be a company, a trust, or a foundation. Section 13, by contrast is confined to close companies.

3.4 These differences, and particularly that in paragraph 3.2 above, are reflected in the different proposals for the two codes in the draft legislation. Thus:

1 In relation to transfer of assets, one change only is proposed (on the EU aspect), namely insertion of a new s742A providing relief for economically significant activities.

2 In relation to s13, four new exemptions are proposed, exempting:
   - i assets used for the purposes of economically significant activities carried on through a foreign permanent establishment;
   - ii assets effectively connected with a business establishment outside the UK and used in a trade or for economically significant activities;
   - iii assets whose acquisition, holding, and disposal is untainted by tax avoidance; and
   - iv furnished holiday lettings.

3.5 The CIOT does not believe the proposed economically significant activity concept will by itself make either code compliant with EU law. This is because that concept is derived from case law on establishment and not from case law on capital. As indicated in paragraph 2.11 above, capital has a different *raison d'etre* to establishment, and legislation can only be upheld, at least within the EU, if it is

targeted on arrangements which do not reflect economic reality and whose only purpose is to secure the tax advantage at issue.

3.6 However, even on the basis that it is establishment rather than capital which is at issue, the CIOT doubts whether the draft legislation would be EU compliant. This is for the following reasons:

1 In relation to transfers of assets, non arms length transactions are excluded. Such transactions may, obviously, be wholly artificial, but equally can give rise to genuine economic activity.

2 Businesses which consist of the making of investments are excluded. The CIOT considers there is no basis for the blanket exclusion of such businesses. An investment business can be conducted from premises, employ staff and use equipment. This is particularly true where the investment is a real estate portfolio, but the same is the position with actively managed share portfolios.

3 A particular consequence of excluding investment businesses is that overseas holding companies are also excluded. If so, the absurd result is reached that an operating subsidiary may carry on economically significant activities whereas its parent may not, with the result there will be exposure under the transfer of assets code or section 13 when the parent receives dividends or disposes of the subsidiary.

4 Activities carried on in the UK are excluded from being economically significant activities. The CIOT sees no justification for this as, quite plainly, activities carried on in the UK are not per se abusive or wholly artificial.

5 No attempt is made to address features of section 13 and the transfer of assets code which are particularly disproportionate.

3.7 In relation to this last point, the current provisions are all or nothing and are in several respects inherently unfair. We will address this issue again in our subsequent comments on a wider review of the provisions. However, the point is relevant in an EU context because the current provisions are disproportionate and proportionality is an important consideration in EU law. In this context we refer in particular to TCGA 1992 section 79B, which imputes treaty-protected section 13 gains to trustees, and ITA 2007 section 727 which, on one view at least, can impose tax on a transferor who is incapable of benefiting from the income on which he is taxed. Another example of disproportionality is that section 13 taxes a UK shareholder who has owned share for only one year on all the gains arising from a property which has been owned by the company for, say, 50 years. Another example arising in relation to transfer of assets is that on the wording of the legislation the transferor can be taxed in principle on the whole of the non-resident’s income, even if he only transferred a very small proportion of the initial investment.

3.8 The fact that the proposed defences are also all or nothing defences, means that they fail to take account of the fact that a more proportionate response may be to permit an apportionment. Another related point is that the provisions do not raise the possibility of being able to rely on the economically significant activity test in relation to some operations and the motive defence in relation to others. For example, one could have a case where a business is established abroad which does not satisfy the motive defence but does satisfy the economically significant activity test. There could be other associated operations (for example the insertion of a foreign parent for foreign tax reasons) which viewed in isolation would satisfy the motive defence but not the economically significant activity test. It surely cannot be right that a tax charge

should arise in such a case.

3.9 The CIOT believes the Commission is likely to share its view about the economically significant activity concept. A broadly similar approach to that concept was taken in amendments to the CFC legislation made in 2007(TA 1988 section 751A). The Commission considered that these amendments did not eliminate the discriminatory features of the CFC regime (Commission Press Release, 20 May 2011).

3.10 As indicated above, the proposed relief for economically significant activity is the only amendment proposed to the transfer of assets code to make it EU compliant. If the proposed section 742A is enacted the issue will be whether it, together with the existing sections 736-42, will make the code EU compliant. Particularly as section 742A does not address the freedom to move capital, the CIOT considers it will not.

3.11 In the case of section 13, the proposed qualifying economic activity relief needs to be read with the other proposed amendments detailed in paragraph 3.4(2) above.

3.12 The CIOT broadly welcomes the simple motive or purpose test which is proposed as section 13(5)(cc). This is much clearer than its equivalent in the transfer of assets code. Nonetheless the CIOT does not consider that this, on its own, it is sufficient to make section 13 EU compliant. This is for the following reasons:

1. As respects establishment, it fails to ask whether, as well as tax avoidance purposes, there is also an absence of genuine economic activity (paragraph 2.10 above)

2. As respects capital, it is not restricted to schemes or arrangements whose sole purpose is tax avoidance.

3.13 The CIOT does not consider the other new reliefs to section 13 bear greatly on EU companies. Given this, the CIOT's conclusion is that even the combined effect of all the section 13 changes are likely to prove insufficient to make section 13 EU compliant.

4 What can the Government do?

4.1 The CIOT recognises it is extremely difficult to protect the UK tax base in a way which complies with EU law. However, it is important to ensure that these provisions are amended to make them clearly compliant with EU law. It would be most unsatisfactory if the rules were amended in such a limited way that compatibility with EU law was not clear. Whether or not the EU infringement proceedings were halted by the changes, lack of clarity on the point would inevitably result in continued claims by taxpayers based on an EU defence, which would continue the uncertainty for taxpayers and HMRC.

4.2 In our view, to be compatible the codes would have to have defences to deal with both genuine cases of freedom of establishment and freedom to move capital.

4.3 If we ignore provisions attributing rights of connected participators to a participator, consideration could be given to drawing a distinction between the EU and countries outside the EU. Subject to paragraph 4.4, the difficulty, of course, is that the line between anti-avoidance legislation which can be justified by making such a distinction and such legislation which cannot be is ill defined: see paragraph 2.12 above.

4.4 The CIOT considers that in relation to section 13 the third country problem may be overcome if the *de minimis* is raised from 10% to 25%. The recent case of *Scheunemann v Finanzamt* (Case C31/11) indicates this should mean establishment is the only freedom engaged. If that were done, the CIOT would then suggest the legislation be restricted in relation to EU companies to wholly artificial arrangements with no purpose other than tax avoidance. This would also enable a distinction to be drawn between EU and third countries. If similar thresholds were placed on the transfer of asset code, similar distinctions could also be justified on the same basis. We would also note in this context that 25% is often a significant voting threshold (as it is in the UK) as a matter of the company law of non-UK jurisdictions, whereas 10% is far more rarely so. As such a 25% threshold would have some further objective justification as the sort of level of votes below which a shareholder has no practical influence over the affairs of the company.

4.5 In particular, in relation to transactions wholly within the EU, the ECJ has clearly said that what is compatible with EU law is something that applies only to 'wholly artificial arrangements'. It is difficult to see what other formulation of the test that the Government could use to ensure the provisions are compatible with EU law. It should be explicitly provided that the phrase be construed in accordance with ECJ jurisprudence.

4.6 In relation to the transfer of assets code, the CIOT considers that the best solution is a radical rethink of the whole code. As mentioned above, the CIOT intends to submit a further paper dealing with this, and the remaining issues raised by the consultation in due course.

5 The Chartered Institute of Taxation

5.1 The Chartered Institute of Taxation (CIOT) is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

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