Tax Journal/2021/Issue 1517, 29 January/Articles/Analysis — EU freedoms in cross-border transactions – Tax Journal, Issue 1517, 12

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Analysis — EU freedoms in cross-border transactions

Insight and analysis

Dominic Stuttaford

Norton Rose Fulbright

is a partner at Norton Rose Fulbright LLP. He specialises in the tax aspects of corporate finance with a particular interest in the insurance and technology sectors. Dominic's experience includes mergers and acquisitions of public and private companies and group restructurings. Email: dominic.stuttaford@nortonrosefulbright.com; tel: 020 7444 3379.

Greg Branagan

Norton Rose Fulbright

is a senior associate in the corporate tax team at Norton Rose Fulbright LLP. He advises on a variety of corporate transactions with a focus on the insurance and technology sectors. He also has experience advising on various employment tax and incentives matters. Email: greg.branagan@nortonrosefulbright.com; tel: 020 7444 2896.
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Speed read: The recent decisions in Volkerrail and Gallaher raise interesting points around the primacy of EU law and the extent to which an EU member state has the right to seek to protect its tax base and prevent multinational taxpayers from claiming double deductions. While the First-tier Tribunal in Volkerrail took a very strict approach in adhering closely to existing CJEU case law, the decision of the Upper Tribunal in Gallaher (and the referrals that were intended to have been made) acknowledges that the application of EU law to UK tax matters is not a straightforward task — and it is one that is now more complicated following the end of the Brexit transitional period.

Buried among the flurry of activity leading up to the end of the Brexit transitional period on 31 December 2020 were two judgments by the First-tier Tribunal (FTT) and Upper Tribunal (UT) (respectively) relating to the interrelation between UK tax legislation and two of the fundamental freedoms relating to the operation of the European Single Market. It is of course these freedoms (and cases taken to enforce them) that historically have had such an influence on the UK direct tax system. The first decision to be released was *Volkerrail Plant Ltd & Ors v HMRC* [2020] UKFTT 476 (TC), which considered the denial of group relief claims in respect of losses incurred by a UK permanent establishment (PE) of a Dutch resident entity. The second decision was *Gallaher Ltd v HMRC* [2020] UKUT 354 (TCC), which was an appeal against a FTT decision around the denial of no gain/no loss relief under TCGA 1992 s 171 and CTA 2009 ss 775 and 776 in relation to certain transfers of IP and shares within an EU-wide corporate group.

Volkerrail

This appeal related to group relief claims of c.£36.5m in respect of losses incurred by a UK PE of a Dutch resident entity in 2007 and 2008. The claim was denied by HMRC because the losses were deductible (and, in fact, they had largely been deducted) in the Netherlands as a result of the relevant entities being part of a fiscal unity. As a result, under the UK statutory provisions, the losses could not be used against UK profits of the rest of the group under ICTA 1988 s 403D(1)(c) (which, broadly, precluded surrender of losses by a PE to the extent deductible or otherwise allowable against non-UK profits of the company or any other person).

The appellant claimed the denial was a restriction on the freedom of establishment in line with the CJEU decision in *HMRC v Philips Electronics UK Ltd* (Case C-18/11) (*Philips*). To summarise the decision in *Philips,* the CJEU held that:

1. a domestic company and a foreign company with a UK PE were objectively comparable and so s 403D(1)(c) was a restriction on the freedom of establishment;
2. CJEU case law was clear that the prevention of double deductions was not sufficient to justify the restriction because the use of losses in another jurisdiction had no impact on the UK taxing rights;
3. it is not for the UK to restrict the use of losses on the grounds of a potential double deduction because it has the primary right to tax the profits;
4. while not relevant (as the justification for the restriction had not been established), the restriction would not, in any event, be proportionate because it went beyond what was necessary to prevent double deductions; and
5. the only suitable remedy was a disapplication of s 403D(1)(c) where the freedom of establishment was breached.

Given the decision in *Philips*, one may wonder why HMRC sought to argue that the losses of the PE could not be surrendered. The reason for this was the 2018 decision in *NN A/S v Skatteministeriet* (Case C-28/17) (*NN*) which held that a restriction on the double use of losses (this time between Sweden and Denmark) could be permissible as part of a legitimate public policy objective to prevent the double deduction of losses.

The key issues and decision

The two key issues that fell to be determined by the FTT were therefore: (i) whether the CJEU decision in *NN* had meant the decision in *Philips* was no longer binding on the UK courts; and (ii) if *Philips* was to be followed and a restriction on the freedom of establishment identified, what the appropriate remedy would be.

The FTT held that *Philips* had not been overtaken by *NN* because the two cases could be distinguished on their facts. As the facts in *Philips* more closely matched the facts of the current case, it was clear that, as a matter of EU law, s 403D(1)(c) restricted the freedom of establishment in a manner that was not justifiable or proportionate. Furthermore, the FTT felt bound to apply *Philips* in relation to the appropriate remedy for this restriction and therefore held that s 403D(1)(c) should be disapplied in its entirety. The CJEU in *NN* had not expressly overruled *Philips*; this was despite the fact that the AG opinion in *NN* had suggested that it was perhaps appropriate to moderate the decision in *Philips*.

In a post-BEPS world, the surprising outcome for the taxpayer was the ability to claim a double deduction: a

Tax Journal, Issue 1517, 12 at 13

deduction against profits in the Netherlands and relief against profits of UK group companies. While because of these cases, the issue is purely theoretical, one may speculate what would happen if the same issue was raised afresh now. The Dutch 'recapture' mechanism, designed to claw back the benefit of losses to the extent profits subsequently arise in the overseas jurisdiction, did not apply due to the removal of the relevant entity from the fiscal unity once the UK PE moved to profit. The UK prohibition on use of losses has also been narrowed in scope since the accounting periods considered in *Volkerrail*. As a result of the decision in *Philips,* CTA 2010 s 107 (the rewritten destination of s 403D(1)(c)) was amended by FA 2013 to the effect that the UK PE's losses will only be available for surrender to the extent they do not (and amounts brought into account in their calculation do not) correspond to amounts actually deducted from, or otherwise allowed against, non-UK profits of any person.

Gallaher

In 2011, the taxpayer is part of a large international group with an immediate Dutch parent. It had transferred certain IP rights to a Swiss entity within the same EU group for c.£2.4bn (the 2011 transfer). In 2014, the taxpayer had transferred the shares in an Isle of Man subsidiary to its Dutch parent entity for c.£2.1m (the 2014 transfer). As the transferees in both the 2011 transfer and the 2014 transfer were not UK taxpayers, it was not possible for the transfers to qualify for the no gain/no loss treatment contained in TCGA 1992 s 171 or CTA 2009 ss 775 and 776 (the group transfer rules). It is also assumed that the 2014 transfer did not qualify for relief under the UK substantial shareholdings exemption regime (although it is noted that the conditions for relief have been relaxed significantly since the date of the transfer). HMRC therefore issued partial closure notices which required corporation tax to be paid by the taxpayer in relation to the gains/profits made as a result of these transfers. The taxpayer subsequently appealed these partial closure notices on the grounds that the group transfer rules operated in a manner contrary to EU law (specifically a restriction on the Dutch parent company's freedom of establishment in the UK and the freedom to move capital), in that in both cases, they required the transferee of the asset to be within the charge to UK tax.

In the FTT decision ([2019] UKFTT 207 (TC)), it was held that the free movement of capital was not relevant as the transactions related to shareholdings which conferred definite influence over the relevant entities and so, in line with existing CJEU case law, it was not possible to rely on the free movement of capital freedom. In relation to the freedom of establishment of the taxpayer's Dutch parent company, the FTT held that the imposition of an immediate charge to corporation tax in relation to the 2011 transfer was not contrary to EU law on the basis that the group transfer rules would have applied in exactly the same way (as the transferee was Swiss), regardless of whether the taxpayer's parent company was a UK tax resident entity or (as was the case) a Dutch tax resident entity. However, in relation to the 2014 transfer, it held that an immediate charge to corporation tax was contrary to EU law and, in the absence of the ability to interpret UK law in a way that was consistent with EU law, the legislation imposing the charge to tax had to be disapplied, removing the tax charge entirely. This also meant that if the transferee company left the group, there was no recapture of the deferred gain.

The key issues and decision

The FTT decision was then appealed both by the taxpayer and HMRC in relation to five key areas:

1. whether the freedom of movement of capital was relevant;
2. whether the 2011 transfer amounted to a restriction of the freedom of establishment;
3. if so, whether any such restriction was proportionate;
4. if there was a restriction on the freedom of establishment, whether a conforming interpretation should be applied to the group transfer rules, whether the relevant legislation should be dis-applied entirely; and
5. whether the case should be referred to the CJEU.

Both parties agreed that a conforming interpretation should be applied, and neither endorsed the view of the FTT that the provision should be disapplied entirely. The taxpayer argued that this should lead to a full deferral of the tax liability until such time as the assets were directly or indirectly disposed of to a third party, while HMRC's view was that a payment by instalment mechanism should be applied (in line with the amendment in the FA 2020 response to the FTT decision).

The UT ultimately decided that, in line with the principles summarised in *Coal Staff Superannuation Scheme Trustees Ltd v HMRC* [2017] UKUT 137, because the matter of EU law was critical to the decision and because the UT was not able to resolve the issues itself with 'complete confidence', it was necessary to refer the matters to the CJEU. Of particular note are the UT's specific questions relating to:

- the nature of the remedies that should be applied to resolve any potential breach of EU law (which picks up the points noted in the preceding paragraph); and
- whether EU law or national law takes precedence, i.e. whether any remedy needs to ensure the least amount of interference with the relevant EU law, or whether is it only required to amend the national law to the minimum extent possible to bring the law into compliance with EU law.

Points of interest

The two cases present an interesting comparison of the interrelation between EU law and national law. In *Volkerrail*, the FTT was clear that the issue had already been determined by the CJEU in *Philips* and so used *Philips* as the sole basis for the decision. However, HMRC raised interesting arguments around the impact of *NN* and whether, in this new anti-BEPS era, the need to prevent the use of tax losses twice has become a much more important factor in applying the EU freedoms. As such, an appeal by HMRC seems possible.

In *Gallaher*, while there was no suggestion of any avoidance, questions have been raised around whether the EU law or national law takes precedence and the extent to which member states are entitled to take steps to protect their taxing rights. In addition, in light of

Tax Journal, Issue 1517, 12 at 14

the legislative change made in FA 2020 to include a payment by instalment regime for various transfers to non-UK entities which fall outside the scope of relieving provisions, it will be interesting to see whether the CJEU agrees that such a mechanism is sufficient to ensure that any restriction on the freedom of establishment is proportionate.

Impact of Brexit

As the transitional arrangements between the UK and EU have now ceased, there is a broader question as to the extent to which any judgment of the CJEU will be binding on the UK going forward. The position in relation to *Gallaher* itself appears relatively simple: the CJEU will retain jurisdiction to decide on the matters put before it by the UT (which assumes the referral was submitted prior to the end of the transitional period) pursuant to article 86 of the UK Withdrawal Agreement (as incorporated into UK law by the European Union (Withdrawal Agreement) Act 2020 s 5).

However, to the extent there have been other taxpayers who have undertaken similar transactions (and are now seeking to reclaim any historic tax paid or argue none should be payable), the impact of any decision by the CJEU in relation to *Gallaher* is less clear. This may depend on whether the taxpayer has commenced proceedings within the terms of the European Union (Withdrawal) Act 2018, which provides that if a taxpayer has yet to commence proceedings which seek to rely on EU law, such taxpayer will no longer be able to rely on such arguments. In addition, pursuant to s 6(1) of that Act, courts and tribunals will no longer be bound to follow any decisions of the CJEU, although they will still be entitled to have regard to any such decisions so far as such decisions relate to matters before the court or tribunal. As previously mentioned in this journal ('Brexit: retained EU law' (Ashley Greenbank), *Tax Journal*, 9 October 2020), it appears likely that the exact scope of retained EU law will be litigated for years to come, particularly in the event that situations arise where taxpayers which are in similar circumstances are treated differently due to the application of EU law to one, but not both, set of circumstances.

Finally, it is also worth noting that *Gallaher* may well be the last referral of a direct tax matter to the CJEU. It is therefore perhaps fitting that the matters to be determined by the CJEU include the question around whether the EU freedoms or national law should have effective primacy and what remedy should be applied if the EU freedoms do apply.

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- Cases: *Gallaher Ltd v HMRC* (7.1.21)
- Brexit: retained EU law (A Greenbank, 9.10.20)

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