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Memories of David Oliver (JDBO)

As announced in this *Review* in 2019,[1] David Oliver (or JDBO as he was widely known) sadly died on 13 June 2019. David was joint editor of this *Review* from 1984 until 2008 and, prior to that, assistant editor from 1980. David was a valued member of the *Review*'s Advisory Panel from 2008.

The initial plan for this issue was to produce a composite celebration of David Oliver's contribution to the tax community, written as a joint editorial. However, the invited contributions were so personal and heartfelt that we have decided to leave them as separate comments and to attribute them. Here then are our thoughts and memories of David as a colleague, teacher, mentor, member of the tax community and friend. He is very much missed. Readers may also be interested to see a note about David's contribution published in 2008 on his retirement[2] and our special issue dedicated to David in this *Review* in 2011.[3]

Tax professional

After an early stint in industry, David spent his entire professional career in what is now PwC. He had a very broad knowledge of tax but his particular expertise concerned international taxation and in particular issues relating to double tax treaties.

His expertise attracted a constant flow of requests from within the firm for help with difficult or novel tax problems in the international sphere. Despite a heavy workload, he would always make time available to help others, particularly in the case of junior members of staff who were finding their way in the world of tax. In that regard he was, for many who passed through the firm, a fantastic mentor. He had a warm and infectious enthusiasm, which really did make the process of dealing with complex tax problems fun. He would always adopt a thoughtful and considered approach, meaning that especially difficult tax problems in particular would be considered from different perspectives or at different levels, leading to much more complete answers. The combination of his warm enthusiasm, his modesty, his willingness to help and his penetrating and thoughtful analysis made him an inspiration to many.

Richard Collier

Fellow international tax enthusiast and joint editor of the BTR

David Oliver had an extremely long association with this *Review*, writing the first of many articles in 1970, becoming assistant editor in 1980, then joint editor from 1984 to 2008. A special issue in his honour was published in 2011, the editorial saying "[t]he editors and authors are pleased to offer this special issue as a small thank you to David for all these contributions to the tax community".[4] I worked closely with him throughout much of this period. He was a person who did whatever needed doing for the *Review* without any fuss; it was only afterwards that you

[1] Joint General Editors, "Editorial" [2019] BTR 581.
[2] J. Freedman, "Editorial" [2008] BTR 197, 198.
[3] [2011] BTR 603–717.
[4] The Editors, "Editorial: Introduction to the Special Issue in Honour of David Oliver" [2011] BTR 603.

realised how much time and thought he must have devoted to it. His particular interest, which we shared, was tax treaties and I remember many interesting discussions that we had over regular lunch meetings and in correspondence. I was recently clearing out some old papers and came across some correspondence with David in 1983 following the unexpected decision of the Canadian Supreme Court that the reference to domestic law in Article 3(2) of the OECD Model was static rather than ambulatory. We were discussing whether there were any UK statutory provisions, particularly some obscure transitional provision in 1966, that assumed that it was ambulatory, which depended on whether the meaning of "interest" in domestic law included interest within the definition of distribution. David wrote me a four page letter on the topic offering some thoughts but saying "though quite how I would tie them into art 3(2) I am not clear about at present but hope you will be able to draw some conclusions from them". I quote this because it was typical of him to leave no stone unturned trying to get to the bottom of any problem. I always thought that his combination of a law degree (we were both at Trinity College Cambridge but we did not overlap) and being a chartered accountant was an ideal one for a tax career.

David was involved in tax teaching as a Visiting Professor on the London University LLM course (I remember we used to do a double act on non-discrimination) and after his retirement he increased his teaching commitment as a visiting lecturer and a member of the Committee of Management of the Centre for Tax Law at Cambridge University, in the course of which he wrote a book with Peter Harris, *International Commercial Tax*.[5]

He was a friend and colleague who made an enormous contribution to the tax community.

John Avery Jones

JDBO: eagle-eyed editor

J. David B. Oliver, for many years joint editor of this *Review*, was a quiet, gentle, unassuming chartered accountant of charming nature with a dapper sense of dress (for instance, he always wore a bow tie). He had an encyclopaedic knowledge of tax. When I first met him in the late 1970s, he was a tax partner in what was then Deloitte Plender Griffith with additional responsibility for organising training for the tax department.

He was later approached to join the editorial board of the *Review*, to which he also made regular contributions as an author.[6] He had an eagle eye when reading proofs and was a much valued colleague.

Erica Stary

Mentor

I first met David when I submitted an article to this *Review*. The article examined the relationship between financial accounting and taxation[7] and there was no-one better to give this very junior academic lawyer comments than David, who had studied both law and accounting. His

[5] P. Harris and D. Oliver, *International Commercial Tax* (Cambridge: CUP, 2010).
[6] See the works referred to in [2011] BTR 603–717.
[7] J. Freedman, "Profits and Prophets: law and accountancy practice on the timing of profits" [1987] BTR 61, 104 (two parts).

encouragement was essential to the refinement and eventual publication of that article, which was important in getting me started with writing academic articles and helping me to obtain tenure at the LSE. It was typical of David that despite being a busy tax professional and editor of this *Review* he managed to find time to help a junior entrant into academia with an article that was very rough around the edges. Once I had discussed tax with David, I was not going to escape and I soon found myself drawn (very happily) into the BTR editorial team. David tutored me in the process of assessing contributions, refereeing and securing referees, proofreading and all the other more arcane procedures that go on behind the scenes to produce a journal. He was always encouraging, kind and gentlemanly, but simply assumed one had the same level of interest in, knowledge of and enthusiasm for tax as he had, so I tried not to start a conversation with him about taxation without doing my homework first!

When David asked me to take over as editor of this *Review* from him I was thoroughly alarmed. I knew I could not step into his shoes, but with his continuing support and lots of help from others I found it was possible to edit the *Review* my way. We were fortunate to enlist the help of Jane O'Hare, who ably picked up David's copyediting duties, and Jane has commented on how courteous, kind and helpful David was whenever she spoke to or contacted him for advice. If David did not like some of the things we did once he ceased to be editor he never showed it and he was always generous with his counsel as a member of the advisory board. The wisdom he has imparted will continue to guide the editors.

Judith Freedman

Colleague and collaborator

It was with great sadness that I learned of JDBO's passing. It is now more than eight years since the special issue in this *Review* in his honour to which I contributed a small piece.[8] That piece recounts a special ten year period in my life during which I shared an office, a course and authorship of a book with JDBO at Cambridge. As the piece noted, by that stage JDBO had already retired from activities at Cambridge. After that, his visits to Cambridge became infrequent. One particularly sad visit was following John Tiley's passing in 2013. For 10 years we had been a troika, a triad, triumvirate, trinity, some might even say an academic ménage à trois, but that event underlined that that time had passed.

I was in contact with JDBO early in 2019 regarding the second edition of the book we published together, which sadly he could not contribute to but was pleased to see was nearly ready for production. He desperately wished to attend Judith Freedman's [non-] retirement conference in May 2019 but was not able, due to ill health.

Colleagueship and comradery are strange affairs that sadly some of us do not experience at a deep level in our daily lives. Bonds can be formed through celebration, endeavour and, unfortunately, distress. I am fortunate to have a new colleague at my work, whose company I also enjoy very much, but that does not replace the warm and constant reflections on a different time. When I look back over my (lengthy) career, I can see that the time with JDBO and John Tiley was special, and never in that career have I laughed as much at work as I did through those years, and never has my academic work developed as fast as it did then. I write this on my 55th

[8] P. Harris, "A gentleman and a scholar: 10 years with JDBO at Cambridge" [2011] BTR 604.

birthday. This evening I shall sit with a glass of champagne, a pair of large spectacles and donning the biggest and brightest bow-tie I can find, imagining that JDBO is there with me toasting happy times.

Peter Harris

Teacher

I had the great pleasure of being a student of David Oliver's on the *International Commercial Tax* course during my LLM at Cambridge in 2003–2004. David co-taught the course with Peter Harris and he usually wore his signature bow tie. The two of them frequently engaged in extended, highly informative, and entertaining debates on the international tax subject de jour. I vividly remember one especially animated class on triangular situations when I am convinced David and Peter forgot for several minutes that there were students in the room! David was an engaging teacher, with an infectious enthusiasm for his subject, of which he was clearly a master. Our paths crossed many times after Cambridge, at various conferences and on BTR matters, and it was always a personal highlight to catch up with him. He is fondly missed.

Glen Loutzenhiser

Contribution to IFA

David Oliver was a member of IFA's Executive Committee from 1994 until 1999 and Vice President of IFA from 1996 until 1999. From 2002 until 2008 he was Chair of the Nominations Committee, involved in the procedures for the establishment of several new IFA Branches.

In 1998 David was President of the IFA Congress London that attracted more than 1,600 participants and more than 450 accompanying persons, one of the most successful congresses at that time. That London Congress also included a two-way video conference link between an OECD Panel in Ottawa and the IFA Panel in London for the seminar on the tax consequences of information technology, allowing a transatlantic online discussion on the tax problems arising from modern information technology (including the internet) on electronic trade—a "webinar" *avant la lettre*.

Last but not least, David was an excellent chairman in many sessions during IFA Congresses and a good friend of numerous IFA Members. It was a privilege and a pleasure working with him. IFA is grateful for his invaluable contribution to our Association and appointed him to Honorary Member of IFA at our 2014 Congress in Mumbai.

IFA secretariat ☞

The Editors

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Current Notes

The gig and sharing economies: millions of new entrepreneurs; billions in lost VAT

Introduction

The gig and sharing economies, powered by online marketplaces, have freed millions of individuals to offer their labour and underutilised assets to businesses and consumers across the world. Mastercard[1] has estimated that the two economies will double in value from US$204 billion in 2018 to US$452 billion by 2025.

But the success of these economies is threatening to undermine governments' tax receipts due to structural issues in the tax code. Individuals working through the platforms are today largely regarded as self-employed, contracting with the consumer, whilst the marketplaces take on an agency role. This means there is no employer to collect income tax (and other employer/employee taxes), or to charge VAT on the services. Instead, it is down to the individual to self-declare both. For VAT, where the UK has the highest threshold when considered in relation to other comparable countries, this means that most income from the gig and sharing economies goes VAT-free. The tax losses aside, this creates a competitive handicap for traditional businesses, be they taxis or hotels, which are losing out to non-VAT charging gig ride-sharers or sharing house-renters.

Gig and sharing economies VAT issues: practical remedies

This note focuses on the VAT issues relating to the gig and sharing economies. These issues include:

1. a definition of the two markets, explaining the differences between them and the relevant VAT nuances;
2. an explanation of VAT liabilities, and the challenges for tax authorities, individuals and marketplaces;
3. a spectrum of potential remedies for these issues, from the voluntary to the mandatory;
4. the attractions and challenges of making marketplaces responsible for VAT collections in the form of withholding taxes or as the VAT principal;
5. a review of how related regulatory and employment cases in this area are pointing toward more VAT liabilities for the marketplaces; and
6. lastly, a mention of crowdfunding, a unique area of the sharing economy.

[1] Mastercard and Kaiser Associates, *Mastercard Gig Economy Industry Outlook and Needs Assessment: The Global Gig Economy: Capitalizing on a ~$500B Opportunity* (May 2019), available at: *https://newsroom.mastercard.com /wp-content/uploads/2019/05/Gig-Economy-White-Paper-May-2019.pdf* [Accessed 3 March 2020].

VAT focus: but employment and regulatory issues cannot be ignored

Income tax, employment and regulatory problems, and potential remedies, have already been widely debated in reports produced by Taylor, et al.,[2] the Office of Tax Simplification[3] and elsewhere. In the UK, IR35 rules[4] on off-payroll workers come into effect in April 2020, with a pre-launch review[5] announced in January 2020.

Nevertheless, this note includes a review of some employment and regulatory cases which are having a direct impact on UK and wider VAT policy in both economies.

Defining the gig and sharing economies

The internet, and major online marketplaces, have enabled businesses and people to buy and sell goods and services on a hugely expanding scale in the past five years. The EU Commission estimates online e-commerce is worth €550 billion per annum.[6]

The digital gig and sharing economies constitute a newly emerging subset of this online market in which individuals trade services directly with each other. This subset can be characterised as follows:

1. It covers transactions between individuals for labour-based services, skills, capital, assets and other property.
2. Transactions are temporary only, with no transfer of legal title of any goods.
3. The time and the assets being traded by individuals are often underutilised resources, and are, therefore, open to commercial exploitation.
4. It is centred around any of an expanding group of online marketplaces which enable some element of: introductions between both parties to the transaction; agreeing terms; delivery (see below); and payment processing.
5. Often, these marketplaces contract with the individual supplier, and the marketplaces act as the contracting party to provide the service.
6. Businesses, including food delivery businesses, are participating increasingly as the supplier of services.
7. The marketplaces' "facilitation" role is becoming significant in determining VAT (and other tax/employment) treatment.

[2] M. Taylor, et al., *Good Work: The Taylor Review of Modern Working Practices* (Gov.UK, Department for Business, Energy & Industrial Strategy, July 2017), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/627671/good-work-taylor-review-modern-working-practices-rg.pdf* [Accessed 3 March 2020].

[3] Office of Tax Simplification, *The "Gig" economy – what does it mean for tax?* (June 2017), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/621174/20170620_OTS_Gig_economy_Focus_paper_update.pdf* [Accessed 3 March 2020].

[4] HMRC, Policy Paper, *Rules for off-payroll working from April 2020* (updated 11 July 2019), available at: *https://www.gov.uk/government/publications/rules-for-off-payroll-working-from-april-2020/rules-for-off-payroll-working-from-april-2020* [Accessed 3 March 2020].

[5] HM Treasury and The Rt Hon Jesse Norman MP, *Off-payroll review launched* (7 January 2020), available at: *https://www.gov.uk/government/news/off-payroll-review-launched* [Accessed 3 March 2020].

[6] European Commission, *VAT for Online Businesses*, available at: *https://ec.europa.eu/taxation_customs/sites/taxation/files/vat-e-commerce-factsheet.pdf* [Accessed 3 March 2020].

Separating the gig and sharing economies

Both the gig and sharing economies are defined as enabling individuals (but also businesses) to offer their resources on very flexible terms to a whole world of potential customers that they would not have been able to reach economically in the pre-digital age. Thanks to online marketplaces, the whole process for both sides of finding and screening each other can be done securely, online. The payment processing has been hugely simplified via collecting marketplaces.

But what are the differences between these twinned markets, and what has made them so attractive to both individuals and consumers to result in such high growth?

1. *The gig economy* consists of individuals offering their time in the form of services, generally on a freelance or part-time basis. These services include: ride-sharing; professional; design; consulting; and delivery. Millions of people around the world are now participating in the gig economy, either through choice or by force of circumstance. It enables them to offer their spare time and to work flexibly around other work or family commitments to earn additional income in a potentially global market. Increasingly, they may offer their service to multiple customers and on many platforms simultaneously. In return, customers get to source extra labour, often specialised and from around the world, at short notice without incurring hiring or agency costs.
2. *The sharing economy* involves individuals or groups, renting out assets they own to customers who need them. These assets include: homes; parking; car clubs; crowdfunding; and peer-to-peer lending. The sharing economy allows individuals to generate income from underused assets, which may enable them to fund initial purchase finance. For the customer, they can gain selective access to a much wider range of services. Crucially, there is no transfer of ownership of the assets.

A summary of the various sub-sectors of both economies is set out in Figure 1.

Figure 1

Sector	**Gig or sharing**	**Physical or digital delivery**	**Examples**
Ride-sharing	Gig	Physical	Uber; BlaBlaCar; Lyft; Grab; Didi
Short-term accommodation	Sharing	Physical	Airbnb; Booking.com; HomeAway; Flipkey
Delivery services	Gig	Physical	Deliveroo; Just Eat; Eat with Me; Instacart
Household services	Gig	Physical	TaskRabbit; Handy
Professional services	Gig	Digital	Freelancer; Fiverr; Upwork
Click-work	Gig	Digital	Amazon mechanical turk
Finance, including Crowdfunding and PeP lending	Sharing	Digital	Lending Club; Lendico; Bitcoin; Ripple; Funding Circle

In terms of make-up: accommodation accounts for 54 per cent; ride-sharing 18 per cent; household services 18 per cent; on-demand professional services 7 per cent; and collaborative finance 3 per cent.

Growth is putting the gig and sharing economies on the labour law and tax radars

The value of the gig economy is expected to more than double from US$204 billion in 2018 to US$452 billion by 2025.[7] In the UK, the Trades Union Congress (TUC) estimated in the summer of 2019 that 4.7 million people now work regularly on one or more of the gig economy platforms. Two-thirds of them are aged between 16 and 34 and most are male.[8]

Both the gig and sharing economies groups have become a major concern for the tax authorities because of their growth and lack of an effective taxing model to prevent erosion of the tax base.

VAT obligations for individuals: a tax avoidance haven for the gig economy

The following section summarises the VAT position in relation to most gig and sharing economy models involving individuals as the self-employed service provider. Such service provision involves contracting via marketplaces with consumers. The writer also discusses the problems associated with the operation of VAT registration thresholds which problems can be seen as being particularly acute when compared to the traditional, offline world.

VAT liabilities for individuals: the threshold test

Self-employed individuals providing a taxable service must register for VAT when their income exceeds, or is expected to exceed, the VAT registration threshold in the previous 12 months.[9] (Many other countries use calendar-month based thresholds.) The compulsory UK VAT registration threshold is £85,000.[10] A peculiar gig-economy trap in calculating whether an individual has passed this threshold lies in such individuals having to incorporate services brought from abroad. These services include those provided by many non-resident marketplaces to individuals. For example, Uber is based in the Netherlands and its charges to its ride-sharing drivers in other countries have to be included when evaluating whether or not the threshold has been crossed.

This feature of the gig and sharing economies is at the heart of the tax challenge. Almost all individual participants are below the level of the threshold. Or, if they are not, it is difficult to determine when they cross the threshold. The gig and sharing economies have enabled millions of individuals to earn additional taxable incomes easily whilst slipping below the VAT threshold or radar of the tax authorities. Often this involves such individuals leaving or cutting down on traditional employment which is subject to PAYE/income tax and which relies on their employers levying VAT on their supplies.

[7] Mastercard and Kaiser Associates, above fn.1.
[8] TUC, *UK's gig economy workforce has doubled since 2016, TUC and FEPS-backed research shows* (Issue date 28 June 2019), available at: *https://www.tuc.org.uk/news/uk's-gig-economy-workforce-has-doubled-2016-tuc-and-feps-backed-research-shows* [Accessed 3 March 2020].
[9] VATA 1994 s.3(2) and Schs 1–3A.
[10] VATA 1994 s.3(2) and Sch.1.

This shift in the workforce is reaching proportions which are difficult to ignore: the number of self-employed workers has risen from 12.5 per cent of the workforce in 2009 to 18 per cent in 2019 according to the Office for National Statistics (ONS).[11] This loss of income tax deductions and VAT represents a fundamental and growing threat to the tax base, which funds public services and welfare payments.

VAT registration threshold clustering: magnified online

The UK operates by far the highest VAT registration threshold in the EU and OECD. This has generally been portrayed as a targeted tax subsidy for start-up businesses which are seen as a key sector for future job creation and innovation. However, it has always suited the UK Treasury to keep around 3.5 million sole proprietorships out of the tax administrative net given the low-cost benefit.

The effect is to encourage businesses lawfully (by turning down work) or unlawfully (by splitting sales into another business or receiving cash-in-hand) to supress their turnover below the threshold. There is clear evidence of a large volume of businesses "clustering" at the turnover level just below the threshold. This has been looked at by the UK Office of Tax Simplification,[12] followed by a public consultation[13] completed at the end of 2018.

The gig economy is magnifying this problem of the exemption, and the loss of tax revenues. It is creating a swelling population of individuals who are nearing the threshold, and may be manipulating working patterns to avoid registering and having to levy VAT. In short, the high threshold has created an attractive, and legal, VAT avoidance scheme for the gig economy. The UK Government is committed to not increasing the VAT threshold until at least 2022,[14] but it may be forced to restructure the threshold sooner.

VAT issues for the Government: invisible individuals

HMRC's whole premise when it comes to raising income tax is based on collecting tax and National Insurance for multiple staff from a single employer with finance skills and experience of the rules. However, they are now moving towards having to collect tax from a multitude of individuals with limited or no tax expertise. The vast majority of these individuals will be below the VAT registration threshold. The challenges for the tax authorities include:

1. identifying who these individuals are;
2. capturing all of the individuals' VAT sales since they may be working on multiple platforms, and working in the offline world, too;

[11] ONS, *EMP14: Employees and self-employed by industry* (18 February 2020).
[12] OTS, *Value added tax: routes to simplification* (7 November 2017), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/657213/Value_added_tax_routes_to_simplification_web.pdf* [Accessed 3 March 2020].
[13] HM Treasury, *VAT registration threshold: Summary of responses* (October 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752042/VAT_Threshold_Call_for_Evidence_Summary_of_Responses_digicomms.pdf* [Accessed 3 March 2020].
[14] HMRC, Policy Paper, *VAT: maintain thresholds for 2 years from 1 April 2020* (29 October 2018), available at: *https://www.gov.uk/government/publications/vat-thresholds-remain-unchanged/vat-maintain-thresholds-for-2-years-from-1-april-2020* [Accessed 3 March 2020].

3. determining the VAT status of the individuals, marketplaces and other parties in the multitude of business models;
4. identifying and processing the correct VAT treatment, with added complexity in the growing cross-border gig market; and
5. registering and auditing of large volumes of individuals with low levels of income.

Tax risks for traditional economy: unfair gig competition

The tax system has always provided subsidies and preferential VAT benefits to the self-employed to reflect the risks of entrepreneurship and to offer a subsidy to a dynamic corner of the economy which helps generate the job-creating businesses of the future. This differentiation has always meant complexity, leading to tax leakage and opportunities for evasion. This was tolerated because of the relatively low numbers. But the explosive growth of the gig economy has magnified the tax losses hugely.

It has also given individuals a competitive advantage since the difficulties in tracking and detection mean they can operate more cheaply than compliant traditional businesses. This affects service businesses, recruitment companies and property letting agencies. Either the individual or the marketplaces can benefit from this, for VAT, income tax and National Insurance contributions (NICs). Self-employed staff are exempt from the 13.8 per cent NICs, and there is no employer contribution. This means platforms can save 17 per cent on National Insurance.

Tax challenges for individuals

The gig economy is generating many new VAT liable individuals. They may not be aware of their responsibilities and obligations for a number of reasons:

1. Some of the transactions are entirely new, or an expansion of previously untaxed activities such as occasional rental of rooms.
2. Income may be diverse in terms of only being occasional or spread over different platforms. This makes assessing the liabilities a challenge.
3. Tax obligations are not clear, and few individuals have any experience or awareness of the VAT rules and threshold obligations. HMRC report that most voluntary registrations are down to individuals being unclear about if the threshold will apply.

Food delivery double helping

It is worth looking at the VAT position on food delivery services since it involves mixed rate suppliers for the delivery and food services respectively. In the case of major food delivery platforms, which offer consumers food from multiple local restaurants via home delivery, the transaction comes in two parts:

1. Food service, charged to the consumer by the restaurant. Hot, take-away food[15] is standard rated.

[15] HMRC, Guidance, *Catering, takeaway food (VAT Notice 709/1)* (7 October 2013), available at: *https://www.gov.uk/guidance/catering-takeaway-food-and-vat-notice-7091#hot-take-away-food-and-drink* [Accessed 3 March 2020], para.4.

2. Delivery fee, charged by the marketplace at the standard VAT rate. The marketplace will contract with individual freelance drivers for the delivery. It is down to these drivers to manage their own VAT if they are over the threshold.

Typically, the marketplace acts as the collector, billing the customer online for both the food and delivery services in the same payment. This means the marketplace charges the net amount for the food service, and leaves the VAT calculation to the restaurant (which must determine the differing rates for hot or cold food, drinks, etc.). This does mean business customers will struggle to recover the VAT as they do not receive a full VAT receipt for the food service.

Practical VAT remedies

There is an array of more practical VAT measures that are in place, or could be explored, to resolve the VAT issues around the gig and sharing economies. The shared aim of these measures would be to reduce the VAT leakage in the least administratively onerous way possible for all parties. Ideally, through voluntary measures so as not to hit legislative blocks.

Below is a summary of the potential policies, together with some operating examples, which could be implemented to resolve the VAT issues relating to the gig and sharing economies. The challenges to the implementation of such policies are also discussed.

VAT education programmes: targeting individuals

Most individuals do not understand their tax obligations. This is down to lack of readily available information, written in layman's terms. Since the issues are novel and complex, this lack of understanding is understandable. The regular route of seeking qualified tax advice is, usually, prohibitively expensive for those on the low incomes associated with the gig and sharing economies.

Increasingly tax authorities, including HMRC, are creating dedicated materials, primarily on the web, for individuals operating in these sectors. Examples include social media campaigns, such as those in Denmark, France and Australia, which reach out to all registered ride-sharing drivers each quarter. Ireland obliges individuals to report their quarterly income on house-sharing, which the Revenue then uses to remind them to report in their annual tax return. HMRC have a small business online forum on reporting and paying taxes for the first time, some of it peer-to-peer.

Using public data: limits on privacy

However, and also increasingly, tax authorities use advanced public data gathering tools to amass details on individuals, products, pricing and activities on gig and sharing platforms. In December 2019 French courts gave the tax authorities powers to trawl users' profiles, posts and pictures for evidence of undisclosed income.[16]

Mostly, tax authorities are using crude scraping and crawling tools. Progressively, artificial intelligence and data analytics are being deployed to compare VAT declarations (or lack of

[16] BBC, *French government to scan social media for tax cheats* (27 December 2019), available at: *https://www.bbc.co.uk/news/world-europe-50930094* [Accessed 3 March 2020].

them!) with activities on gig platforms. In Europe, Spain is possibly the most advanced in this area.

However, data protection, General Data Protection Regulation (GDPR)[17] and civil liberties issues create concerns about tapping into individuals' public profiles. The French court acknowledged that users' privacy and freedom of expression could be compromised and has included caveats to the legislation. This indicates that mining public data for VAT evasion may have its limits.

Legislative simplification: roll on e-invoices

The modification and simplification of compliance is the measure which is most readily controllable by the tax authorities. Starting with the VAT registration process, a number of countries are looking to basic application processes for the gig and sharing economies which give only a limited range of VAT features. Countries like Australia and New Zealand now provide basic VAT number schemes which allow declarations of income and sales VAT only. There is no scope for deducting input VAT, which is often exploited for VAT fraud. This is based on the premise that it is preferable to have individuals in the system paying taxes rather than outside the system committing evasion.

VAT registration thresholds, whilst well-meaning as a tax subsidy for start-ups, generally only serve to confuse individuals as to when and if they should be registered (see above). One solution is to require immediate registration irrespective of income, but with automated calculation determined by the tax authorities based on declared outputs (sales). This would eliminate any doubt individuals, and the marketplaces which register them, may have about whether or not an active VAT number needs to be in place. Countries which have already adopted live transaction/e-invoice reporting (Italy; Spain; Hungary; Brazil; and many more) now have the data for this. They are piloting pre-completed VAT returns based on this input to reduce the scope for error and fraud by individuals.

Marketplace voluntary measures and reporting

Since marketplaces hold individuals' data—albeit limited to the business model needs of these individuals—these marketplaces are an obvious source of information. This can help the tax authorities to at least identify individuals who are active in marketplaces. Some marketplaces may hold and provide transactional-level data (goods; prices; customers; etc.) to help calculate VAT liabilities.

The UK is relatively advanced in this area as evidenced by the UK's marketplace voluntary code of conduct[18] on tackling VAT fraud.[19] Signatory marketplaces must follow a code of good

[17] Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) [2016] OJ L119/1.

[18] HMRC, Guidance, *Tackling online VAT fraud and error - the role of online marketplaces in co-operating with HMRC (The agreement)* (updated 3 September 2018).

[19] HMRC, *HMRC calls on online marketplaces to sign agreement tackling VAT fraud* (25 April 2018), available at: *https://www.gov.uk/government/news/hmrc-calls-on-online-marketplaces-to-sign-agreement-tackling-vat-fraud?utm_source=6dac8d8a-148f-405f-8cbe-72729a4ff6b2&utm_medium=email&utm_campaign=govuk-notifications&utm_content=daily* [Accessed 3 March 2020].

conduct protocol on reducing fraud. The code of conduct covers: education of individuals active in the marketplaces; and provision of data on request to HMRC. HMRC now publish the names of those online marketplaces that sign up to the agreement: effectively a "whitelist" of participants. Denmark has been investigating the voluntary disclosure of property rental income by the major marketplaces.

Whilst this has been helpful in setting a level playing field for marketplaces, there are complications. Voluntary disclosures can break down when cross-border platforms are involved. Data protection and privacy rules in countries like Germany prevent widescale data surrender; only information pursuant to individual requests can be surrendered.

Marketplace compulsory measures and reporting: blunt but effective

As voluntary reporting obligations on marketplaces have had mixed fortunes, countries in Europe are now introducing mandatory measures. However, so far, it has been limited to e-commerce goods.

Since 2018, the UK has obliged marketplaces to verify all non-EU third party sellers' VAT numbers. In 2019, Germany introduced a controversial "digital signature" requirement, which obliged foreign sellers to obtain a paper certificate from their German federal tax office to prove they are up to date on their VAT. This must then be provided to the marketplace which would be held liable for any missing VAT on unchecked sellers. In October 2019, the EU Commission has challenged this measure as disproportionate since it is paper based.[20]

Whatever the compulsory requirements on marketplaces, what has been interesting is that the outcome has been for marketplaces to impose blanket VAT registrations on all their sellers. If they do not provide a valid VAT number, then they are blocked irrespective of the VAT registration threshold to which the seller or individual may be entitled. Full compliance for all.

In terms of compulsory reporting, Italy and France now require monthly or quarterly transaction listing of sellers from marketplaces. Again, so far, only for e-commerce goods.

Without doubt, these VAT measures and reporting requirements on marketplaces will migrate to the gig and sharing economies. Uber provides income data for both self-employed drivers and taxi firms to the Czech authorities. It is done as a real-time cash reporting process by Uber. It also checks if the driver is VAT registered. Norway is progressing towards home rental marketplaces, such as Airbnb and HomeAway, disclosing the taxable activities of hosts on their websites.

Payment provider compulsory reporting: legacy issues the blocker

A tax data source for the future could be payment service providers. These include: issuers of credit cards; bank debit and transfer providers; online payments (for example, PayPal); e-wallets; and cryptocurrencies. The EU[21] has planned that there will be compulsory reporting of e-commerce

[20] European Commission, *October infringements package: key decisions* (10 October 2019), available at: *https://ec.europa.eu/commission/presscorner/detail/EN/INF_19_5950* [Accessed 10 March 2020].

[21] European Commission, Taxation and Customs Union, *Online payment companies to help in the fight against tax fraud*, available at: *https://ec.europa.eu/taxation_customs/news/online-payment-companies-help-fight-against-tax-fraud_en* [Accessed 3 March 2020].

goods payments by this sector by 2024. Since most payments are readily identifiable when going through a marketplace, it is not a major stretch to extend this to the gig and sharing economies.

The challenge here is the legacy systems of payment service providers. Their IT architecture does not support deep transactional data and could, in no way, help calculate possible VAT liabilities. They will have to make a significant investment to support a meaningful exchange of tax data—the major reason for the 2024 deadline.

VAT compliance help: compulsion is the trend

In addition to providing basic education on VAT obligations, some marketplaces provide individuals with names and contact details of VAT specialist advisory firms. Marketplaces also try to negotiate discounted rates with the firms on behalf of the individuals. However, the marketplaces stay out of the contracting.

Increasingly, marketplaces are obliging individuals to sign up with these firms during the on-boarding process. Failure to do so may mean they are blocked. Individuals do, however, retain the option to use compliance firms of their own choice, provided they produce evidence on contracting.

In the e-commerce world, Amazon has built in a VAT returns service to its Seller Central account.[22] Each month/quarter, transaction data is automatically extracted from the seller's records, VAT calculated, and a draft return prepared for the seller to review. The return is then filed for the seller via an outside VAT specialist firm. Again, the VAT compliance obligations and liabilities rest with the seller and the VAT firm, not the marketplace.

Co-opting platforms as tax collectors

Tax authorities have long eyed marketplaces with frustration arising from these marketplaces having helped to create the huge gig and sharing sectors. However, this frustration is mixed with the tax authorities' relish for the opportunity to co-opt the marketplaces as unpaid tax collectors.

The opportunity: data and automation attractions

Aside from believing that the onus is upon the marketplaces to assist in the enforcement of VAT obligations, tax authorities believe increasingly that marketplaces have the data and automation skills necessary to help with ease, because:

1. The marketplaces hold background and tax transactional data in relation to the suppliers, and therefore possess the individuals' details and information on how much to levy for VAT and income taxes. The marketplaces often challenge the latter assumption (see below).
2. To some degree, marketplaces have attracted the existing informal cash economy market, and therefore represent a channel to tax these long-missed traders in addition to the new entrepreneurs of the gig or sharing economies.

[22] Amazon Seller Central, *EU VAT Calculation Services Methodology* (last updated 18 December 2019), available at: *https://sellercentral.amazon.co.uk/gp/help/external/help.html?itemID=202084570&ref=efph_202084570_cont_home* [Accessed 3 March 2020].

3. The digitisation of transactions and payment processes by marketplaces needing the ability to scale their business models means that they have deep data lakes, which can be mined with increasingly sophisticated analytical tools. This puts tax determination on a mass scale within easy reach and avoids having to educate or empower individuals with little or no expertise.

The next question then becomes: in what guise could the marketplaces extract the VAT—as intermediary withholders of VAT; or as VAT principals? Both guises would require major legal changes and would impose colossal reporting infrastructure requirements on the marketplaces.

Withholding VAT/split payments: a tough calculation cracked in the US

A preferred route to VAT collections from the authorities' perspective would be live tax calculation, with splitting or withholding of the VAT by the marketplace. This would then be remitted directly to the tax authorities. The historical VAT return could then be used to reconcile differences and missed transactions. Withholding VAT is similar in principle to PAYE income tax deductions from salaries.

See the section "Marketplaces as the deemed supplier: a question of control" (below) for marketplaces' objections to this regime.

South American countries are major exponents of withholding VAT regimes due to the major fraud issues which exist in these countries. Often the withholding is forced onto the credit card issuers. Argentina is the latest example of such a regime, imposing the obligation to withhold VAT on payments by consumers subscribing to non-resident streaming media and other electronic service providers. Mexico has recently imposed income tax deduction obligations on ride-sharing platforms. It has, so far, not included VAT.

Europe has struggled to come to terms with withholding VAT. In December 2017 the EU Commission ruled out Split Payments as cumbersome and expensive to implement.[23] The UK is currently running a payment provider industry consultation on the practicalities of implementing a witholding VAT regime.[24] Any scheme is unlikely to see the light of day before 2023.

The major challenge of withholding VAT is the complexity of calculation. Varying thresholds for individuals and reduced VAT rates mean that it may only be possible to impose the standard VAT rate on all transactions and then leave it to the taxpayer to try to true-up the position in their VAT return. Issues like refunds and credits, plus bad debts would also need to be accommodated.

In the sharing economy, the US may have much to teach the rest of the world about the flexibility of automation to solve these problems. The US has imposed sales tax collection obligations on marketplaces in most states (Supreme Court ruling in *South Dakota v Wayfair*[25]) to lighten the burden of tax collections. When an individual signs up to Airbnb, HomeAway and other sharing platforms, the accommodation tax compliance (rentals are sales tax-free) is

[23] European Commission, Deloitte, *Analysis of the impact of the split payment mechanism as an alternative VAT collection method: Final Report* (December 2017), "Executive Summary".
[24] Accountancy Daily, *Working group to investigate feasibility of VAT split payments* (November 2018), available at: *https://www.accountancydaily.co/working-group-investigate-feasibility-vat-split-payments* [Accessed 10 March 2020].
[25] *No. 17–494 Supreme Court of the United States, No.17-494, South Dakota, Petitioner v Wayfair, Inc. et al.*, on writ of certiorari to the Supreme Court of South Dakota [June 21, 2018] 585 U. S. (2018).

automated for them. This is achieved either by: the marketplace deducting and remitting the tax; or electronic files with transaction-level tax calculations being uploaded into tax declaration software. The individual then just logs on, reviews the return and presses "file".

Airbnb has many other accommodation tax agreements in place in jurisdictions that have imposed the turnover tax on hotels and home-rentals. These jurisdictions include: France (Paris); Bermuda; Brazil; and Canada (goods and services tax (GST)). Argentina has a preventative withholding mechanism in place for taxpayers who cannot prove they have sufficient financial resources. If they fail to prove that they have such insufficient resources, they must prepare special invoices where the VAT is declared but is withheld by the customer.

Marketplaces as the deemed supplier: a question of control

As an alternative to withholding VAT, the marketplaces could be placed in the role of tax principal.

Currently, marketplaces are largely treated as agents in the gig or sharing economies. This makes them responsible only for the VAT on the introductory fees charged by the marketplaces in relation to the transactions between the individual seller and the customer. The preferred solution of the tax authorities would be to put the marketplaces in the position of the deemed supplier or principal (responsible for charging and collecting VAT under its own VAT number for the services of the individual). This would be simplest administratively for both the tax authorities and individuals.

Understandably, the marketplaces have a number of objections to this solution (and to the withholding VAT model discussed above) for the following reasons:

1. It imposes VAT liabilities on marketplaces which they have to track, and which are not built into their business models or pricing.
2. Marketplaces claim that collecting any further information from individuals for tax often deters them from the signing-up process and undermines their own growth.
3. Many of the largest and most successful marketplaces are built and valued on the hugely scalable freelance model. Imposing VAT obligations could severely curtail or even terminate their activities.
4. Individuals earn income from multiple sources to which the marketplace has no access for tracking registration thresholds.
5. It would require a major investment in accounting, Enterprise Resource Planning (ERP) and related IT to capture and process VAT calculations and reporting.
6. The measure puts smaller marketplaces and new entrants at a huge disadvantage given the costs, and so may solidify monopolies for the well-established players. It is challenging to allow exemptions for smaller marketplaces since tax evaders may then migrate to them to exploit tax differences.
7. It would also place individuals using participating marketplaces at a disadvantage to their offline, self-employed counterparts. The latter would still be in a position to avoid or evade VAT. This would distort the development of the new economy.

8. Cross-border transactions, an increasing part of the gig economy, would he highly challenging to assess and report upon properly given the lack of information and access to the individuals.
9. Confidentiality laws restrict marketplaces handing over wholesale data to the tax authorities, so major legislative changes would be required. Internationally, gaining unanimity on this would be highly challenging with countries such as Germany being resistant to data exchanges. This could draw in GDPR modifications.

Legally, in order to force the marketplace from the role of a mere agent into that of the VAT principal depends on the level of control the marketplace has over the transaction. If the level of control is limited, then the individual remains responsible. The relevant HMRC rules[26] list a range of determinates such as price-setting and being able to vary the terms of the service. Tax cases, such as the Supreme Court's decision in *Airtours Holidays Transport Ltd (Appellant) v HMRC (Respondent)*,[27] show clearly that if another party controls the terms and conditions of a service, then they take over the VAT.

For the gig and sharing economies, it is likely that tax authorities over the next few years will, where they can, push VAT liabilities onto the marketplaces based upon the criteria being adopted by the 2021 EU electronic interfaces (marketplaces) deemed supplier obligations for e-commerce goods.[28] These obligations make the marketplaces liable for VAT when they "facilitate" the transaction between customer and seller.

For the gig and sharing economies, the criteria listed below could be referred to in order to identify those transactions for which the marketplace would be responsible:

1. the platform has control over the general terms of the sales contract;
2. the platform directly or indirectly controls the price of the service (indirect control could be exercised via the marketplace ranking individuals according to their price levels);
3. the platform charges for payment on behalf of the individual;
4. the platform participates in the ordering, fulfilment or delivery of the service; and
5. platforms which merely list services, with no participation by way of provision or collections, would be excluded.

Regulatory and employment law decisions point to VAT rethink

Whilst this note is concerned with VAT issues in the gig and sharing economies, it is worth looking at the direction being taken by regulatory and employment law rulings. Where the marketplace-individual relationship is switched from mere contractor to one of employee, then the individual's VAT responsibilities come to an end.

[26] HMRC, Internal Manual, *VAT Taxable Person Manual* (published 12 April 2016; updated 26 July 2016), VTAXPER36820, "Agency and disbursements: how to distinguish agency: the six indicating factors", available at: *https://www.gov.uk/hmrc-internal-manuals/vat-taxable-person/vtaxper36820* [Accessed 4 March 2020].
[27] *Airtours Holidays Transport Ltd (Appellant) v HMRC (Respondent)* [2016] UKSC 21.
[28] European Commission, *Proposal for a COUNCIL IMPLEMENTING REGULATION amending Implementing Regulation (EU) No 282/2011 as regards supplies of goods or services facilitated by electronic interfaces and the special schemes for taxable persons supplying services to non-taxable persons, making distance sales of goods and certain domestic supplies of goods* (Brussels: 11.12.2018, COM(2018) 821 final, 2018/0416 (NLE)).

Internationally, governmental reviews and court cases are pointing towards the marketplaces being held liable for the VAT instead of the individual. In the UK HMRC have been tracking this trend as they consider the VAT position of ride-sharing and other models in the sector.

CJEU and US regulators close on ride-sharing contractor model

Two key CJEU regulatory cases concerning the ride-sharing platform, Uber, point towards gig platforms being viewed as employers in the future. This would result in individuals being transferred onto the payroll, and income tax deductions would be made on their behalf. Any VAT obligations would be removed from them. Both cases ruled that the Uber platform, which has control over the relevant terms and conditions, is a taxi service rather than a mere introduction and information provider.

- *Asociación Profesional Élite Taxi v Uber Systems Spain SL*[29]: in December 2017, the CJEU found in favour of Barcelona taxi drivers by providing that Uber was a taxi service, not an information service. The Court pointed out that Uber exercised "decisive influence"[30] over the conditions under which drivers provided their services. Such an intermediation service, the CJEU concluded, must be regarded as forming an integral part of an overall service, the main component of which was transport.
- *Uber France SAS v Bensalem*[31]: in April 2018, the CJEU found that France was within its rights to ban the French UberPop service as an illegal transport service. The Court ruled that the UberPop service came within the field of transport and did not constitute an information society service within the meaning of the regulations directive.[32] In the Court's view, the UberPop service offered in France was essentially identical to the service provided in Spain.
- In a French appeals hearing concerning the employment rights of a driver working for Uber France, the highest court of civil appeal in France, *la Cour de cassation*, found in March 2020 that ride-sharing drivers were employees: "[T]here is a relationship of subordination between the driver and the company. Therefore, the driver does not perform his service as a self-employed worker but as an employee."[33]

In the US, states have started reassessing ride-sharing, and have implemented employer obligations in relation to ride-sharing companies. California, for example, passed in September 2019 an amendment to its Labor Code[34] to this effect.

[29] *Asociación Profesional Élite Taxi v Uber Systems Spain SL* (*Uber Spain*) (C-434/15) EU:C:2017:981 (20 December 2017).
[30] *Uber Spain* (C-434/15), above fn.29, EU:C:2017:981 at [39].
[31] *Uber France SAS v Bensalem* (C-320/16) EU:C:2018:221 (10 April 2018).
[32] Directive 98/34/EC of the European Parliament and of the Council of 22 June 1998 laying down a procedure for the provision of information in the field of technical standards and regulations [1998] OJ L204/37.
[33] Cour de cassation, press release, *Uber* (4 March 2020), available at: *https://www.courdecassation.fr/IMG/20200304_arret_uber_communique_eng.pdf* [Accessed 13 March 2020].
[34] Assembly Bill No.5, Chapter 296, An act to amend Section 3351 of, and to add Section 2750.3 to, the Labor Code, and to amend Sections 606.5 and 621 of the Unemployment Insurance Code, relating to employment, and making an appropriation therefor (approved by Governor September 18, 2019; filed with Secretary of State September 18, 2019).

HMRC to shift their VAT position

HMRC had been waiting to see which way the two CJEU cases went before determining whether they should also consider Uber as a VAT supplier of transport services. This would switch the current VAT obligation from the driver—who only needs to charge 20 per cent VAT when they are in the rare position of being over the £85,000 threshold—to Uber which would certainly be required to start charging full standard VAT on each trip.

Uber in dialogue with HMRC on its VAT position

In October 2019, Uber disclosed in its annual accounts that it "is involved in an ongoing dialog with HMRC"[35] to determine if it should be classified as a transportation provider. This would imply 20 per cent VAT being due on taxi fares and/or the service fees to the drivers. This would reverse the current position whereby the driver need only charge 20 per cent VAT if they are over the £85,000 threshold. This would be due retrospectively. The amount of the liability provision has not been made available in the group's company accounts.

Campaigners take on Uber VAT liabilities

The issue of Uber's potential UK VAT liabilities has also attracted the attentions of the Good Law Project (GLP),[36] the crowd-funded legal campaigning group led by QC, Jolyon Maugham. It estimates Uber's VAT liability at up to £1.5 billion.[37] It has launched several legal actions, including:

1. suing Uber for a VAT invoice[38];
2. a claim to deduct notional VAT from an Uber invoice against business expenses[39]; and
3. a judicial review against HMRC for not raising a protective assessment on any historic VAT due.[40] This type of assessment would enable HMRC to stop the clock on the statute of limitations expiring on any historical VAT liabilities. HMRC could make ordinary assessment against Uber but suspend collection until litigation is resolved. This latter case is still progressing, with a ruling in November 2019 that HMRC had to notify the GLP of the amount of any assessment.[41] This indicates that an assessment has been raised.

[35] Uber London Ltd, *Directors' report and financial statements: 31 December 2018* (7 October 2019), 19.
[36] Good Law Project, available at: *https://goodlawproject.org* [Accessed 4 March 2020].
[37] Good Law Project, *Uber's £1bn+ VAT Bill: Good Law Project Limited v Uber: A Briefing* (18 November 2019).
[38] Good Law Project, *Uber Case Update: We Have Issued Proceedings* (May 2017), available at: *https://goodlawproject.org/uber-case-update-1/* [Accessed 10 March 2020].
[39] Letter of 30 June 2017 from Jolyon Maugham QC to HMRC, available at: *https://jolyonmaugham.files.wordpress.com/2017/06/hmrcinputtaxletter.pdf* [Accessed 10 March 2020].
[40] Irwin Mitchell LLP, *Letter Before Claim for Judicial Review* (6 March 2019), available at: *https://d2l6cjylzkj2qa.cloudfront.net/wp-content/uploads/2019/03/12162927/Letter-Before-Action.pdf* [Accessed 10 March 2020].
[41] *Good Law Project Ltd v HMRC* (and Uber as interested party) [2019] EWHC 3125 (Admin) (QB) (19 November 2019).

2020 to settle VAT question

If a protective assessment has been raised, as now seems possible, then 2020 could see a major shift in the employment basis. This would include shifting the VAT responsibilities from the individual to the platform.

It is possible that HMRC will not act in the Uber case until its employer status is determined by the Supreme Court in the upcoming *Aslam* appeal. In December 2018 the majority of the Court of Appeal upheld the Employment Appeal Tribunal decision that Aslam drivers are workers entitled to the minimum wage and paid holidays.[42] It is also worth looking at an associated case, *Addison Lee Ltd v Lange and others*,[43] where freelance drivers were held at an Employment Appeal Tribunal to actually be employees because they had limited control over turning down rides offered to them.

There are many similar cases, including *Ms E Leyland and others (Claimants) v Hermes Parcelnet Ltd (Respondent)*,[44] where the tribunals have tilted towards categorising gig workers as employees. This would take gig workers out of the VAT obligation net.

Globally, ride-sharing takes the VAT hit

If HMRC do opt to shift VAT liabilities onto gig platforms, they will be reflecting a global trend:

1. Australia has classified ride-sharing platforms as taxi services, and therefore liable to charge 10 per cent GST since 2015.
2. Azerbaijan imposed 18 per cent on car-sharing platforms in 2017.
3. Canada has amended the definition of ride-sharing to be a taxi service and therefore liable to GST since July 2018. No registration threshold has been provided.
4. Egypt has agreed with Uber at the start of 2019 that it would charge 14 per cent VAT on ride fares.
5. Costa Rica imposed 13 per cent VAT on ride-sharing in 2019.

House-sharing marketplaces dodge the VAT traps

Ride-sharing should be contrasted with accommodation platforms which seem to be avoiding regulatory and VAT traps. At the CJEU in December 2019, lawyers, on behalf of the French tourism association, had argued that Airbnb was acting as an unlicensed estate agent. But the CJEU concluded that the house rental site was an "information society service".[45] The crucial determination from a VAT perspective was that Airbnb did not control the transaction and was not a "decisive influence"[46] over the price. This included property owners being able to offer

[42] *Uber BV and others v Aslam and others* [2018] EWCA Civ 2748 on appeal from [2018] ICR 453 (EAT) (appeal No.UKEAT/0056/17/DA).
[43] *Addison Lee Ltd v Lange and others* [2019] ICR 637 (EAT) (appeal No.UKEAT/0037/18/BA).
[44] *Ms E Leyland and others (Claimants) v Hermes Parcelnet Ltd (Respondent)* [2018] 6 WLUK 464 (Employment Tribunal) (Case Nos: 1800575/2017 1800594-1800599/2017 1801037-1801039/2017 1801166-1801169/2017 1801320/2017) (30 April (reading), 1, 2 and 3 May 2018).
[45] *Criminal Proceedings against X (request for a preliminary ruling in the criminal proceedings against X: interveners: Airbnb Ireland UC and others)* (*Criminal Proceedings against X*) (C-390/18) EU:C:2019:1112 (ECJ Grand Chamber) (19 December 2019) Ruling 1.
[46] *Criminal Proceedings against X* (C-390/18), above fn.45, EU:C:2019:1112 at [67] and [68].

their premises on multiple sites in addition to that of Airbnb. This meant Airbnb was not essential to the supply.

To help placate the tax authorities, Airbnb has struck deals on accommodation taxes. These are consumption taxes on short-term stays at hotels and other accommodations. They are popular in the US, and increasingly at city-level across Europe. Airbnb has already struck accommodation tax withholding deals with cities in: France (Paris); Germany; India; Italy, the Netherlands; Portugal; Switzerland; and the US.

Crowdfunding VAT issues

Whilst still a small slice of the sharing economy, crowdfunding is one of the fastest growing areas of this economy and, as a financial services activity, has its own unique VAT issues.

Crowdfunding uses the internet to attract large numbers of people to contribute small amounts of cash to fund projects. These projects can take on many forms such as new business ventures and campaigns to further many types of political or social policy. The first internet-based crowdfunding project was in 1997 to raise US$60,000 to fund a US-tour by the UK rock band Marillion.

Most crowdfunding opportunities are for debt, bonds or an equity stake in a venture. Debt-based crowdfunding is enjoying huge growth rates as an enabler for financing micro-businesses all over the world. From a VAT perspective, this type of crowdfunding is generally viewed as an exempt financial service. However, participation in future profits from intellectual property rights crowdfunding will be subject to VAT.

Reward crowdfunding creates a VAT liability

Increasingly, donors are accepting gifts or rewards related to the campaign cause. Such gifts or rewards can include goods or services, such as: tickets to funded concerts or films; naming rights in books or other media; discounted goods from new businesses.

Increasingly tax authorities are viewing goods or services promised to investors in exchange for their funds in crowdfunding campaigns as liable to VAT as a taxable transaction. In 2015, the European Commission consulted with Member States on the VAT treatment of crowdfunding, and suggested reward-based projects should be liable to VAT.[47]

In addition, for all types of crowdfunding, the services of intermediary platforms, that provide fundraising services, are within the scope of VAT.

Conclusion

The stellar growth rate of the gig and sharing economies, fuelled by wildly successful marketplace platforms, is an economic wonder. By choice or need, it has given millions of individuals access to new income streams, and consumers a limitless source of new suppliers and choices at low prices.

[47] European Commission, *VAT treatment of crowdfunding* (Brussels: 6 February 2015, taxud.c.1(2015)576037 – EN), available at: *https://circabc.europa.eu/sd/a/c9b4bb6f-3313-4c5d-8b4c-c8bbaf0c175a/836%20-%20VAT%20treatment%20of%20Crowd%20funding.pdf* [Accessed 10 March 2020].

But tax codes have been found wanting as the individual income earners drop out of the trusted tax deduction regimes into self-employment status. The issues relating to collections that are associated with this change in status are particularly arduous. Instead of one business collecting taxes on behalf of many employees, the tax authorities are faced with many unidentified individuals able to operate below the radar of traditional tax collection processes. The VAT threshold stands out for special blame as it has created a legal VAT shelter.

If the tax authorities were reinventing the VAT system today, they certainly would avoid the current self-declaration and delayed payment regime. It is administratively cumbersome and wide open to fraud and errors in the new digital economies.

So, what will the tax authorities do? Whilst a myriad of measures to pick up these new taxpayers are being tried out, ultimately the tax authorities are looking to co-opt the marketplaces. It is the marketplaces that have the data, analytical expertise and resources to calculate, collect and report the VAT on the gig and sharing economies that they have built and benefited from. This may mean ultimately that it is the marketplaces that will become the VAT principal.

The challenge now is to come up with a solution that will tax the marginal income of gig and sharing-based workers at the same rates as the employed. Any neutral reform will mean someone losing out, probably the individuals and marketplaces. And would there need to be a transition period?

The OECD is about to embark on a consultation of best practices for VAT in the gig and sharing economies.[48] Marketplaces want to help. But tax authorities will have to be careful not to distort these exciting new economies or to solidify the monopolies of the incumbents with expensive tax obligations.

Richard Asquith[*]

VAT: quick fixes 2020

Introduction

In 2016, the EU Commission launched a plan to turn the current VAT system into a destination-based framework, the so-called "definitive system".[1] Since then, the VAT framework has been in the process of being reviewed and updated.[2] The grand finale is foreseen for 2022.

[48] OECD, Public consultation document, *Model Rules for Reporting by Platform Operators with respect to Sellers in the Sharing and Gig Economy 19 February 2020 – 20 March 2020* (OECD, 2020), available at: *http://www.oecd.org/tax/exchange-of-tax-information/public-consultation-document-model-rules-reporting-platform-operators-with-respect-sellers-sharing-gig-economy.pdf* [Accessed 4 March 2020].

Crowdfunding; Digital technology; E-commerce; Online intermediaries; VAT; Zero hours contracts

[*] VP Global Indirect Tax, Avalara.

[1] European Commission, *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, on an action plan on VAT: Towards a single EU VAT area - Time to decide* (Brussels: 7 April 2016, COM(2016) 148 final), available at: *https://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_148_en.pdf* [Accessed 30 January 2019].

[2] C. Remeur, Members' Research Service, PE 628.222 – September 2018, *Steps towards a definitive VAT system* (European Parliamentary Research Service, 1 October 2018): "A total of 11 legislative proposals amending the VAT

Pending the introduction of the definitive system, several simplification schemes known as the "quick fixes" entered into force on 1 January 2020.[3] Their importance should not be minimised. If the lifespan of these "quick fixes" is set at two years, rumour has it that the definitive system will be pushed back several years, which implies a correlative extension of the quick fixes' lifespan.

The quick fixes are meant to improve the current system via harmonisation and simplification of certain rules applicable to the VAT taxation of trade between Member States. Harmonisation and simplification of the system should decrease the burden of dealing with VAT for business operators. It should also prevent fraudsters from being able to rely on mismatches between national legislations and systems and unintegrated approaches between tax authorities in order to divert the VAT due/collected on intra-community trade.

In that context, the Council of the European Union (the Council) adopted three legislative acts[4] to adjust some of the EU's VAT rules in order to fix four specific issues related to: 1. call-off stock arrangements; 2. the VAT identification number in the context of the exemption for intra-Community supplies; 3. proof of intra-EU supply; and 4. the chain transactions. Without claiming to be exhaustive, the issues, the quick fixes and the inevitable early teething troubles are analysed in this note.

1. Simplified treatment of call-off stock

In our modern world, speedy fulfilment has become a must. The first quick fix concerns the VAT rules applicable to arrangements facilitating the speediness of trade: where a vendor transfers stock at the disposal of a known acquirer in another Member State.

The analysis of the quick fix is preceded by a high-level review of the current rules and the issues that the quick fix aims to solve.

The writer suggests that this quick fix, although paved with good intentions, is hampered by unresolved issues.

1.1. Previous rules

From a VAT standpoint, a cross-border call-off stock generates three different transactions: a deemed intra-EU supply; a deemed intra-EU acquisition; and eventually a domestic supply.[5] The supplier is liable for VAT in the Member State of arrival on both the acquisition and on the

legal framework have been put forward, in several instalments between December 2016 and May 2018, to implement the VAT action plan."

[3] Council Directive (EU) 2018/1910 of 4 December 2018 amending Directive 2006/112/EC as regards the harmonisation and simplification of certain rules in the value added tax system for the taxation of trade between Member States ST/12848/2018/COR/1 [2018] OJ L311/3 Art.2.

[4] Council Directive (EU) 2018/1910, above fn.3; Council Regulation (EU) 2018/1909 of 4 December 2018 amending Regulation (EU) No 904/2010 as regards the exchange of information for the purpose of monitoring the correct application of call-off stock arrangements [2018] OJ L311/1; Council Implementing Regulation (EU) 2018/1912 of 4 December 2018 amending Implementing Regulation (EU) No 282/2011 as regards certain exemptions for intra-Community transactions [2018] OJ L311/10.

[5] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (VAT Directive) [2006] OJ L347/1 Arts 14(1), 17 and 20.

subsequent sale.[6] The consequence for the supplier is that they need to be VAT registered in the Member State of arrival and to comply with all reporting obligations in that Member State.[7]

This being said, most Member States have implemented simplifications based on which suppliers can escape the VAT registration and the subsequent compliance in the Member State of arrival. Such simplification is achieved by the call-off stock being ignored for VAT purposes, and the transaction being treated as a direct intra-EU supply of goods by the seller to the customer. Under such a scheme, VAT is accounted for by the customer when the stock is drawn off and the seller gets rid of the red tape associated with the normal process.

However, not all Member States had implemented such a simplification and the conditions for applying the simplification were not harmonised.[8]

1.2. Quick fix

New Article 17a of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (VAT Directive) provides for a simplified and uniform VAT treatment for call-off stock arrangements[9]: the transfer from one Member State to another no longer qualifies as a deemed intra-EU supply and a deemed intra-EU acquisition and so from a VAT standpoint nothing happens. It is only when the customer takes the goods out of the stock that the supplier performs an intra-EU supply to the customer. Thanks to these arrangements, the supplier does not have to report any transaction subject to VAT in the Member State of arrival and, therefore, does not have to register for VAT purposes in that Member State or abide by the subsequent compliance obligations. The VAT liability rests on the customer who accounts for the VAT due on the intra-EU acquisition via that customer's VAT return.

Several conditions must be met for the simplification to apply[10]:

- the final client must be known by the supplier;
- the supplier and the customer are taxable persons registered for VAT;
- the supplier cannot be established in the Member State of destination;
- the goods cannot be held in the Member State of destination for more than a year;
- the supplier must keep a register of shipments made under this arrangement[11];
- the supplier must report the transfer in their EC sales list.[12]

The new rules represent a significant improvement for the impacted businesses. The vendors avoid foreign VAT registrations and the customers benefit from the advantage of the reverse charge mechanism (deferred payment and compensation).

Unfortunately, the simplification has a limited scope in that it only covers the situation in which the intended acquirer is known. The reason for this limitation is probably to circumvent the risk by identifying upfront the person eventually liable for the VAT. If the vendor were not

[6] VAT Directive, above fn.5, Art.2(1)(a) and (b) and Arts 193 and 200.
[7] VAT Directive, above fn.5, Art.214.
[8] For example, VAT laws in Greece, Portugal, Spain and Luxembourg do not provide for such a simplification regime.
[9] VAT Directive, above fn.5, Art.17a inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(1).
[10] VAT Directive, above fn.5, Art.17a(2) inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(1).
[11] VAT Directive, above fn.5, Art.243(3) inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(4).
[12] VAT Directive, above fn.5, Art.262(1) and (2) inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(5).

to fulfil the requisite conditions and abscond without charging the VAT due, the tax authorities would know where to turn.

Even where the acquirer is known, not all is rosy. The writer considers that two points are particularly likely to create confusion.

One condition in particular which raises concerns is the requirement that the vendor has neither established their business nor has a fixed establishment in the Member State of arrival of the goods. The operation of the call-off stock involves warehousing the goods until the customer draws them off. Therefore, the question is whether such a warehousing constitutes an establishment for VAT purposes. The use of a warehouse is not insignificant and this explains the concern as to whether such a use may trigger a VAT presence. Warehouse operations cover a wide array of processes from receiving, organisation, fulfilment, and eventually distribution. Those processes and activities indicate a structure that in terms of technical and human resources shall be seen as creating a fixed establishment. On this basis, the VAT Committee has concluded rightly that a fixed establishment is created in the situation where the warehouse is "directly run by the supplier with his own means present in the Member State where the warehouse is located".[13] In all other circumstances, the vendor should not be seen as being established in the Member State of the warehouse and should consequently be entitled to enjoy the benefits of the quick fix. However, even if the conclusions of the VAT Committee are perfectly in line with the purpose of the quick fix and with the case law of the CJEU, the Committee's conclusions are not legally binding on Member States. In fact, the Committee's conclusions were not arrived at unanimously which proves that some Member States disagree with the conclusions and consider, among other things, that the simple ownership of a warehouse does lead to the creation of a fixed establishment. Businesses will probably be confronted with diverging interpretations from Member States in this respect and may be refused the benefit of the quick fix in some cases. The efficiency of the quick fix will, unfortunately, be reduced, at least until the CJEU intervenes to reposition the recalcitrant Member States.

Also worthy of mention are the consequences arising from the destruction, loss or theft of goods before the customer has taken ownership of them.

The quick fix provides that in these situations the conditions for the call-off stock arrangements cease to be fulfilled.[14] As the conditions for the call-off stock arrangements cease to be fulfilled, a transfer is deemed to take place, with all the compliance consequences for the seller.

The writer is troubled by this for two reasons. In accordance with the VAT Directive, in so far as the taxable person, acting as such at the time when he acquires goods, uses the goods for the purposes of his taxable transactions, he is entitled to deduct the VAT paid in respect of the

[13] VAT Committee Working Paper No 974: VAT Committee, *Guidelines Resulting from the 113th Meeting of 3 June 2019*, Document C – taxud.c.1(2019)7898957 – 974. In May, in Working Paper 968 (Document taxud.c.1(2019)3533969) the VAT Committee had taken a different approach, seemingly revised later. The CJEU has dealt on various occasions with the issue of fixed establishment. See the CJEU judgments in *Gunter Berkholz v Finanzamt Hamburg-Mitte-Altstadt* (C-168/84) EU:C:1985:299; *Faaborg-Gelting Linien A/S v Finanzamt Flensburg* (C-231/94) [1996] EU:C:1996:184; *Commissioners of Customs and Excise v DFDS* (C-260/95) EU:C:1997:77; *ARO Lease BV v Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam* (C-190/95) EU:C:1997:374; *Planzer Luxembourg Sàrl v Bundeszentralamt für Steuern* (C-73/06) EU:C:2007:397; *Welmory sp. z o.o. v Dyrektor Izby Skarbowej w Gdansku* (C-605/12) EU:C:2014:2298.

[14] VAT Directive, above fn.5, Art.17a inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(1).

goods.[15] In that respect, considering the quick fix to be inapplicable in cases of destruction or loss of the goods seems inadequate. The seller transfers and stocks the goods for the purposes of the subsequent (and documented) sale, the seller's intentions are clear and consequently he is entitled to a deduction right. Depriving the seller of the benefit of the quick fix will require him to register and account for VAT in the Member State where the goods were stored but he will also be able to deduct that VAT. The operation will only trigger a compliance burden and loss of time to taxpayers and tax authorities. Only in cases where the supplier does not have a full deduction right or when the disappearance of the goods is due to theft does the restriction make sense because Member States, in the first case, have to and, in the second case, are allowed to require adjustment of the VAT deductions.[16] It would have been less costly to provide that the call-off stock arrangements cease to be fulfilled in those cases only.

The other disturbing element in respect of the consequences attached to destruction, loss or theft of the goods that the writer would like to highlight is the fact that the quick fix deems an intra-EU acquisition to happen on the date that the goods were actually removed or destroyed. This goes beyond the temporal alteration of reality; it actually creates a whole fiction: the seller is deemed to acquire something that does not exist.

This could have a dramatic effect on the principle of effectiveness as it could render the exercise of the right to deduct impossible or excessively difficult. In fact, the Member State of arrival could consider that, because the right to deduct arises at the time when the deductible VAT becomes chargeable, namely when the goods are acquired, which in that case is when they are destroyed or removed, no such right has ever arisen. Even if this seems far-fetched, it could well happen as Member States have proved capable of developing all kinds of far-fetched and therefore arguably ineffective arguments.

Before bringing the discussion to a close, it must be pointed out that the Explanatory Notes of the Commission services (the Explanatory Notes)[17] have developed many scenarios deriving from the general case covered by the quick fix. In some of these scenarios, the setting of the transaction is different, but the benefit of the simplification can still be enjoyed while in other cases, the change of setting terminates the simplification. All these developments show that the quick fix fails to simplify the system even if it achieves the targeted harmonisation to a limited extent.

2. Customer VAT number as substantive requirement for exemption of intra-EU supply

This quick fix concerns the VAT rules through which a business may exempt an intra-EU supply of goods. The analysis of the quick fix is backed up by a helicopter view of the definitions underlying the exemption which substantiate the need for improvement of the current rules.

The writer suggests that this quick fix only partially achieves its aim and lacks foundations especially in view of the substance over form principle.

[15] VAT Directive, above fn.5, Arts 168 and 185(2).
[16] VAT Directive, above fn.5, Art.185(2).
[17] European Commission, *Explanatory Notes on the EU VAT changes in respect of call-off stock arrangements, chain transactions and the exemption for intra-Community supplies of goods "2020 Quick Fixes"* (December 2019).

2.1. The exemption of intra-EU supply

An intra-EU supply of goods is a transaction in which goods are dispatched or transported from one Member State to another Member State.

Under the current rules, when an intra-EU supply of goods is carried out between taxable persons, it is localised in the Member State of departure for taxation purposes. There, in the Member State of departure, it is exempt with a deduction right based on Article 138(1) of the VAT Directive. For this exemption to apply a number of conditions need to be fulfilled.[18] One of these conditions is that the purchaser of the goods is a taxable person acting as such in another Member State. Becoming a "taxable person" is straightforward: the VAT Directive establishes that any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity, becomes a taxable person.[19]

The condition that the purchaser must be a taxable person for this exemption to apply may seem obvious, but practice has demonstrated otherwise, as illustrated by the CJEU case law. For example, in *Traum EOOD v Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna praktika' Varna pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite* (*Traum*),[20] a Bulgarian company had performed supplies under the VAT exemption to a purchaser in Greece. The authorities challenged the application of the exemption because the VAT identification number of the purchaser had been suspended. In the case *Euro Tyre BV – Sucursal em Portugal v Autoridade Tributária e Aduaneira* (*Euro Tyre*),[21] a supply had happened under the VAT exemption between Portugal and Spain. The exemption was denied by the Portuguese tax authorities because the Spanish purchaser only possessed a VAT identification number which was valid for domestic transactions and which was not entered in the VAT Information Exchange System (VIES). The tax authorities' confusion probably derived from the fact that the VAT Directive requires Member States to enable operators to obtain information on the VAT status of the parties with which they are dealing.[22] However, neither the VAT identification number nor the VIES registration of the customer are obligatory—they are not substantive conditions—in determining whether or not an operator is a taxable person and therefore whether or not they can apply the exemption.[23]

It has thus been recognised by the Court that the VAT Directive does not require the recipient to be registered for VAT to qualify as a taxable person and therefore to benefit from the exemption for intra-EU supply. Such lack of formalism adheres perfectly to the letter of the text but deprives the national tax authorities of the tool that, since the opening of the borders in 1993, has been the sole means at their disposal of monitoring intra-EU transactions. The registration of taxable

[18] Under VAT Directive, above fn.5, Art.138(1) Member States are to exempt supplies of goods. It is notably required for the exemption to apply that the goods are dispatched or transported cross-border within the EU, by or on behalf of the vendor or the person acquiring the goods, for another taxable person, or for a non-taxable legal person acting as such in a Member State other than that in which dispatch or transport of the goods began.

[19] The definition of "taxable person" is set out in the VAT Directive, above fn.5, Art.9(1).

[20] *Traum EOOD v Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna praktika' Varna pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite* (C-492/13) EU:C:2014:2267 (CJEU).

[21] *Euro Tyre BV – Sucursal em Portugal v Autoridade Tributária e Aduaneira* (C-21/16) EU:C:2017:106 (CJEU).

[22] VAT Directive, above fn.5, Art.214(1)(b) requires Member States to take all measures necessary to identify by means of an individual number, in particular, every taxable person or non-taxable legal person who makes intra-Community acquisitions.

[23] *Euro Tyre* (C-21/16) (CJEU), above fn.21, EU:C:2017:106 at [31] and [32].

persons for VAT provides the authorities with the identity of those operating in their territories. This knowledge gives the authorities the capacity to target their actions, to request data from those in charge of collecting VAT and eventually facilitates the detection of irregularities and the countering of, in particular, carousel fraud. Such an observation led the Economic and Financial Affairs Council (ECOFIN) to suggest making the VAT-identification number a condition for granting the exemption to intra-EU supplies.[24]

2.2. Quick fix

As from 1 January 2020, the VAT Directive has been modified so that, in addition to the existing conditions, two new substantive conditions have to be met in order to be able to exempt intra-EU supplies.

First, the VAT number of the customer is to be regarded as a substantive requirement for applying the VAT exemption to intra-EU supply. Until now, the obligation to communicate the VAT identification number of the person acquiring the goods was merely a formal requirement.[25] The new rule states that

> "the taxable person or non-taxable legal person for whom the supply is made *is identified for VAT purposes* in a Member State other than that in which the dispatch or transport of the goods begins and has indicated this VAT identification number to the supplier".[26]

Therefore, where the person acquiring the goods does not indicate their VAT identification number to the supplier, the conditions for applying the exemption will be seen as not having been fulfilled and the supplier shall have no other option but to charge VAT.[27]

This condition addresses the aforementioned issues and finds its legitimacy in the observation that, from a procedural perspective, as a formal requirement, the VAT identification number has had only a limited impact. However, the condition raises some questions, notably in respect of its co-ordination with the principle of substance over form that prevails in VAT matters. This principle builds on the notions of formal and substantive conditions which result in the granting of an exemption from VAT once the substantive requirements have been satisfied.[28] The substantive conditions are those which govern the substance and scope of the right to which they

[24] Council conclusions of 8 November 2016 on Improvements to the current EU VAT rules for cross-border transactions (No. 14257/16 FISC 190 ECOFIN 1023 of 9 November 2016).

[25] See, to that effect, the CJEU judgment of *Vogtländische Straßen-, Tief- und Rohrleitungsbau GmbH Rodewisch (VSTR) v Finanzamt Plauen* (*VSTR*) (C-587/10) EU:C:2012:592 (27 September 2012) at [51].

[26] VAT Directive, above fn.5, new Art.138(1)(b) inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(3)(a) (emphasis added).

[27] This interpretation has been confirmed by VAT Committee, *Guidelines Resulting from the 113th Meeting of 3 June 2019*, Document E – taxud.c.1(2019)7900313 – 976.

[28] The CJEU has developed a line of case law concerning the principle that substance should prevail over form. See notably the following judgments: *Firma Hans Bühler KG v Finanzamt de Graz-Stadt* (C-580/16) EU:C:2018:261; *UAB „Enteco Baltic" v Muitinės departamentas prie Lietuvos Respublikos finansų ministerijos* (C-108/17) EU:C:2018:473; *Santogal M-Comércio e Reparação de Automóveis Lda v Autoridade Tributária e Aduaneira* (C-26/16) EU:C:2017:453; *'Toridas' UAB v Valstybinė mokesčių inspekcija prie Lietuvos Respublikos finansų ministerijos* (*Toridas*) (C-386/16) EU:C:2017:599; *Josef Plöckl v Finanzamt Schrobenhausen* (C-24/15) EU:C:2016:791. See also concerning the principle of substance over form, M. Lamensch, "The principle of 'substance over form' with respect to the exercise of the right to deduct input VAT – A critical analysis of the Barlis jurisprudence" (2017) 6(2) *World Journal of VAT/GST Law* 129.

are attached whereas the formal conditions regulate the rules governing the exercise and monitoring of that right.[29] In that context and considering that the quality of taxable person is not dependent upon the registration for VAT[30] and, as such, is not per se a substantive element, it seems rather convoluted to make the registration for VAT purposes, and the correlative VAT identification number, a substantive condition for the exemption. For the coherence of the system, the VAT registration should bear the same weight in the acquisition of the quality of taxable person as it does in the granting of the exemption for intra-EU supply.

The condition also raises questions in respect of the quick fixes' aim of delivering simplification. Up until now, businesses traditionally checked the validity of their customers' VAT number at the time the EC Sales List (ESL) filings were being done. Businesses will now have to check the validity of their customers' VAT number at the time the order is placed or at the latest when the invoice is being issued. Such an immediate check will require a process shift and possibly the assistance of an automated tool.[31] Moreover the reliance on the VIES for the checks will require that the VIES platform works efficiently, which has not always been the case until now.

Secondly, the exemption will also be dependent on the intra-EU supply being reported in the supplier's ESL.[32] The new provision mentions that this condition is neutralised if the failure to report the supply in the ESL can be justified. The text does not provide any indication of what justifications may validly be invoked. The absence of a standard is concerning. Bearing in mind that the importance given to substantive conditions by the principle of substance over form is meant to circumvent inappropriate limitations by the Member States on the right to exempt, the elusiveness of the new provision is regrettable because it voids the whole purpose of making the condition substantive. It also contravenes the principle of legal certainty and may introduce discrepancies between the operators based on their Member States of reporting and thus it may deter the achievement of the single market.

The Explanatory Notes provide a remedy for this loophole by including a list of situations where the shortcomings of a supplier could be considered duly justified. The examples so provided limit the justifications that one may advance in cases where the report was submitted either with mistakes of content or was misplaced in the wrong ESL.

"• The supplier has by accidental mistake not included the exempt intra-Community supply in the recapitulative statement covering the period in which the supply took place but has included it in a recapitulative statement covering the subsequent period;

• The supplier has included the exempt intra-Community supply in the recapitulative statement covering the period in which the supply took place but made an unintentional mistake as regards the value of the supply in question;

[29] See for elements of distinction the judgment of the CJEU in *Idexx Laboratories Italia Srl v Agenzia delle Entrate* (C-590/13) EU:C:2014:2429 at [41] and [42].

[30] VAT Directive, above fn.5, Art. 9(1) does not mention any registration requirement to qualify as a taxable person.

[31] For example, EY has developed the EY VIES Validator, a tool that quickly validates VAT ID numbers in bulk from a Microsoft Excel spreadsheet with the VIES website of the European Commission.

[32] VAT Directive, above fn.5, new Art.138(1)(a) inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(3)(a).

- A re-structuring of the company acquiring the goods has resulted in a new name and a new VAT identification number but the old name and VAT identification number continue to exist during a short interim period. On the recapitulative statement, the supplier has by mistake included the transactions under that old VAT identification number."[33]

Unfortunately, the Explanatory Notes are not legally binding and as such will not be able to provide the certainty needed or to ensure a level playing field.

3. Documentary proof for zero rating of intra-EU supplies of goods

This quick fix standardises the documentary evidence of proof of transport to another Member State for the purpose of applying the exemption applicable to intra-EU supply.[34]

In the following paragraphs, the quick fix is described and evaluated from the perspective of the pre-existing state of play and its related limitations.

The writer suggests that this quick fix has great potential but that it is threatened by the fact that it can only be relied upon when the documents are issued by independent parties.

3.1. Zero-rating of intra-EU supplies' rules

An intra-EU supply of goods is a transaction in which goods are dispatched or transported from one Member State to another Member State. It is divided into two sub-transactions, a supply and an acquisition. The former is exempt from VAT subject to a series of conditions and the latter is taxed. One of the conditions of the exemption relates to the physical movement of the goods from one Member State to another: the goods must have left the Member State of supply.[35]

Member States have discretion over the evidence that they require to establish the effective crossing of frontiers.[36] In that context, it must be recognised that the abolition in 1993 of frontier checks between the Member States has made securing evidence of the crossing of frontiers a challenge for the tax authorities.[37] As a result it is principally on the basis of the evidence provided by taxable persons that the tax authorities satisfy themselves that there has been an effective crossing. But the matter is not crystal clear as demonstrated by the fact that the CJEU has had to render numerous judgments dealing with the details of the documentary evidence required. In that context, the CJEU has provided a number of safeguards surrounding the discretion given to Member States.[38] The evidence must ensure the correct and straightforward application of the exemption and prevent any possible evasion, avoidance or abuse. In the pursuit of these objectives,

[33] Explanatory Notes, above fn.17, 74 and 75.
[34] Council Implementing Regulation (EU) 2018/1912, above fn.4, Art.1.
[35] VAT Directive, above fn.5, Art.138(1); and judgment of the CJEU, *The Queen, on the application of Teleos plc and Others v Commissioners of Customs & Excise* (*Teleos*) (C-409/04) EU:C:2007:548 at [33].
[36] VAT Directive, above fn.5, Art.131. The CJEU has confirmed the national competence of Member States to adopt measures of national law to substantiate the exemption, see for example *VSTR* (C-587/10), above fn.25, EU:C:2012:592 at [42].
[37] Council Directive 91/680/EEC of 16 December 1991 supplementing the common system of value added tax and amending Directive 77/388/EEC with a view to the abolition of fiscal frontiers [1991] OJ L376/1.
[38] The case law of the CJEU has stated the common rules for evidence in the cases *Teleos* (C-409/04), above fn.35, EU:C:2007:548; *Albert Collée v Finanzamt Limburg an der Lahn* (*Collée*) (C-146/05) EU:C:2007:549; *Twoh International BV v Staatssecretaris van Financiën* (*Twoh International*) (C-184/05) EU:C:2007:550.

when requesting evidence, Member States must comply with the general principles of law as well as with the fundamental freedoms established by the EC Treaty.

Despite these safeguards, the discretion afforded to Member States has given rise to a variety of issues which have in turn increased the compliance costs and risks for businesses and impaired the free movement of goods within the internal market to name but a few of the main drawbacks which have resulted.[39] Among the issues identified is the fact that Member States have never aligned their views on the appropriate type of documentary evidence which is required. As such, the exemption is based on a variety of types of documentary evidence applying across the EU. Operators who do business across the EU therefore have to abide by a variety of different approaches and provide a myriad of documents. Another issue which has been identified relates to the constant increase in the level of documentary evidence required to enable the exemption. In practice, this has given rise to situations in which suppliers have been unreasonably refused the exemption, where disproportionate compliance burdens have been imposed upon legitimate businesses and where local initiatives have been put in place in breach of the EC framework. An example of such a questionable local initiative is *Gelangensbestätigung* (certificate of entry) which was introduced in Germany in 2012. Another such initiative is the Electronic Trade and Transport Control System (the EKAER system) which was implemented in Hungary in 2015.

3.2. Quick fix

In order to provide a solution to the identified issues, this quick fix introduces a common framework for the documentary evidence which is required in relation to the cross-border transport of goods.

The common framework incorporates a rebuttable presumption that the cross-border transport of the goods has taken place. When a supplier is able to provide two non-contradictory evidential documents issued by two different parties that are independent of each other and of the vendor and of the acquirer pertaining to a dedicated list, it is assumed that the goods were transported to another Member State.[40]

Being a rebuttable presumption, the tax authorities can defeat it by proving that the goods have not been transported. The Explanatory Notes provide for a real-life scenario:

> "This can for instance be the case when during a control the tax authorities find out that the goods are still present in the warehouse of the supplier or the tax authorities are aware of an incident during transport that resulted in the goods being destroyed before leaving the territory."[41]

When the presumption is rebutted, the vendor cannot avail himself of the exemption because the rebuttal necessarily requires that the transport of the goods has not taken place. However, in the case of the presumption not applying, for example because the documents are not satisfactory,

[39] VAT Expert Group, *Proof of Evidence of Intra-Community Supplies*, taxud.c.1(2016)933710 (14 December 2015).
[40] This presumption only covers the exemption condition which relates to the transport, therefore to be able to exempt the supply, the other conditions set out in the VAT Directive need to be fulfilled (the conditions of VAT Directive, above fn.5, Art.138).
[41] Explanatory Notes, above fn.17, 76.

there is no assumption of cross-border transport but a vendor may still exempt his supply provided he proves to the satisfaction of the tax authorities that the conditions for the exemption are met.

With regard to the evidential documents, not all those which evidence the transport of goods will afford the benefit of the safe harbour provided for by the presumption. The documents need to belong to a list, drawn up for the purpose of the common framework, which is arranged in two categories:

- Category A: documents in relation to the transport of the goods. For example, a signed CMR document, a bill of lading, an airfreight invoice or an invoice from a carrier of the goods.
- Category B: documents such as an insurance policy in relation to the transport of the goods, proof of payment of the transport of the goods, official documents issued by a public authority, such as a notary, confirming the arrival of the goods in the Member State of destination or a receipt issued by a warehouse keeper confirming the storage of the goods in the Member State of arrival.

The presumption is deemed to be fulfilled if the supplier has transported the goods himself and if he has obtained at least two Category A documents, or one Category A document and one Category B document. In the situation where the transport is arranged by the customer, the supplier must also possess a written statement in which the customer confirms that the goods have been transported to the Member State of arrival. The customer shall provide the vendor with the written statement by the 10th day of the month following the supply. In the first version of the draft Explanatory Notes, in cases where the written statement was not provided in due time, it was envisaged that the vendor could not benefit from the presumption.[42] However, in the final version of the Explanatory Notes, a completely different approach is taken. Considering that the purpose of the deadline is not to penalise the vendor and deprive him of the possibility of benefiting from the presumption when the acquirer has not submitted a confirmatory written statement in time, the Explanatory Notes state that even if the deadline has elapsed, the vendor remains entitled to rely on the presumption provided all the other relevant conditions are met. This obviously results in the condition being without substance.[43] That said, the added value of the written statement is not clear enough to bemoan its loss.

Another point relating to the Category A and B documents that deserves to be mentioned is the requirement that they must be issued by two parties which are independent both of each other and of the vendor and the acquirer. The meaning of "independent" in the context of that provision is not provided. The Explanatory Notes relate the guidelines of the VAT Committee which specify that

> "two parties shall not be regarded as 'independent' where they share the same legal personality; and the criteria set out in Article 80 of the VAT Directive shall be used, so that parties in respect of which 'family or other close personal ties, management, ownership,

[42] European Commission, *Explanatory Notes on the "2020 Quick Fixes"*, draft version, taxud.c.1(2019)6275014 (11 September 2019).
[43] Explanatory Notes, above fn.17, 79.

membership, financial or legal ties' exist may not be regarded as independent of each other".[44]

In practice, such ties often exist between companies belonging to the corporate group of either the seller or the purchaser, which means that the overall utility of the common framework is threatened by this restriction.

4. Chain transactions

In cross-border trading, it is a common practice to purchase and sell goods without acquiring physical ownership as the goods are delivered directly from the original supplier to the final customer. Such transactions are known as chain transactions.[45]

The quick fix related to these transactions addresses the issue of the identification of the supply to which the transport or dispatch of the goods is to be ascribed, that is to say, the determination of which supply is the exempt intra-EU supply in the chain.

The writer believes that the quick fix addresses the problems caused by the excessive flexibility of the system.

4.1. Current rules

A basic sales chain transaction is shaped in such a way that the physical delivery is distinct from the contractual path: business A in Member State 1 sells goods to business B in Member State 2, B sells the goods to business C in Member State 3 and the goods are dispatched or transported from A to C. For VAT taxation purposes, the contractual path is followed, generating as many VAT transactions in the chain as there are legs involved. In the case of a cross-border supply chain, since only one transport takes place, the intra-EU transport is attributed to only one leg, which implies that only one of the legs gets to be the exempt intra-EU supply.[46] The other legs are local taxable supplies.

The determination of the exempt leg is not an easy task especially because the VAT legislation does not provide any rules for the allocation of transport.[47] The allocation depends on an overall assessment of the facts from which the supply which fulfils all the conditions relating to an intra-EU supply must be determined.[48] The relevant facts include, among others, the contractual terms and conditions of the trade, the incoterms and the VAT numbers used for invoicing. In practice, the tax authorities in the different Member States involved do not gain access to all the

[44] Explanatory Notes, above fn.17, 77.

[45] The term "Chain Transaction(s)" is not defined by the VAT Directive. It appears as a keyword in the CJEU case *EMAG Handel Eder OHG v Finanzlandesdirektion für Kärnten* (*EMAG Handel Eder*) (C-245/04) EU:C:2006:232.

[46] CJEU judgments *Toridas* (C-386/16), above fn.28, EU:C:2017:599 at [34]; and *EMAG Handel Eder* (C-245/04), above fn.45, EU:C:2006:232 at [45]; Opinion of Advocate General Kokott in *AREX CZ a.s. v Odvolací finanční ředitelství* (Opinion of Advocate General Kokott in *AREX CZ*) (C-414/17) EU:C:2018:624, point 55.

[47] An exception concerns the triangular transactions for which the VAT Directive does provide such an allocation. VAT Directive, above fn.5, Art.141.

[48] CJEU judgments *Kreuzmayr GmbH v Finanzamt Linz* (C-628/16) EU:C:2018:84 at [32]; *Toridas* (C-386/16), above fn.28, EU:C:2017:599 at [35]; *VSTR* (C-587/10), above fn.25, EU:C:2012:592 at [32]; and *Euro Tyre Holding BV v Staatssecretaris van Financiën* (*Euro Tyre Holding*) (C-430/09) EU:C:2010:786 at [27]; and Opinion of Advocate General Kokott in *AREX CZ* (C-414/17), above fn.46, EU:C:2018:624, points 58 and following and Opinion of Advocate General Kokott in *EMAG Handel Eder* (C-245/04), above fn.45, EU:C:2005:675, point 56.

same underlying facts and their overall assessment of all the circumstances of the case are therefore inevitably skewed or at least inconsistent. At the end of the day such a situation triggers uncertainty and may even cause double taxation for businesses. In the face of these challenges, the CJEU has provided some guidance.[49] But that guidance, regarded as insufficient,[50] has not provided the security needed by businesses.

4.2. Quick fix

The quick fix modifies the VAT Directive so that uniform criteria are provided to ascribe the transport to one of the supplies in a sales chain transaction.

The quick fix only targets situations where an uncertainty could exist, namely situations where an intermediary arranges the move.[51] The uncertainty in such a situation derives from the fact that if the intermediary arranges the transport he is then involved in two transactions which implies that the said transport can be ascribed to either of the transactions.

The default position is that the transport shall be ascribed to the supply to the intermediary who takes care of the transport or dispatch. However, the transport shall be ascribed to the supply of goods made by the intermediary in case that intermediary has communicated to his supplier his VAT identification number in the Member State of departure.[52]

In the default position, all supplies preceding the intra-EU supply and the intra-EU supply itself are deemed to take place in the Member State of departure and all subsequent supplies are deemed to take place in the Member State of destination.[53] For instance in the basic sales chain transaction mentioned above, the transport is ascribed to the supply from A to B. Thus, the supply by A is an intra-EU supply of goods exempt in Member State 1 (if the conditions of Article 138 of the VAT Directive are fulfilled). A taxable intra-EU acquisition is performed by B in Member State 3. The supply from B to C is considered to be a domestic transaction taxable in Member State 3.

[49] CJEU judgments *AREX CZ a.s. v Odvolací financní reditelství* (C-414/17) EU:C:2018:1027; *VSTR* (C-587/10), above fn.25, EU:C:2012:592; *Euro Tyre Holding* (C-430/09), above fn.48, EU:C:2010:786; *EMAG Handel Eder* (C-245/04), above fn.45, EU:C:2006:232.

[50] The insufficiency of the guidance provided by the case law is highlighted in the working document prepared by R. Korf, Chair of the FEE VAT Task Force, EU VAT FORUM meeting of 14 October 2015, *Intra-community supply of goods – Identification of the intra-community transaction in case of successive supplies, giving rise to a single dispatch or transport of the goods*, available at: *https://circabc.europa.eu/sd/a/96a30f2e-79ef-4c92-888f-04f1a5ad82ca/Intra-Community%20supplies.pdf* [Accessed 14 February 2020]. The same insufficiency is reported in the Opinion of Advocate General Kokott delivered on 3 October 2019 in the CJEU case *Herst, s.r.o. v Odvolací finanční ředitelství* (C-401/18) EU:C:2019:834 as she indicates that "in the view of the referring court clear criteria for determining the place of supply and ascribing the exemption to one of the supplies in a supply chain still cannot be inferred from the Court's previous case-law".

[51] The quick fix is also not applicable to the cases where "a taxable person facilitates, through the use of an electronic interface such as a marketplace, platform, portal or similar means, distance sales of goods imported from third territories or third countries in consignments of an intrinsic value not exceeding EUR 150", or "the supply of goods within the Community by a taxable person not established within the Community to a non-taxable person": VAT Directive, above fn.5, new Art.36a(4) inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(2).

[52] VAT Directive, above fn.5, new Art.36a(1) and (2) inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(2).

[53] This corresponds to the rule in the VAT Directive, above fn.5, Art.32. The rule was further explained in CJEU judgment *EMAG Handel Eder* (C-245/04), above fn.45, EU:C:2006:232 at [50].

Things are different if B is VAT registered in the Member State where the transport or dispatch starts and B communicates to A the VAT identification number issued to him by this Member State. In such a situation, the transport is ascribed to the supply from B to C. Thus, the supply from A to B is a domestic transaction by A in Member State 1 and the supply from B to C is an intra-EU supply by B exempt in Member State 1 (if the conditions in Article 138 are fulfilled). Lastly, C performs an intra-EU acquisition taxable in Member State 3.

One concern seems to be for businesses not to get confused between the determination of the supply susceptible to qualifying as a VAT exempt supply and the exemption itself. It should not be assumed that because the transport has been ascribed that the benefit of the exemption of Article 138(1) of the VAT Directive is automatic. Seemingly, the proofs are distinct; on the one hand the proof concerns the organisation of the transport and on the other hand it concerns the transport per se.

Another concern seems to the writer to be the determination of the intermediary; a point which is rather central to the matter at hand. The quick fix includes a definition of intermediary[54]: this is the supplier in the chain other than the first supplier, who dispatches or transports the goods, himself or by a third party on his behalf. While this definition seems straightforward and capable of doing away with the uncertainties that have prevailed up until now, the Explanatory Notes relate the VAT Committee's guidelines according to which other criteria could intervene such as the risk of loss or damage to the goods during the transport.[55]

All in all, this quick fix seems to achieve its aims of simplification and harmonisation of the VAT rules. It sets a simple rule that fits in well with the VAT rules applicable to the intra-EU trade and that provides the legal certainty needed.

5. Conclusion

The aims of the quick fixes are to deter the avoidance of accounting for VAT or absconding with VAT and to bring simplification for businesses. To achieve these aims the quick fixes seek to streamline and harmonise the VAT system, to overhaul disparate national rules, to simplify and tighten up processes.

At this stage, the conclusion that can be drawn is mixed. The quick fixes achieve a certain harmonisation and bring a level of legal certainty for businesses. They should also bring some reassurance to tax authorities. But the quick fixes also bring wide-ranging changes that have proved to be technically complex. The simplification feature has in some cases been lost in the process. The obvious proof of this complexity is that the Commission services have issued an 85 page Explanatory Note to accompany the implementing regulations. The new requirements will increase the administrative burden on businesses and could unleash certain complications which had remained hidden until now.

[54] VAT Directive, above fn.5, new Art.36a(3) inserted by Council Directive (EU) 2018/1910, above fn.3, Art.1(2).

[55] Explanatory Notes, above fn.17, 51. This criterion is proposed in the Opinion of Advocate General Kokott delivered on 3 October 2019 in the CJEU case *Herst, s.r.o. v Odvolací finanční ředitelství* (C-401/18), above fn.50, EU:C:2019:834 at [79]. It is also presented as an alternative in VAT Committee, *Guidelines Resulting from the 113th Meeting of 3 June 2019*, above fn.27, point 3.6.5.

At the end of the day, only practice will allow for the proper evaluation of the quick fixes' strengths and weaknesses. ☙

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☙ Chain transactions; EU law; Intra-Community supplies of goods; Tax simplification; VAT; Zero rating

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Case Notes

Starbucks and *Fiat Chrysler*: is the European Commission defending national tax regimes?

The judgments in *Netherlands (supported by Ireland intervening) v European Commission; Starbucks Corp and another v European Commission* (*Starbucks*)[1] and *Luxembourg (supported by Ireland intervening) v European Commission; Fiat Chrysler Finance Europe (supported by Ireland intervening) v European Commission* (*Fiat Chrysler*)[2] have been eagerly awaited by a wide range of interested parties. Both the factual background and the legal implications are extensive. The very limited review of them which is possible here is intended to provide a base from which to take an overview of the litigation and some of the most important questions which it raises. For example, do these cases question the scope of the powers of Member States in relation to tax or is it merely the proper application of the domestic tax rules which is being addressed? In addition, one may ask if the arm's length principle in tax, the credibility of which is currently under a certain amount of pressure, is comparable to relevant principles in state aid law. One may also ask if it is appropriate to conflate arm's length transactions with commercial transactions.

Both the UK and Ireland had to consider the subsidiary issue of whether or not to intervene in the litigation. The two states came to different conclusions. In doing so they made choices which reflect their different political positions and aspirations. Whether, with hindsight, they will be content with their respective positions remains to be seen.

The judgments shine an unusually bright and, perhaps, uncomfortable light upon the activities of corporate taxpayers and national tax administrations and the relationship between them. The European Commission, controller of the state aid search light, has had the task of interpreting what it has discovered in a territory which it has only relatively recently begun to explore. Some will think that its reaction to unfamiliar terrain, while understandable, will need to exhibit more sophistication in the future. Member States meanwhile, have reacted unenthusiastically, and on some occasions with undisguised concern, to the activities of strangers to the land of national tax administration.

The Commission's decisions that the tax rulings of the authorities in the Netherlands and Luxembourg gave rise to state aid were both given on 21 October 2015.[3] The General Court judges hearing the challenges to both the Commission's decisions were sitting in an identically

[1] *Netherlands (supported by Ireland intervening) v European Commission; Starbucks Corp and another v European Commission* (Joined Cases T-760/15 and T-636/16) EU:T:2019:669; [2019] STC 2323.

[2] *Luxembourg (supported by Ireland intervening) v European Commission; Fiat Chrysler Finance Europe (supported by Ireland intervening) v European Commission* (Joined Cases T-755/15 and T-759/15) EU:T:2019:670; [2019] STC 2416.

[3] Commission Decision 2017/502/EU of October 21 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks [2017] OJ L83/38 and Commission Decision 2016/2326/EU of October 21 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat [2016] OJ L351/1.

constituted seventh chamber with extended composition. Ireland supported the Netherlands, Luxembourg and Fiat Chrysler Finance Europe. The Court decisions were both delivered on 24 September 2019. Thereafter the course of the two sets of proceedings diverge. The Commission's decision in relation to the Netherlands was annulled whereas its decision in relation to Luxembourg was upheld. Only the decision in relation to Luxembourg has been appealed.[4]

Some basic facts: *Starbucks*

Starbucks concerned an advance pricing arrangement (APA) entered into by the Netherlands' tax authorities on 28 April 2008. It was valid for the period 1 October 2007 to 31 December 2017. In contrast, Fiat Chrysler concerned a tax ruling made on 3 September 2012 which was to be valid for the five tax years, 2012 to 2016. At first sight, one may think that the longer ruling would be the most vulnerable. In fact, the opposite turned out to be the case.

The *Starbucks* APA concerned Starbucks Manufacturing Emea BV (SMBV) which was established in the Netherlands. It was a subsidiary of the Starbucks group the controlling company of which had its headquarters in Seattle. SMBV was mainly responsible for the production of roasted coffee beans and their provision, along with related products, to Starbucks' shops in Europe, the Middle East and Africa (the EMEA region). It had a roasting facility in the Netherlands.

SMBV paid a royalty to Alki LP (Alki). Alki was another subsidiary of the Starbucks group. It was established in the UK and indirectly controlled SMBV. The royalty was paid by SMBV for the use of Alki's intellectual property in respect of roasting technologies and roasting know-how.

The APA was established for the purposes of SMBV's corporate income tax declarations in the Netherlands. Article 8b(1) of the Law on Corporation Tax[5] imposed an arm's length standard where one entity participated directly or indirectly in the management, control or capital of another entity and the conditions between these entities differed from those which would have been made between independent parties. In such circumstances the profit of the entities is to be determined as if the conditions were those which would have been made between independent parties.[6]

The APA aimed to establish SMBV's remuneration for its production and distribution activities within the Starbucks group using the arm's length method. It also endorsed the amount of the royalty to be paid. The royalty was calculated according to the transactional net margin method (TNMM). The Commission used the comparable uncontrolled price (CUP) method to analyse it. As is well known, both methods are included amongst the methods permitted under the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995–2013) (the Guidelines) which aim to assist enterprises and administrations in their application of the arm's length principle authoritatively stated in Article 9.1 of the OECD's *Model Tax Convention on Income and on Capital*.

[4] See *Ireland v Commission and others* (C-898/19 P) and *Fiat Chrysler Finance Europe v Commission* (C-885/19 P).
[5] Law on Corporation Tax (*Wet op vennootschapsbelasting*) 1969.
[6] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [4].

By the decision of 21 October 2015 the Commission found that the APA constituted aid incompatible with the internal market and Article 107(1) of the Treaty on the Functioning of the European Union (TFEU), and ordered the recovery of €25.7 million. It considered that the royalty paid was not a reliable approximation of a market-based outcome and would not have resulted from negotiations between independent undertakings negotiating in comparable circumstances. Consequently, SMBV obtained a selective advantage.

Some basic facts: *Fiat Chrysler*

Fiat Finance and Trade Ltd (FFTL), based in Luxembourg, provided treasury services and financing to the companies of the Fiat/Chrysler automobile group established in Europe. The Luxembourg tax code and a circular issued by the director of Luxembourg taxes ensured that an arm's length principle was part of Luxembourg's tax law.[7] It required transactions between group companies to be taxed as if they had been agreed to by independent companies negotiating under comparable circumstances at arm's length. The tax ruling in issue endorsed a method for arriving at a profit allocation to FFTL within the Fiat/Chrysler group so as to establish its yearly corporate income tax liability to Luxembourg.

The allocation was established using the TNMM and the profit attributed to FFTL had a risk remuneration element and a functions remuneration element. There was no remuneration in respect of FFTL's equity designated as supporting its equity in two companies outside Europe. By its decision, the Commission found that the ruling constituted operating aid incompatible with the internal market and Article 107(1) TFEU and ordered recovery of the aid.

In coming to its conclusion, the Commission rejected the use of the TNMM and a number of aspects of the methodology used in the relevant analysis. For example, it considered the use of the hypothetical regulatory capital of FFTL to be both inappropriate and underestimated the return on such capital out of line with the arm's length principle. The Commission concluded that the tax ruling in issue had conferred a selective advantage on FFTL. It had resulted in a tax liability which was lower than that of stand-alone companies under Luxembourg's corporate income tax system. The liability was also lower than that under the regime applicable to integrated companies.

Starbucks and the General Court: a detailed attack succeeds

The General Court annulled in its entirety the decision of the European Commission in relation to the ruling by the Netherlands' tax authorities. It concluded that the reasoning of the Commission in the decision had not demonstrated the APA had conferred on SMBV an "advantage" within Article 107 TFEU. It followed that the Commission had not demonstrated, as it had to do, that the ruling derogated from the law on corporate income tax and the relevant transfer pricing decree, so that less tax was paid than would otherwise have been the case.

The Commission had committed numerous errors. It had wrongly concluded that the mere choice of the use of the TNMM resulted in an advantage,[8] wrongly based its analysis on

[7] See Luxembourg Income Tax Code of December 4, 1967, Art.164(3) and Circular L.I.R. No 164/2 of January 28, 2011 issued by the director of Luxembourg taxes.
[8] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [216].

information that was not available or reasonably foreseeable in April 2008 when the APA had been entered into,[9] incorrectly concluded that SMBV did not need to pay a royalty,[10] and failed to demonstrate that SMBV had made a loss on its roasting activities since 2010 so making the payment of royalty impermissible.[11] Furthermore, there were a number of criticisms to be made of the analysis of the comparability of relations between SMBV and Alki and the Starbucks group and third parties.[12] In particular, the Commission was wrong to assert that analysis of the group and third parties would have shown that, using the CUP, there would have been no royalty payment passing between the two companies in question.[13]

The catalogue of errors continued. The Commission made errors in saying that the royalty should have been less than that affirmed under the APA[14] and went wrong in its consideration of the appropriate mark-up for coffee beans.[15] The Court said that the Commission's attempt to replicate the tax adviser's analysis of SMBV's position with that of a corrected peer group of companies "first, lacks reliability, and, second is vitiated by a number of errors".[16] One of those errors involved comparing the incomparable, namely, the operating profits of comparable companies with the taxable profits of SMBV.[17] Furthermore, adjustments by the Commission made to ensure appropriate comparability between SMBV and other companies could not be justified.[18]

It is hardly surprising that the General Court's judgment in *Starbucks* is not being appealed. Margrethe Vestager Executive Vice-President of the European Commission expressly confirmed the position on 27 November 2019.[19]

By concentrating on the details of the Commission's analysis, the Netherlands managed to undermine the Court's confidence in it. That is often the best approach to challenging decisions of the Commission. Anyone used to attacking decisions to impose anti-dumping duty, for example, will have had the same experience. Those decisions too require a detailed prior investigation. If the detailed prior investigation can be shown to be inadequate the subsequent decision falls. High-flown attacks involving matters of political significance may appear more attractive. In reality, a court is much more likely to accede to a case which is founded on tightly defined issues of technical competence.

That is not to say that the Netherlands did not raise more general matters, it did. Like Luxembourg it alleged improper tax harmonisation by the Commission. The Court repeated some general observations about EU law and tax which will be regarded as important by Member

[9] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [251].
[10] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [265].
[11] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [278].
[12] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [288]–[345].
[13] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [346].
[14] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [372].
[15] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [402].
[16] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [500].
[17] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [493].
[18] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [548].
[19] L. Crofts and N. Hirst, *Starbucks' EU court victory on tax bill to go unchallenged, Vestager says* (MLex, 2019), available at: *https://mlexmarketinsight.com/insights-center/editors-picks/antitrust/europe/starbucks-eu-court-victory-on-tax-bill-to-go-unchallenged-vestager-says* [Accessed 15 January 2020].

States.[20] The Commission, on the other hand, will note that the Court concluded that it could use the arm's length principle in an investigation under Article 107(1) TFEU.[21] Nevertheless, the Commission could not be taken to have said in its decision that there was a general principle of equal treatment in relation to tax inherent in Article 107(1) TFEU. That would give that article "too broad a scope".[22]

In an observation which may well come to be significant in future cases, the Court acknowledged that the Commission is to give Member States a margin of appreciation in relation to their tax systems. It said

> "where the Commission checks whether the taxable profit of an integrated undertaking in application of a tax measure corresponds to a reliable approximation of a taxable profit realised under market conditions, it may determine the existence of an advantage within the meaning of art 107(1) TFEU only provided that the discrepancy between the two factors goes beyond inaccuracies inherent to the method used to obtain that approximation".[23]

In all the circumstances the provision of such a margin of discretion is inevitable. Its existence is an acknowledgement that the comparative exercise which the Commission undertakes in cases concerning a tax ruling is far from precise. The application of the arm's length rule is necessarily an exercise in approximation. Precise numbers are frequently used in imprecise ways.

Fiat Chrysler and the General Court: a more general attack fails

Like the Netherlands, Luxembourg contended that the Commission was engaging in tax harmonisation in disguise. In addition it relied upon the division of competences between Member States and the EU and the principle that the Commission has only those powers which are conferred upon it.[24]

The General Court made it clear that the Commission was not engaging in tax harmonisation. As may have been expected it re-stated the basic proposition that

> "since the Commission has the power to monitor compliance with Article 107 TFEU, it cannot be accused of having exceeded its powers when it examined the tax ruling at issue in order to determine whether it constituted State aid and, if it did, whether it was compatible with the internal market, within the meaning of Article 107(1) TFEU".[25]

The Court also accepted that direct taxation falls within the competence of Member States. In doing so it used a formulation which is familiar to anyone who has read any decision of the Court of Justice concerning the application of the fundamental freedoms to national tax law, namely

[20] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [143] and [158].
[21] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [163].
[22] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [168].
[23] *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [498] and [512].
[24] Reliance was placed on the Treaty on European Union Arts 3(6), 4, 5(1) and 5(2). See the judgment in *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [100] and [101].
[25] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [107].

> "according to settled case-law, while direct taxation, as EU law currently stands, falls within the competence of the Member States, they must nonetheless exercise that competence consistently with EU law…".[26]

Dealing with matters more specifically linked to state aid law, Member States, including Ireland no doubt, will have been pleased to see that the Court accepted that:

> "the Commission does not, at this stage of the development of EU law, have the power autonomously to define the 'normal' taxation of an integrated undertaking, disregarding national tax rules".[27]

Luxembourg failed, however, to sustain its contention that the use of the arm's length principle constituted an infringement of its fiscal autonomy or that it breached the principles of legal certainty and the protection of legitimate expectations.[28] Other unsuccessful submissions related to the methodology of establishing state aid including the existence of an advantage and selectivity, the obligation to state reasons, the alleged failure of the Commission to engage in sufficient analysis of the competitive effect of the tax ruling[29] and the alleged breach of the principle of legal certainty in relation to recovery of the aid.[30]

Luxembourg did have, however, one area in which to make detailed submissions about the analysis of the Commission. It concerned, largely, the methodology for calculating the remuneration of FFTL and, in particular, the segmentation of its capital to which four out of five alleged errors were related.[31] The fifth error concerned the rate of return applied to the hypothetical regulatory capital.[32] These were all rejected by the Court. Consequently, the Commission was able to sustain its conclusion that the tax ruling conferred an advantage. Consequently, Luxembourg's further submissions denying the existence of an advantage were considered only for the sake of completeness.[33]

The weight of the Netherlands' attack on the technicalities of the Commission's investigation carried it to victory. Luxembourg in contrast may be thought to have advanced a somewhat more limited technical attack (which is not to say it will necessarily be unsuccessful on appeal). As the Commission is not appealing the decision in relation to *Starbucks* that appeal is of considerable significance. For the Commission to lose the appeal in *Fiat Chrysler* would be the worst possible start to its attempt to apply state aid law to tax rulings. All Member States will be watching what happens carefully. So too will one country which is no longer a Member State, namely, the UK.

To intervene or not: the UK and Ireland

Given their attitude to the taxation of companies, it is no surprise that Ireland and the UK intervened in both cases. They were granted leave to intervene in *Starbucks* on 25 May 2016

[26] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [104].
[27] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [112].
[28] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [126].
[29] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [398].
[30] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [399] onwards.
[31] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [193].
[32] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [194].
[33] *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [287].

and in *Fiat Chrysler* on 13 June 2016. On 9 November 2016, however, the UK withdrew its intervention in both cases. It may be that the UK, apparently like the great majority of EU Member States, thought that its interests were best served by not being associated with state aid cases concerning tax rulings in the Netherlands and Luxembourg. That may be an entirely supportable position. Had the UK taken that view, however, it would not have intervened in the first place.

The reason for withdrawal would seem more likely to be related to the fact that the UK had held its referendum on membership of the EU on 23 June 2016 and that there was a majority in favour of Brexit. If intervention could be justified before the referendum, however, it could certainly be justified afterwards, at least if the political declaration on the future of the EU/UK relationship of 17 October 2019, and subsequently amended, is to be regarded as significant.[34]

The political declaration, even in its renegotiated form, makes clear that, in future relations between the EU and the UK, distortions of trade and unfair competitive advantages should be prevented. Accordingly, it envisages the maintenance of common high standards in areas including state aid and relevant tax matters. In addition, the parties commit to the principles of good governance in taxation and the curbing of harmful tax practices. The declaration envisages a trade agreement which will give more than one possible ground for examination of the rulings of the UK's tax authorities.[35]

The calculation for Ireland in relation to its involvement in these cases is obviously somewhat different from that of the UK. These proceedings help to establish a regime to which Ireland and the Irish tax authorities will be subject in future. That is, of course, true also for the other Member States but Ireland may have particular sensitivities in relation to national tax policy. In those circumstances Ireland's decision to ally itself with Luxembourg is worth considering.

It is entirely understandable that Ireland may consider that the early cases in relation to tax rulings may establish a line of jurisprudence which could subsequently be applied in relation to its tax regime. Consequently, it may have been thought essential for Ireland to ensure that its views are acknowledged as early as possible in relevant litigation. Both judgments of the General Court, perhaps particularly the judgment in *Fiat Chrysler*, contain material which will be helpful to Member States who wish to preserve their sovereignty in tax matters. Two points, however, may usefully be kept in mind.

First, the history of the cases concerning the fundamental freedoms and national taxation shows that Member States have had relatively little success when they advance broad propositions to the effect that national tax systems are their business and theirs alone. Greater success has come when they have acknowledged the application of the fundamental freedoms to national taxation but have sought then to rely upon the details of the particular case before the Court to limit the effect of the freedoms. The respective results of the cases involving the Netherlands and Luxembourg may indicate a similar state of affairs in relation to state aid.

Secondly, the nature of the tax system which Luxembourg operated at the relevant time is not the same as the tax system which is in issue in Ireland in relation to Irish tax rulings. That is

[34] Political declaration setting out the framework for the future relationship between the European Union and the United Kingdom [2019] OJ C384 I/178 (12 November 2019). It is a revised version of the declaration published on 25 November 2018 which is available at [2019] OJ C66 I/185 (19 February 2019).

[35] See the revised political declaration, above fn.34, Pt II, s.XIV "Level playing field for open and fair competition", para.77.

true, in particular, so far as concerns the presence or absence of the arm's length principle in the two tax systems. There are specific considerations to be borne in mind in relation to the arm's length principle and taxation in Ireland. Consequently, in due course Ireland may well want to distance itself from Luxembourg rather than ally itself with it.

The "arm's length standard"—fallacious and commercial?

Throughout these cases the European Commission may appear to be posing as the advocate of the arm's length standard. It was the arm's length standard that it applied during the state aid investigations. It was the arm's length standard that formed part of the normal system of taxation against which the ruling and its effects were tested. Both the systems of taxation in the Netherlands and in Luxembourg expressly incorporated the arm's length standard. As was noted above, in the Netherlands that was achieved by article 8b(1) of the Law on Corporation Tax, referred to above. In Luxembourg it was achieved by Article 164(3) of the Luxembourg Income Tax Code[36] and Circular LIR No 164/2 of 28 January 2011[37] which was concerned with the remuneration of intra-group financing companies. Rather than see the Commission as applying an arm's length standard established independently of the respective tax systems one may read the cases as justifying the Commission ensuring the proper application of the arm's length principle in domestic tax law. Such activity is defending national tax law not distorting or developing it.

In considering the arm's length principle, the Court referred to material from the OECD including Article 9 of the Model Convention and the Guidelines as well as national law.[38] It also acknowledged that Article 107(1) TFEU permits the Commission to check whether the pricing of intra-group transactions corresponds to prices that would have been charged at arm's length where the normal national tax system itself provides that integrated companies are to be taxed on the same basis as stand-alone companies.[39] That is not the same as saying that an arm's length principle, as such, is part of EU law. Despite some possible lack of clarity as to the foundation of the arm's length principle, the CJEU did make clear that the arm's length principle was being applied in the context of the examination of a national tax measure.[40] That must always be borne in mind.

Notwithstanding the fact that the arm's length principle was part of the relevant national tax system, the EU courts are likely to find it helpful to be made aware of some of the difficulties which surround the arm's length principle in transfer pricing generally. The Court could, for example, be referred to material in Volume 102B of the *Cahiers de droit fiscal international* in relation to the future of transfer pricing.[41] The General Report of Sergio André Rocha notes that

[36] *Loi du 4 décembre 1967 concernant l'impôt sur le revenu* (Law of 4 December 1967 on income tax).
[37] Circular LIR No 164/2 of 28 January 2011.
[38] See the judgment in *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [6] and [7] and *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [13]–[15].
[39] See the judgment in *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [149]–[151] and the judgment in *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [157].
[40] See the judgment in *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [166] and the judgment in *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [153].
[41] S.A. Rocha, *The future of transfer pricing – General Report, Cahiers de droit fiscal international* (2017), Vol.102B, 191.

originally the arm's length principle was based on three pillars.[42] First, there was the fiction of legal entities. Secondly, there was the relevance of contractual arrangements. Thirdly, there was the principle of the comparability of transactions. He then observes that "the foundations of these pillars are not as strong as expected".[43]

In relation to the comparability of transactions Professor Avi-Yonah is quoted as referring to

> "a fallacy that lies at the system's core: namely, the belief that transactions among unrelated parties can be found that are sufficiently comparable to transactions among members of multinational groups that they can be used as meaningful benchmarks for tax compliance and enforcement…".[44]

The EU courts may also find it helpful to consider the debate over arm's length transactions and commercial transactions in the context of the law of the fundamental freedoms. In *Hornbach-Baumarkt AG v Finanzamt Landau* (*Hornbach-Baumarkt AG*)[45] the taxpayer company challenged an amendment to its tax liability imposed by the German tax administration. The tax authority based its amendment on the gratuitous provision of a comfort letter, provided to a bank by Hornbach-Baumarkt AG, in respect of the liabilities of certain related foreign companies established in the Netherlands. The law under which the amendment was made would not have applied if all the relevant companies were domestic companies.

The CJEU held that the legislation permitting the amendment was not contrary to the freedom of establishment so long as it permitted the resident taxpayer the opportunity to prove that the terms of the relevant facility were agreed for commercial reasons resulting from its status as a shareholder of the non-resident company. The Court noted in particular that

> "there may be a commercial justification by virtue of the fact that Hornbach-Baumarkt AG is a shareholder in the foreign group of companies, which would justify the conclusion of the transaction at issue…under terms that deviated from arm's-length terms".[46]

It had to be determined whether or not Hornbach-Baumarkt AG was in a position, without being subject to undue administrative constraints, to put forward elements attesting to a possible commercial justification

> "without it being precluded that economic reasons resulting from its position as a shareholder of the non-resident company might be taken into account in that regard".[47]

In allowing commercial reasons relating to the company's position as a shareholder to be taken into account, the CJEU was acknowledging that transactions between group companies are not exactly comparable to transactions between independent companies and that there may be commercial factors affecting intra-group relationships which do not exist in relations between unrelated companies. It would be wrong to say that the Court is acknowledging the fallacy to

[42] Rocha, above fn.41.
[43] See Rocha, above fn.41, 197.
[44] See Rocha, above fn.41, 198 quoting from R. Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation" (2010) 2(1) *World Tax Journal* 3, 8.
[45] *Hornbach-Baumarkt AG v Finanzamt Landau* (C-382/16) EU:C:2018:366; [2018] STC 1267.
[46] *Hornbach-Baumarkt AG* (C-382/16), above fn.45, [2018] STC 1267 at [56].
[47] *Hornbach-Baumarkt AG* (C-382/16), above fn.45, [2018] STC 1267 at [57].

which Professor Avi-Yonah referred, but it certainly is acknowledging that associated and independent companies are not in precisely the same positions.

The difficulty of analysing transactions between associated companies and the contrast between a commercial transaction and an arm's length transaction was relevant also in the *Thin Cap Group Litigation*.[48] It is not necessary to review that case in detail here. Suffice it to say that Arden LJ, dissenting in this respect from the approach of the other members of the Court of Appeal, noted that:

> "While it might be tempting to think that, if a transaction fails to meet a test of arm's length, it cannot be commercial, it is necessary to recall the jurisprudence of the court prior to *Thin Cap* and the context in which the question of what is commercial arises."[49]

Having examined the relevant jurisprudence, the learned judge concluded that the relevant UK tax regime in relation to thin capitalisation ought to have allowed the taxpayer the opportunity to show that the relevant transaction was on commercial terms, not just that it was on arm's length terms.[50] The comments of the Advocate General when the matter was before the CJEU are, also, worth keeping in mind. The Advocate General noted, when considering proportionality, that:

> "It must be possible for a taxpayer to show that, although the terms of its transaction were not arm's length, there were nonetheless genuine commercial reasons for the transaction other than obtaining a tax advantage."[51]

There is no need to add to the material used to refute the comparability analysis carried out in *Starbucks* but it may be useful in future for the CJEU to explore in even more detail the difficulties inherent in such an analysis.

The market operator tests and margins of appreciation

It is, of course, fundamental to the law of state aid that the activities of the state are to be judged against the activities of a private operator under normal market conditions. That is true whatever activity the state is involved in. It may be acting as an investor, a creditor, or a provider of goods and services.

Two comments may be made in the light of this. First, the two state aid cases concerning tax rulings which the Court has decided do not require there to be any comparison between the activities of the state and a private actor. Instead, the Commission is examining state responses to commercial activity and carrying out a comparison between the conduct of associated and independent companies. Was it perhaps the unfamiliarity of this activity, in this context, which led to the Commission's catalogue of errors in *Starbucks*?

[48] *Test Claimants in the Thin Cap Group Litigation v IRC* (*Thin Cap ECJ*) (C-524/04) EU:C:2007:161; [2007] STC 906 and *Test Claimants in the Thin Cap Group Litigation v R & C Commissioners* (*Thin Cap CA*) [2011] EWCA Civ 127; [2011] STC 738.
[49] *Thin Cap CA*, above fn.48, [2011] STC 738 at [94].
[50] *Thin Cap CA*, above fn.48, [2011] STC 738 at [104]–[105].
[51] *Thin Cap ECJ* (C-524/04), above fn.48, [2007] STC 906 at [67] of the Advocate General's Opinion.

Secondly, the fact that the Commission is examining state responses to commercial activity rather than carrying out a direct comparison between state and commercial activity confirms that the state should be given a margin of appreciation of some considerable breadth. As has already been noted, the Court is conscious that there is a degree of uncertainty contained within the arm's length standard itself.[52] States will, however, develop their own approaches to the application of that standard appropriate to their own particular tax system. That seems unlikely to be objectionable in principle so long as the approach that they adopt is adopted generally and consistently and not selectively.

Conclusion

These two cases on tax rulings have resulted in understandable concern by Member States that their powers in relation to their own tax systems are being constrained. They may well remain concerned over the use of the arm's length principle by the Commission and what may be regarded as some confusion over its foundation. There was a suggestion, for example, that the Commission was attempting, at the hearing of the cases, to change the basis of the arm's length principle which it had applied.[53] What is clear, however, is that both the national tax systems which the Commission analysed in these cases incorporated the arm's length principle in domestic law. That being so, it may be said that all that the Commission was doing in investigating the tax rulings was ensuring that the domestic tax rules were applied without giving rise to state aid. That will not necessarily be controversial.

Should the Commission want to take a more general approach it is likely to find that its position is much less easy to defend. For one thing, the deficiencies in the arm's length principle are increasingly being recognised. The OECD itself acknowledges in its recent BEPS related work that the alternative courses of action that are set out in its Programme of Work under Pillar One "all go beyond the arm's length principle and depart from the separate entity principle".[54]

Perhaps the Commission has a choice. It may frame its contentions in relation to tax rulings and state aid in such a way as to cast itself as defending the proper operation of national tax systems and their domestic rules. Alternatively, it may advance broader contentions which encourage the suggestion that it is applying an arm's length principle, which is at least substantially similar to the one derived from Article 9.1 of the OECD *Model Tax Convention on Income and on Capital*. Even the OECD now recognises the limitations of that principle. Any such choice ought not to be too difficult to make.

Timothy Lyons

[52] See fn.23 above and the quotation to which it relates.
[53] See the judgment in *Starbucks* (Joined Cases T-760/15 and T-636/16), above fn.1, [2019] STC 2323 at [165] and the judgment in *Fiat Chrysler* (Joined Cases T-755/15 and T-759/15), above fn.2, [2019] STC 2416 at [153].
[54] OECD, public consultation document, *Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October 2019 – 12 November 2019* (OECD, 2019), para.10, third bullet point.

Advance pricing agreements; Arm's length transactions; EU law; European Commission; Interveners; Luxembourg; Member States; Netherlands; State aid; Tax determinations

Foojit Ltd v HMRC: EIS preference share dividends ITA 2007 sections 173(2A) (EIS), 257CA(2) and (3) (SEIS) and 285(3A) and (3B) (VCT)—purposive construction of a closely-articulated statute

Foojit Ltd v HMRC (*Foojit*) is the first reported decision to address the preference dividend restrictions on an issue of Enterprise Investment Scheme (EIS) shares.[1] The mailing services company's November 2014 offer of 910 £1 "B" shares at a subscription of £400,000 failed to meet the shares requirement for EIS relief because its articles of association did not specify a date upon which the preferred dividend became payable during period B (the three years following issue)[2] thereby falling foul of section 173(2A) of the Income Tax Act 2007 (ITA 2007).[3] The disappointed shareholders were collectively denied a total of £120,000 in EIS relief. The preference shares appear from the report of the decision not to have been covered by an advance assurance obtained from HMRC earlier in the funding round, because they remained subject to the filing of a satisfactory EIS 1 certificate.[4] Section 173(2A) ITA 2007 requires that shares must be ordinary shares that do not, "at any time during Period B" carry a preferential right to dividends encompassed by sub-section 173(2A) ITA 2007. Sub-section 173(2A)(a) ITA 2007 bans preference dividends when

> "the amount of any dividends payable pursuant to the right, or the date or dates on which they are payable, depend to any extent on a decision of the company, the holder of the share or any other person".

Foojit's articles as amended for the issue defined the amount of the preferential right at 44 per cent of profits available for distribution but were silent as to when the dividend became payable.[5]

The company's argument before the Tribunal was essentially for a literal interpretation. It merely had to demonstrate that no decision of the company, the shareholder or any other person as to the date the dividend became payable was necessary. Foojit's primary position, on the basis of other provisions in the articles, was that the payment of the dividend was automatic upon the signing off of the audited consolidated profit and loss account, without any resolution of the board or any decision of the company.[6] If that were so, then no date needed to be specified in the articles. Alternatively, accepting that the intention in framing Foojit's articles was to merit shareholder claims for EIS relief, then there ought to be an implied term in order to give business efficacy to the articles, this term again being that the dividend became payable on signing off

[1] *Foojit Ltd v HMRC* [2019] UKFTT 694 (TC). *Flix Innovations Ltd v HMRC* (*Flix*) [2016] UKUT 301 (TCC); [2016] STC 2206 and *Abingdon Health Ltd v HMRC* (*Abingdon*) [2016] UKFTT 800 (TC) have previously considered ITA 2007 s.173(2)(aa) restriction on preferential rights in a winding up.
[2] ITA 2007 s.159(3) read with s.256(1).
[3] The corresponding provisions for Seed Enterprise Investment Scheme (SEIS) investment are ITA 2007 s.257CA(2) and (3), and for Venture Capital Trust (VCT) investment they are ITA 2007 s.285(3A) and (3B).
[4] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [5], [7] and [8].
[5] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [19], [44] and [55].
[6] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [22](1)–(5).

the accounts.[7] HMRC disputed any attempt to construe the articles as automatically necessitating payment, submitting that the directors retained a clear discretion as to if and when a distribution was to be made.[8] It should be noted that HMRC couched their submissions in the semantically distinct and incorrect terms of the "date of payment" of the dividend, rather than the date on which it is payable, a very material distinction which was, however, upheld by the Tribunal.[9]

The decision

Judge Jennifer Dean adopted a purposive construction, directing herself first and foremost by reference to the summary of principles given by the Upper Tribunal in *HMRC v Trigg (a partner of Tonnant LLP)* (*Trigg*).[10] She quoted extensively from paragraphs 16 and 33 to 35 of that authority and in doing so she not only referred herself to the doctrine in a manner extolled by Malcolm Gammie QC in his article "Trigg v HMRC: reflections on purposive construction", but also drew on an earlier paper by Leonard Hoffmann, formerly a Lord of Appeal, both of which writings were first published in this *Review*.[11] Judge Dean then held that:

> "Construing the wording of the statute purposively, I have concluded that the clear reference in s173(2A) to 'the date or dates on which they are payable' requires identification of any such date in the same way as the statute requires identification of the amount of any dividend."[12]

She went on to give reasons why the automatic liability to pay a preference dividend on signing off the accounts, contended for by the company, might give rise to difficulties of "business common sense", most obviously it would crystalise dividend entitlement for the shareholders even if there was insufficient cash in the company to pay it.[13]

Comment

Foojit is correctly decided. Admittedly, on a literal construction, all that sub-section 173(2A)(a) ITA 2007 requires is that there be no room for any element of discretion concerning the date that the preference dividend becomes payable, either on the part of the company, its shareholder or any other person. Yet how else does one implement that restriction without specifying a date, whether it is an actual calendar date, or (perhaps) one expressed referentially to some other day the occasion of which cannot be influenced by a decision either of the company, the shareholders or any other person? The writer says "perhaps" because referential dating will now require

[7] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [22](8).
[8] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [23].
[9] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [23], [26], [27] and [52].
[10] *HMRC v Trigg (a partner of Tonnant LLP)* [2016] UKUT 165 (TCC); [2016] STC 1310; *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [43]. Note that the actual decision of the Upper Tribunal in *Trigg* was reversed on appeal, see *Trigg v HMRC* [2018] EWCA Civ 17; [2018] 1 WLR 5180.
[11] M. Gammie, "Trigg v HMRC: reflections on purposive construction" [2018] BTR 521, especially 524 fn.17; L. Hoffmann, "Tax avoidance" [2005] BTR 197, 205. The Hoffmann article had been earlier quoted by Lewison J in *Berry v HMRC* [2011] UKUT 81 (TCC); [2011] STC 1057 at [31(vi)] and by Proudman J in *Mayes v HMRC* [2009] EWHC 2443 (Ch); [2010] STC 1 at [30].
[12] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [56].
[13] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [58].

extreme care. The repeatedly encountered rubric that precipitates a dividend on the day immediately preceding any winding up is now unlikely to comply. Indeed it is difficult even to contrive a viable academic illustration of a proxy date.[14] "Date", it should be said, means a day.[15] Foojit, of course, argued for a trigger based on the adoption of the statutory accounts.[16] It is true that despite the common law presumption that preferential dividends are payable only if declared, a prescribed preferential dividend may be made payable, without more, simply upon of the availability of profits, see *Evling v Israel & Oppenheimer Ltd* (*Evling*).[17] However, if this is to be so then the terms of the article(s) providing for it must be clear. *Evling* is not mentioned in the *Foojit* judgment and, handed down as it was in 1917, it would today have to be read subject to the provisions of Part 23 of the Companies Act 2006 (CA 2006). However, in that light Foojit's contention for an automatic or self-determining mechanism was an ambitious one, arising as the conjunctive product of several other provisions of the company's articles and even then, as Judge Jennifer Dean pointed out, since it still left a residual discretion as to the preparation and signing off of the accounts in the directors.[18] Having regard to the words "depend to *any* extent" (writer's emphasis) in sub-section 173(2A)(a) ITA 2007 and the ratio of *Flix Innovations Ltd v HMRC* that remaining element of discretion, even if for all practical purposes de minimis, could not be ignored.[19] Not only that, but there is clear support in the *Trigg* judgment for a purposive construction, for example:

> "Even within closely-articulated or prescriptive legislation there may be individual provisions which fall to be construed purposively in a way which would be different from a literal construction."[20]

Finally, there is nothing in *Foojit* that conflicts with the wider policy of the provisions. The aim of circumscribing the payment of dividends throughout period B, and indeed the withholding of rights in a winding up is, apparently, to ensure that preference shares continue to be risk investments and oversight by management or the shareholder in relation to the amount and/or date of any dividend would plainly afford them the opportunity to mitigate risk to capital.[21]

It is important to recognise that for EIS, Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trust (VCT) companies sections 173(2A), 257CA(2) and (3) and 285(3A) and (3B) ITA 2007 respectively upset the accustomed expectations of the company and its shareholders, even to the lengths of turning a few of the time honoured tenets completely on their head. Preference shares, like any type of share capital, represent a compromise of tensions

[14] Quaere Maundy Thursday? Referential designation will be common in the case of the *amount* of any dividend, as indeed in *Foojit* where it was pegged to a percentage of profits.
[15] *Cartwright v MacCormack, Trafalgar Insurance Co Ltd Third Party* [1963] 1 WLR 18 (CA).
[16] *Foojit*, above fn.1, [2019] UKFTT 694 at [52].
[17] *Evling v Israel & Oppenheimer Ltd* [1918] 1 Ch 101 (Ch) per Eve J at 109; *Paterson v R Paterson & Sons Ltd* 1917 SC (HL) 13 at 15–16 per Lord Kinnear and at 17 per Lord Parmoor; *Re Bradford Investments Ltd* (*Bradford Investments*) [1991] BCLC 224 (Ch) at 231 c–g per Hoffmann J; P.G. Xuereb, *The Rights of Shareholders* (Oxford: BSP Professional Books, 1989), 50; G. Morse (ed.), *Palmer's Company Law* (London: Sweet & Maxwell, looseleaf), para.6.110.
[18] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [60] and [61].
[19] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [60]; *Flix*, above fn.1, [2016] UKUT 301 (TCC); [2016] STC 2206 at [36] to [39] and see also *Abingdon*, above fn.1, [2016] UKFTT 800 (TC) especially at [189]–[191].
[20] *Trigg*, above fn.10, [2016] STC 1310 at [33].
[21] *Flix*, above fn.1, [2016] UKUT 301 (TCC); [2016] STC 2206 at [42].

between the shareholders, who see their holding as an investment, and company management for whom the allotment is primarily about raising capital. The two groups will frequently have conflicting goals as regards dividends, rates of return of capital, re-investment of profits, timescales, participation in the control of the company and so on.[22] Over the last century and a half conventions and presumptions have been established to accommodate these rival aspirations.[23] In the case of companies seeking to qualify for EIS, SEIS or VCT relief the balance of this evolved reconciliation is, to the detriment of the shareholders, radically altered by legislative interference. First by the intervention of sections 173(2A) (EIS), 257CA(2) and (3) (SEIS) and 285(3A) and (3B) (VCT) ITA 2007 and, secondly, by section 14 of the Finance Act 2018 which, with effect for issues of shares on or after 15 March 2018 enacted the risk to capital condition as a kind of overriding objective in sections 157A(EIS), 257AAA (SEIS) and 286ZA (VCT) ITA 2007.[24] One of the consequences is that EIS, SEIS and VCT scheme compliant preference shares, which are neither risk nor equity capital in CA 2006, attain some sort of quasi status termed "relevant shares" (EIS/SEIS) and "eligible shares" (VCT).[25] The remarks that follow encompass the respective preference share provisions of all three venture capital relief schemes, save that the wording of section 285 ITA 2007 (VCT) differs from the others in several ways, one of which, the omission of any time period, is very material to the discussion.[26]

The usual rationale for setting the date of payment of a preference dividend is that the right is presumed to be cumulative and it is therefore desirable to make sure that any arrears accrue.[27] However, EIS and SEIS eligible preference shares cannot be cumulative "at any time during" period B.[28] Nor can they carry any present or future preferential right to the company's assets in a winding up.[29] In these circumstances the consequence for the shareholders of appointing a date on which the dividend is payable is entirely reversed from being one of preserving an entitlement to becoming one increasing the risk that no dividend is declared at all. This could occur just because the company's financial standing, as the ordained date approaches, does not render it prudent for the board, acting in good faith, to do so and no alternative later date can be entertained. From the company's perspective there must be no duty or obligation upon it to declare a dividend, because if there were to be, then fixing the date (and the amount) would render it, quite literally,

[22] Xuereb, above fn.17, 4.

[23] Chronicled in L.C.B. Gower, et al., *Gower's Principles of Modern Company Law*, 4th edn (London: Stevens & Sons, 1979), 414–421. The only notable statutory inhibition was imposed by the Companies Clauses Act 1863, ss.13 and 14 of which capped the level of preference dividends attaching to the shares of companies operating public undertakings, and prevented them from being cumulative. This was intended to provide some parity of entitlement with ordinary shareholders and restrain the burgeoning use of preference dividends by railway companies, see G.H. Evans Jr, *British Corporation Finance 1775 – 1850: A Study of Preference Share*s (Baltimore: John Hopkins Press, 1936), 124–126 and T. Alborn, *Conceiving Companies: joint stock politics in Victorian England* (London: Routledge, 1998), 204–205.

[24] The Finance Act 2018, Section 14 and Schedules 4 and 5 (Commencement) Regulations 2018 (SI 2018/931) reg.2.

[25] CA 2006 ss.548 and 560, Morse (ed.), above fn.17, para.6.107, ITA 2007 ss.157(1)(a) and 173 (EIS), 257AA(a) and 257CA (SEIS) and 285 (VCT).

[26] Another contrast, less significant for present purposes, is that the VCT provisions omit the word "ordinary" so that VCT share eligibility may be wider in scope than EIS and SEIS.

[27] *Webb v Earle* (1875) LR 20 Eq 556 (Ct of Ch); P.L. Davies and S. Worthington, *Gower's Principles of Modern Company Law*, 10th edn (London: Sweet & Maxwell, 2016), 795 canon 8.

[28] ITA 2007 s.173(2A)(b) (EIS) and s.257CA(3)(b) (SEIS).

[29] ITA 2007 s.173(2)(aa) (EIS) and s.257CA(2)(b) (SEIS).

a hostage to fortune. Not only is this, as the Tribunal in *Foojit* observed, commercially artificial, but to develop the scenario a little further, if there were not to be enough money in the company to enable it to pay a mandatory dividend as stipulated, then the investors would have to forego it.[30] That situation would, customarily, create an event of default triggering other rights of the sort commonly accorded to unpaid preference shareholders.[31] *Re Bradford Investments Ltd* is a pertinent precedent in which the company's articles laid down deemed payment dates.[32] From the perspective of the issuer's advisor drafting in clear language will always be required when contradicting any of the familiar norms.[33] In the case of EIS and SEIS lucid expression is indispensable because the statutory preconditions apply, and must therefore be met, *continuously* from the issue of the shares, throughout period B so that mistakes spotted after issue cannot be rectified. Shares issued by a company to a VCT are not liable to such stringent compliance. Section 285 ITA 2007 does not appoint any period or, critically, use any such terminology as "at any time during". It is therefore much more forgiving and if Foojit had been a VCT financed company it would have simply been possible to amend the articles on discovering the error.

In terms of settling the amount of the dividend one would wish to avoid any arrangement of rights that approximate EIS, SEIS or VCT preference shares to a debt instrument, for instance a traditional preference dividend fixed at (say) 5 per cent of nominal share value, as in some circumstances this could contravene the risk to capital condition, even if the absence of any preferential rights in a winding up sustained the argument that the shares remained dividend carrying shares rather than interest bearing borrowing. Foojit, of course, set its dividend by reference to 44 per cent *of the profits available*. Whilst this is no doubt safer from a scheme compliance point of view, in accounting terms, given that the dividend cannot be cumulative, the characterisation of expenses as chargeable against income or capital may assume greater importance to the parties. Similarly, deprived of dividend cumulation, if instead of the whole ascertained profit, a lesser fund is to be set apart out of which the dividend is to be made, that fund will need to be delineated with precision.[34]

The facts of *Foojit* are somewhat unusual in that one does not often have preference dividends in an EIS company for the reason that normally EIS companies are youthful enterprises that cannot be expected to pay dividends due to lack of reserves. Not just that, but EIS investors generally prefer their return by way of capital, which is tax free—dividends are taxable. Sub-section 173(2A) ITA 2007 was introduced by section 39 of and Schedule 7 to the Finance Act 2012 with effect for EIS shares issued on or after 6 April 2012 largely in order to give parity with the amendments previously made in respect of the VCT scheme, where arguably the wide variety of rights that can be attached to preference shares including attendance at meetings,

[30] *Foojit*, above fn.1, [2019] UKFTT 694 (TC) at [57]–[58]. Once "payable" dividends are a debt owed by the company to the shareholder, see *Potel v IRC* (1970) 46 TC 658 at 668–669; [1971] 2 All ER 504 (Ch) at 513d per Brightman J; *In re Kidner* [1929] 2 Ch 121 (Ch) at 126 per Eve J.

[31] For example a just and equitable winding up, see Harman J in *Re a company (No 370 of 1987) Ex p. Glossop* [1988] 1 WLR 1068 (Ch) at 1074G–1075B and at 1076C–F, or an unfair prejudice application, per Peter Gibson J in *Re Sam Weller & Sons Ltd* [1990] Ch 682 (Ch) especially at 693C–G.

[32] *Bradford Investments*, above fn.17, [1991] BCLC 224 (Ch) especially at 230–231 per Hoffmann J.

[33] Davies and Worthington, above fn.27, 280 para.12.1; P. Millet (ed-in chief), *Gore-Browne on Companies*, 45th edn (Bristol: LexisNexis, looseleaf), para.21[2].

[34] Morse (ed.), above fn.17, para.6.113.

voting, and conversion can have a more significant role.[35] The writer is not convinced that what one might call the "risk" aspects of preference dividends were comprehensively appraised by HMRC at the time. The imperative then was to assist VCT's in adjusting to the rigours of the evolving EU state aid regime which called for them to dramatically increase their portfolio proportion of equity stakes in investee companies from 30 per cent to 70 per cent, whereas formerly loan stocks had provided the VCT with a steady yield.[36] The initial admission of preference shares to the VCT scheme may, therefore, have owed more to pragmatism than a coherent risk strategy. What seems slightly odd about imposing strictures on the dividend process is that it is (or should be) trite that dividends can only arise after capital has already been risked. It also overlooks the fact that a cumulative dividend can present just as much jeopardy as a non-cumulative one if pressing arrears accrue. Taking all these comments into consideration it may be better to refrain from utilising preference shares in EIS and SEIS companies as far as possible and consider instead how one might structure any dividend rights so as to reward several separate classes, or sub-classes of ordinary shares without creating a preference.[37] Paragraphs 19 and 44 of the *Foojit* decision, contrasting as they do a dividend of 44 per cent of the profits available for distribution with one of 44 per cent of the amount of any dividends declared, may provide useful inspiration for such an endeavour. ☙

Andrew Harper[*]

N Luxembourg 1 and others v Skatteministeriet: beneficial ownership and abuse of rights under the EU Interest and Royalties Directive

Across many Member States of the EU, it is common for payers of certain payments to be required to deduct local tax, at the applicable rate, from that payment and account for the same to the local tax authority, subject to the availability of any local exemption, or relief under a double tax treaty (DTT) or EU directive.

With respect to cross-border payments of, amongst others, interest between entities resident in EU Member States, the so-called EU Interest and Royalties Directive (IRD)[1] mitigates any local withholding tax on those payments. Very broadly, where an EU payer makes, amongst others, an interest payment to an "associated" EU payee, that EU payee is not liable to local tax

[35] See F(No.3)A 2010 s.5 and Sch.2 para.2(6) now found in ITA 2007 s.285(3A)(a) and (3B)(a) and A. Harper, "Section 5 and Schedule 2: venture capital schemes" [2011] BTR 40, 44.

[36] F(No.3)A 2010 s.5 and Sch.2 para.2(2)(b) and (c), see Harper, above fn.35, especially 43–44.

[37] "relevant shares" for EIS and SEIS must be ordinary shares, see ITA 2007 s.173(2) (EIS) and s.257CA(2) (SEIS). As to whether shares constitute a "class" and what might distinguish classes apart see the ambiguous words "in all respects uniform" in CA 2006 s.629. Historically see *In re Powell-Cotton's Resettlement* [1957] Ch 159 (Ch) at 162–163 per Roxburgh J.

☙ Dividends; Enterprise investment scheme; Income tax; Preference shares; Reliefs; Seed enterprise investment scheme; Share issues; Venture capital trusts

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[1] 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 [2003] OJ L157/49.

on that payment and, generally subject to completion of procedural formalities, the EU payer can make the payment gross without deduction on account of local tax; in other words, any local withholding that would otherwise apply to that interest payment is eliminated by the IRD.

The application of the IRD to cross-border interest payments was considered by the Court of Justice of the European Union (CJEU) in the joined cases of *N Luxembourg 1 and others v Skatteministeriet* (the IRD Decision).[2]

IRD Decision

Background

On 26 February 2019, the CJEU passed judgment on a number of cases relating to Danish withholding tax on dividend and interest payments made by Danish companies to companies resident in other Member States. This note only considers the judgments relating to interest payments and the availability of the IRD in respect thereof.

Although the facts of each of the joined cases vary, all concern the interposition of companies in holding structures:

- three of the four joined cases concerned private equity funds which advanced loans to Danish companies through a Luxembourg holding company; and
- the fourth case concerned a US group which, through a Cayman subsidiary, advanced a loan to a Swedish subsidiary which, in turn, on lent those funds to a Danish company.

Under Danish domestic law, subject to the availability of any exemption or relief, Danish companies are required to deduct Danish withholding tax from a payment of interest to non-resident (i.e. non-Danish) payees.[3] A Danish payer will not be required to deduct Danish withholding tax from an interest payment to a non-resident payee where, amongst others, the requirements of the IRD are satisfied.

In each case the Danish tax authority refused to grant the relevant Danish company exemption from Danish withholding tax provided for by the IRD in respect of interest paid to payees established in Luxembourg and Sweden. The Danish tax authority took this position as it considered that those payees were not the beneficial owners of the interest paid but, rather, were conduit companies.

The taxpayers' position was that no withholding on account of Danish tax was required from the interest payments as the exemption set out in Article 1 IRD was available.

[2] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) EU:C:2019:134.

[3] A summary of the Danish domestic withholding tax regime is set out at *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [19]–[26].

The concept of "beneficial ownership of the interest"

The first question considered by the CJEU was the interpretation of "beneficial owner of the interest" for the purposes of Article 1 IRD. In considering the drafting of the IRD (including the different language versions) the CJEU determined that

> "the term 'beneficial owner' concerns not a formally identified recipient but rather the entity which benefits economically from the interest received and accordingly has the power freely to determine the use to which it is put".[4]

Although the meaning of beneficial ownership is not defined in the IRD, the CJEU noted that Article 1(4) IRD provides that to treat a company as the beneficial owner that company is required to receive the interest "for its own benefit and not as an intermediary…for some other person".[5]

To support its position, the CJEU considered the meaning of beneficial owner in the *OECD Model Tax Convention on Income and on Capital* (the Model Convention) (and the accompanying commentary) on the basis that the IRD drew upon the interest article in the 1996 version of, and pursues the same objectives as, the Model Convention. In so doing, the CJEU noted that

> "the concept of 'beneficial owner' excludes conduit companies and must be understood not in a narrow technical sense but as having a meaning that enables double taxation to be avoided and tax evasion and avoidance to be prevented".[6]

The abuse of rights principle

The second question considered by the CJEU was whether, in order to combat an abuse of rights in applying the IRD, a Member State needed to have adopted a specific domestic provision transposing the IRD or whether it may refer to domestic or agreement-based anti-abuse principles or provisions.

In considering this question the CJEU first reiterated the general principle that EU law cannot be relied upon for abusive or fraudulent ends, and the application of EU law cannot be extended to cover transactions carried out for the purpose of fraudulently or wrongfully obtaining advantages provided for by EU law.[7] Accordingly

> "a Member State must refuse to grant the benefit of the provisions of EU law where they are relied upon not with a view to achieving the objectives of those provisions but with the aim of benefiting from an advantage in EU law although the conditions for benefiting from that advantage are fulfilled only formally".[8]

[4] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [89].
[5] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [88].
[6] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [92].
[7] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [96], [97], [117] and [118].
[8] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [98].

The CJEU went on to note that:

> "To permit the setting up of financial arrangements whose sole aim is to benefit from the tax advantages resulting from the application of Directive 2003/49 would not be consistent with such objectives and, on the contrary, would undermine economic cohesion and the effective functioning of the internal market by distorting the conditions of competition."[9]

Although Article 5 IRD expressly provides for the refusal or withdrawal of the benefit of the IRD in prescribed circumstances and notwithstanding that there is no reference in the IRD to the general EU law principle of abuse of rights or to the withdrawal of, or refusal to grant, the benefit of the IRD on the basis of such principle, the CJEU held that

> "it is incumbent upon the national authorities and courts to refuse to grant entitlement to rights provided for by Directive 2003/49 where they are invoked for fraudulent or abusive ends. Thus, in the light of the general principle of EU law that abusive practices are prohibited and of the need to ensure observance of that principle when EU law is implemented, the absence of domestic or agreement-based anti-abuse provisions does not affect the national authorities' obligation to refuse to grant entitlement to rights provided for by Directive 2003/49 where they are invoked for fraudulent or abusive ends."[10]

In other words, the EU abuse of rights principle may be used to deny or withdraw the benefits otherwise conferred by the IRD even if those benefits could not be denied or withdrawn under domestic or agreement-based anti-avoidance provisions or anti-avoidance provisions included in the IRD.

Constituent elements of an abuse of rights

The CJEU was asked by the referring courts what the constituent elements of an abuse of rights were and how those elements may be established.

Based on its previous case law, the CJEU determined that as a general principle proof of an abusive practice requires both:

1. objective circumstances in which, despite formal satisfaction of the applicable rules, the purpose of those rules had not been achieved; and
2. a subjective element consisting in the intention to obtain an advantage of those rules by artificially creating conditions for obtaining it.[11]

Accordingly, the CJEU noted that:

> "Examination of a set of facts is therefore needed to establish whether the constituent elements of an abusive practice are present, and in particular whether economic operators

[9] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [107].
[10] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [110] and [111].
[11] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [124].

have carried out purely formal or artificial transactions devoid of any economic and commercial justification, with the essential aim of benefiting from an improper advantage."[12]

Although it is not the role of the CJEU to assess facts and apply general principles to those facts (that being the role of the relevant national authorities/courts), the CJEU went on to provide guidance on the type of factors that should be taken into account as part of an examination of the facts, including, amongst others, the following:

1. A group of companies may be regarded as being an artificial arrangement where it is not established for reasons that reflect economic reality, its structure is purely one of form and its (or one of its) principal objective(s) is to obtain a tax advantage contrary to the aim or purpose of applicable tax law.[13]
2. An arrangement may be treated as intending to obtain improper entitlement to the IRD where all, or almost all, of the interest paid is, soon after receipt, passed on by the recipient to entities which do not fulfil the conditions for the application of the IRD because:
   (a) those entities are not established in any Member State;
   (b) they are not incorporated in one of the forms specified in the IRD;
   (c) they are not subject to one of the taxes listed in Article 3(a)(iii) IRD without being exempt; or
   (d) they are not associated companies within the meaning of Article 3(b) IRD.[14]
3. The artificiality of an arrangement may be demonstrated where the recipient of the interest is required to pass that interest on to a third company which does not fulfil the conditions of the IRD and, consequently, it makes only an insignificant taxable profit on the interest receipt when it acts as a conduit company in order to enable the flow of funds from the debtor to the entity which is the beneficial owner of the interest.[15]
4. The fact that a company acts as a conduit may be established where its sole activity is the receipt of interest and its transmission to the beneficial owner (or to other conduit companies). The absence of actual economic activity must, in the light of the specific features of the economic activity in question, be inferred from an analysis of all the relevant factors relating, in particular, to the management of the company, its balance sheet, the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has.[16]

[12] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [125].
[13] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [127].
[14] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [128].
[15] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [130].
[16] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [131].

5. Indications of an artificial arrangement may also be constituted by the various contracts existing between the companies involved in the financial transactions concerned. The way in which the transactions are financed, the valuation of the intermediary companies' equity and the conduit companies' inability to have economic use of the interest received may also be indicators of such an arrangement. In this regard such indications are capable of being constituted not only by a contractual or legal obligation of the recipient to pass interest on to a third party but also by the fact that, in substance, the recipient, without being bound by such a contractual or legal obligation, does not have the right to use and enjoy those sums.[17]

The indicia set out above may be strengthened

> "by the simultaneity or closeness in time of, on the one hand, the entry into force of major new tax legislation, such as the Danish legislation at issue in the main proceedings, which some of the groups of companies strive to circumvent and, on the other hand, the setting up of complex financial transactions and the grant of intragroup loans".[18]

The CJEU further noted that an arrangement may still be regarded as artificial and abusive even if the ultimate beneficial owner of the interest is resident for tax purposes in a state with which the payer jurisdiction has a DTT which eliminates any withholding tax on that payment. Specifically, the CJEU said: "The existence of such a convention [a double taxation convention] cannot in of itself rule out an abuse of rights."[19]

For completeness, the CJEU held that where the beneficial owner of the interest is resident for tax purposes outside of the EU, refusal of the benefits of the IRD does not require there to be a finding of fraud or abuse of rights.[20]

Finally, in addressing a question concerning the burden of proof as regards the abuse of rights principle, the CJEU held that:

1. it is for the interest recipient to demonstrate that it is the beneficial owner of the interest and that the conditions for the IRD are satisfied[21]; but
2. it is for the national authority to demonstrate the existence of elements constituting an abusive practice and, in so doing, it is required to take into account all relevant factors, albeit there is no obligation on the national authority to identify the actual beneficial owner of the payment.[22]

[17] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [132].
[18] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [133].
[19] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [134]–[137].
[20] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [138].
[21] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [140]–[141].
[22] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [142]–[144].

Implications

The IRD Decision should be seen within the wider context of international, EU and national developments over recent years that have sought to address certain tax practices involving holding companies.

For many years the Organisation for Economic Co-operation and Development (the OECD) has been seeking to address questions concerning the availability of treaty relief for holding companies. It has been clear for some time that a structure which simply "treaty shops" and interposes a holding company into a structure for the sole purpose of accessing a treaty benefit will be open to challenge. Conversely, it was relatively clear that holding companies established for commercial reasons would be able to access treaty benefits.

More recently, at the international level, access to treaty benefits was subject to scrutiny as part of the OECD Base Erosion and Profit Shifting Project.[23] One outcome of that was the introduction of so-called "principal purpose tests" (PPTs) into DTTs which seek to deny DTT benefits if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining a DTT benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit would be in accordance with the object and purpose of the relevant DTT provisions.[24] This marked a global shift in approach to accessing treaty benefits.

At the EU level, Article 6 of the EU Directive on laying down rules against tax avoidance practices that directly affect the functioning of the internal market (commonly referred to as the EU "Anti-Tax Avoidance Directive") contains a general anti-abuse rule applicable where arrangements are in place for the main purpose (or one of the main purposes) of obtaining a tax advantage that defeats the object or purpose of the applicable tax law and are not genuine having regard to all relevant facts and circumstances.[25]

In this regard and against this wider context, the IRD Decision could be seen as a simple continuation of that theme by the CJEU. However, it represents a shift by the CJEU in terms of its approach to tax avoidance cases, reflected by the fact that the approach adopted by the CJEU diverges from the position set out in the Opinion of Advocate General Kokott (the Opinion).[26]

First, the CJEU appears to have been influenced by the approach taken internationally to similar cases. For instance, as noted, the CJEU had regard to the Model Convention (and associated commentaries) in interpreting "beneficial owner" for the purposes of the IRD. On the other hand, AG Kokott considered that that expression should be interpreted under EU law "autonomously and independently"[27] of the Model Convention, noting that the Model Convention is not legally binding and commentaries on the Model Convention "cannot have a direct effect

[23] OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD Publishing, 2015).

[24] OECD, *Model Tax Convention on Income and on Capital, Condensed Version 2017* (Paris: OECD Publishing, 2017), Art.29(9).

[25] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1. For further information, see A. Cedelle, "The EU Anti-Tax Avoidance Directive: a UK perspective" [2016] BTR 490.

[26] Opinion of Advocate General Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16) EU:C:2018:143.

[27] Opinion of Advocate General Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16), above fn.26, EU:C:2018:143 at [55].

on the interpretation an EU directive".[28] In this regard, the Opinion considered, based on previous case law of the CJEU, the person who "owns the interest-bearing claim" (being the person entitled under civil law to demand payment of the interest) to be the beneficial owner for the purposes of the IRD.[29] Compared with the practical difficulties presented by the CJEU's approach, the Advocate General's approach has the benefit of providing certainty—identifying the person who owns the right would be relatively simple.

Secondly, historically at least, the CJEU's focus was on cases involving wholly artificial arrangements,[30] a point highlighted in the Opinion and, as noted, recognised by the CJEU in the IRD Decision itself.[31] Although Advocate General Kokott and the CJEU both agreed that EU law cannot be relied upon for fraudulent or abusive ends,[32] absent a definition of abuse in the IRD, the approach taken by the Advocate General in the Opinion and the CJEU in the IRD Decision to determine whether the arrangements in question were abusive diverged.

Prior to the IRD Decision, the vast majority of case law considering the EU abuse of rights principle has been in the context of VAT, with the CJEU looking to determine whether the obtaining of a tax advantage was the "essential aim" of the transaction.[33] In the IRD Decision, the CJEU went a step further and applied those principles in a different context adopting the different terminology of "principal objective or one of [the] principal objectives".[34] Whether that different terminology makes any substantive difference is beyond the scope of this note but, by adopting terminology which is very similar to that adopted by the OECD as part of the PPT (as well as Article 6 of the EU Anti-Tax Avoidance Directive), it is apparent that the CJEU's position is that where treaty relief would be denied under a PPT the IRD should not be available. Although, in principle, that could be said to be a reasonable approach it requires uniform application otherwise there is a risk of taxpayer uncertainty where equivalent phrases are given different interpretations and applied differently across Europe (and, indeed, globally when it comes to applying the PPT).

Perhaps to address those concerns, the CJEU issued guidance as part of the IRD Decision relating to the application of the abuse of rights principle. However, unfortunately, the CJEU's guidance does not rule out commercial structures being caught and regarded as abusive for these purposes; there are no clear "safe harbours". Equally, it is unclear how much substance is required for an intermediary to be regarded as the beneficial owner of any interest received.

[28] Opinion of Advocate General Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16), above fn.26, EU:C:2018:143 at [52].

[29] Opinion of Advocate General Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16), above fn.26, EU:C:2018:143 at [47].

[30] See, for instance, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (C-196/04) [2006] ECR I-7995; [2006] STC 1908.

[31] For instance see fn.12 above and the reference to "purely formal or artificial transactions devoid of any economic and commercial justification", *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [125].

[32] Opinion of Advocate General Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16), above fn.26, EU:C:2018:143 at [61].

[33] See *Halifax plc, Leeds Permanent Development Services Ltd and County Wide Property Investments Ltd v CC&E* (C-255/02) [2006] ECR I-1609; [2006] STC 919.

[34] *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.2, EU:C:2019:134 at [127].

In this regard, as noted, the approach of the CJEU differs from the Opinion. The Opinion was of the view that the structures in question were not "wholly artificial" and that "it cannot be seen as an arrangement that does not reflect economic reality" if the company is validly created, can be reached at its registered office and has tangible and human resources at its offices.[35] The Opinion goes on to note that establishing a company in a jurisdiction to benefit from more favourable legislation does not, in and of itself, constitute abuse, with the result that simply interposing Luxembourg companies in a commercial structure (as was the case here) "does not, therefore, automatically mean that abuse must be assumed".[36] The Opinion further notes that:

> "Where the taxable person has a choice between two possibilities, he is not obliged to choose the one which involves paying the higher amount of tax but, on the contrary, may choose to structure his business so as to limit his tax liability. Thus, again according to the Court, taxable persons are generally free to choose the organisational structures and the form of transactions which they consider to be most appropriate for their economic activities and for the purpose of limiting their tax burdens. The mere fact that a business structure was chosen in the present case that did not generate the maximum tax burden (in this case additional and final liability for tax at source) cannot in itself qualify as abuse."[37]

Although the Opinion goes on to consider circumstances where abuse may be found (for instance, where a structure is used to take advantage of a lack of information exchange between states so as to prevent effective taxation), the approach is markedly different to that adopted by the CJEU and, if the CJEU had followed this approach in the IRD Decision, would certainly have offered taxpayers greater certainty and comfort that commercial structures should not be regarded as abusive for these purposes.

However, ultimately, the CJEU took a different approach. The concern with the CJEU's approach is that, by its nature, the approach adopted and guidance issued is also open to be interpreted and applied inconsistently by tax authorities and courts across Europe. That, in of itself, exacerbates the uncertainty for business, creating unwelcome unpredictability. There is also the added potential state aid complication if a local tax authority fails to apply the abuse of rights principle or does so less robustly than other tax authorities. In an investment context specifically, when making an investment decision the financial modelling will need to be carefully undertaken before deciding whether to proceed; following the IRD Decision that may well prove difficult in respect of cross-border investments in European assets.

Final remarks

Although the IRD Decision may be seen as a continuation of international, EU and national developments over recent years, it represents a change in approach by the CJEU, illustrated by the divergence in views between the CJEU and the Advocate General in this case. Unfortunately,

[35] Opinion of Advocate General Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16), above fn.26, EU:C:2018:143 at [65] and [67].
[36] Opinion of Advocate General Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16), above fn.26, EU:C:2018:143 at [70].
[37] Opinion of Advocate General Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16), above fn.26, EU:C:2018:143 at [71].

the IRD Decision raises more questions than answers for business and creates a degree of uncertainty when seeking to rely on the IRD in respect of cross-border interest payments.

In practice, following the IRD Decision, businesses will need to consider their payment flows especially where reliance has historically been placed on the IRD to mitigate any local withholding taxes and, together with their advisors, grapple with the guidance issued by the CJEU and attempt to apply it to their structures. Of course, a DTT may be available to mitigate an exposure (although the application of any PPT may need to be considered). It may be possible to apply for clearances with tax authorities but these can be time consuming; amending contractual documentation to cater for withholding exposures can be impractical and undesirable. Focusing on increasing the levels of substance in the relevant holding company/companies may assist although, unfortunately, it may still be difficult to predict with certainty whether the benefits of the IRD would be available to mitigate any withholding exposure following the CJEU's approach in the IRD Decision.

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Abuse of rights; Beneficial ownership; EU law; Interest; Tax avoidance; Withholding tax

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Accounting Profits, Tax Profits and Unitary Taxation (Revisited)

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Lynne Oats**

Abstract

Unitary taxation requires the adoption of a set of rules that enables a combined group tax profit base to be determined. Setting aside questions as to which entities should be included and how the resultant profit should be allocated to relevant jurisdictions, this article focusses on the question of what is an appropriate base, and whether accounting principles, in particular external financial reporting principles, are fit for this purpose. The authors contribute to the ongoing debate on this issue, now even more salient in relation to the digital economy and the "unified approach" proposed by the OECD, by considering more recent changes in both financial reporting and taxation. The article concludes that there is considerable preparatory work to be done before an appropriate base for unitary taxation can be developed, if that is even possible.

Introduction

> "From the perspective of a lawyer, financial reporting is a strange practice that seeks to describe and evaluate many events that only exist as a result of legal relations. In making its description, financial reporting often departs from the general legal rules that set the context of the events it seeks to describe, e.g. as to entities, ownership and what is an asset. This lack of consistency with the basic legal rules makes it hard for an income tax law to follow financial reporting in many situations."[1]

The question of the relationship between accounting profit and tax profit is debated from time to time: a flurry of interest occurred, for example, as international financial reporting standards (IFRS) were evolving and implemented, as attempts to standardise accounting principles and rules led to speculation that accounting profit could be used as the corporate tax base.[2]

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[1] P. Harris, "IFRS and the Structural Features of an Income Tax Law" in G. Michielse and V. Thuronyi (eds), *Tax Design Issues Worldwide, Series on International Taxation* (Alphen aan den Rijn: Wolters Kluwer Law International, 2015), Vol.51, 95–96.

[2] In respect of the UK see J. Freedman, "Ordinary Principles of Commercial Accounting - Clear Guidance or a Mystery Tour?" [1993] BTR 468; J. Freedman, "Defining Taxable Profit in a Changing Environment" [1995] BTR 434; J. Freedman, "Accounting Standards: a Panacea?" [2004a] *The Tax Journal* 9; J. Freedman, "Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges" [2004b] *eJournal of Tax Research* 71; S. Green, "Accounting Standards and Tax Law: Complexity, Dynamism and Divergence" [1995] BTR 445; G. MacDonald

The prospect of aligning accounting and tax profits has also given impetus to debates about unitary taxation, under which the profits of a multinational enterprise (MNE) are combined and then allocated to the jurisdictions in which the MNE operates according to a predetermined formula. The adoption of some form of global unitary taxation would be a radical departure from the existing system of taxing cross border commercial activity but, nonetheless, proponents defend the idea of radical change on the assumption that it would correct the apparent inefficiencies and injustices in the current profit allocation mechanism through the method of applying arm's length pricing between affiliates. Although the term unitary taxation can refer to several models that treat groups of entities as a single entity for tax purposes,[3] in this article, the authors use the term to mean the version that entails establishing a unitary tax base and subsequent distribution of that base to relevant jurisdictions by means of a formula, sometimes referred to as global formulary apportionment.

Discussion of unitary taxation as an alternative to the current system has been taken up by a number of socially focussed non-governmental organisations (NGOs)[4] and lobby organisations.[5] The published work on unitary taxation[6] has gained increased significance in recent years and has lent support to the reinvigoration of the common consolidated corporate tax base (CCCTB) in the EU, subsequently rebranded as the common corporate tax base (CCTB). Much of the focus of debate has been on the development and impact of the formula for apportionment[7]; much less attention has been given to developing an appropriate base. More recently, the question of using, for tax purposes, figures derived from accounting has arisen tangentially in relation to the digital services tax in the UK, under which revenues attributable to user participation must be determined in order that the appropriate share can be attributed to the UK for taxing purposes. The Government position paper on the digital economy in March 2018 acknowledges that taking

and D. Martin, "Tax and Accounting a Response to the 2003 Consultation Document on Corporation Tax Reform" [2004] *Tax Law Review*, The Institute for Fiscal Studies; P. Sikka, "Accounting and taxation: Conjoined twins or separate siblings?" (2016) 41(4) *Accounting Forum* 390; G. Whittington, "Tax policy and Accounting Standards" [1995] BTR 452; A. Wilson, "Financial Reporting and taxation: marriage is out of the question" [2001] BTR 86. In respect of the US, where there is considerable debate about book-tax differences, see M. Desai, "The Divergence Between Book and Tax Income" (2003) 17 *Tax Policy and the Economy* 169.

For a more global perspective see W. Schön, "International Accounting Standards — A 'Starting Point' for a Common European Tax Base?" (2004) 44 *European Taxation* 426; W. Schön, "The Odd Couple: A Common Future for Financial and Tax Accounting?" (2005) 58 *Tax Law Review* 111.

[3] S. Picciotto (ed.), *Taxing Multinational Enterprises as Unitary Firms* (Institute of Development Studies, 2017) describes several approaches to unitary taxation in addition to formulary apportionment that treat transnational groups as unitary firms, specifically residence based worldwide taxation and destination based corporate tax (at 27).

[4] See for example C. Godfrey, *Business Among Friends: Why corporate tax dodgers are not yet losing sleep over global tax reform* (Oxfam, 2 May 2014), available at: *https://www.oxfam.org/en/research/business-among-friends* [Accessed 14 February 2020]; Christian Aid, *No more shifty business* (February 2013), available at: *https://www.christianaid.org.uk/resources/about-us/no-more-shifty-business-2013* [Accessed 14 February 2020] and ActionAid, *Levelling Up: Ensuring a fairer share of corporate tax for developing countries* (July 2015), available at: *https://www.actionaid.org.uk/sites/default/files/publications/levelling_up_final.pdf* [Accessed 14 February 2020].

[5] e.g. The Greens in the European Parliament.

[6] See for example Picciotto (ed.), above fn.3.

[7] Petutschnig, for example, explores the interaction between the proposed CCCTB formula and limitation on benefits clauses in M. Petutschnig, "Common Consolidated Corporate Tax Base and Limitation on Benefits Clauses" [2018] BTR 68.

user participation into account may lead to significant divergence between tax and accounting profits.[8]

Picciotto, quoting from the G20 mandate for the OECD's Base Erosion and Profit Shifting (BEPS) Project, suggests that reform of the international tax rules is necessary to ensure that MNEs are taxed "where economic activities occur and value is created".[9] He concludes from this "that MNEs should be treated in accordance with the business reality that they operate as single firms",[10] observing that the BEPS proposals "remained unclear and complex on the crucial question of criteria for allocating profits".[11] Historically, the allocation of profits between jurisdictions has contained elements of both an independent entity and a unified approach and this is reflected in the allocation methods adopted in practice.[12] Rogers and Oats,[13] in this *Review*, present evidence from a longitudinal study of transfer pricing professionals that suggests that increasing dissatisfaction with arm's length pricing has resulted in tax practitioners moving from a position of strenuous opposition to formulary apportionment to a more accommodating stance.

The practical barriers to any change from the current international tax system to unitary taxation are significant, and the early exclusion of this topic from the BEPS debate signals considerable resistance from institutions, corporations, advisors and politicians. The work of the International Centre for Tax and Development amongst others helps to stimulate debates about the existing system of taxing MNEs and also about any alternative methods that could be developed and adopted. More recently, however, the OECD has released, in May 2019, details of its Programme of Work in relation to the taxation of the digital economy.[14]

Having failed to resolve the vexed issue of the appropriate mechanisms for taxing the digital economy, Action 1, *Addressing the Tax Challenges of the Digital Economy*, of the OECD BEPS Project[15] brought into existence the Task Force on the Digital Economy, as a subsidiary body of the Committee on Fiscal Affairs, which embarked on a series of consultations seeking public input. This has become a highly politicised issue on which progress is urged by the G20. The May 2019 Programme of Work[16] has potential for far reaching impact on the way multinationals are taxed. The work is divided into two Pillars, Pillar 1 dealing with the allocation of income between jurisdictions[17] and Pillar 2 dealing with minimum levels of taxation to prevent base

[8] HM Treasury, *Corporate tax and the digital economy: position paper update* (March 2018).
[9] Picciotto (ed.), above fn.3, 1 quoting G20, *Tax Annex to the St. Petersburg G20 Leaders' Declaration* (2013), available at: *http://www.oecd.org/g20/summits/saint-petersburg/Tax-Annex-St-Petersburg-G20-Leaders-Declaration.pdf* [Accessed 21 February 2020], 4.
[10] Picciotto (ed.), above fn.3, 1.
[11] Picciotto (ed.), above fn.3, 2.
[12] Picciotto (ed.), above fn.3, 6.
[13] H. Rogers and L. Oats, "Emerging Perspectives on the Evolving Arm's Length Principle and Formulary Apportionment [2019] BTR 150.
[14] OECD, *OECD/G20 Inclusive Framework on BEPS: Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (Programme of Work) (Paris: OECD, 2019), available at: *www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm* [Accessed 14 February 2020].
[15] OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Paris: OECD Publishing, 2015), available at: *https://doi.org/10.1787/9789264241046-en* [Accessed 14 February 2020].
[16] OECD, Programme of Work, above fn.14.
[17] OECD, Programme of Work, above fn.14, Ch.II, "Revised Nexus and Profit Allocation Rules (Pillar One)".

erosion (GloBE).[18] Supporting documents produced by the OECD Secretariat were released in October and November 2019 (Public Consultation Documents)[19] to assist the Inclusive Framework in its ambition to achieve consensus among 130 participating countries by the end of 2020. The tight timeframe is in part a result of the implementation of several unilateral measures which have been taken in various countries to impose digital services taxes or similar, which potentially will create a patchwork of rules that will be detrimental to efforts to achieve global consensus.[20]

The relevant strand of the Pillar 1 proposal for the purposes of this article is "the 'significant economic presence' proposal" that would allow countries to tax a share of the multinational's profit in the absence of physical presence. The proposal uses the concept of "fractional apportionment" which is reminiscent of US state formula apportionment, the EU CCCTB mechanism and global formulary apportionment. The October 2019 unified approach identified by the OECD Secretariat includes calculating a "routine" profit and "residual profit", although importantly the proposal does not define these terms or how they should be calculated.

The Pillar 2 proposal is in four parts: a minimum tax required to be paid by the shareholder if the company has not paid sufficient tax (an income inclusion rule); a switch from exemption to credit method for branches subject to a low effective tax rate (a switch over rule); denial of deduction for related party payments that are not subject to a minimum rate (an undertaxed payment rule); and a matching rule requiring that treaty benefits be tethered to adequate taxation in the other state (a subject to tax rule).

For present purposes, it is important to note that these proposals require new calculations; for routine and residual profits under Pillar 1 and for the amount of undertaxed payments and the minimum tax under Pillar 2. The OECD Public Consultation Documents note, in regard to the determination of the tax base, that the appropriate starting point is the relevant accounting rules, subject to adjustments to align accounting income with taxable income, acknowledging that the use of different accounting standards may result in increased compliance costs and distortions.[21] It is not clear what adjustments will be required to convert accounting profits into taxable profits; an issue that has dogged previous discussions about the appropriateness of using accounting profits for tax purposes given the myriad different approaches to both in different jurisdictions. The move towards a globally agreed tax base for GloBE will be a major departure from current practice and may open the door for adoption of the Pillar 1 unified approach and ultimately for global unitary taxation more broadly.

This article seeks to contribute to this ongoing debate by reconsidering the relationship between financial accounting profit and tax accounting profit. It should be noted that the authors do not have a preference either for the current system or for any alternative system such as some form

[18] OECD, Programme of Work, above fn.14, Ch.III, "Global anti-base erosion proposal (Pillar Two)".

[19] OECD, Public Consultation Document, *Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October 2019 – 12 November 2019* (Pillar One Document), available at: *https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf* [Accessed 21 February 2020]; and OECD, Public Consultation Document, *Global Anti-Base Erosion Proposal ("GloBE") - Pillar Two, 8 November 2019 – 2 December 2019* (Pillar Two Document), available at: *https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf* [Accessed 21 February 2020].

[20] For a discussion of these issues see L.V. Faulhaber, "Taxing Tech: The Future of Digital Taxation" (2019) 39 *Virginia Tax Review* 145.

[21] OECD, Public Consultation Documents, above fn.19. For example Pillar One Document, 14; and Pillar Two Document, 9.

of unitary taxation. The authors do not seek, or even argue for, an "optimal" tax system, recognising that any tax system is a product of history, politics, practicalities and in application a certain measure of "horse trading" between vested interests. The authors' concern is to revisit the question of whether profits calculated for accounting purposes can sensibly be used for taxing purposes. One point to note here is that, unlike taxation, accounting recognises that income does not have a true geographical source and, as it is concerned with firm level performance and is effectively blind to jurisdictional borders, does not need to differentiate between jurisdictions. The need for tax systems to determine a geographical nexus arises because of the need for each jurisdiction to determine its share of global profits in order to tax them.

The structure of this article is as follows. In order to examine the relationship between financial accounting profit and tax accounting profit, in section 1 the authors provide some reflections on the nature of a corporation and how a corporation's commercial activities are recorded in the accounts. In section 2, the authors explore some of the characteristics of accounting profit and their origins. In section 3, the authors discuss the implications of recent changes to accounting regulations. Finally, section 4 contains some concluding comments.

1. Corporations, activities and books of record

At a very basic level the actions, events, contracts, arrangements, etc. that constitute the utilisation of the assets, property and resources of a corporation[22] are recorded in that corporation's books of account or books of record (hereafter "the books"),[23] often in monetary form. The books form the informational foundation of: 1. internal decision making; 2. the production of published financial statements; and 3. the determination of any income, profits and gains (referred to hereafter as, collectively, "profits") that create a tax liability. It is the latter two with which this article is concerned, that is, the frameworks that enable corporations to move from the information recorded in the books to the production of the financial statements or the determination of taxable profit.

It is mundane to acknowledge that significant differences exist between the two practices and hence, of necessity, between the two frameworks. These differences are linked in part to the different purposes that underlie accounting practice as compared to tax practice, which are captured by considering the following basic questions:

- What is being measured or determined?
- For whom is it being measured or determined?
- Why is it being measured or determined?
- On what basis is it being measured?

[22] References to a corporation in this article are references to a limited company that is engaged in some form of commercial activity. This article does not therefore consider "not for profit" corporations.

[23] The books of account or books of record will include not only the nominal ledger and associated accounts in which some form of double entry recording occurs but will also include the evidence of various of the activities undertaken by the corporation that may not be entirely captured by double entry recording. For example, the books of account or books of record will include title documents (relating to land and buildings, patents, etc.) and contractual agreements (for example, lease agreements or employment contracts).

These questions are useful to highlight key areas of difference between accounting and taxation. For corporate income tax, as readers of this *Review* will be well aware, what is being measured or determined is an amount that the government estimates to be subject to tax. This varies considerably over time and between jurisdictions. Profit subject to tax is measured in order to determine what contribution the taxpaying entity should make to the state in the form of tax. It is only measured for one stakeholder, the government[24]; and it is measured largely on the basis of realised incomes and costs. In the context of accounting practice the answers to these questions are quite different.

In section 4 (the authors' discussion and conclusions) the authors argue that the use for tax purposes of any part of the financial statements that are the product of accounting practice without acknowledging both: 1. the significant differences that exist between the practice of accounting and the practice of tax; and 2. how the answers to the questions above are *necessarily* different, is foolhardy.

2. Accounting, accounting practice and the nature of profit

The accounting standard setting process for the UK is a double layered system. Since 2015, all publicly quoted companies have been required to report using IFRS, which are issued by the International Accounting Standards Board (the IASB). Since then, IFRS have also been adopted by many UK public sector organisations such as the NHS and for the Whole of Government Accounts (WGA). Small and medium sized companies, private companies and other organisations such as limited partnerships, trusts and off-shore companies are permitted to report under a different system of UK domestic accounting standards (known as UK Generally Accepted Accounting Practice (UK GAAP)), issued by the Financial Reporting Council (FRC), which has reduced disclosure requirements when compared to IFRS. In addition to reduced disclosure, there are some differences between IFRS and UK GAAP in the treatment of particular items in the financial statements. The most significant differences relate to the treatment of intangible assets, including: the criteria for determining which intangibles can be included in the balance sheet; the treatment of goodwill, which must be amortised over a finite life under UK GAAP but can be considered to have an infinite life and be subject to regular impairment reviews under IFRS; and the policies permitted for the valuation of inventory.

It is important to note that neither of the accounting standard setters relating to the UK are Government bodies. The FRC is a company limited by guarantee, which is financed by the large accounting firms and its board of directors is appointed by the Secretary of State for the Department of Business, Energy and Industrial Strategy. It includes a Conduct Committee and the Financial Reporting Review Panel, which together monitor the application and interpretation of accounting standards by organisations. The IASB has no power to enforce the accounting standards it issues, largely because the mechanisms for policing and enforcing accounting regulations exist at the national, domestic level in each country and not at an international level. In the UK, it is therefore the FRC which monitors the interpretation and application of IFRS as well as of UK GAAP. Following the collapse of Carillion and other large UK companies, the

[24] Although the authors acknowledge that estimations of tax liabilities are a necessary precursor to determining distributable profits under the Companies Act 2006 and therefore are for the benefit of shareholders.

Kingman Report (2018)[25] recommended significant changes to the FRC in terms of its governance, powers, culture and ways of working.

In the rest of section 2, the authors consider further the basic questions posed in section 1, above, in the context of the framework of existing rules and principles relevant to the practice of accounting, in particular in the creation of financial statements for the purposes of reporting to stakeholders. The authors also examine the origins of some of the ideas currently used in accounting practice. Before doing so, however, the authors clarify how accounting regulations came into being.

2.1. What is measured?

In accounting, particularly financial reporting, the ideas emanating from classic economic theory, such as Fisher's[26] and Hicks'[27] theories of income measurement, have been very influential, principally in the US but also in the development of IFRS.[28] The basis of these theories is that income is defined as the change in economic value of an organisation over a period of time. It should be noted, however, that several academic authors have claimed that the way in which these theories are used by the accounting regulators is based on a fundamental misreading of Hicks' work.[29] In the following discussion, the authors focus on the development of accounting thinking in this regard and its influence on the design of accounting standards, since this is important if accounting standards are to be considered as possibly relevant and useful in the design and construction of a unitary tax base.[30]

For financial accounting purposes, what is being measured or determined is an estimate of the economic value generated by a firm. The proxy used by the IASB, in their Conceptual Framework, to represent this measure is seen in the definition of income as the change in value of assets and liabilities.[31] It is only under the assumptions of a perfect economic world that the IASB definition of income would represent the economic value generated. In this case, with perfect markets and full, transparent disclosure, where all assets and liabilities could be recorded at their fair (market) values and everything could be measured with certainty, the economic value generated by a firm could be measured using a Hicksian-type model of income. In this case, the change in the value of the net assets of the firm over a period of time would equate to the profit earned for that period and also to the change in the firm's equity market valuation. In practice, of course, the firm's market value and accounting book value can diverge significantly and income measurement differs from this ideal in a number of key respects. Markets, be they markets for financial instruments (such as equity shares), information, or goods and services, are frequently

[25] J. Kingman, *Independent Review of the Financial Reporting Council* (2018), available at: *https://www.gov.uk/government/publications/financial-reporting-council-review-2018* [Accessed 14 February 2020].
[26] I. Fisher, *The Nature of Capital and Income* (New York: Macmillan, 1906).
[27] J.R. Hicks, *Value and Capital – An Inquiry into Some Fundamental Principles of Economic Theory*, 2nd edn (US: OUP, 1975).
[28] In the economics literature and in some strands of the accounting literature, writers tend to use the terms "income" or "earnings" when referring to profit.
[29] For example, see M. Bromwich, R. Macve and S. Sunder, "Hicksian Income in the Conceptual Framework" (2010) 46(3) *Abacus* 348, discussing the IASB's interpretation.
[30] This term is used here to mean the tax base for the economic unit or group in aggregate.
[31] IASB, *The Conceptual Framework for Financial Reporting* (IFRS Foundation, 2018), available at: *https://www.ifrs.org/projects/2018/conceptual-framework/* [Accessed 18 February2020].

far from complete and perfect; disclosure of information by firms is partial and less than transparent and accounting rules and practices are affected by the political behaviour and relative power wielded by the parties involved, who are competing to pursue their own self-interests.[32] In accounting, therefore, the intention is to create a measure of a firm's financial performance (profit) that best represents the change in economic value, given the market imperfections under which the firm operates.

It is important to note, at this point, the difference between the terms "income" and "profit" as used in financial reporting. While there is a fixed, single definition of the term income in the IASB Conceptual Framework (which is the change in the value of assets and liabilities, mentioned above), a published set of accounts contains several different measures of profit, which cover various components of income.

The overall change in net asset values is usually termed "comprehensive income" and disclosed in a separate financial statement (the statement of comprehensive income). The required disclosure under IFRS, particularly under International Accounting Standard (IAS) number 1 ("Presentation of Financial Statements"), is structured so that it is possible for readers of accounts to identify, from the main income statement, which parts of the comprehensive income derive from core business activities (termed "operating profit" or "profit before interest and tax") and which parts derive from other activities of the firm or other factors that do not arise from normal trading, such as currency fluctuations, revaluations of pension funds or changes in the market value of non-current assets, which appear as items of "other comprehensive income". It is also possible within operating profit to separately identify the costs of financing the firm, taxation, indirect overheads, profits or losses from other sources such as joint ventures and profits associated with discontinued activities. In addition to these mandatory disclosures, firms also frequently disclose other measures of their profit voluntarily, such as earnings before interest, taxation, depreciation and amortisation (EBITDA).

2.2. The questions of to whom we account and why

In the accounting world, the question of why economic value is measured is usually considered jointly with the question of for whom is it measured. The primary objective of the financial reporting system is taken to be the provision of information for two main purposes: first for the purpose of making economic decisions by the users of the reports (the decision-usefulness function); and, secondly, for the purposes of controlling, monitoring and rewarding the performance of managers in the firm (the stewardship function).[33,34,35] Over time, views have changed about the scope of the relevant economic decisions, the identity of those taking them and the nature of the stewardship function. This has caused successive accounting regulatory bodies to place different degrees of emphasis on the two objectives and to arrive at different

[32] R.L. Watts and J.L. Zimmerman, *Positive Accounting Theory* (Englewood Cliffs, NJ: Prentice-Hall, 1986); S. Zeff, "'Political' Lobbying on proposed Standards: A Challenge to the IASB" (2002) 16(1) *Accounting Horizons* 43.
[33] H. Edey, "The Nature of Profit" (1970) 1(1) *Accounting and Business Research* 50.
[34] R. Macve, "Conceptual Frameworks of Accounting: some brief Reflections on Theory and Practice" (2010) 40(3) *Accounting and Business Research* 303.
[35] S. Zeff, "The Objectives of Financial Reporting: A Historical Survey and Analysis" (2013) 43(4) *Accounting and Business Research* 262.

conclusions about the extent to which one set of information can serve both purposes. It is also the cause of significant differences between the two main, global, financial reporting frameworks currently operating in practice, the IFRS[36] and the standards created by the US Financial Accounting Standards Board (the FASB).[37]

Research into these matters[38] has concluded that since markets are imperfect in practice, it is not possible to determine accurately the value of assets (or liabilities) as it is impossible to forecast accurately the future economic benefits (costs) associated with them, which are needed for estimating fair values. Given the different interests of the competing parties, there is clearly no possibility of certainty in the measurement of profit, nor of creating a perfect set of rules to meet every possible case that might arise in practice. Therefore, in addition to the rules, such as in IFRS and US Generally Accepted Accounting Principles (US GAAP), there must be an additional means of ensuring that accounting, in practice, fulfils its intended purposes, thus achieving what is referred to in the literature as "functional completion".[39] In the case of financial reporting this function is fulfilled by the accounting principles contained in the accounting Conceptual Frameworks.[40] There has been a long and contentious debate about what is the appropriate balance between detailed rules and general principles, needed to achieve effective accounting regulation (hereafter "accounting rules"). Historically, the US regulators[41] and the IASB have taken different views, with the US favouring more detailed rules and the IASB favouring greater use of principles.[42]

To a large extent, these differences of view are driven by the question of for whom the accounts are produced. Some of the earliest expositions of the objectives of financial reporting were

[36] IASB, above fn.31.

[37] FASB, *Concepts Statements* (2009–2019), "Concepts Statements 4–8", available at: *https://www.fasb.org/jsp/FASB/Page/PreCodSectionPage&cid=1176156317989* [Accessed 18 February 2020].

[38] For example, R. Ball, "International Financial Reporting Standards, (IFRS): Pros and Cons for investors" (2006) 36 (Special Issue) *Accounting and Business Research* 5.

[39] Ball, above fn.38.

[40] For example the IASB *Conceptual Framework for Financial Reporting* (2010), available at: *https://www.ifrs.org/issued-standards/list-of-standards/conceptual-framework/* [Accessed 18 February 2020]; and for later developments see IASB, *Exposure Draft, Snapshot: Conceptual Framework for Financial Reporting* (2015), available at: *http://archive.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Summary.aspx* [Accessed 18 February 2020]. The 2018, revised, version of the framework was made generally available from the IASB in January 2019 (IASB, above fn.31).

[41] FASB and the Securities and Exchange Commission (SEC).

[42] Following the Enron and Worldcom scandals in the US, the SEC commissioned a study and produced a report recommending the adoption of principles-based standards in the US (SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (2002), available at: *https://www.sec.gov/news/studies/principlesbasedstand.htm* [Accessed 18 February 2020]). This led directly to the establishment of the Norwalk Agreement (FASB (2002), available at: *https://www.fasb.org/news/nr102902.shtml* [Accessed 18 March 2020]), a Memo of Understanding, established between the FASB and the IASB on the development of joint accounting principles and joint accounting rules. The joint IASB/FASB programme has, in practice, proved to be far from harmonious and the convergence project broke down in 2012 amid some rather acrimonious press reports (e.g. R. Crump, Editorial, "IASB branded 'not fit for purpose' as it clashes with FASB", *Accountancy Age*, 6 July 2012, available at: *http://www.accountancyage.com/aa/news/2193181/iasb-branded-not-fit-for-purpose-as-it-clashes-with-fasb* [Accessed 18 February 2020]). The joint statements on accounting principles issued during the convergence project generated a significant amount of critical comment during the exposure process. To a large extent, the difficulties in forging joint regulations arise from fundamental differences in the FASB and the IASB philosophies about the purposes of financial reporting, which lead to differences in ideas about the processes of measurement, recognition and valuation.

delivered in the US in the 1920s when the requirements of the taxation system were seen as an integral part of corporate financial reporting. For example, in 1922, Paton[43] identified the government as a main stakeholder in the financial reporting process and suggested that "federal income and profit taxes" should be disclosed in the accounts as a distribution of net income, in the same way that dividends to shareholders are shown as a distribution of profit rather than as a cost to the organisation. Paton was a proponent of the entity theory of accounting, under which the figures disclosed in the financial statements are compiled from the viewpoint of the managers of the firm. The theory recognises a wide range of stakeholders in the financial reporting process, none of whom is given precedence. Later statements of financial reporting objectives from the US adopted the alternative, proprietary, view of the firm[44] where financial statements are constructed from the viewpoint of the owners (proprietors), that is, the equity investors. In 1966, the American Accounting Association published a *Statement of Basic Accounting Theory*[45] that was based wholly on the decision-usefulness approach, deriving from the work of Staubus.[46,47]

In 1973, the American Institute of Certified Public Accountants (the AICPA) produced a report on their research into financial reporting objectives, entitled *Objectives of Financial Statements: Report of the Study Group on the Objectives of Financial Statements* which became known as the *Trueblood Report*.[48] The main conclusion of the research was that, within the decision-usefulness model, the range of potential decision-makers to whom financial statements were addressed should be narrowed down to include only the providers of capital, shareholders and lenders. Since this point, all subsequent US pronouncements on the objectives of financial reporting have been rooted in the idea that reports should provide economic information relevant to the decisions taken by shareholders and, to a lesser extent, creditors.

In contrast to this, the UK has historically taken a rather different approach to determining the objectives of financial reporting and, until recently, explicitly identified a wider group of stakeholders, including the government. Various commentators have suggested that this may be as a result of differences in the relative power wielded by the accounting professions, particularly the UK accounting institutes and large professional firms, and the bodies representing the capital markets, such as the SEC in the US.[49,50] The early attempts to define the objectives of financial reporting in the UK included *The Corporate Report*,[51] which identified a wide group of users of financial information and suggested, in addition to traditional balance sheet and income statements, six novel financial statements to meet the needs of these different groups. Among these was a

[43] W.A. Paton, *Accounting Theory, with Special Reference to the Corporate Enterprise* (New York: The Ronald Press Company, 1922).
[44] Zeff, above fn.35.
[45] American Accounting Association (AAA), *A Statement of Basic Accounting Theory* (Evanston, IL: American Accounting Association, 1966).
[46] G.J. Staubus, "The Residual Equity Point of View in Accounting" (1959) 34(1) *The Accounting Review* 3.
[47] G.J. Staubus, *A Theory of Accounting to Investors* (Berkeley: University of California Press, 1966).
[48] American Institute of Certified Public Accountants, *Objectives of Financial Statements: Report of the Study Group on the Objectives of Financial Statements* (AICPA, 1973), also known as the *Trueblood Study Group Report*.
[49] K.V. Peasnell, "The Function of a Conceptual Framework for Corporate Financial Reporting" (1982) 12(48) *Accounting and Business Research* 243.
[50] Zeff, above fn.35.
[51] Accounting Standards Steering Committee (ASSC), *The Corporate Report. A discussion paper published for comment by the Accounting Standards Steering Committee* (London: The Institute of Chartered Accountants in England and Wales, 1975).

"statement of money exchanges with government", designed to reflect the interests of the government as a stakeholder in the firm, largely through the corporation tax system. Although this statement was never adopted widely in practice, the UK's first complete Conceptual Framework for financial reporting, the *Statement of Principles*,[52] separately identified "governments and their agencies" as one of the primary stakeholder groups in the financial reporting process. When IFRS were adopted by quoted UK companies in 2005, the associated Conceptual Framework, created by the International Accounting Standards Committee (now the IASB), also still referred to a wide range of users of financial reports.[53]

2.3. The politics of convergence in accounting

Between 2005 and 2012, the IASB and FASB made an attempt to converge their accounting standards, which ultimately proved unsuccessful.[54] In the joint IASB/FASB Conceptual Framework issued in 2010, as part of the convergence project, the only users of financial reporting identified were the providers of capital.[55] This is linked directly to the idea that financial reporting information is produced for decisions about investment. This implies, for example, that current values of assets and liabilities are more important than historic values and that forecasting future cash flow is more important than recording historic transactions, which is an approach that is incompatible with many of the ideas in the existing international accounting standards. Examples of such accounting standards include: the standard relating to the valuation of property, plant and equipment (IAS 16, "Property, Plant and Equipment"), which allows for valuation at historic cost; the standard relating to provisions (IAS 37, "Provisions, Contingent Liabilities and Contingent Assets"), which currently requires that provisions are measured at the best estimate of the expenditure required to settle the present obligations resulting from past events, as opposed to forecasting future obligations, including estimates of the risks and uncertainties involved; and the standard relating to inventories (IAS 2, "Inventories"), which requires that inventories are valued at the lower of their historic cost and their net realisable value. Following its split from the FASB, the IASB's thoughts concerning the users of financial reporting have been expressed more recently in its 2018 revisions to the Conceptual Framework. This version of the Conceptual Framework was published solely by the IASB, rather than jointly with the FASB, and in it the IASB specifically re-introduced the term "stewardship" into its guidance on financial reporting objectives, which implies a wider constituency of users of financial reports.[56]

It is clear that the mixed measurement basis allowed in the valuation of assets and liabilities, by the Conceptual Framework and IFRS, results ultimately in a balance sheet that does not approximate closely to the original idea of economic value. It can be seen from this that the questions of why and for whom this value (economic or otherwise) is being measured have been contentious and complicated in financial reporting. However, regardless of which users of accounts are acknowledged explicitly in the Conceptual Framework, a variety of stakeholders

[52] Accounting Standards Board (ASB), *Statement of Principles for Financial Reporting* (London: Financial Reporting Council, 1999).
[53] IASB/IASC, *Framework for the Preparation and Presentation of Financial Statements* (London: IASC, 1989).
[54] See, above fn.40.
[55] IASB, above fn.31.
[56] IASB, above fn.31.

still exists in practice, including managers, shareholders, lenders, auditors, employees, investors, the government and regulators. Accounting profit, in this sense, is more multifunctional than tax profit. In this context, the role of accounting regulations, such as the IFRS, is to contribute to reducing the level of uncertainty in accounting numbers that arises from the complex environment in which they are produced, and to strike a balance between the interests of the parties in the financial reporting process, since the adoption of different rules and principles and accounting methods will impose different costs on the various interested parties.[57]

The main problem with financial reporting convergence has been that, despite pressure for the global integration of accounting rules and practices, the political and market forces affecting the individual firms, national regulators and national professions remain at the local level.[58] The breakdown of the FASB/IASB convergence project was undoubtedly a blow to the attempt to create a set of global accounting standards and, in the end, the individual approaches of the two parties proved too dissimilar to combine. Hail, et al.[59] conclude their analysis of whether the US should adopt IFRS with the statement that the US could add specific disclosure requirements on top of IFRS disclosure, in order to "assert its leadership in the area of capital market-orientated reporting". This is the crux of the problem for financial reporting. The capital market orientation of the US could not be satisfied by requiring extra disclosure in IFRS accounts, it is a fundamentally different basis of reporting from that used in the development of IFRS. These differences were characterised by Zeff[60] as being "functionalist" and "representationalist" approaches to financial reporting, the former describing the US approach and the latter the IASB approach. The differences have shown themselves primarily in: the debates about the use of fair values[61] for assets and liabilities; the need for conservatism (or prudence) in valuing assets or liabilities and in reporting profit; and the debate over the concept of stewardship and its role as an objective of financial reporting.

3. The basis of accounting information

Having outlined some of the complexities relating to the first three basic questions (the what, who and why questions) in relation to accounting, the authors now consider the fourth, the question about the basis of accounting information. In discussions concerning the role of accounting in a unitary tax base, some commentators[62] highlight the importance of the capital maintenance concept, as applied in accounting, and criticise the application of different maintenance concepts to different aspects of financial reporting. The concept of capital maintenance states that profit should only be recognised once a firm has maintained the value

[57] Ball, above fn.38.
[58] Ball, above fn.38.
[59] L. Hail, C. Leuz and P. Wysocki, "Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part II): Political Factors and Future Scenarios for U.S. Accounting Standards" (2010) 24(4) *Accounting Horizons* 567, 585.
[60] S. Zeff, "The Evolution of the Conceptual Framework for Business Enterprises in the United States" (1999) 26(2) *Accounting Historian's Journal* 89.
[61] Under fair value accounting, assets and liabilities are recorded at a "fair", arm's length, market value or an estimation of a market price.
[62] For example, R. Murphy and P. Sikka, "Unitary Taxation: The Tax Base and the Role of Accounting" in Picciotto (ed.), above fn.3.

of its capital. The interpretation of what this means in practice clearly depends on how capital and costs are defined and measured so the concept is critical to the debate about the nature of profit.[63] Many writers have suggested that, traditionally, the objective of stewardship has been associated with the system of historic cost accounting and therefore is more consistent with principles of taxation, which on the whole require chargeable gains to be realised. In contrast, the objective of decision-usefulness in financial reporting tends to be more associated with the use of fair value accounting.

In the context of the CCTB debates, it has been suggested[64] that the reason why both the IASB and FASB frameworks are incompatible with the CCTB is because they are "heavily focussed" on fair valuation rather than revenue recognition, and the CCTB specifies that profits and losses can only be recognised for tax purposes when they are realised.[65] Rather than being solely based on fair values, accounting profit derives from a mixed valuation base. Currently, IFRS permit the use of fair values for the valuation of property, plant and equipment,[66] the impairment of assets,[67] the valuation of intangible assets,[68] the valuation of financial instruments,[69] the valuation of investment property,[70] measuring share-based payments,[71] valuing the minority (non-controlling) interest in business combinations,[72] valuing financial liabilities[73] and in some aspects of revenue recognition.[74] As noted earlier, there are several different versions of profit and what some commentators[75] refer to as "accounting profit" is disclosed in the accounts as "comprehensive income", usually in a different financial statement from operating profit (the comprehensive income statement). It is here that the changes in fair values of assets and liabilities tend to appear. In a firm's main income statement, the profits disclosed derive from the operating activities of the business and are based on realised (earned) income and matching costs. However, the definition of realised (earned) income in IFRS has changed over time. One of the joint standards issued under the IASB/FASB convergence project, was adopted by the IASB and thus in the UK, as IFRS 15 (accounting for "Revenue from Contracts with Customers"), which came into effect for year ends on or after 31 December 2018.[76] Prior to IFRS 15, revenue was accounted

[63] The main capital maintenance concepts used in accounting include nominal financial capital maintenance (associated with historic cost accounting) and operating or physical capital maintenance (associated with replacement cost accounting and fair value accounting).
[64] For example, by Murphy and Sikka, above fn.62.
[65] European Commission, *Proposal for a Council Directive on a Common Corporate Tax Base* (Strasbourg: 25.10.2016, COM(2016) 685 final), available at: *https://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_685_en.pdf* [Accessed 18 February 2020].
[66] IAS 16, "Property, Plant and Equipment". Note the IAS (International Accounting Standards) are the forerunners of the IFRS, issued by the IASB, still currently in force.
[67] IAS 36, "Impairment of Assets".
[68] IAS 38, "Intangible Assets".
[69] IAS 39/IFRS 9, "Financial Instruments: Recognition and Measurement".
[70] IAS 40, "Investment Property".
[71] IFRS 2, "Share-based Payment".
[72] IFRS 3, "Business Combinations".
[73] IFRS 13, "Fair Value Measurement".
[74] IFRS 15, "Revenue from Contracts with Customers", see also below.
[75] For example, Murphy and Sikka, above fn.62.
[76] Another relevant change in IFRS that will affect the reporting of income and the value of assets and liabilities in the balance sheet for years ending 31/12/19 onwards is the issue of IFRS 16, "Leases", which will mean that many

for under the old IASB standard, IAS 18, on the basis of whether the rights and responsibilities of ownership, for example of goods, had been transferred to the customer. Under the new standard, revenue is accounted for on a contract-by-contract basis and based on whether the firm has satisfied the specific terms (performance obligations) of each contract. This change has significantly affected the pattern of revenue recognition for specific industries and firms such as mobile phone companies, long-term contract businesses, the construction, aerospace and engineering industries and the technology sector.

Although it may be too early to judge at this point what the effects of adopting IFRS 15 might be in practice, it seems clear that the new standard is likely to introduce more estimation and subjectivity into the process of recognising income. Organisations are now required to allocate the whole price of the contract to each of the specific obligations they have to fulfil to complete the contract, in proportion to the fair (market) value of each separate obligation. In practice, each obligation under the contract might not exist separately or might not have a market value in isolation from the other elements of the contract and thus estimates and trade-offs have to be made. The new regulations have also resulted in items of deferred revenue (amounts of income received/invoiced by a company in advance of earning it, such as a deposit) and accrued revenue (where a term of a contract has been fulfilled but not yet invoiced) appearing far more frequently in balance sheets.

The case of IFRS 15 provides an example of how the principles followed by IFRS (and in this case US financial reporting standards too) complicate the relationship between tax and accounting profit. Starting from the idea that financial reports are used by investors and creditors led the IFRS and FASB to base the revenue recognition standard on the notion that revenue should reflect the increase in value of a firm caused by the performance of specific obligations under contracts with customers. The concept behind this is that the income reported reflects the economic activity (the parts of the contracts completed) in the accounting period, regardless of whether invoices have been issued relating to that activity or whether cash has been received. It might appear, superficially, that recognition of revenue based on the firm's specific contracts would bring the financial reporting treatment of revenue closer to the tax treatment, reflecting the idea of realised income and based on completing a transaction. In practice, however, the use of fair values in IFRS 15 means that the pattern of revenue recognition becomes less like the traditional transactional basis, which is likely to identify the issuing of an invoice or receipt of cash as the trigger for recognising income.

Despite this, if, as some commentators suggest,[77] the most contentious issues in tax arise after EBITDA, the operating profit of a firm may be a more appropriate starting point for a tax base than comprehensive income and they are correct to note that no single capital maintenance concept underlies accounting profit. Ball[78] notes:

> "It is simply incorrect to view the prevailing financial reporting model as 'historic cost accounting'. Financial reporting, particularly in common law countries is a mixed process involving both historical costs and (especially contingent on losses) fair values."

leased assets and associated financing commitments that would previously not have appeared on the balance sheet must now be included.

[77] For example, Murphy and Sikka, above fn.62.

[78] Ball above fn.38, 14.

It has always been the case in UK financial reporting that losses and potential losses have been valued at "fair value" and have been recognised earlier than potential gains, by application of the concept of prudence/conservatism. This principle was another that had previously figured strongly in the philosophy of the IASB but not that of the FASB, which was excluded from the joint IASB/FASB Conceptual Framework. Following the breakdown of the FASB/IASB convergence project, the IASB has reintroduced prudence, along with stewardship, as a principle into its revised Conceptual Framework.[79] The important point about the concept of prudence is that it encourages an asymmetric treatment of gains and losses, whereby for potential losses, fair values and recognition before the point of realisation are used whereas for potential gains, historic costs and recognition based on realisation are used. This is seen clearly in the requirement, in IAS 2, to value inventories at the lower of their cost and their net realisable value. The need to remove the concepts of prudence and stewardship from the joint Conceptual Framework occurred in part because of the extent to which they conflict with the use of fair values in relation to the measurement of assets and liabilities. Whittington[80] provides an analysis of the conceptual problems with the use of fair values in financial reporting and Penman,[81] although he is a noted advocate of fair values in theory, analyses some of the problems in their implementation in practice. The most significant of these derive from three main issues: first, the subjectivity of the valuation process for assets for which there are no active markets; secondly, that frequently no markets exist at all for liabilities; and, lastly, the fact that market values may not reflect the value of assets as they are used in the firm and thus their contribution to the firm's economic value. The intractability of these problems with fair values was significant enough to expose the differences in principles underlying the IASB and FASB approaches to valuation and measurement, which ultimately led to the breakdown of the convergence project and a less co-operative relationship between the two regulators.

While the presentation of financial statements under IFRS and US GAAP appears superficially similar, there are some notable differences in the accounting policies allowed under the two different regimes, which result in different profit figures.[82] For example, the US focus on detailed rules (see earlier) as opposed to principles, has resulted in a significantly different approach to the treatment of intangible assets, in comparison to the IFRS approach. In the case of development costs for new products or for processes used within the business, the IFRS principle for allowing such costs to be capitalised[83] (recorded as an asset) is based on the definition of an asset in the IFRS Conceptual Framework, that the expenditure will generate future economic benefits for the firm. Specific criteria are therefore applied to establish the likely existence of future economic benefits, based on the technical feasibility of the product or process, the firm's intent to complete the asset, the availability of sufficient resources to do so and an ability to sell the asset (if it is a

[79] IASB, above fn.31.
[80] G. Whittington, "Fair Value and the IASB/FASB Conceptual Framework Project: An Alternative View" (2008) 44(2) *Abacus* 139.
[81] S. Penman, "Financial reporting quality: is fair value a plus or a minus?" (2007) 37 (sup 1: Special Issue, International Accounting Policy Forum) *Accounting and Business Research* 33.
[82] EY, *US GAAP versus IFRS: The Basics* (2018), available at: *https://www.ey.com/Publication/vwLUAssets/IFRSBasics_00901-181US_23February2018/$FILE/IFRSBasics_00901-181US_23February2018.pdf* [Accessed 18 February 2020].
[83] Under IAS 38, "Intangible Assets".

product) in the future for more than it cost to complete. In contrast, the US GAAP approach is to expense all development expenditure in the period in which it is incurred, thus reducing operating profit, with the exception of computer software developed for external use,[84] which may be capitalised once technical feasibility is established. In general, IFRS also permits the revaluation of intangible assets to fair value whereas US GAAP permits only valuation at cost.

Another well-known difference between US GAAP and IFRS lies in the accounting treatment of inventories. In situations where the price of inventory is fluctuating during the year, firms often base the cost of goods sold included in the income statement and the value of year-end inventory in the balance sheet on average prices. This process requires an assumption about the flow of inventories over the year. While US GAAP allows firms to account for inventories on a last-in, first-out (LIFO) basis,[85] this policy is forbidden under IFRS.[86] The effect of this is that firms preparing their accounts under IFRS will value their inventory at the latest prices and record the cost of goods sold at prices that occurred earlier in the year. In a period when inventory prices are rising, the most common case, this means that compared to a firm reporting under US GAAP, the firm reporting under IFRS will report a higher value for its inventory and a lower cost of sales figure, and thus higher profit. In addition, where a write-down of inventory has occurred in a firm, for example due to fluctuating market prices, IFRS allows firms to reverse such a write-down if the trend in underlying prices reverses, whereas US GAAP forbids such a treatment. Overall, the presence of such differences observed between the two largest financial reporting systems in the world, US GAAP and IFRS, serves to illustrate that accounting profit is a changeable concept that can be used to represent different ideas in different contexts.

By this point, it is obvious that the answers to the four fundamental questions concerning the nature of profit are significantly more complicated for accounting than for taxation purposes. In addition to the points about the range of potential stakeholders, conflicting objectives and mixed measurement bases, the practice of financial reporting involves concepts and definitions that have been described by some as too fuzzy to be used for taxation purposes.[87] The complicated processes through which accounting regulations are created and enforced also result in a wide range of possible accounting policies from which managers are permitted to choose, and a high level of subjectivity in that selection process.[88] There is a significant body of critical scholarship which posits that profit for the purpose of financial reporting is something of a chimera: it is recognised and measured in a manner designed simply to serve the interests of particular stakeholder groups and is socially constructed. This ephemeral nature of profit and its multiple purposes are matters of concern recognised by academics researching these areas. The chimeric nature of profit is ably captured in the title of a paper by Ruth Hines: "Financial accounting: In

[84] Accounting Standards Code (ASC) 985-20, which provides guidance on costs of software to be sold, leased, or marketed.

[85] ASC 330-10-30 which specifies the most common cost flow assumptions used: 1. first-in, first-out (FIFO); 2. last-in, first-out (LIFO); and 3. weighted-average.

[86] IAS 2, "Inventories".

[87] For examples see M. Lamb, "Defining Profits for British Income Tax Purposes: A Contextual Study of the Depreciation Cases: 1875-1897" (2002) 29(1) *Accounting Historians Journal* 105.

[88] See, for example, R.M. Pierce-Brown and A. Steele, "The economics of Accounting for Growth" (1999) 29(2) *Accounting and Business Research* 157; T. Fields, T. Lys and L. Vincent, "Empirical research on accounting choice" (2001) 31(1–2) *Journal of Accounting and Economics* 255; E. Kvaal and C. Nobes, "International differences in IFRS policy choice: A research note" (2010) 40(2) *Accounting and Business Research* 173.

communicating reality, we construct reality".[89] The subsequent adoption of IFRS has not affected the relevance of this paper to financial reporting practice. On the contrary, the wider use of fair values, forecasting models and subjectivity associated with the adoption of IFRS tends to make the conclusion that the accounting profession constructs its own reality more relevant now than it was in 1988 at the time of publication.

4. Discussion and conclusion

Many discussions about alternative tax bases, including those relating to what is an appropriate base for global unitary taxation and, more recently, those relating to the taxation of the digital economy, have proceeded without precisely specifying how such bases are to be calculated. Indeed there often appears to be an assumption that determining an appropriate base will be unproblematic.[90] In the case of unitary taxation in the US it operates at state level, and this system is frequently put forward as a model of successful implementation of formulary apportionment. The unitary base is the profit determined by the Federal tax code which has the benefits both of uniformity and of being well understood. The difficulties that arise in that system stem from differences in the formula used to allocate the profits between states for the purposes of levying state level corporate income tax. In the case of a global or regional unitary tax that does not have a pre-existing defined base, the creation of an agreed base is profoundly problematic.

There are two main possibilities for defining a unitary tax base. The consolidated profit of the group for accounting purposes could be used, with or without adjustments for tax purposes. Alternatively, a separate set of rules could be devised that define the unitary tax base without reference to the financial statements. In 2005, when the CCCTB proposals were being discussed in Europe, the use of IFRS for the corporate base was dismissed as

> "[it] was felt unlikely that the [IFRS] consolidation would be acceptable without adjustment and the scale of the adjustments would be such that there was no advantage in starting with [IFRS] consolidated figures".[91]

The original draft CCCTB proposal did not start with an accounting basis and adopted instead a revenues less exempt revenues and deductible items approach (also known as the transactional approach) which has carried through into the 2016 draft CCTB directive.

Although, as indicated, the OECD's BEPS Project explicitly rejected unitary taxation, the Action Plan[92] does suggest that the complexity of modern commercial activity might require the adoption of special measures, which could even go beyond the transfer pricing arm's length principle in certain circumstances. For example, some type of formula could be agreed upon to

[89] R. Hines, "Financial accounting: In communicating reality, we construct reality" (1988) 13(3) *Accounting, Organizations and Society* 251.
[90] See for example M. Durst, "A Practical Approach to a Transition to Formulary Apportionment" in Picciotto (ed.), above fn.3.
[91] Cited in J. Lamotte, "European Union - New EU Tax Challenges and Opportunities in a (C)CCTB World: Overview of the EU Commission Proposal for a Draft Directive for a Common Consolidated Corporate Tax Base" (2012) 52(6) *European Taxation* 1.
[92] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), available at: *https://www.oecd.org/ctp/BEPSActionPlan.pdf* [Accessed 18 February 2020].

allocate or apportion taxable profit that has been generated by a particular intangible asset.[93] However, applying a formula in the context of a particular transfer pricing matter is not the same as adopting an alternative system based on unitary taxation.

Although it would be a radically different way of taxing multinational enterprises compared to the method that now exists within the majority of national tax systems (and bilateral or multilateral agreements), it is entirely possible that at some time in the future, MNEs could be taxed on the basis of a system of unitary taxation; indeed this is the current direction of travel in relation to the digital economy. The likelihood of this hinges on the practicability of the component parts of such a system. Specifically, which entities would form part of the unitary group, how the unitary tax base should be calculated, the mechanism for aggregating the tax base for the participating entities and the formula for allocating the aggregated unitary tax base.

By identifying the different features of a framework of accounting (see section 2 of this article) as compared with a framework of tax and in interrogating each framework with the questions set out in section 1 of this article, it becomes clear that there are different rules of recognition. What is being measured within a framework of tax is some form of profit that has arisen as a consequence of the actions, arrangements, and transactions of any entity that is identified in the tax code as being a potential taxpayer. Profit as identified by a tax code is, in effect, shared between the taxpayer and the tax authority. Identifying and sharing any such profit sooner rather than later offers advantages to tax authorities and hence to governments. The framework of tax is thus not about measuring economic value at a point in time. Conversely, it could be argued that corporation tax is based on a flow, the value of which must be measured over a period of time, before the government share and timing of entitlement can be determined.

When a consolidated set of accounts is prepared, the balance sheet is based on the value of the net assets under the control of the shareholders of the parent company at a point in time. It is perfectly reasonable that the shareholders do not want to be misled about what they control and, because they are interested in the future value of their investment, that the consolidated accounts include some expected but unrealised changes in value. Hence the removal of intra-group transactions, the use of fair values for the valuation of certain assets and liabilities, the inclusion of certain intangible assets and the use of provisions to reflect expected future liabilities.

Despite this, it is important to realise that there are many different versions of accounting profit and the version found in a firm's main income statement, operating profit or profit before interest and tax, is (the previous discussion of revenue recognition under IFRS 15 notwithstanding) based primarily on the principles of realised income and matched costs. If the effects of depreciation and amortisation are also removed from this measure, to produce EBITDA,[94] then the resulting figure is more in line with the principles usually applied in assessing profit for tax purposes. Even so, the potential for earnings management by firms under both IFRS and US standards, or local variations of these frameworks, still renders a measure based on reported accounting profits less suitable for taxation purposes, where more certainty and objectivity is required. Tax rules have traditionally dealt with this issue by removing/replacing the main items

[93] See R.S. Avi-Yonah and I. Benshalom, "Formulary Apportionment: Myths and Prospects - Promoting Better International Policy and Utilizing the Misunderstood and Under-Theorized Formulary Alternative" (2011) 3(3) *World Tax Journal* 371.

[94] This is the measure proposed by Murphy and Sikka, above fn.62.

that are associated with subjectivity and greater accounting policy choice such as depreciation, provision and the valuation of intangibles.

Setting aside the possibilities of dishonest reporting, accounting and tax rules and the practices associated with them vary considerably over time as each adapts to changing social and economic conditions. In both cases, the rules and practices also vary between countries. As noted earlier, even the increasing adoption of supposedly consistent international accounting standards is riddled with inconsistency, as countries make local adaptations and interpretations.[95,96] Arguably this opens the way to accounting standard arbitration and places additional pressure on tax authorities to master the intricacies of accounting standards. Importantly, it is in the interests of the government of each country to retain as much control as possible over their own taxation arrangements and to leave themselves enough flexibility to change those arrangements should the need arise.

The relationship between accounting and tax profits is, of course, an issue that has been debated over a long period of time by numerous academics in many jurisdictions, including the General Editor of this *Review*.[97] There is no question that debates about the use of accounting concepts in tax continue to be important. These raise not only issues in taxation and accounting but also possibly more important issues associated with the relationship between commercial activity and society. ☙

[95] C. Nobes and S. Zeff, "Auditors' Affirmations of Compliance with IFRS around the World: An Exploratory Study" (2008) 7(4) *Accounting Perspectives* 279.

[96] C. Nobes, *International Variations in IFRS Adoption and Practice*, ACCA Research Report 124 (London: Certified Accountants Educational Trust, 2011), available at: *https://www.accaglobal.com/content/dam/acca/global/PDF-technical/financial-reporting/rr-124-001.pdf* [Accessed 18 February 2020].

[97] See Freedman (1993, 1995, 2004a and 2004b), above fn.2.

☙ Corporation tax; Generally Accepted Accounting Principles; Groups of companies; Profits; Tax administration; Tax principles

Taxing Earnings from the Platform Economy: An EU Digital Single Window for Income Data?

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Abstract

Income earned through gig platforms, letting platforms, and other digital intermediaries presents new challenges for taxation. This article evaluates the efforts of three EU Member States—Denmark, Estonia, and France—to obtain data on platform users' earnings directly from platform companies, including Uber, Airbnb, and domestic platforms. The authors furthermore assess the viability of scaling up the national initiatives into an EU-level "Digital Single Window" that would facilitate the automated reporting of income data by platforms, and the forwarding of that data to national tax and social security agencies for taxation and collection according to national rules.

I. Introduction

Digital transaction platforms, such as Uber, Airbnb, Deliveroo, and Upwork, have emerged as a new source of income for private individuals. It is difficult to estimate the size of the platform economy for various reasons including the fact that it is often a source of secondary income and the income earned is not consistently reported to tax authorities.[1] According to some estimates, the gig economy[2] in the EU alone generated €3.6 billion in revenue in 2015 while online outsourcing was projected to grow to $4.8 billion in 2016.[3] Some platforms offer work in exchange

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[1] O. Kässi and V. Lehdonvirta, "Online Labour Index: Measuring the Online Gig Economy for Policy and Research" (2018) 137 *Technological Forecasting and Social Change* 241, 242.

[2] Comprising crowd funding, asset sharing, transport, on-demand household services, and on-demand professional services.

[3] See A. Hunt and E. Samman, *Gender and the gig economy: Critical steps for evidence-based policy* (2019) ODI Working Paper 546, available at: *https://www.odi.org/sites/odi.org.uk/files/resource-documents/12586.pdf* [Accessed 20 February 2020], 10 and S.C. Kuek, et al., *The Global Opportunity in Online Outsourcing* (World Bank, 2015) Report No.ACS14228, available at: *http://documents.worldbank.org/curated/en/138371468000900555/pdf/ACS14228*

for income, while others allow people to provide services or rent out property. These new income sources present new challenges for tax and social security systems. This is especially the case for so-called gig economy or labour platforms.

Platform work refers to

> "all labour provided through, on, or mediated by platforms, and which features a wide array of standard and non-standard working arrangements/relationships".[4]

It is typically

> "a way of working that is based on people having temporary jobs or doing separate pieces of work, each paid separately, rather than working for an employer".[5]

Platform work includes both localised gig work such as taxi and food delivery services provided through platforms like Uber and Deliveroo, as well as web-based platform work such as graphic design and data entry through platforms like Fiverr and Upwork.

While it is not a main source of employment, platform work is growing rapidly. According to one study, platform work is the main source of income for approximately 2 per cent of adults across 14 EU Member States, while up to 8 per cent earn occasional income from it.[6] Platform work has thus gained a foothold in European labour markets.

Taxation and social security protection of platform workers

The rapid development of platforms presents policymakers with new challenges; these novel ways of organising work are challenging how we collect taxes and social security contributions. Consequently, there is a risk that a significant amount of platform work is not fully taxed, and that platform workers are not adequately covered by social security systems, with future adverse consequences for individuals and public finances.[7]

Part of the difficulty of taxing and extending social security coverage to platform workers stems from their complicated employment status. In most, but not all, instances, platform workers

-ESW-white-cover-P149016-Box391478B-PUBLIC-World-Bank-Global-OO-Study-WB-Rpt-FinalS.pdf [Accessed 20 February2020], 3.

[4] S. Garben, *Protecting Workers in the Online Platform Economy: An overview of regulatory and policy developments in the EU - Safety and Health at Work - EU-OSHA* (European Agency for Safety and Health at Work (EU-OSHA), 2017) European Risk Observatory Discussion paper, ISSN: 1831-9343, available at: *https://osha.europa.eu/en/publications/protecting-workers-online-platform-economy-overview-regulatory-and-policy-developments/view* [Accessed 20 February 2020], 13.

[5] Definition of "gig economy" in *Cambridge Dictionary*, available at: *https://dictionary.cambridge.org/dictionary/english/gig-economy* [Accessed 10 February 2020].

[6] A. Pesole, et al., *Platform Workers in Europe* (Luxembourg: Publications Office of the European Union, 2018) EUR 29275 EN, available at: *https://publications.jrc.ec.europa.eu/repository/bitstream/JRC112157/jrc112157_pubsy_platform_workers_in_europe_science_for_policy.pdf* [Accessed 20 February 2020], 3.

[7] High-Level Expert Group on the Impact of the Digital Transformation on EU Labour Markets, *The Impact of the Digital Transformation on EU Labour Markets* (2019) Report Commissioned by the European Commission, available at: *https://ec.europa.eu/digital-single-market/en/news/final-report-high-level-expert-group-impact-digital-transformation-eu-labour-markets* [Accessed 20 February 2020].

are classified as self-employed contractors.[8] The self-employed tend to be significantly less tax compliant than employees whose salaries and wages are subject to employer withholding schemes, a fact that is well-documented in tax evasion literature.[9] Non-compliance by the self-employed is often a result of a combination of factors including high compliance costs and inadvertent underreporting. The self-employed often have little tax knowledge, struggle to navigate complex compliance rules, and cannot afford high compliance costs such as the cost of a qualified accountant or tax advisor. They also have an increased opportunity for outright evasion because they can more easily under-declare their income, exaggerate their deductible expenses, or operate wholly in the shadow economy.

In addition to these general challenges, tax and social security compliance by platform workers is complicated by the fact that they are often involved in multiple simultaneous engagements, possibly on different terms, and therefore may have different employment statuses even within one country. Platform workers can, moreover, provide labour in multiple jurisdictions thereby earning income that may be taxable in more than one state, and subject to different rules on deductibility of expenses in those jurisdictions. A further complication arises when one attempts to apply a progressive income tax to platform income earners, even within a single jurisdiction, and more so across borders. Finally, in the EU, these complexities are compounded by the fact that companies operating the platforms are often based outside the EU.

Thus, the proliferation of platform work and other types of platform income pose significant revenue mobilisation challenges for tax and social contribution agencies and, if improperly managed, could contribute to an increase in the shadow economy. Non-compliance could also result in an unfair competitive advantage for firms utilising platform work and platform-based models of providing accommodation and other services. Moreover:

> "If a sizeable segment of the population does not pay social contributions or insurance and underpays on tax and pensions, this will eventually negatively impact the ability of national social protection systems to provide public goods and social benefits, while the demand for those benefits will increase."[10]

[8] For the purposes of this article, the authors assume that the vast majority of platform workers are regarded as self-employed under the law. However, the authors acknowledge the limits of this assumption because of the diversity of employment categories in various countries.

[9] M. Casanegra de Jantscher and V. Tanzi, *Presumptive Income Taxation: Administrative, Efficiency, and Equity Aspects* (1987) IMF Working Paper WP/87/54; B. Torgler, "The Importance of Faith: Tax Morale and Religiosity" (2006) 61 *Journal of Economic Behavior & Organization* 81; J. Slemrod, "Cheating Ourselves: The Economics of Tax Evasion" (2007) 21 *Journal of Economic Perspectives* 25; B. Torgler and N.T. Valev, "Gender and Public Attitudes Toward Corruption and Tax Evasion" (2010) 28 *Contemporary Economic Policy* 554; H. Jacobsen Kleven, et al., "Unwilling or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark" (2011) 79 *Econometrica* 651; C. Kogler, S. Muehlbacher and E. Kirchler, "Testing the 'Slippery Slope Framework' among Self-Employed Taxpayers" (2015) 16 *Economics of Governance* 125; A. Cinta, G. Cabral, C. Kotsogiannis and G. Myles, "Self-Employment Income Gap in Great Britain: How Much and Who?" (2019) 65(1) *CESifo Economic Studies* 84, available at: *https://doi.org/10.1093/cesifo/ify015* [Accessed 20 February 2020]; A. Advani, W. Elming and J. Shaw, *The Dynamic Effects of Tax Audits* (2017) IFS Working Paper W17/24; D. Ogembo, "Are Presumptive Taxes a Good Option for Taxing Self-Employed Professionals in Low and Middle-Income Countries?" (2019) 5(2) *Journal of Tax Administration* 26, available at: *http://jota.website/index.php/JoTA/article/view/233* [Accessed 20 February 2020].

[10] R. Florisson and I. Mandl, *Platform Work: Types and Implications for Work and Employment – Literature Review* (2018) Working Paper WPEF18004 Eurofound, 100.

To address these challenges, some EU Member States have embarked on initiatives to obtain data on platform users' earnings directly from the platform companies. The objective of the authors in this article is to construct case studies depicting the efforts made by three Member States to obtain income data from platforms and then assess the viability of upscaling those national initiatives by developing an EU-level "Digital Single Window" that would facilitate the automated reporting of income data by platforms, and the forwarding of that data to national tax and social security agencies for taxation and collection according to national rules.

Methodology

To achieve their objectives, the authors have used a case study approach. The authors began by selecting three Member States that have initiated efforts to gain income data directly from platform companies. The authors then used qualitative data from desktop research and a small number of unstructured interviews with key experts from each country to construct a case study of each country's efforts in this area (informants are listed in Table 2 at the end of this article). The case studies aim to highlight the most salient aspects of each case and identify the history, motivation, objectives, design characteristics, and functionalities of the data reporting systems, as well as the relevant stakeholders, administrative and infrastructure requirements, costs, and any evaluation results. Cross-case analysis was then conducted to identify potential gains that could be achieved and difficulties or risks that would be encountered if the individual national efforts were replaced with an EU-level approach. Based on the findings, the authors put forward two alternative models of an EU Digital Single Window.

The three countries selected for case studies were Denmark, Estonia and France. These countries were selected for study because of the unilateral initiatives that they had taken to set up reporting systems for obtaining income data from platforms for the purposes of taxation and social security contributions. Other EU Member States have also taken steps in this direction; for instance, there are plans in the UK for a potential "system equivalent to PAYE for self-employed platform workers (without affecting their employment status)".[11] However, the three selected cases are among the most advanced in this respect.

Denmark is an interesting case because of its commitment to developing a technologically sophisticated mandatory automated income reporting system, the technology of which could be later shared with other Member States. Denmark's Ministry of Taxation (SKAT)[12] is developing an application programming interface (API) through which platforms can report data directly into its systems. Although the Danish reporting system is not yet operational, the API is at an advanced design stage and is going through technical pilots. Estonia provides a good comparison to the Danish case because it operates a voluntary semi-automated system whereby platforms share income data with the tax agency, the Estonian Tax and Customs Board (ETCB), digitally via email. Unlike the Danish fully automated system that has only been tested in pilot projects,

[11] Office of Tax Simplification, *Platforms, the Platform Economy and Tax Simplification* (2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/729322/OTS_platform_paper.pdf* [Accessed 20 February 2020].

[12] Denmark has a Ministry of Taxation that consists of nine specialised agencies. One of the agencies, the IT and Development Agency, is developing the data reporting system in collaboration with other agencies. For simplicity, the authors will refer to the whole and its parts as SKAT.

the Estonian semi-automated system has been operational since 2017. In France, the data reporting system has only just been legislated for, and the case study does not include details of its technical implementation. The authors nevertheless include France as a concise case study that focuses more on the legislative history and details because the aims of the new French legislation appear ambitious and cover taxation as well as the social security coverage of platform workers. The differences between the social security systems of the three countries are also notable and have implications for their data reporting systems.

The platform economy consists of many types of platforms, from gig economy and web-based labour platforms to property letting and services. The national systems have diverse foci in terms of what kinds of platforms they target. In the case of Denmark, the data reporting system will initially apply only to letting platforms,[13] with labour platforms intended to follow later. In Estonia, the voluntary system is currently used only by gig economy and letting platforms, even though, in principle, web-based labour platforms could also use it. In France, the system is intended to apply to all kinds of labour platforms. Regardless of the specific foci of these national initiatives, much of the evidence obtained from these initiatives is likely to be of help in obtaining user income data from all kinds of platform companies.

II. The platform income reporting system in Denmark

> "There are approximately 140 multi-sided platforms, including the peer-to-peer online platforms, operating in Denmark…with around 4 % of the population involved in supplying such services."[14]

At the same time, there has been very little regulatory response to the platform economy in Denmark.[15] The number of platforms operating in Denmark is a testament to the fact that the Government is not necessarily averse to innovative businesses; however, like other Member States, Denmark has struggled to reconcile its traditional regulations with the business models of platforms such as Uber.[16]

In collecting income data from platforms, SKAT has adopted two approaches: first, conducting ordinary targeted tax audits in order to get income data for previous tax years; and, secondly, setting up an automated income reporting system for future use with potentially all platforms. The idea of an automated income reporting system was driven by demand from Danish platforms, citizens, politicians, and various Government departments for a solution which would address the lack of automatic reporting of income earned through platforms.[17] At the time of writing, the solution is at an advanced stage of development, with a technical pilot involving several platforms

[13] In order to crack down on underdeclared income earned from casual sub-lets through platforms such as Airbnb.

[14] OECD, *The Sharing and Gig Economy: Effective Taxation of Platform Sellers: Forum on Tax Administration* (Paris: OECD Publishing, 2019), available at: *https://www.oecd-ilibrary.org/taxation/the-sharing-and-gig-economy-effective-taxation-of-platform-sellers_574b61f8-en* [Accessed 20 February 2020], 18.

[15] A. Ilsøe and L. Weber Madsen, *Industrial Relations and Social Dialogue in the Age of Collaborative Economy (IRSDACE): National Report Denmark* (2018) FAOS Research Paper 163, 4.

[16] Ilsøe and Weber Madsen, above fn.15, 10–11.

[17] Interview with M.C. Buur, Officer in the Danish Agency for Development and Simplification, part of the tax administration (Telephone Interview, 7 October 2019).

ongoing. The purpose of the technical pilot is to investigate the technical feasibility of having an automated reporting scheme and the technology needed to support platforms and taxation.

The technical pilot, together with other initiatives by SKAT, led to the recognition that amendments to existing legislation were needed for collection of income data for tax purposes, with new tax rules (Bill No L 102) being passed on 20 December 2018 stating that digital platforms that facilitate the letting of property (homes, cars, etc.) should report all income earned by users of the platforms to the Danish tax authorities.[18] Gig work platforms were also considered but excluded from the scope of this initial legislation because of Denmark's complex social security legislation.[19]

Indeed, it has turned out to be challenging to secure gig economy workers within Denmark's comprehensive but complex social security system. The social security system relies on assumptions that are not in tune with the realities of gig work as it is practiced in Denmark today. Determining social security contributions due from income earned from letting is less complex, however, and therefore the initial data reporting legislation focused on letting.[20] There are no technical or data related barriers to including labour platforms in the automated data reporting system; rather, the challenge lies in determining how social security ought to work for gig workers in the first place.[21]

Several non-letting platforms have also sought to join the automated income reporting initiative to lessen the compliance burden on their users, but they have had to be turned away because of the legislative and administrative limitations referred to above.[22] These Danish service or web-based platforms are demanding that they be included in the legislation and want to be part of the group that benefits from the new API system, but at the time of writing the law does not facilitate their involvement. The Danish Government is, however, looking at how to address this challenge as a matter of urgency.

Technical implementation

In order to ensure that there are only minimal additional compliance obligations for platform companies, SKAT is building an API that will be similar to the interfaces with which platform companies are familiar when dealing with external systems.[23,24] SKAT's key priority is to make compliance as easy as possible so as not to disadvantage Danish platforms, since it is likely that large international platforms will find it easier than domestic platforms to navigate complex

[18] Buur, above fn.17. The new rules, Bill No L 102, *Better conditions for growth and proper tax payment in the sharing and platform economy*, adopted by the Danish Parliament at the 3rd reading on 20 December 2018 are available (in Danish) at: *https://www.ft.dk/ripdf/samling/20181/lovforslag/l102/20181_l102_som_vedtaget.pdf* [Accessed 12 March 2020].

[19] Buur, above fn.17.

[20] Buur, above fn.17.

[21] According to Buur, above fn.17, due to the tax-positive attitude in Denmark, several non-letting platforms have sought to join the automated income reporting initiative, but they have had to be turned away because of these legislative and administrative limitations. However, the Danish Government is working to address this challenge as a matter of urgency.

[22] Buur, above fn.17.

[23] In technical terms, the API is made available to platform companies as a RESTful web service.

[24] SKAT's intention is to have the system operating in July 2020, spend six months educating platform operators and internal staff, and then receive the first official income data in 2021.

compliance obligations. Under Danish law, if a company or other entity is required to report income to SKAT, the citizen is obligated to facilitate such reporting[25]; thus, there are no legal barriers to automatic income data reporting even without express consent from the taxpayer.

SKAT consulted platforms regarding whether they preferred annual or transaction-based reporting; based on the feedback received, the preferences were split equally between the two options. SKAT has, therefore, built a system that can be utilised for both types of reports; all platforms must report income earned by their users by 20 January, but can opt to do so either in one go or throughout the year on a per-transaction basis.[26] As per SKAT's existing practice, it will make the income data available to other government authorities for such purposes as the calculation of social security contributions.

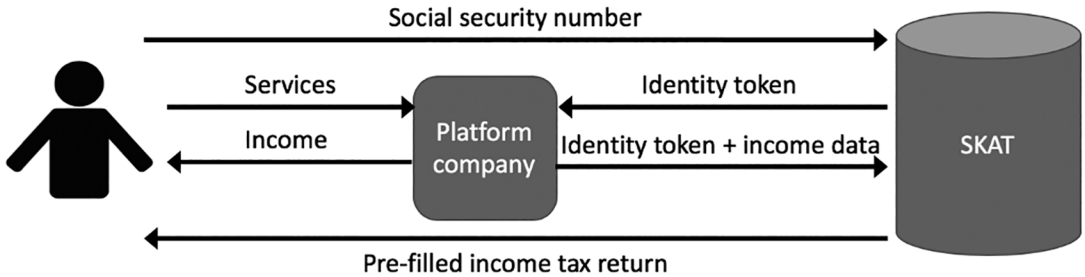

Figure 1: design of the Danish tax authority's (SKAT) system for receiving automated income data from platforms

The type of data expected to be collected through the API is quite simple; SKAT will not know who the users let their property to, but it will know the income year, taxpayer identity, address, and the amount of money that the user received. SKAT has built a system where users first verify their identity through a portal maintained by SKAT when signing up for or logging in to the platform, after which the portal sends the platform a token number, which the platform can use to identify the user to SKAT. The token number that the platform receives is meaningless in the hands of anyone else, but it is a stable identity number that SKAT can link to the user's social security number.[27] The overall design of the system is illustrated in Figure 1.

Bill No L 102 allows letting platforms that do not have a registered presence or a permanent establishment in Denmark to operate as if they did, for purposes of submitting their users' income data.[28] Since SKAT would find it extremely difficult to enforce the legislation if such platforms chose not to comply, the legislation incentivises these platforms by providing that the users whose platforms report their income directly enjoy a higher income threshold before they become liable for tax on their earnings.[29] This approach seems to have been successful: in 2018 a letter of intent was signed between SKAT and Airbnb (which lacks a registered presence or permanent

[25] Buur, above fn.17.
[26] Buur, above fn.17.
[27] Buur, above fn.17.
[28] SKAT, *Renting out a room or property you live in*, available at: *https://skat.dk/skat.aspx?oid=2285757* [Accessed 4 March 2020].
[29] Ilsøe and Weber Madsen, above fn.15, 19.

establishment in Denmark), in which Airbnb consented to using this system, stating that it was keen to support any initiative that would enhance transparency in the platform economy.[30]

The start-up costs of the API system are significant; the Danish Government has invested approximately DKK 40 million (€6.8 million) to develop the system. A large part of the investment has gone into developing technology to convert data generated by platforms into formats compatible with the old information systems in the tax agency. However, this investment is comparable in size to other development projects within the tax administration. Regarding running costs, at the time of writing, SKAT does not expect it to be necessary for a lot of manual work to be done on the data, but this all depends on the quality of the data ultimately received by SKAT from platforms. Thus, it is difficult to estimate what the running costs will be until the system is adopted by all platforms.

III. The platform income reporting system in Estonia

In 2014, fee-paying transport services between private individuals through platforms such as Uber, Lyft and Bolt (Taxify) were banned in France, and some other European countries were quick to follow this precedent. Uber, perhaps keen to create at least one success story in Europe and demonstrate that Uber could partner with European governments to craft a positive relationship, worked closely with the Estonian Government to develop a more permissive regulatory framework. The Estonian Government had been cultivating a reputation for embracing technology and being solution-oriented and forward-looking when it comes to technology. Thus, the two parties had a common interest to "promote the Government's e-Estonia action plan [and] Uber's innovative technology platform".[31]

Against this background, on 9 October 2015, the ETCB and Uber announced that they were

> "setting up a working group to analyse collaboration points between Uber's global cash-free service and the ETCB's contactless reporting scheme in order to offer new ways of paying tax liabilities in [the] transport sector".[32]

The primary objective of this joint effort was to develop an income data reporting system that would simplify the tax declaration process for Uber drivers, in line with the Estonian Government's priority to minimise bureaucracy and facilitate automatic tax reporting for businesses and entrepreneurs.

The voluntary income reporting system has been operational since the 2017 tax year. It is not limited to the ride sharing sector; all platform operators can use the system if they wish. For instance, Airbnb has adopted the system. However, so far, there has been no up-take by international web-based labour platforms. This disparity means that income earned by Estonians working through web-based platforms such as Upwork and Fiverr is still invisible to the ETCB, unless the workers choose to report it themselves.

[30] Interviews with A. Ilsøe, Associate Professor at the Employment Relations Research Centre (FAOS) University of Copenhagen (Telephone Interview, 10 September 2019) and Buur, above fn.17.
[31] M. Aasmäe and Republic of Estonia Tax and Customs Board, *ETCB and Uber collaborate in seeking solutions for the development of the sharing economy* (9 October 2015), available at: *https://www.emta.ee/eng/etcb-and-uber-collaborate-seeking-solutions-development-sharing-economy* [Accessed 20 February 2020].
[32] Aasmäe, above fn.31.

Right from the start, the ETCB was keen to build trust-based relationships with platform owners and to encourage voluntary trust-motivated compliance rather than mandatory fear-based compliance. Indeed, the ETCB opted for a voluntary system based on the belief that introducing a new system and making it mandatory would result in resistance and backlash.[33] The ETCB was keen to assess the tax morale of platform users and to determine whether people genuinely want to pay tax and are simply inhibited by complex administrative processes.[34] The Estonian tax administration system is motivated by a service ethos and this ethos greatly influenced the decision to present the system as a voluntary one before slowly transitioning to a mandatory system.

Technical implementation

The Estonian reporting system is a *voluntary semi-automated* system.[35] The ETCB has partnered with participating platforms to create an inbuilt feature in the platform's user interface that allows the platform user to select the option to have their annual income, earned through the platform, reported directly to the ETCB.

For instance, every January, in the Bolt ride hailing app, drivers can choose to push a button inside the app to report their income earned through the app automatically to the tax authority. The income will then appear on the driver's pre-filled e-tax return in February. In the case of Airbnb, the platform sends out a communication to users every December, enquiring whether they wish to opt in to have their income for the previous year reported to the tax agency.[36]

Ensuring that the system is straightforward, and that the requirements are not onerous, was a key priority for the ETCB. Thus, the income reporting requirement is designed to involve just one reporting event a year, and the information that platforms are asked to report is kept to a minimum, that is, the ETCB only requires the personal identification code and income earned. The data held by the platform is encrypted and sent to the ETCB via email.[37] The email is manually opened, and the data entered in bulk to the ETCB's information system. From there onwards the data flows into the ETCB's existing automated process for producing pre-filled tax returns. Overall the process is thus semi-automated.

The introduction of a special business account and presumptive tax regime,[38] which covers social and pension contributions for natural persons who earn income through platforms has further lowered the tax burden for these taxpayers.[39] Thus, drivers providing services through ride sharing platforms have three taxation options described in Box 1:

[33] Interview with E. Liivamägi, Head of the Tax Department at the Estonian Tax and Customs (Skype Interview, 27 September 2019).
[34] Liivamägi, above fn.33.
[35] Liivamägi, above fn.33.
[36] Liivamägi, above fn.33.
[37] M. Loite, *e-stonian look at: collaborative economy* (eCommerce Experts Group, 13 October 2016), available at: *https://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=26192&no=8* [Accessed 4 March 2020].
[38] Note that, eligibility for the simplified tax regime is not limited to platform workers. It is designed for individuals who earn income only through the special business account to ensure that, as long as the minimum social contribution is made, such individuals also have social security that is equal to workers with regular labour contracts.
[39] Note that this business account and presumptive tax regime applies only to natural persons earning up to €40,000 a year. Platform workers who provide regular services and earn income above the €40,000 threshold are considered

Box 1: taxation of drivers providing services through platforms in Estonia[40]

- OPTION 1: platform drivers who offer *occasional driving services,* can choose to report their income from such services as "other income" on their annual income tax return, and be taxed according to the ordinary tax rules. The user would not be allowed to deduct any expenses, including but not limited to, platform service fees, car repair charges and fuel.
- OPTION 2: alternatively, platform drivers who earn up to €40,000 a year can choose to have their income taxed under the presumptive tax regime. Under this regime, platform users pay 20 per cent on gross income for amounts up to €25,000 per year and 40 per cent on gross income for amounts exceeding €25,000 per year. These taxpayers open a special business account and the tax is paid via this account; the bank automatically reserves a fixed percentage of the income to cover taxes and transfers it to the tax agency. This tax covers social tax and contributions to mandatory funded pensions; in addition, the platform user is not expected to keep books of accounts or deduct expenses, keeping the compliance requirements simple.
- OPTION 3: platform drivers providing *regular services* should register as sole proprietors or private limited companies. Their income would be taxed as ordinary business income, subject to relevant deductions. They would also be liable for VAT, labour taxes, social tax, unemployment insurance, and mandatory pension deductions.

The Estonian reporting system has been very cost effective. The development cost was low as the system connects to existing semi-automated processes at the ETCB for receiving data from institutions for the purposes of pre-filling tax forms. In addition, because the system is specifically designed not to be burdensome for the reporting party, the compliance costs for the platform operators are kept low, although the platform operators did have to implement changes to their user experience. The low compliance and running costs are partly a consequence of the fact that government and institutional databases in Estonia are well integrated and therefore the additional data required from platform users and owners is minimal.

Overall, the ETCB views the outcomes of the income reporting system very positively.[41] In 2016, before the system was operational, only 69 taxpayers reported income earned from Uber and Bolt (Taxify), representing a total value of €67,800. In 2017, after the reporting system became operational, the number of taxpayers reporting income through the Uber and Bolt (Taxify) platforms increased to 319, and the total amount declared was approximately €450,000, or almost seven times greater than in the previous year.[42]

That said, these numbers are still clearly quite small compared to the size of these platforms' operations; Bolt alone has thousands of drivers in Estonia. In part, this discrepancy can be explained by the fact that many drivers who earn significant income through the platform declare their income through a legal entity rather than as individual taxpayers. Bolt suggests that as many as three quarters of the drivers in Estonia, even though most are only part-time drivers, declare their income through companies, presumably to be able to make tax deductions[43]; this would

to earn business income and are expected to register with the Commercial Register as a sole proprietor or establish a private limited company. Sole proprietors are permitted to deduct business-related expenses from their business income, and are expected to pay income tax, social tax, and, if they have joined the mandatory funded pension system, contribute to a mandatory funded pension scheme.

[40] Republic of Estonia Tax and Customs Board, *Taxation of the income of drivers providing taxi service through a ride-sharing service platform* (13 November 2017), available at: *https://www.emta.ee/eng/private-client/declaration-income/business-income/taxation-income-drivers-providing-taxi-service* [Accessed 21 February 2020].

[41] Republic of Estonia Tax and Customs Board, *Taxation of the income of drivers providing taxi service through a ride-sharing service platform*, above fn.40.

[42] M. Aasmäe and the Republic of Estonia Tax and Customs Board, *Income declared through Uber and Taxify has overwhelmingly increased* (1 June 2017), available at: *https://www.emta.ee/eng/income-declared-through-uber-and-taxify-has-overwhelmingly-increased* [Accessed 25 February 2020].

[43] Email discussion with M. Villig, Co-founder, Bolt (Taxify) (17 September 2019).

leave only a quarter of these drivers in the target group for the app-based income reporting system.

Still, even considering these numbers, the ETCB has concluded that, based on its analysis of the numbers, the voluntary participation rate has reached its limit.[44] To enhance compliance, the ETCB now wants to move towards a mandatory fully automated reporting system by 2021. A mandatory reporting system would require amendment of the legislation in Estonia because of data protection and privacy rules.

IV. The platform income reporting system in France

> "In France, between 200 and 300 peer-to-peer online platforms provide services…The total turnover of these platforms is estimated between EUR 3 and 4 billion."[45]

Presently, there are no special rules in France that govern the taxation of income earned through platform work; the ordinary tax rules apply. Thus, income earned through platform work is treated in the same manner as

> "profits and capital gains from self-employed workers which generally fall in the category of industrial and commercial profits (Bénéfices Industriels et Commerciaux – BIC), non-commercial profits (Bénéfices Non-Commerciaux – BNC) or real estate income, whether or not they derive from professional activities within the meaning of the Social Security Code…".[46]

Income falling under these categories may be taxed under the ordinary tax rules, or—if the individual self-employed worker's income falls below a certain threshold, and they are eligible for the "micro-tax system"—under a simplified tax regime known as the "micro-entrepreneur system".

Box 2: features of the micro-tax system in France[47]

Taxpayers who are eligible for the micro-tax system may opt for:

1. Reporting their gross income in a simplified form.
2. Benefitting "from a proportional tax-free allowance on their annual gross income, which takes into account, in a simplified way, expenses incurred for the activity".
3. A micro-entrepreneur tax system and pay "flat tax in discharge of income tax instead of progressive scale taxation after application of a tax allowance".
4. Ordinary tax rules and the tax authority applying the proportional tax-free allowance and thereafter calculating how much tax is due.

A new draft law—the *loi d'orientation des mobilités*—on the special status of platform workers was reintroduced by the Government in 2018 and worked its way through the French

[44] Liivamägi, above fn.33.
[45] OECD, above fn.14, 18.
[46] É. Bocquet, et al., *Taxation and the Collaborative Economy: The Need for a Fair, Simple and Unified System* (Finance Committee, 2017), Senate Information Report No.481 (2016–2017), available at: *http://www.senat.fr/rap/r16-481-2/r16-481-2.html* [Accessed 25 February 2020], 22. There are some notable exceptions to this: income derived from online platforms for cost-sharing and second-hand sales is subject to different provisions.
[47] Bocquet, et al., above fn.46, 23–24.

National Assembly.[48] The intention is to create a special category for platform workers: an intermediary status between "employee" and "self-employed".[49] The French income reporting system is designed around several pillars, outlined below.

Sharing information with users

French law requires platforms to inform their users about their tax and social contribution obligations.[50] In complying with this provision, platforms:

- "are required to provide, each time a transaction is concluded, fair, clear and transparent information about the tax and social contribution obligations of the persons who carry out commercial transactions through them"; and to
- "communicate to their users, in January of each year, a document summarising the gross amount of all known transactions received through them in the previous year".[51]

Complying with the requirements of the system to share information with users is reasonably straightforward for labour platforms such as Upwork and Uber, as well as for letting platforms such as Airbnb. But it is much less straightforward for platforms such as YouTube, where users are paid per "click" or per "view".[52] Strictly interpreted, the platform may end up sending the user thousands of reports an hour if the user's content attracts thousands of views in that period. The statutory provision also does not explicitly exempt platforms that are exempt from taxation—such as cost-sharing[53] and second-hand sales platforms—from the obligation to send an annual summary of transactions to users. It is arguable that such a statement sends a confusing signal to users and could cause them to think that they ought to pay tax on the gross income, while a wholesale exemption from compliance with the provision may result in inadvertent or deliberate breaches.[54] Overall, compliance with the fairly detailed provisions of the French reporting system may create challenges for some platforms.

Automatic reporting under the Social Security Financing Act, 2017

Article 18 of the Social Security Financing Act, 2017[55] creates two systems in relation to the social security system: automatic affiliation and automatic reporting and collection of social contributions. The article provides that:

[48] Bocquet, et al., above fn.46. See Loi No.2019-1428 du 24 décembre 2019 loi d'orientation des mobilités (Law No.2019-1428 24 of December 2019).
[49] Bocquet, et al., above fn.46, 22.
[50] Art.87 of Finance Act No. 2015-1758 of 29 December, 2015, codified in Art.242 bis of the General Tax Code (*Code Général des Impôts*, CGI).
[51] Article 242 bis of the General Tax Code (*Code Général des Impôts*, CGI, above fn.50).
[52] Bocquet, et al., above fn.46, 51.
[53] Cost-sharing in this context refers to "co-consumption" which is "the provision of a service which also benefits the private individual who offers it, and not only the persons with whom the costs are shared"; an example is the French carpooling platform BlaBlaCar: Bocquet, et al., above fn.46, 28.
[54] Bocquet, et al., above fn.46.
[55] Art.18 of Act No. 2016-1827 of December 23, 2016, on Social Security Financing for 2017.

- All self-employed workers engaged in work via an online platform may voluntarily elect to automatically affiliate with the social security system and direct the platform to make the necessary reports on their behalf.
- In respect of micro-entrepreneurs, online platforms shall automatically report "to the '*Union de recouvrement des cotisations de sécurité sociale et d'allocations familiales*' (URSSAF)"[56] and deduct social contributions at source.

The initial challenges arising from the implementation of this reporting requirement are centred on "the voluntary nature of the proposed mechanism, its operational complexity, and…the absence of a financial incentive".[57] For instance, due to the complexity of the underlying social security system and its incompatibility with the innovative nature of platform work, it is difficult for platform operators to ascertain when platform workers have crossed the threshold for affiliation with the social security system, that is, when they have exceeded the micro-social system threshold; and the correct rate of social contributions to then apply.[58] These hurdles have severely limited the automatic collection of social security contributions.

Mandatory reporting under the General Tax Code

The original language of the legislation proposed by the Senate required automatic income reporting by platforms, but the language was watered down by the National Assembly, at the insistence of the French Government, and reduced the obligation from reporting user's income to the tax agency to merely informing users of their compliance responsibilities. However, via a subsequent amendment under Article 24 of the Amended Finance Act for 2016,[59] platforms must automatically report the income earned on the platforms by online platform users to the tax authority. With effect from 2019, online platform operators are required to submit user reports to the French tax authorities, and these reports ought to include "data on the users as provided by article 242 bis of the EU VAT Directive 2006/112/EC that will enter into force in 2020".[60]

Box 3: features of the provision on mandatory reporting under the General Tax Code[61]

1. The mandatory reporting provision binds all online platforms regardless of where they are established or situated.
2. The platforms are only bound by these obligations when their users reside in France or make sales or provide services in France pursuant to the VAT regulation.
3. The platforms are required to ascertain the French VAT taxable turnover in respect of their users' transactions.

The income reporting rules for tax purposes have only recently come into force. It is perhaps too early to determine the challenges in this system's daily operations. However, tax experts are already expressing some concerns regarding increased compliance costs for platform operators. For instance, the new legislation requires platforms to report to French tax authorities "the amount

[56] Bocquet, et al., above fn.46, 54.
[57] Bocquet, et al., above fn.46, 55–56.
[58] Bocquet, et al., above fn.46.
[59] Amended Finance Act 2016, No.2016–1918, 29 December 2016, Art.24.
[60] KPMG, *Online platforms: major extension of the French reporting obligation* (29 August 2019), available at: *https://home.kpmg/content/dam/kpmg/us/pdf/2019/08/tnf-france-aug29-2019.pdf* [Accessed 25 February 2020].
[61] General Tax Code (*Code Général des Impôts*, CGI, above fn.50).

of taxable turnover related to its users' transactions subject to French VAT".[62] This requirement incorporates platforms as active allies in the fight against tax fraud, but it poses a significant "administrative and technical burden in order to determine the territoriality of each of the operations carried out on the platform".[63]

While an increase in compliance costs may not pose a significant problem for large multinational platforms, these costs may stifle the growth of small start-ups in France. It is also entirely possible that platform operators may begin to pass on the increased compliance costs to platform workers, thus reducing the amount of income these workers earn through platform work.

V. Summary of case study findings

Findings from the country case studies are summarised in Table 1.

Table 1: comparison of platform income data reporting systems across three case countries[64]

Dimensions	Estonia	Denmark	France
Motivation for creating reporting system	• Facilitating platform work • Simplifying tax and social contribution compliance • Business friendly environment • Open government	• Facilitating platform work • Simplifying tax compliance • Not disadvantaging Danish platforms • Developing a technologically sophisticated system that can be used by all Member States and types of platforms	• Reducing tax evasion • Facilitating entrepreneurship • Ensuring collection of social contributions
Reporting system launched	2017	2020	?
Automated v semi-automated	Semi-automated	Automated	?
Mandatory v Voluntary	Voluntary	Mandatory	Voluntary for social contributions and mandatory for tax purposes
Scope	All platforms	Letting platforms	All platforms
Legislative limits on data	Require legislative amendment for mandatory collection	Mandatory collection permitted by law. No need for user consent.	New legislation introduced for mandatory collection
Data points collected	• Universal personal identification code • Income amount	• Income year • Taxpayer identity • Letting location • Income amount	?
Stakeholders	• Platform owners • Platform users	• Platform owners • Platform users	?
Initial investment	Low; semi-automated, integrated easily with existing systems	DKK 40 million, comparable to other tax authority development projects	?

[62] KPMG, above fn.60, 2.
[63] KPMG, above fn.60, 2.
[64] Where the "?" symbol is used in this table, it denotes the fact that the authors do not have sufficient data to make an accurate statement.

Dimensions	Estonia	Denmark	France
Running cost	Low; but could increase if take-up among platforms increases, since it requires some manual labour	Expected to be low, but depends on quality of data submitted by platforms	?
Hurdles	• Voluntary system reaching saturation; need to move to mandatory • Securing participation of international web-based labour platforms without a registered presence in Estonia	• Legislation limited to letting platforms • How to arrange social security for platform workers • Securing participation of international web-based labour platforms without a registered presence in Denmark	• Automatic voluntary reporting for social contributions not working as it should: voluntary; complex; no financial incentive • Detailed provisions create complexity in compliance for some platforms
Benefits	• Increased tax and social security compliance, though still far less than perfect • Reduced compliance cost for taxpayers already willing to report • Positive relationships between tax authority and platforms	• Much increased tax and social security compliance expected • Reduced compliance cost for taxpayers expected • Positive relationships between tax authority and platforms • Technological foundation for automatic data reporting from a broader range of platforms in the future	• Increased tax and social security compliance expected
Tax regime(s) for platform workers	• Ordinary tax regime • Presumptive tax regime • Business income taxation	• Higher deduction for users whose income data is sent to SKAT via API	• Ordinary tax regime • Micro-tax system
Social Security System	• Straightforward • Lean • Compatible with platform work (via presumptive regime)	• Comprehensive • Complex • Incompatible with platform work	• Comprehensive • Complex • Incompatible with platform work

Some notable similarities and differences are apparent between the cases. First, Estonia, with its new and advanced administrative systems, has been able to move much faster in implementing its data reporting system. The reporting system has been up and running since 2017, and the ETCB has had ample opportunity to pick up weaknesses and improve on the original set-up. Countries with older and more complex legacy systems, like France and Denmark, are having to move more slowly.

Secondly, the countries differ in their basic design choices. Estonia opted for a semi-automated voluntary system, Denmark went for an automated mandatory system, while France appears to have opted for a hybrid model. Estonia's choices were influenced by the Government's service-oriented ethos and desire to build relationships of trust with taxpayers. The ETCB's expectation was that, if the system was simple and fair, taxpayers would voluntarily elect to report their income. In the end, there has been some voluntary uptake but the ETCB now recognises that it has to move towards a mandatory system. Denmark's options were motivated by the tax-positive attitude in the country—existing legislation requiring and allowing mandatory reporting by platforms without users' consent—and the desire to design a world-class automated system whose technology could eventually benefit other EU Member States.

Thirdly, the three countries have all found that web-based labour platforms that do not have a registered presence in the country pose a challenge for compliance. It may well be possible to secure voluntary participation from many platforms, as the case of Airbnb in both Denmark and

Estonia shows. However, in those cases in which a platform declines to comply, it is difficult to enforce the law. This is one area in which it appears that EU Member States would benefit from pooling their power and clout.

Fourthly, the utilisation of income data for social and pension contribution purposes remains a significant challenge. While the successful reporting of the data would solve one problem, social security institutions in countries with comprehensive, complex, and traditional social security systems would still find it difficult to utilise this data in order to determine the contributions and benefits due to platform workers. It is for this reason that Denmark's laws and systems for income reporting for the platform economy are currently limited to letting platforms, while France's voluntary automatic income reporting system for social security purposes has not been as successful as anticipated. Assumptions based on regular employment in the service of a single employer, which underpin much of social security legislation, are incompatible with the reality of gig work as it is practiced today. Estonia has managed to cut through the complexity, but much work may be needed in most other Member States to either reform social security or regulate platform work so that it conforms to existing systems. Deeper consideration of this issue is beyond the scope of this article, but the authors note that there is emerging work on "Digital Social Security"[65] as well as ways of making social security more compatible with self-employment in general.[66]

Fifthly, in terms of outcomes, the Estonian case demonstrates that it is possible to improve compliance by using an income reporting system; however, the Estonian case also demonstrates that the effectiveness of a voluntary system is limited, and that a mandatory system as envisaged by Denmark is more promising in the long run. The Danish system is yet to be launched publicly and it is too early to assess its impacts; however, since it is an improvement on Estonia's semi-automated voluntary system, which realised a modest success, it is entirely possible that it will generate very positive results in the near future as regards both increasing compliance and lowering taxpayers' compliance costs. The French law has just come into force and it is too early to assess its impacts in any further detail.

Finally, it is worthwhile to consider the incentives created by a data reporting scheme. In Estonia, there is an apparent tendency for gig workers to incorporate. A mandatory data reporting scheme covering only unincorporated workers could provide a further incentive for labour to incorporate, which could be an undesirable outcome from both labour and tax law perspectives. In France, the mandatory data reporting scheme for platform workers could balance the incentives between platform workers and traditional self-employed people, by improving the formers' tax compliance. However, if taken too far, automated reporting of data on platform workers but not on traditional self-employed workers could, arguably, start to disadvantage platform workers when compared to the traditionally self-employed. At the same time, the Danish case suggests that self-employed people can benefit from the reduced compliance cost brought about by automated reporting, providing an incentive to work via platforms rather than independently.

[65] E. Weber, *Digital Social Security: Outline of a Concept for the 21st Century* (2019) Hans-Böckler-Stiftung Working Paper No 138 of May 2019, available at: *https://www.boeckler.de/pdf/p_fofoe_WP_138_2019.pdf* [Accessed 25 February 2020].

[66] High-Level Expert Group on the Impact of the Digital Transformation on EU Labour Markets, above fn.7.

The strength and direction of these incentives hinge mostly on Member State level decisions concerning what data is used and how.

VI. Implications for an EU-Level reporting system

First, it is evident that it is often even more complicated to collect income data for social contribution purposes than it is to collect such data for tax purposes. Existing social contribution rules were not designed with the platform economy in mind and are not sufficiently flexible to dovetail seamlessly with the way income is earned and reported in the platform economy. Even in Nordic countries like Denmark, with generous but complex social security nets, it has proven hard to provide adequate social protection to platform workers. Thus, assuming that Member States were able to agree on a single income reporting mechanism for tax purposes, much work would be required to determine how such income data could be utilised by domestic agencies dealing with social insurance and pension contributions.

Secondly, while it is fairly easy to obtain data from platforms with a local registered presence, each case country appeared to struggle when it came to obtaining data from international web-based platforms. These web-based platforms typically do not have permanent establishments in the case countries, and without a local presence it is impossible to compel them to comply with domestic legislation. This is an issue in relation to which an EU-level approach could deliver better results than a national approach. Obtaining compliance from web-based platforms operating from outside the EU could still present a challenge, but they could at least be pursued collectively with pooled resources.

One solution may be to have a "network model" where Member States collect data from web-based platforms having a permanent establishment or registered office in their jurisdiction and share that data with other Member States whose taxpayers use the platforms but do not have such a permanent establishment or registered office. However, it is possible that this solution may require an amendment to existing General Data Protection Regulation (GDPR) rules which limit the data that a country can collect; tax agencies may face challenges in justifying the need to collect data regarding users who are not tax resident in their countries. Further, since the income reporting systems currently in existence in the case countries are largely limited to local gig platforms and letting platforms, local tax agencies know the data that they need and can ask for what is relevant for their purposes. Additional information would be required for the multilateral EU-wide reporting system to work; Member States' tax agencies would have to agree on, and define, the minimum data required for the taxation of platform workers. A recent initiative by Member States tax agencies (FPG/097 initiated under TADEUS[67]) has identified the minimum information that would be required as:

- Identification information: who received the payment?
- Transaction information:

[67] *Tax ADministration European Union Summit (TADEUS) 2019 Outcomes Statement: 1st Plenary Meeting, Helsinki, Finland* (17 September 2019), available at: *https://ec.europa.eu/taxation_customs/sites/taxation/files/tadeus_2019_outcomes_statement_-_1st_plenary_meeting_helsinki_finland.pdf* [Accessed 25 February 2020]. Note that this initiative included only 18 Member States and the future inclusion of other Member States may significantly expand the list and nature of data listed here.

  - How much money they received?
  - What supply of service or good generated the payment?
- Platform information: what platform facilitated the transaction and therefore will have the reporting obligation?
- Additional tax relevant data, for example, if the income is from accommodation services.

The nature and quality of data is only one consideration. The timing of the data reporting is also important. Tax agencies would require the data before the deadline for taxpayers to remit their returns so that the tax agencies have an opportunity to pre-populate taxpayers' tax returns. For this reason, Denmark is unsure about the feasibility of a network model. SKAT's primary concern is that it would require income data by 20 January each year in order to pre-populate tax returns, and that there is no guarantee that tax agencies in Member States with manual systems would be in a position to meet such strict timelines. Thus, since the timing and quality of data required in each country is different, and there is significant disparity in technology adoption, much work would be needed to ensure that the data shared is fit for purpose. Data protection and privacy rules also come into play. If income reporting is voluntary, these rules do not pose much of a challenge. However, as the Estonian case demonstrates, voluntary compliance quickly reaches its saturation point and a mandatory system is required to keep the system effective. Data protection restrictions pose a hurdle for mandatory reporting and Member States may not have the rights to collect information about non-residents from the platforms resident in that Member State.[68]

Some of the limitations of a network model could be avoided by adopting a "hub and spoke" style Digital Single Window for income data reporting, so termed because its topology resembles a cartwheel. In this set-up, Member States would nominate a central agency (the "hub") to receive income data from all the platforms with users in the Member States and then forward that data to national tax and social security agencies (the "spokes"), in whatever form such agencies require. Such a model is currently unprecedented in the EU when it comes to taxation.

The main strength of such a model would be that it would address both the issue of sharing data with Member States as well as obtaining data from platforms in the first place, in particular, from international web-based platforms based outside the EU. But it also presents various challenges that bring its viability at the present time into question. The chief among these challenges would be satisfying the requirement that a central organisation be efficient, effective, well-funded and perceived as legitimate by the Member States. It would be challenging to develop such an organisation in light of the fact that income taxation is not harmonised in the EU. Another challenge is the legal basis of the data collection. Would national tax authorities be able to delegate their powers legally to a hub, or could some other legal basis be found or legislated for on the EU level? Also, while a hub and spoke model would be simpler than creating 28 different systems in the Member States, it still introduces an additional level of bureaucracy and organisational complexity.

[68] *Tax ADministration European Union Summit (TADEUS) 2019 Outcomes Statement: 1st Plenary Meeting, Helsinki, Finland*, above fn.67.

Finally, the legal status of platforms appears to still be in flux. For instance, in December 2017, the CJEU ruled that Uber is a taxi firm and not simply an "information society service".[69] However, two years later, in December 2019, the CJEU ruled that, unlike Uber, Airbnb is an "information society service" and not a property broker.[70] In distinguishing its analysis of the two platforms, the CJEU relied heavily on the fact that Airbnb has much less control over transactions on its service than does Uber.[71] It is likely that we will continue to witness changes in the way courts analyse the services provided by platforms and these analyses are likely to have significant consequences for how much governments can regulate the platforms and even collect income data from them.

VII. Conclusion

Based on the case studies, the authors take the view that there are several benefits to be derived from developing an EU-wide income reporting system. First, collecting income data from foreign platforms without a registered presence or permanent establishment in the country is a challenge for all three case countries, and is likely to be a significant hurdle for all the Member States. With a Digital Single Window, Member States can pool their power and clout to exert pressure on foreign platforms to comply with an EU-wide requirement.

Secondly, developing a sophisticated automated API-based reporting solution that presents low compliance and maintenance costs is an expensive venture. While the cost and technology may be within the reach of higher income-earning Member States like Denmark, it may not be easily affordable or accessible for some other Member States. A Digital Single Window would allow Member States to pool their financial and technical resources for a more cost-effective system.

Thirdly, it is evident that the case countries are already at advanced stages of designing different income reporting systems and it is likely that other Member States will begin similar initiatives. While this approach may not pose a challenge for platforms that operate only domestically, a Digital Single Window would benefit platforms that operate cross-jurisdictionally by saving them from having to use and comply with 28 different reporting systems. Further, a lower compliance cost could encourage the growth of smaller domestic platforms and nudge them towards expanding to other Member States without experiencing higher compliance costs. This growth and expansion would benefit innovation in Europe.

However, the authors are also cognisant of the significant barriers to achieving such an ambitious system. The most significant barrier remains the lack of harmonisation of income taxation and social security systems in the EU and the fact that income taxation is not an EU

[69] *Asociación Profesional Élite Taxi v Uber Systems Spain SL* (C-434/15) EU:C:2017:981; CJEU, press release, *Judgment in Case C-434/15 Asociación Profesional Elite Taxi v Uber Systems Spain SL* (Luxembourg: 20 December 2017, Press Release No.136/17), available at: *https://curia.europa.eu/jcms/upload/docs/application/pdf/2017-12/cp170136en.pdf* [Accessed 25 February 2020].

[70] *Criminal Proceedings against X (request for a preliminary ruling in the criminal proceedings against X: interveners: Airbnb Ireland UC and others)* (*Criminal Proceedings against X*) (C-390/18) EU:C:2019:1112; CJEU, press release, *Judgment in Case C-390/18 Airbnb Ireland* (19 December 2019), available at: *https://curia.europa.eu/jcms/upload/docs/application/pdf/2019-12/cp190162en.pdf* [Accessed 25 February 2020].

[71] *Criminal Proceedings against X* (C-390/18), above fn.70, EU:C:2019:1112; CJEU, press release, *Judgment in Case C-390/18 Airbnb Ireland*, above fn.70.

competence. Further, if taxpayers' data is being shared more widely or stored more centrally, there is a risk of more frequent or more serious data breaches.

The most workable avenue for the time being may be for each Member State to continue developing its own solutions. In time, some data sharing which resembles the network model is likely to develop spontaneously between competent authorities under the auspices of existing data sharing arrangements, such as the mandatory Automatic Exchange of Information scheme. The FPG/097 Working Group's[72] efforts to develop standard data schema will help drive this forward. While a hub and spoke Digital Single Window would allow the pooling of resources and clout and could simplify compliance, it would require the creation of a new legal basis in EU law; a more distant prospect. It may also be that the network model would eventually lead to a Member State serving as a hub, a scenario that may only require amendments to existing tax co-operation and information sharing arrangements rather than new EU legislation.

Table 2: expert interview participants

Martin Buur	Product Owner, IT and Development Agency of the Danish Ministry of Taxation (SKAT)
Antonio Casilli	Associate Professor, Paris School of Telecommunications (Telecom Paris)
Kirsi Haapakoski	Tax Policy Officer, DG Taxation and Customs Union, European Commission
Anna Ilsøe	Associate Professor, Employment Relations Research Centre (FAOS), University of Copenhagen
Evelyn Liivamägi	Head of the Tax Department, Estonian Tax and Customs Board (ETCB)
Arto Lanamäki	Postdoctoral researcher in the Interact Research Unit, University of Oulu
Martin Villig (informant via email)	Co-founder, Bolt (previously known as Taxify) ☞

[72] *Tax ADministration European Union Summit (TADEUS) 2019 Outcomes Statement: 1st Plenary Meeting, Helsinki, Finland*, above fn.67.

☞ Denmark; Estonia; EU law; Financial reporting; France; Income tax; Online intermediaries; Online services; Social security administration; Tax administration

Ardmore: Some Reflections on the "Practical Approach" to Identifying the Source of an Interest Payment

Gerald Montagu*

Abstract

This article seeks both to trace the origins of the "practical approach" taken by the Court of Appeal in Ardmore Construction Ltd v HMRC *to establishing the source of interest and also, by reference in particular to the experience of South Africa and Australia, to test whether that approach augurs well.*

On one reading, *Ardmore Construction Ltd v HMRC* (*Ardmore CA*)[1] may perhaps be seen as little more than the Court of Appeal measuring arguments put forward on behalf of the taxpayer against the test in *Edwards (Inspector of Taxes) v Bairstow*[2] and concluding that the hurdle to set aside the Tribunals' decisions had not been met.[3] Indeed, Arden LJ, with whom Sales LJ and Leggatt LJ both agreed, said:

> "Ardmore has to satisfy this Court that the Tribunals were wrong in the sense that they left a material factor out of account or took a matter into account that should have been left out, or misdirected themselves in law or fact or reached a perverse conclusion. I do not consider that Ardmore discharges that burden."[4]

Yet, on 12 June 2019, just under a year after the Court of Appeal handed down its judgment in *Ardmore CA*,[5] HMRC updated their published guidance[6] as to how HMRC determine whether interest has a UK source. Previously, HMRC had taken the view that although all the facts and circumstances should be considered the debtor's residence was the "most important" factor.[7]

* Counsel, Gide Loyrette Nouel LLP.

[1] *Ardmore Construction Ltd v HMRC* [2018] EWCA Civ 1438.

[2] *Edwards (Inspector of Taxes) v Bairstow* (1953–1956) 36 TC 207 (HL).

[3] That was, the author understands, a view towards which one of this article's anonymous reviewers tended. However, the change made by HMRC in June 2019 to HMRC's published practice, shortly after that review took place, indicates that HMRC take the view that *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 did indeed move the goalposts. The author is very grateful, nonetheless, to both anonymous reviewers and has endeavoured to do the aforementioned reviewer's comments justice. Compare C. Yorke, "Ardmore: withholding and UK source", *Tax Journal*, 5 July 2018, 10, 11 where the author concluded that it was possible to read *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 as not contradicting HMRC's pre-June 2019 guidance.

[4] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [40]–[41].

[5] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438. The Court of Appeal handed down its judgment on 21 June 2018.

[6] HMRC, Internal Manual, *Savings and Investment Manual* (HMRC, SAIM) (originally published 19 March 2016), SAIM9090.

[7] As at 8 June 2019, SAIM9090 included the following statement: "HMRC consider the residence of the debtor to be most important because this, along with the location of the debtor's assets, will influence where the creditor will sue for payment of the interest and repayment of the loan. 'Residence' in these circumstances is not the same as tax residence. Residence of the debtor is residence for the purposes of jurisdiction." The National Archives, HMRC,

HMRC's updated guidance modifies that view and, describing the multifactorial approach adopted by the House of Lords in *National Bank of Greece SA Appellants v Westminster Bank Executor and Trustee Co (Channel Islands) Ltd Respondents* (*National Bank of Greece HL*)[8] as having been "reinforced" by the Court of Appeal's decision in *Ardmore CA*,[9] dispenses with the primacy that had previously been accorded to the place where a debtor is resident.

This article will seek to tease out how *Ardmore CA*[10] may be said to "reinforce" the use of the multifactorial approach. In doing so, this article will both travel back in time as far as the early 20th century and also examine the more recent experience of other jurisdictions (in particular Australia and South Africa[11]) with determining the source of interest. That experience, it will be argued, indicates that applying what Arden LJ referred to as a "practical approach"[12] may be far from straightforward and, however superficially attractive, is likely to have undesirable consequences; at least if value is placed upon achieving certainty of outcome (that is, with a certain result proving elusive prior to the First-tier Tribunal (FTT) being asked to weigh all the factors).

The facts in *Ardmore*

The facts in *Ardmore* can be stated fairly briefly.

The trustees of two trusts, which were each resident in Gibraltar, lent sums, on an unsecured basis, to a UK incorporated and tax resident company (Ardmore Construction Ltd (Ardmore CL)). Ardmore CL carried on a construction business wholly in the UK. The terms of the loans made by the trustees to Ardmore CL provided that all payments in respect of the loans should be made to an account of each trustee with a non-UK resident subsidiary of the National Westminster Bank in Gibraltar (or such other bank in Gibraltar as might be notified to the borrower from time to time) and that all payments (including of interest) should be paid from a source outside the UK. The loans were governed by the laws of Gibraltar and the parties submitted to the exclusive jurisdiction of the Gibraltar courts. The trustees of each trust were put in funds to make the loans by a British Virgin Islands (BVI) company, the ordinary shares in which were owned by each trustee. The beneficiary of each trust was a UK resident individual who was a director of Ardmore CL and the owner of 50 per cent of Ardmore CL's share capital. Each BVI company issued "A" redeemable preference shares to Ardmore CL. Ardmore CL funded the

[ARCHIVED CONTENT] SAIM9090, HMRC, Internal Manual, *Savings and Investment Manual*, "Duty to deduct tax from interest with a UK source" (archived 8 June 2019), available at: *https://webarchive.nationalarchives.gov.uk/20190608010603/https://www.gov.uk/hmrc-internal-manuals/savings-and-investment-manual/saim9090* [Accessed 6 February 2020].

[8] *National Bank of Greece SA Appellants v Westminster Bank Executor and Trustee Co (Channel Islands) Ltd Respondents* [1971] AC 945 (HL).

[9] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.

[10] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.

[11] Compare the contribution of UK tax law to Hong Kong tax law, as to which see M. Littlewood, "The Legacy of UK Tax Law in Hong Kong" [2008] BTR 253, which broaches the question whether the experience of Hong Kong, where a model of income tax legislation has been retained which resembles the position in the colonies in the 19th century rather than the current state of the law in the UK and other developed ex-colonies, suggests that the process of tax law reform in the rest of the developed English-speaking world over the last 100 years or so is better characterised as progress or as degeneration.

[12] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [34], [37] and [39].

subscription for the preference shares from its general working capital, said to arise from the profit of its UK trade.

The decisions of the Tribunals in *Ardmore*

Counsel for the taxpayer in *Ardmore Construction Ltd v HMRC* (*Ardmore FTT*)[13] sought to persuade the FTT that the source of interest was located in the place where the credit was provided; it being agreed between the parties that the test for the source of interest was distinct from the source of trading income and also distinct from the *situs* of the debt. The FTT reviewed a range of Commonwealth and Privy Council cases which had been put before it for consideration, including the Privy Council's judgment in *CIR v Orion Caribbean Ltd (In Voluntary Liquidation)* (*Orion*) relating to the taxation of profits (including interest) derived from Hong Kong, in the course of which Lord Nolan recognised[14]:

> "the whole range of authority starting from the judgment of Atkin L.J. in *F L Smidth & Co v Greenwood (Surveyor of Taxes)* onwards, to the effect that the ascertaining of the actual source of income is a 'practical hard matter of fact', to use words employed, again by Lord Atkin, in *Rhodesia Metals (in liq) Ltd v Commissioner of Taxes* [1940] AC 774 at 789. No simple, single, legal test can be employed."

The FTT concluded that the scheme of taxation in other jurisdictions is so different from that in the UK that not much can profitably be derived from those cases. However, the FTT recognised that in the case of both those authorities and *National Bank of Greece HL*[15]

> "it appears that the court did consider and weigh a variety of, albeit different, factors including, e.g. the residence of the debtor, the residence of any guarantor, the location of any security, the situs of the debt, the proper law of the contract and the place of payment of interest".[16]

The FTT, rejecting the "place of credit" approach, concluded that a "multifactorial approach" should be applied. On this basis, Ardmore CL was UK resident, the situs of the debt (although not a determinative factor) was located where Ardmore CL was resident and the UK provided the source and origin of the funds as well as the place of enforcement of the debt.[17]

The Upper Tribunal (UT) heard the appeal by Ardmore CL together with a separate appeal, on different facts, by a Mr Perrin.[18] During its review of the case law, the UT followed the FTT's interpretation, as referred to above, of Lord Nolan's judgment in *Orion*[19] and drew attention to an example given by Lord Nolan of a simple loan by a Hong Kong corporation to a borrower in New York, where Lord Nolan indicated that[20]:

[13] *Ardmore Construction Ltd v HMRC* [2014] UKFTT 453 (TC) at [24].
[14] *CIR v Orion Caribbean Ltd (In Voluntary Liquidation)* [1997] STC 923 (Privy Council (Hong Kong)).
[15] *National Bank of Greece HL*, above fn.8, [1971] AC 945.
[16] *Ardmore FTT*, above fn.13, [2014] UKFTT 453 (TC) at [41].
[17] *Ardmore FTT*, above fn.13, [2014] UKFTT 453 (TC) at [42].
[18] *Ardmore Construction Ltd and Perrin v HMRC* (*Ardmore UT*) [2015] UKUT 633 (TCC).
[19] *Orion*, above fn.14, [1997] STC 923.
[20] *Ardmore UT*, above fn.18, [2015] UKUT 633 (TCC) at [36].

> "[T]here might be little difficulty in saying that the location of the source of the interest was New York. In such a case, however, there was no question of the source of the interest being determined by the place, Hong Kong, from which the creditor had undertaken the lending activity. By contrast, in a case such as *Orion* itself, where the activity constituted borrowing and on-lending for profit, and those activities had been carried on in Hong Kong by the Hong Kong corporation on behalf of its Cayman Islands subsidiary, it was that activity which constituted the source of the income, and the source was accordingly a Hong Kong source. *Orion* does not therefore support [the] argument. In the case of a simple debt, it points in the opposite direction towards the place of the borrower."

The UT observed that care must be taken in seeking to translate findings which are findings of fact, and made in the context of the laws of a different jurisdiction, to the domestic context in which findings fall to be made. Echoing (albeit without explicitly stating that that is what it was doing) the passage from Lord Atkin's judgment in *Rhodesia Metals Ltd (In Liquidation) v Commissioner of Taxes* (*Rhodesia Metals*)[21] to which the FTT had (as noted above) alluded, the UT concluded that:

> "Where the source of trading or business activity must be ascertained, an analysis as a practical hard matter of fact may give rise to a different result from the case of a simple debt."[22]

The UT upheld the decision of the FTT in *Ardmore FTT* (and, indeed, upheld the FTT's decision in *Perrin v HMRC* as well).[23]

The approach taken by the UT in the conjoined appeals was essentially that the ratio in *National Bank of Greece HL* was that the source of an obligation must be ascertained by means of a multifactorial enquiry having regard to "all the circumstances and all the relevant factors"[24] and

[21] *Rhodesia Metals Ltd (In Liquidation) v Commissioner of Taxes* [1940] AC 774 (Privy Council (South Africa)) at 789.

[22] *Ardmore UT*, above fn.18, [2015] UKUT 633 (TCC) at [39]. The UT also considered the South African case of *Commissioner for Inland Revenue v Lever Brothers and another* (*Lever Brothers*) 14 SATC 1; [1946] AD 441, of which more will be said below. The Tribunal concluded (at [41]): "The finding, in such a case, that it is not the debt that is the source of the interest, but the activities of the creditor which earned the income, cannot be regarded as a finding of principle, applicable to all cases. Any argument that it were such would be bound to fail, in a UK context, as it would be contrary to the binding authority of the *Greek Bank* case. The South African court, in rejecting one argument that there was a legal rule determining source, was not attempting to substitute another such rule."

[23] *Ardmore UT* , above fn.18, [2015] UKUT 633 (TCC) at [90]–[91] (for Ardmore CL) and [65]–[68] (for Mr Perrin); *Ardmore FTT*, above fn.13, [2014] UKFTT 453 (TC); *Perrin v HMRC* [2014] UKFTT 223 (TC).

[24] *Ardmore UT*, above fn.18, [2015] UKUT 633 (TCC) at [53].

It is questionable whether the UT's identification of the ratio in *National Bank of Greece HL*, above fn.8, [1971] AC 945 was strictly speaking sound, or whether the Tribunal was correct in its assertion that the House of Lords' decision was binding on the Tribunal in determining the source of interest on a debt owed by an original debtor (as opposed to a guarantor).

M. Gammie, "An Older Tale of Default on Greek Bonds" in J. Tiley (ed.), *Studies in the History of Tax Law* (Hart Publishing, 2012), Vol.5, 359–379 commented that: "The leading case on the topic is usually regarded as the *National Bank of Greece* case…In fact, careful consideration of the arguments reveals that the case is authority for the correct source of interest paid by a guarantor [namely, the underlying bond] rather than the question of whether that interest paid was UK or foreign income."

See also J.F. Avery Jones, "Commentary on Ardmore Construction Ltd v HMRC" [2014] *International Tax Law Review* (Pt 6) 992 where attention is drawn in particular to the submission of Mr Heyworth Talbot QC (for the successor

that there was no hierarchy of materiality or weight in respect of those factors.[25] It followed that no single factor determined the source of an obligation. The legal *situs* of debt (including a specialty debt) was irrelevant.[26] In a "normal" case of a "simple loan" the place of the creditor's "underlying activity" was not relevant.[27]

By reference to the facts in *National Bank of Greece HL*,[28] the following factors either bore no weight, or did not outweigh the factors referred to by Lord Hailsham[29]: the creditor's residence; the place where credit was advanced; the place of payment of interest; the existence of a moratorium on a creditor's right to sue and enforce security against the debtor; the jurisdiction of enforcement; the proper law of the contract; and the substitute guarantor's place of business. The place of a debtor's residence, in the UT's view, although a "material" factor was not the most important factor; albeit that the place of residence was a factor regardless of whether the parties may bring proceedings in that jurisdiction.[30]

However, if a debt arose in the course of a trade, that trade "might" be regarded as the source of interest; in "special circumstances" the source of interest might not be determined by reference to "normal" factors.[31] In this context, the UT referred to the South African case of *Commissioner for Inland Revenue v Lever Brothers and another* (*Lever Brothers*)[32] (of which more is said below) in which an original (Dutch) debtor was substituted by another (South African) debtor and the source of the interest was held not to be in South Africa; in *Lever Brothers*, the involvement of the substitute debtor was the only nexus with South Africa and the South African Treasury had consented to the substitution on the condition that neither interest nor capital were paid out of South African funds.

The Court of Appeal's decision in *Ardmore CA*

By the time the Court of Appeal came to consider the source of interest in *Ardmore CA*,[33] the parties had agreed that the correct test to apply was a "multifactorial" test. The question had seemingly evolved to become: what did that mean? As Arden LJ put it:

> "The issue is how the source principle is to be applied to interest paid on a foreign loan in this case. There is no universal test for applying the source principle: in this case, using the language of the day, the test has been described as 'multifactorial' and thus as involving an overall assessment of the situation."[34]

guarantor) in *National Bank of Greece HL*, above fn.8, [1971] AC 945, in the course of which Counsel stated (at 952): "It is not disputed that if the claim had been against the principal debtor and there had been no moratorium in Greece and if the claim had been for interest under the terms of the bond, the source of the income would have been foreign."

It is, equally, doubtful whether the Tribunal was correct to refer to *National Bank of Greece HL*, above fn.8, [1971] AC 945 as authority with respect to the weight (or lack of weight) to be given to the particular factors.

[25] *Ardmore UT*, above fn.18, [2015] UKUT 633 (TCC) at [29]–[30] and [53].
[26] *Ardmore UT*, above fn.18, [2015] UKUT 633 (TCC) at [29]–[30].
[27] *Ardmore UT*, above fn.18, [2015] UKUT 633 (TCC) at [43].
[28] *National Bank of Greece HL*, above fn.8, [1971] AC 945.
[29] *National Bank of Greece HL*, above fn.8, [1971] AC 945 at 954–955.
[30] *Ardmore UT*, above fn.18, [2015] UKUT 633 (TCC) at [52]–[53].
[31] *Ardmore UT*, above fn.18, [2015] UKUT 633 (TCC) at [40]–[41] and [43].
[32] *Lever Brothers*, above fn.22, 14 SATC 1; [1946] AD 441.
[33] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.
[34] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [1].

Arden LJ went on to observe that the "multifactorial test does not help the Court choose which the determinative factors are".[35] Arden LJ commented that in *Ardmore* the FTT and the UT had "looked to the substantive matters rather than theoretical factors, such as causative link and governing law" and so applied a "practical approach".[36] Quite what that "practical approach" involved was signalled in a passage which merits citing in full:

> "The answer to this particular problem is I think to be found in a number of passages in the decided cases, but I will choose the brief and elegant judgment of Lord Atkin, giving the advice of the Privy Council in *Rhodesia Metals*[37], which was cited to the FTT…. Lord Atkin first made the point, which I would respectfully adopt, that great caution should be applied in adopting decisions on source from different legislative regimes, that what is the source depends to some extent on the perspective from which the question is asked, that it was not possible to provide a universal definition of 'source' and, most importantly, that the question had to be resolved by applying practical sense. I refer to this below as 'the practical approach.'"[38]

Arden LJ concluded that:

> "The Privy Council's reference to matters of fact means that the correct approach to applying the multifactorial test is to ask whether a practical person would regard the source as in this jurisdiction or elsewhere. I do not see any material difference between this approach and that of Lord Hailsham in the *National Bank* case. Lord Hailsham applied a matter of fact approach as opposed to an approach based on legal concepts and rules."[39]

Counsel for HMRC pressed the Court of Appeal as to the importance of having regard to the "underlying commercial reality" and Arden LJ accepted that lead, with a slight clarification[40]:

[35] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [33].
[36] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [43].
[37] *Rhodesia Metals*, above fn.21, [1940] AC 774.
[38] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [34].
[39] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [37].
Whether this is an entirely fair characterisation of the thinking which underpinned Lord Hailsham's approach may be a moot point. Appearing before the Court of Appeal in *Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA* (*National Bank of Greece CA*) [1970] 1 QB 256 (CA) J.P. Warner, representing the Inland Revenue which was before the Court as *amicus curiae*, argued (at 267B) that the "basic test" for determining whether the payments are income arising in the UK was to be found in J.H.C. Morris, *Dicey and Morris on the Conflict of Laws*, 8th edn (London: Sweet & Maxwell, 1967), 508, r.79, on the determination of the *situs* of things. Although Lord Hailsham did not expressly refer to this line of argument, Lord Hailsham indicated that the starting point for his reasoning was Lord Herschell's statement in *Colquhoun v Brooks* (*Colquhoun*) (1889) 2 TC 490 (HL) and implicit in this quotation is a concern with jurisdiction. The natural corollary of *Colquhoun*, when one moves on from generalities relating to a state's taxing rights to analyse the source of a particular obligation, is that the first port of call (albeit not necessarily the final destination) should be private international law's approach to ascertaining the situs of a debt. Private international law concepts were seemingly considered in the context of *National Bank of Greece CA* and, indeed, private international law concepts were very much "in the air" as they permeated the entire saga of which that case formed merely part. Equally, however, Lord Hailsham's consistent reference to the "source of the obligation" (rather than the situs of the obligation) may be seen as intended to leave some space between private international law principles and the determination of whether a particular obligation should be subject to tax in the UK on a territorial principle.
[40] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [38].

> "Those words are appropriate to this case which concerns a commercial transaction but in other types of transaction one might ask which was the source from a practical, or realistic, point of view."

Arden LJ added that this "practical approach" was not merely multifactorial but[41]

> "also acutely fact-sensitive. The court or tribunal must examine all the available facts both singly and cumulatively."

It followed, Arden LJ continued, that an appellate court should be "slow to interfere" and that an appellant should therefore satisfy an appellate court that a tribunal was "wrong in the sense that they left a material factor out of account or took a matter into account that should have been left out, or misdirected themselves in law or fact or reached a perverse conclusion".[42] Thus:

> "In this case, however, the conclusion of the Upper Tribunal that the residence of the creditor should carry little weight cannot be criticised. The immediate search is for the source of the interest rather than a search indirectly for the source of the loan. The funds paid over as interest derived from funds generated in the UK. The activity of lending became passive once the loan was made, whereas the business of Ardmore was actively conducted to produce those funds. There was no default and the Gibraltarian exclusive jurisdiction and governing law clauses would only matter if there was default. The importance of those clauses is also undermined by the fact that the enforcement of any judgment following default on assets of Ardmore would be in the UK (and it is not necessary to go further than to note that all the available assets to meet the liabilities to the lender were in the UK). Furthermore, relative to the links with the UK, the links with Gibraltar were of an insubstantial kind: there was no evidence that they were backed up by any kind of other activity within Gibraltar, nor was it explained why it was necessary for the trusts to form companies in the BVI or what commercial purpose those companies served. The insubstantial nature of the transaction's connection with Gibraltar distinguishes this case from the *Philips* and *Rhodesia Metals* cases where there was a significant connection with the source (active business and mining claims respectively). I see no basis, therefore, for holding that the Tribunals left out of account any material factor or took any immaterial factor into account."[43]

The origins of the "practical approach" to source as a "practical hard matter of fact"

Although Arden LJ made it clear that she regarded Lord Atkin's judgment in *Rhodesia Metals*[44] as merely one instance of the courts taking what she referred to as a "practical approach"[45] to questions of source, Lord Atkin's reference to source as being "a practical hard matter of fact", which had already been noted by the FTT, was not explored in any detail by Arden LJ (indeed,

[41] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [39].

Expanding on this a little, Arden LJ in *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [41], rejected HMRC's contention that some factors were irrelevant: "[O]n a multifactorial test a factor is still relevant even if it carries little weight."

[42] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [40].

[43] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [42].

[44] *Rhodesia Metals*, above fn.21, [1940] AC 774 at 789.

[45] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [34].

no such exploration was needed in order to dispose of Ardmore CL's appeal in accordance with *Edwards v Bairstow* principles). However, given the relative dearth of authority on how to approach identifying source, it is suggested that it may be helpful to take a slightly archaeological approach to Lord Atkin's formulation; that exercise will occupy the following paragraphs of this section.

The key passage in Lord Atkin's judgment, is as follows:

> "Their Lordships incline to the view quoted with approval from Mr. Ingram's work on South African Income Tax Law by de Villiers J. in his dissenting judgment: 'Source means not a legal concept, but something which a practical man[46] would regard as a real source of income'; 'the ascertaining of the actual source is a practical hard matter of fact.'"[47]

The quest to understand what a "practical man" would identify as a "practical hard matter of fact" as the source of interest begins with de Villiers J's judgment in the South African court from which the appeal to the Privy Council in *Rhodesia Metals* originated; and, more particularly, via Villiers J's judgment to "Mr Ingram's work on South African Income Tax Law".

Mr Ingram was, more properly, C.J. Ingram KC the second president of the Cape Tax Court and, although he may not be particularly familiar to UK practitioners, his contribution to South African tax law has been described by his modern biographer as "immeasurable" (and the man himself as "enigmatic").[48] Income tax had only been introduced in South Africa in 1914[49] and Ingram's book was, therefore, mining a rather new seam of law; this book, *The law of income tax in South Africa. A commentary on the Income Tax acts of South Africa, together with the acts relating to surtax* had been published in Johannesburg in 1933.[50]

This is what the passage in Ingram's book that had caught Villiers J's eye had to say in relation to the source of income[51]:

> "Source means not a legal concept, but something a practical man would regard as a real source of income…the ascertaining of the actual source is a practical hard matter of fact."

This passage repays some careful unpacking.

[46] Lord Atkin's "practical man" became, presumably in deference to the modern preference for gender neutrality, in Arden LJ's judgment a "practical person": *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [37].

[47] *Rhodesia Metals*, above fn.21, [1940] AC 774 at 789.

[48] C.J. Ingram was born in 1879 in England, the son of a solicitor, and educated at Harrow before reading law at Brasenose, Oxford, after which he left for South Africa in 1902. From 1922 to 1949 Ingram seems to have been responsible for some 122 tax judgments, before retiring to Matlock in Somerset (in England) where he died in 1959. For Ingram's life, see further, A. Marais, "C J Ingram K.C.: Academic Pioneer and second President of the Cape Tax Court" in J. Hattingh, J. Roeleveld and C. West, *Income Tax in South Africa: The First 100 Years (1914 - 2014)* (Juta & Company (PTY) Ltd, 2016), 362–367.

[49] Income Tax Act No.28 of 1914.

[50] For a very helpful, more modern, review of the development of the South African law in relation to source—albeit focusing in particular on the source of income arising from the performance of personal services—see the commentary provided by J. Hattingh, "X v Commissioner for the South African Revenue Service [Case Number 14218]" (2018) 20 ITLR 658, 660–668.

[51] C.J. Ingram, *The law of income tax in South Africa. A commentary on the Income Tax Acts of South Africa, together with the acts relating to surtax* (Johannesburg: 1933), 66.

As a first step, this passage benefits from being set in the context of what Ingram had to say "generally" about source, which was as follows[52]:

> "Section 7(1) of the Act…lays down no special definition of the word 'source'.…the term must be interpreted in its ordinary every day meaning and in accordance with the construction placed upon it by the Courts. So far the South African Courts have shown little inclination to generalise on the subject. In Australia, where the principle of income *qua* source is also in vogue, it has been said that 'the question must be decided as a practical matter of fact - taking the substance of the transaction and disregarding the form'[53]. And again that 'Source means, not the legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when or how to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical hard matter of fact[54].'"

Taking this archaeological approach a stage further, it is helpful to look under three further stones, which reveal that:

- South African tax law never really[55] adopted the approach of determining the source of interest as a "practical hard matter of fact" such as may be determined by a "practical man";
- the South African "deemed source" rules create a very different legislative context to that provided by UK legislation relating to the source of interest; and
- the "practical hard matter of fact" approach derived from Australian cases relates, not to the source of interest, but to the source of mining profits (which, as will become apparent, are a rather different kettle of fish to interest).

The following paragraphs look under each of these stones in turn.

First stone: the source of interest was never really determined, for South African tax law purposes, as a "practical hard matter of fact"

A convenient place to pick up the path trodden by the South African Courts is Innes CJ's decision in *Overseas Trust Co Ltd v Commissioner for Inland Revenue* (*Overseas Trust*).[56] This decision would be cited approvingly by Watermeyer CJ in the pivotal case of *Lever Brothers*[57] which we

[52] Ingram, above fn.51, 66.
[53] Ingram's footnote: "N B Rydge on the Commonwealth Acts at p;41, *cit. Adelong Gold Estates No Liability v Commissioner* (1922) SR. at p.203)."
[54] Ingram's footnote: "Rydge, *ibid. cit. Nathan v F. Commissioner of Taxes* (1918 C.L.R. 25 at pp.189 and 190)."
[55] Compare Roper J's attempted synthesis; in Roper J's view: "The question of the source of this is said to be 'a practical, hard matter of facts', or what 'a practical man would regard as a real source of income' (*Rhodesia Metals*, 1940 AD 432: *Lever Brothers*, 1946 AD 441). The 'practical man' is not further defined; but as he would need to have business experience and a grasp of income tax law and practice in order to decide such a question, it seems to me that in its practical application the phrase means nothing more or less than the judge, considering in practical way all the factors in the earning of the profit."

See *Transvaal Associated Hide and Skin Merchants (Pty) Ltd v The Collector of Income Tax* (*Transvaal*) BLR 1964–1967 207 (CA) at 215–216.
[56] *Overseas Trust Co Ltd v Commissioner for Inland Revenue* 1926 AD 444.
[57] *Lever Brothers*, above fn.22, 14 SATC 1; [1946] AD 441.

shall soon come to below, and instructively bears the clear marks of Australian jurisprudence that would be transmitted, through Ingram CJ's textbook on South African tax law and courtesy of Villiers J to Lord Atkin and, through Lord Atkin, to the Court of Appeal in *Ardmore CA*.[58]

Overseas Trust concerned the treatment of a financial and investment company, registered in Cape Town and Windhoek, that had been formed to take over 1. shares and debentures in mining companies in the South West African Protectorate,[59] 2. some shares in mining companies in the Union and 3. certain dividends and surplus assets of companies in liquidation, held by the Custodian of Enemy Property.[60] Ninety-seven per cent of Overseas Trust's share capital was owned by a Dr Luppert, who had established Overseas Trust and transferred those assets to it for less than half their market value. Overseas Trust had sold its assets for £32,628, including selling shares acting through brokers in Germany (at a price fixed by Overseas Trust) for a profit of £4,534. Innes CJ approached the question of the source of those profits,[61] in a passage that Watermeyer CJ would subsequently place reliance upon in *Lever Brothers*, as follows:

> "It remains to localise the source of the income. This is an enquiry of some considerable difficulty. This Court in *Commissioner of Taxes v Dunn & Co* (1918 A.D. p.607) looked at the place where capital was employed to earn income in determining the source of that income. And that seems to have been the general rule of the Australian Courts in construing an Act very similar in this point to our own (See *Rydge's Commonwealth Income Tax Act Annotated*, p. 43). Menzies Murray's *Income Tax Act Annotated* p.35, remarks that 'the source of any income may be said generally to be the location of the business, capital or service which produces the income. If this income-producer is located in the Union, then the particular income has been earned from a source in the Union.' That fairly expresses the result of the decisions, bearing in mind however that 'source' denotes origin, not location, and that capital which produces profit is located where it is employed. Now had these

[58] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.

[59] Today, the Republic of Namibia. In July 1915 German control of what had been the German colony of South West Africa ceased and the Treaty of Versailles, 1919, Art.22 provided for the former German colony to be governed under a League of Nations mandate bestowed upon the Union of South Africa (which then formed part of the British Empire).

[60] The principle established by the Treaty of Versailles, Arts 296–298, on 28 June 1919, was that the right to retain and liquidate all property of German nationals within the territories of the Allied Powers was reserved to the Allied Powers, while Germany was to compensate her own nationals whose property had been taken over by the Allied Powers. It was, in Keynes' words, "one of the most serious acts of political unwisdom for which our statesmen have ever been responsible", see J.M. Keynes, *The Economic Consequences of the Peace* (1919), 92.

[61] Although Innes CJ's judgment was to prove particularly influential, it may be helpful also to note Solomon JA's comment (*Overseas Trust*, above fn.56, 1926 AD 444 at 457) that:

> "[I]t is important, however, to bear in mind that these companies had gone into liquidation before the shares were acquired by the appellant company and that the accumulated profits had accumulated prior the acquisition. The companies in question had ceased to carry on business and were no longer employing capital in South-West Africa for the purpose of earning profits. If we apply the test laid down in *Dunn & Co*'s case, it seems clear that the capital employed to earn the sum of money in question was what was spent in the purchase of the shares, which carried with them the right to participate in the fund in the hands of the Custodian. The purchase of the shares took place in Cape Town, and that is where the capital was employed for the purpose of earning the profit."

In Solomon JA's view (*Overseas Trust*, above fn.56, 1926 AD 444 at 454), the sales of shares via a German broker were isolated transactions controlled throughout from Overseas Trust's Cape Town office and there was no proof that Overseas Trust carried on business in Germany or employed capital there, the brokers being merely agents executing instructions. Capital was, therefore, employed in the Union. The position "would have been different" if Overseas Trust had carried on part of its business in Germany.

> companies been going concerns engaged in mining operations in South-West Africa there would be much to be said for the view that the shareholders drew their dividends from the same source as those companies; and that the source was outside the Union where their business was being carried on and their capital employed. But that is not the position. The companies in question had ceased operations before the appellant acquired their shares, and those shares were merely instruments entitling the holder to certain monies which had been previously paid to, and were being held by, the custodian. The Appellant took over those instruments in order to obtain the money to which they related. And the resulting profit sprang neither from business nor service, but from the employment within the Union of the capital expended in the acquisition of the shares or instruments. That being so, it cannot be said to have been acquired from an extra-Union source."[62]

Watermeyer CJ then proceeded to comment as follows:

> "The statement by Menzies Murray which is quoted above by Innes, C.J.…bears a striking similarity to the statement in *Rydge Income Tax*…which is as follows:
>
> > 'The source of income may be said to be the business capital or service which is responsible for the earning of the income. If the capital or services be located in Australia then the particular income has been earned within the Commonwealth.'
>
> The statement in the judgment of INNES, C.J. that the word 'source' denotes 'origin' and not 'location' should be noticed. It means that the word 'source' in the Act does not denote the quarter from which the money is received but the originating cause of the receipt (i.e., the particular activity of the taxpayer which earns money)."[63]

There is, therefore, a thread that leads directly from Innes CJ's judgment in *Overseas Trust*[64] to Watermeyer CJ's judgment in *Lever Brothers*.[65] Apart from Ingram's *quasi ex cathedra* reflections in his textbook published in 1933,[66] there is little or no sign of South African tax law having adopted a "practical man"/"practical hard matter of fact" test.

The reason for a "practical man"/"practical hard matter of fact" test not being adopted emerges from a careful reading of both the majority and the minority judgments in *Lever Brothers*, which also serves to underline the difficulties with a "practical person"/"practical hard matter of fact" test.

Watermeyer CJ, who spoke for the majority, had this to say about how the "practical man" would approach the facts before the Court[67]:

> "Again, if Lord Atkin's suggestion be followed and the question be asked what would the practical man regard as the real source of the income, though I have some difficulty in differentiating the reasoning of the practical man from that of the theoretical lawyer for this purpose, I think the answer would probably be that the source of Levers' income was the

[62] *Overseas Trust*, above fn.56, 1926 AD 444 at 453–454.
[63] *Lever Brothers*, above fn.22, 14 SATC 1; [1946] AD 441.
[64] *Overseas Trust*, above fn.56, 1926 AD 444.
[65] *Lever Brothers*, above fn.22, 14 SATC 1; [1946] AD 441.
[66] Ingram, above fn.51.
[67] *Lever Brothers*, above fn.22, 14 SATC 1 at 15–16.

> operations of the American Companies which produced the money out of which the interest was paid. I cannot think that the practical man could ever come to the conclusion that the money came from a source in South Africa."

To which Schreiner JA, who gave a dissenting judgment, had this to say in reply[68]:

> "In my view the source of Levers' income, so far as it consisted of the interest, was the debt i.e. the *aes alienum* or money of Levers in the possession of *Overseas Holdings*….No doubt the location of an incorporeal in space by a rule of law carries a flavour of artificiality but even the practical business man of the cases would realise, when the matter was explained to him, that for certain purposes it is unavoidable.…I have referred to the practical business man whose hypothetical views on these matters are said to be entitled to great weight. And it is suggested that the view that interest on a loan debt has its source in the place where the debt is situated is artificial and based on legal fiction. No doubt excessive subtlety is particularly to be avoided in the solution of those income tax problems that are closely related to the conduct of affairs in trade and industry. But I am disposed to think that a practical business man would be surprised if he were informed that the source of interest on a long term loan was the contract, made possibly decades ago, and not the loan debt itself. And if he were told that the Statute made it necessary to fix the local situation of the interest bearing debt, it is not unlikely that, while expressing a tentative layman's view in favour of placing it at the residence of the debtor, he would indicate that the obvious thing to do would be to ask a lawyer. But, after all, we are concerned in this case not with ordinary everyday business transactions but with a series of complicated legal documents of an unusual character, designed to create and transfer legal rights in the light of international developments and not, it may be supposed, without some regard to the revenue laws of the countries concerned. What factors induced Levers to select the soil of South Africa as the most favourable one into which to transplant the fruitful tree whose existence in Holland was threatened we do not know, but the precise effect of the operation does not appear to me to be a matter on which the opinion of the ordinary practical business man would provide much assistance."

In other words, two Judges who reached opposing conclusions on the question before the Court in *Lever Brothers* both sought to demonstrate how a "practical man" would have agreed with each of them, and both found the exercise futile. And, as a result, South African tax law embarked upon a different path (on which it was to remain until earlier this century, as discussed further below) by means of which

> "the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them".[69]

[68] *Lever Brothers*, above fn.22, 14 SATC 1 at 20–22.
[69] *Lever Brothers*, above fn.22, 14 SATC 1 at 8–9.

Instead of following a "practical man" up-valley and down-dale in search of a "practical hard matter of fact", South African tax law therefore took a different path to identify the source of an interest payment. The notion was developed that the source of income for South African income tax purposes should be determined by reference to "the main, the real, the dominant, the substantial source" of income.[70] Ultimately, *Lever Brothers* was, at least in part, overruled by *First National Bank of South Africa Ltd v Commissioner for the South African Revenue Service*[71] where it was held that interest arose from the breadth of a bank's business activities in South Africa notwithstanding that loans were made in a foreign currency to borrowers outside South Africa. However, uncertainty associated with the South African authorities relating to the "true" source of interest became, in an effort to provide certainty (and contain avoidance), overlaid by further statutory deeming rules now contained in section 9 of the South African Income Tax Act 1962.

Those rules were amended on a number of occasions and, prior to 1 January 2012, section 9(6)–(7) of the Income Tax Act 1962 treated interest derived from the utilisation or application in South Africa by any person of any funds or credit obtained in terms of an interest bearing arrangement as having a source in South Africa. Successive amendments to those statutory deeming rules proved unsatisfactory and, as South Africa increasingly sought international investment from the mid-1990s, a residence basis of taxation replaced the source rules for recipients of income who resided in South Africa (with the deemed source rules being retained only in respect of income arising to non-residents). This position too was unsatisfactory and the Taxation Laws Amendment Act 24 of 2011 was introduced in recognition of the fact that the source rules gave "rise to uncertainty, thereby imposing additional costs in respect of cross-border activities with little or no benefit for the *fiscus*".[72] By virtue of the 2011 reforms the South African Treasury decided that[73]:

> "The source of interest will largely be determined using implicit OECD principles. The determination of source of interest will now be based on a two-part test, namely (i) the residence of the debtor paying/incurring the interest, or (ii) the place in which the loan funds are utilised or applied. Therefore, interest will be sourced in South Africa if (i) paid by a South African resident, or (ii) if the interest is derived from use or application in South Africa (e.g. from a South African permanent establishment). The proposal removes any current law focus on the credit provider."

Section 9(2) of the Income Tax 1962, as amended by the 2011 Act, provides that:

> "An amount is received by or accrues to a person from a source within the Republic if that amount—…
> (b) constitutes interest…where that interest—

[70] *CIR v Black* (1957) 3 SA 536 (A) at 543 and also *Essential Sterolyn Products (Pty) Ltd v CIR* (1993) 4 SA 859 (A) and the Botswana case of *Transvaal*, above fn.55, BLR 1964–1967 207 (CA).
[71] *First National Bank of South Africa Ltd v Commissioner for the South African Revenue Service* 2002 (3) SA 375 (SCA).
[72] Republic of South Africa, *National Treasury, Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011* (27 January 2012), para.4.2 II, p.97.
[73] Republic of South Africa, above fn.72, para.4.2 III, p.98.

(i) is attributable to an amount incurred by a person that is a resident, unless the interest is attributable to a permanent establishment which is situated outside the Republic; or

(ii) is received or accrues in respect of the utilisation or application in the Republic by any person of any funds or credit obtained in terms of any form of interest-bearing arrangement."

Bearing in mind that South Africa disclaimed the "practical man's" legacy with respect to interest from 1 January 2012 (when the 2011 Act came into force) because the unattractiveness of that legacy had become all too apparent after the shackles of Apartheid had been removed, it may seem surprising (and, indeed, a retrograde step) that a "practical person" should now be resurrected to serve UK tax law.

Second stone: the South African "deemed source" rules create a very different legislative context to that provided by UK legislation relating to the source of interest

In light of the repeated judicial warnings (including by Lord Atkin himself and also by Arden LJ in *Ardmore CA*[74]) about the dangers of uncritically following jurisprudence relating to a different statutory context in seeking to settle questions of source, the fact that Ingram CJ was writing about the South African Income Tax Act of 1925 which introduced "deemed" source rules should set alarm bells ringing at any suggestion that the "practical" approach Ingram CJ discussed in relation to South African tax law (where the taxation of profit derived from mining activities had a pre-eminent importance) should have any useful application when construing UK legislation concerned (more narrowly) with the source of interest.

Section 9(1)[75] of the South African Income Tax Act of 1925 stated as follows:

"An amount shall be deemed to have accrued to any person from a source within the Union, whenever it has been received by or has accrued to or in favour of such person by virtue of:

(a) any contract made by such a person within the Union for the sale of goods, whether such goods have been delivered or are to be delivered in or out of the Union;

(b) any service rendered or work or labour done by such person in carrying on in the Union of any trade, whether the payment for such service or work or labour is made or is to be made by a person resident in or out of the Union and wherever payment for such services or work or labour is made or is to be made;

(c) any services rendered by such person to or work or labour by such person for or on behalf of the Government of the Union or any provincial or local authority within the Union, notwithstanding that such services are rendered or such work or labour is done outside the Union: Provided that such services are rendered or such work or labour is done in accordance with a contract of employment entered into with the Government of the Union or a provincial or local authority within the Union;

[74] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.

[75] South African Income Tax Act 1925 s.9(2) and (3) addressed, respectively, income of a married woman (deemed to be that of her husband) and the income of a minor child (other than bona fide remuneration for services rendered!).

(d) any pension or annuity granted to such person by any person residing in or carrying on business in the Union or by the Government or Railways and Harbours Administration of the Union or any provincial or other local authority therein, wheresoever payment of such pension or annuity is made and wheresoever the funds from which payment is made are situated: Provided that no pension or annuity shall be deemed to be derived from a source within the Union if the service or employment in respect of which it is granted was performed wholly outside the Union."

This is, it should be clear, a long way indeed from the statutory language in section 368 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA) which refers simply to "interest arising in the United Kingdom…from a source in the United Kingdom" (and, indeed, far from the UK tax statute defining what, when *Rhodesia Metals*[76] came before Lord Atkin, fell within Case III of Schedule D[77]).

Indeed, even within a South African context, a considerable amount of confusion has been caused by questions relating to the extent (if at all) that source should be determined differently in relation to income arising from capital as opposed to from services. That distinction, which was implicit in Innes CJ's decision in *Overseas Trust*,[78] was somewhat blurred by the introduction of statutory source deeming rules in 1925. This is how Ingram described the position in 1933[79]:

> "A well-known classification of income consists in a division between income, the product of the employment of capital, and income which springs from the reward of, labour and services rendered[80]. This division of income is to a certain extent followed by the Act in its provisions relating to source in particular cases. As to any general definition of source the Act is silent. Nor does it lay down any particular guide in the case of income falling under the former head of classification, viz., income derived from the employment of capital.

[76] *Rhodesia Metals*, above fn.21, [1940] AC 774.

[77] The First Schedule to the UK's Income Tax Act 1918 delineated Schedule D Case III as follows (at para.(1)):

"(a) any interest of money, whether yearly or otherwise, or any annuity, or other annual payment, whether such payment is payable within or out of the United Kingdom, either as a charge on any property of the person paying the same by virtue of any deed or will or otherwise, or as a reservation thereout, or as a personal debt or obligation by virtue of any contract, or whether the same is received and payable half-yearly or at any shorter or more distant periods;

(b) all discounts;

(c) profits on securities bearing interest payable out of the public revenue other than such as are charged under Schedule C;

(d) interest, annuities, dividends and shares of annuities payable out of any public revenue where the half-yearly payments in respect thereof do not exceed fifty shillings and are not chargeable under Schedule C;

(e) interest paid or credited in full without deduction of tax by any savings bank to any depositor;

(f) interest on any Exchequer bonds issued under the authority of the Treasury during the continuance of the present war and a period of six months thereafter and on any securities issued under the War Loan Acts, 1914-1917, or any Act amending those Acts, in cases where such interest is paid without deduction of tax."

[78] *Overseas Trust*, above fn.56, 1926 AD 444.

[79] Ingram, above fn.51, 65.

[80] Ingram's footnote: "See *Boosen's case* (1918 A.D. at p.594), and *cf. Hamilton v Commissioner for Inland Revenue* (1921 A.D. at p.6)."

> But in the case of income falling with the latter head, viz., income derived from services rendered, pensions and the like, and also in the somewhat special case of income derived from the sale of goods, it provides by section 9, certain specific attributes the presence of which affects the income to which they relate with a Union source."

The existence, or otherwise, of that distinction would continue to cause difficulty. In *Income Tax Case No.738*,[81] for example, the Court took the position (wrongly, it has subsequently been pointed out, albeit at the time to the evident relief of Dowling J[82]) that *Lever Brothers* did not apply as a general proposition to personal service income. Moreover, the inability of the "originating cause" formulation adopted in *Lever Brothers* to address a composite payment made for services performed in different locations led to a refined search for a "dominant" cause; as Schriener JA put it in a judgment given in the Botswana Court of Appeal "it has been held that the dominant (or main or substantial or real or basic) cause of the accrual of income must be sought".[83] Consequently, South Africa, which seemingly started with a division between the source of income arising from capital and personal services, supplemented that division with statutory deemed source rules, before settling on an "originating cause" approach, which was then further refined to identify a "dominant", etc. cause. That South African experience feels like a very long way from the statutory environment in the UK relating to the taxation of interest (to which, amongst other things, the complicating and obscuring effects of statutory source deeming rules are altogether foreign).

Third stone: the "practical hard matter of fact" approach derives from Australian cases related, not to the source of interest, but to the source of mining profits

As the footnotes to Ingram's work (reproduced above) make quite clear, the "practical hard matter of fact" test derived directly from Australian case law and, in particular, a commentary on Australian tax law written by Norman B. Rydge.[84]

Rydge was primarily concerned with, and drew his material from, two judgments of the Australian courts (which, like the South African courts, were much concerned with profit arising in one form or another from mining).

[81] *Income Tax Case No.738* (1951) 18 SATC 213 (T).

[82] For analysis of the decision, see Hattingh, above fn.50, 666.

Dowling J observed (*Income Tax Case No.738*, above fn.81, (1951) 18 SATC 213 (T)) that a "more difficult question" might have arisen if he had sought to apply the "somewhat difficult learning" propounded by Watermeyer CJ in *Lever Brothers*, above fn.22, 14 SATC 1; [1946] AD 441 in relation to the source of income.

[83] *Transvaal*, above fn.55, BLR 1964–1967 207 (CA) at 219. Compare Roper J who understood the identification of a dominant cause as merely part of the application of the "practical man" test (at 216–217): "But in the search for the dominant factor, or the real and basic cause, added value is not decisive. It is only one of the circumstances which the practical man must take into consideration, and the question of its weight may depend upon degree."

[84] Norman Bede Rydge ACPA AICA (born 1900) described himself, in 1923, as a public accountant and tax consultant. Subsequently establishing Rydge's *Business Journal* (1928), he became a successful stock exchange investor with significant hotel and cinema interests (including from 1945, a close relationship with Arthur J. Rank and, hence, the Rank organisation); he was knighted 1966 and died in 1980. His tax background, perhaps, helps explain the practice adopted by his investment vehicle, Carlton Investments, of paying dividends only in the form of bonus share issues which, in the absence of capital gains tax, could be disposed of without incurring a tax liability. See J. Perkins, "Rydge, Sir Norman Bede (1900–1980)" in National Centre of Biography, Australian National University, *Australian Dictionary of Biography* (published first in hardcopy 2002), available at: *http://adb.anu.edu.au/biography/rydge-sir-norman-bede-11596/text20703* [Accessed 19 February 2020].

The first such judgment, in *Nathan v Federal Commissioner of Taxation* (*Nathan*)[85] concerned the application of the Australian Income Tax Assessment Act 1915–16 (AITA 1915–16) and the Income Tax Act 1915. Section 4 AITA 1915–16, in order to apply differential rates of tax to different categories of income, divided "income" into two classes: 1. "income derived from personal exertion"; and 2. "income derived from property". Section 2 AITA 1915–16 provided that that Act was to be read as one with the Income Tax Act 1915 and section 3 of the Income Tax Act 1915 defined "Income from personal exertion" and "income derived by any person from personal exertion" as meaning "income derived in Australia" consisting of earnings and a number of other matters. "Income from property" was in turn defined as meaning "income derived in Australia and not derived from personal exertion". Consequently, the legislation envisaged "income" being divided into two categories, each of which was mutually exclusive and exhaustive. Section 10 of the Income Tax Act 1915 then provided that income tax was to be levied and paid upon the taxable income "derived directly or indirectly by every taxpayer from sources within Australia". Taking the scheme of the legislation as a whole, and drawing on a Privy Council decision[86] on a New Zealand taxing statute,[87] Isaacs J was content that for these purposes taxable income could be directly or indirectly derived from Australia and that income not so derived was not subject to tax in Australia.

Nathan was concerned with the taxability of income received by a shareholder, who was resident in New South Wales, from S. Hoffnung & Co Ltd, the Bank of Australasia and Farmer & Co Ltd, each of which were incorporated, had a registered office in, and were centrally managed and controlled, in England. The three companies each made profits from activities carried on in Australia and also from activities carried on in England and elsewhere. The question for the Court was whether the dividends that arose constituted "income derived in Australia" and, thereby, had an Australian source. In relation to this, Issacs J had the following to say:

> "But still the question remains: Is the 'source' of the appellant's dividends 'within Australia'?….
>
> The Legislature in using the word 'source' meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of income is a practical, hard matter of fact."[88]

Notwithstanding the subtle distortion and transformation of Isaacs J's somewhat specific reference to the "The Legislature" into Ingram's more expansive formulation of a general definition of source, the origin of Ingram's understanding of the meaning of source is readily apparent.

[85] *Nathan v Federal Commissioner of Taxation* [1918] HCA 45; 25 CLR 183.
[86] *Lovell & Christmas Ltd v Commissioner of Taxes* [1907] NZPC 4; [1907] UKPC 57; [1908] AC 46 at 52 where the House of Lord's decision in *Grainger & Son v Gough (Surveyor of Taxes)* (*Grainger*) [1896] AC 325 was applied. In *Grainger* the House of Lords decided that Louis Roederer, who was a champagne merchant residing and carrying on business in France during the years 1884, 1885, and 1886 did not exercise his trade in the UK within the meaning of Schedule D of the Income Tax Act of 1853.
[87] Land and Income Assessment Act 1900 (64 VICT 1900 No 49) s.52.
[88] *Nathan*, above fn.85, 1918 25 CLR 183 at 189–190.

Before we pass on to consider the second case cited by Rydge (and Ingram), an additional reason for caution before applying the Australian jurisprudence to assist in determining the source of interest for UK tax purposes might be thought to lie in section 10 AITA 1915–16 which provided that "where a company derives income from a source in Australia and from a source outside Australia a taxpayer shall only be taxable on so much of the dividend as bears to the whole dividend the same proportion that the profits derived by the company from a source in Australia bears to the total profits of the company". As Isaacs J himself commented those words "seem to us to indicate the intent of the Legislature in a most unmistakable manner".[89] It would be a somewhat perverse approach to the Australian legislation to ignore those words and, irrespective of Isaacs J's musing on the meaning of "source", the literal force of those words would strongly suggest that Isaacs J's decision that the dividends had an Australian source could have been reached by means of a straightforward process of statutory construction. The significance of a streaming concept, in the context of a consideration of the UK Court of Appeal's decision in *Ardmore CA* is that there is not, and never has been, any equivalent statutory "streaming" provision in the UK relating to identifying the source of interest.[90]

The second case referred to by Rydge (and Ingram) is that of *Adelong Gold Estates No Liability v The Commissioner of Taxation* (*Adelong*).[91] The context for *Adelong* was a prohibition imposed on miners in 1915 from exporting gold from New South Wales and the imposition of a requirement to sell their gold to the Imperial mint. As the gold price soared (and extraction costs increased) during the First World War this prohibition put Australian miners at a significant international disadvantage and, as a result, an association comprised of gold miners was permitted to exchange gold mined by its members for sovereigns produced by the mint; those sovereigns were then exported and sold abroad. The question for the Court was whether profits arising from the sale of the sovereigns was derived from a source in Australia for the purposes of section 4 of the Income Tax Management Act 1912. In a passage that would find its way into Ingram's commentary, via Rydge's commentary, Gordon J observed that the "question must be decided as a practical matter of fact - taking the substance of the transaction and disregarding the form" and held that "the Court must look to the actual result and disregard the means by which that result was obtained".[92]

[89] *Nathan*, above fn.85, 1918 25 CLR 183 at 191.

[90] For an overview of the Australian and New Zealand case law which developed in connection with the need to distinguish between income with a source within the jurisdiction that was subject to tax and income sourced elsewhere which was outside the charge to income tax, and also the contribution of that jurisprudence to Hong Kong tax law, see M. Littlewood, "An Australasian Contribution to Hong Kong Tax Law" (2000) 10 Revenue L.J. 41.

With regard to South African law, Hattingh notes that: "Shreiner's dominant causality approach to the source of income from integrated business transactions caused a divergence to arise in South African jurisprudence because this approach did not admit apportionment of income derived from such highly integrated business transactions. On the other hand, courts clearly allowed apportionment of income derived from personal service income to several sources. These legal positions have ever since co-existed. No South African court has decided that Shreiner's approach to income derived from integrated business transactions that prevailed in 1957 in *CIR v Black*, did away with the law that personal service income could be time-apportioned to several sources." See Hattingh, above fn.50, 669.

[91] *Adelong Gold Estates No Liability v The Commissioner of Taxation* (1922) 22 SR (NSW) 197.

[92] *Adelong*, above fn.91, (1922) 22 SR (NSW) 197 at 203.

The key phrases adopted by Lord Atkin in *Rhodesia Metals*,[93] and in turn by Arden LJ in *Ardmore CA*,[94] can therefore be traced directly back to two Australian cases, neither of which related to interest, and each of which originated in a very different statutory context to that which has existed and exists in the UK.

The nature of that statutory context in Australia can be appreciated by looking at the Australian legislation with reference to which Rydge was writing in 1923. Section 13(1) of the Australian Income Tax Assessment Act 1923 stated:

> "Subject to the provisions of this Act, income tax shall be levied and paid for each financial year upon the taxable income derived directly or indirectly by every taxpayer from sources within Australia during the period of twelve months ending on the thirtieth day of June preceding the financial year for which the tax is payable."

This statute imposed Australian income tax where income was "directly or indirectly" derived from "sources" (note the use of "indirectly" and the plural "sources") in Australia. This formulation is clearly different from the language used in section 368 ITTOIA with which the Court of Appeal was concerned in *Ardmore CA*.[95]

Furthermore, not only was (and is) the Australian statutory context different from the legislative context (then or now) in the UK, but it is evident that Rydge was well aware of the difficulties that could arise if the differences between Australian and UK legislation were not treated with due respect. Indeed, Rydge complained that[96]:

> "Unfortunately, it would seem as though the exact legal position has been somewhat clouded by the application of English decisions which do not entirely apply to our Federal enactment."

The Australian courts have continued to wrestle with the difficulties associated with determining whether income has a source in Australia. Recently, in *Commissioner of Taxation v Resource Capital Fund IV LP* (*RCF IV*)[97] the Federal Court of Australia has expressed the test for whether income has an Australian source for Australian tax purposes as being a search for whether the "proximate source" of income is in Australia.[98]

[93] *Rhodesia Metals*, above fn.21, [1940] AC 774.
[94] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.
[95] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.
[96] N.B. Rydge, *Commonwealth Income Tax Acts, 1922-1923 and Regulations Thereunder: Together with a full explanation of each section and a statement of Departmental Practice and the Decisions of the Imperial, Australian and New Zealand Courts* (Sydney, Melbourne and Brisbane: The Law Book Co. of Australasia Ltd, 1923), 44.
[97] *Commissioner of Taxation v Resource Capital Fund IV LP* [2019] FCAFC 51; 266 FCR 1; 135 ACSR 486.
[98] The Income Tax Assessment Act 1997 s.995-1 provides that "ordinary income or statutory income has an Australian source if, and only if, it is derived from a source in Australia for the purposes of the Income Tax Assessment Act 1936".

Australian domestic law is not, however, necessarily determinative as to whether income has an Australian source. In *Satyam Computer Services Ltd v Commissioner for Taxation* (2018) 21 ITLR 274; [2018] FCAFC 172 the Federal Court of Australia held that the combined effect of a deemed source rule in the Australia/India double taxation treaty (Agreement between the Government of Australia and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income [1991] ATS 49 (entered into force on 30 December 1991)) Art.23 and the Australian International Tax Agreements Act 1953 s.4(2) was to impose Australian tax on a royalty in circumstances in which, were it not for the treaty, the royalty would not have been within the charge to Australian tax (i.e. as imposed solely by Australian domestic law).

In *RCF IV* two corporate limited partnerships had realised a gain from the sale of their shares in a company (Talison Lithium Ltd (Talison)), the value of which was attributable to a lithium mine[99] in Greenbushes, south western Australia. Counsel for the taxpayer argued that: 1. all decisions and negotiations for the investment in Talison were made by the Investment Committee of the general partner outside Australia; 2. monitoring of the investment was conducted by the Investment Committee of the general partner outside Australia; 3. all decisions and negotiations regarding the disposal of the investment were made by the Investment Committee of the general partner outside Australia; 4. the limited partners could not and did not take any part in the management of the partnership and were passive investors; 5. before making important decisions, the Investment Committee of the general partner took advice from the management company, RCF Management LLC, outside of Australia; 6. the shares which were disposed of were listed and were freely tradable on the Toronto Stock Exchange; and 7. the consideration for the disposal of shares was paid on behalf of Tianqi, a Chinese company, and was payable and received outside Australia and in Canadian dollars. However, on the other side of the coin: the strategy adopted comprised not merely the passive holding of shares, but also involved an acquisition of shares and then a restructure and management of the underlying business in order to secure a better profit from a future sale. This was achieved with the help of RCF Management Pty Ltd which had an office in Australia, active employees in Australia (for example, frequently participating in investment committee meetings) and which provided two directors who sat on Talison's Board of Directors.[100]

The Federal Court acknowledged Stephen J's observation in *Esquire Nominees Ltd v Federal Commissioner of Taxation*[101] that:

> "To say that questions of source depend upon practical matters of fact will not necessarily assist in determining which of a range of possible meanings of source is meant, but context should provide a solution.…the source referred to is that from which income is produced by the taxpayer's own acts of derivation or ownership. All this suggests that a quite proximate source is being referred to."[102]

And decided that:

> "A proximate origin of the profits here was thus the scheme of arrangement and the location of that arrangement was unquestionably in Australia. The *locus* of the scheme is analogous to the place where the contract was made in Tariff Reinsurances, and to the making of the contract in New South Wales considered in *Premier Automatic Ticket Issuers Ltd v Federal Commissioner of Taxation* [1933] HCA 51; (1933) 50 CLR 268. In *Premier Automatic*, income payable under a contract had a source in Australia because that was where the contract had been made. As Rich J. said at 286:

[99] Although irrelevant for tax purposes, it is interesting to note that this mine is adjacent to the largest lithium mine in the world, which is responsible for 40% of the global production of lithium.

[100] The general partner of RCF IV had entered into an agreement with RCF Management LLC for the management of the operation and investments of each partnership through an investment committee. RCF Management LLC had, in turn, entered into an agreement with RCF Management Pty Ltd pursuant to which administration and management services were supplied.

[101] *Esquire Nominees Ltd v Federal Commissioner of Taxation* [1973] HCA 67; (1973) 129 CLR 177.

[102] *RCF IV*, above fn.97, [2019] FCAFC 51 at [61].

> 'The profits were derived by the taxpayer from its enforceable right, conferred by the agreement in the events which happened, to a sum amounting to ten per cent of the purchase money. The source of this right was the making of the agreement which took place in New South Wales. For these reasons I think that as a matter of law the profits arose from a source in New South Wales.'

Here, each respondent's 'enforceable right' to the proceeds of the sale of the interests and shares in Talison Lithium arose from the scheme of arrangement. That arrangement took place in Australia, and accordingly, because the scheme was the 'proximate' origin of the profits earned, and because of the other connections with Australia summarised by the primary judge…, including the location of the mine in Western Australia, those profits had a source in Australia. At the very least, it was open to his Honour so to conclude."[103]

So, as *RCF IV* demonstrates, the Australian experience (like that in South Africa) is one in which reliance on a "practical hard matter of fact" has fallen far short.

The observation all this invites in relation to the Court of Appeal's decision in *Ardmore CA*[104] is that, in adopting terminology approved by Lord Atkin, the Court of Appeal seems inadvertently to have fallen into the error that Arden LJ (and before her, Lord Atkin himself in *Rhodesia Metals*[105]) warned should be avoided, namely that of applying foreign authorities in a UK context. In a sense, to the extent that *Ardmore CA*[106] encouraged the source of an interest payment to be approached as a "practical hard matter of fact", the effect of a decision made in England[107] may be said to have allowed Australian (and/or South African) law originally developed nearly 100 years ago to identify the source of profits arising primarily from mining[108] to have "clouded" the determination of the source of interest for the purposes of UK income tax.

Where does this leave UK law in the wake of the Court of Appeal's judgment in *Ardmore CA*?

On a purely practical level, the difficulties in predicting how a "practical person" should divine source as a "practical hard matter of fact" can be illustrated by testing differing fact patterns

[103] *RCF IV*, above fn.97, [2019] FCAFC 51 at [64]–[65].
[104] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.
[105] *Rhodesia Metals*, above fn.21, [1940] AC 774.
[106] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.
[107] Perhaps, in preference to "English judges", because although Lord Atkin was brought up in Wales from the age of three prior to his birth (in 1867) his parents had both emigrated to Australia where James Atkin (as he then was) was born.
[108] Lord Atkin acknowledged "doubt" with respect to the emphasis placed by Innes CJ in *Overseas Trust*, above fn.56, 1926 AD 444 on the "productive employment of capital" and also reflected the (entirely understandable, given the question before the Privy Council in *Rhodesia Metals*) focus upon a business (e.g. rather than a specific right to an interest payment) (*Rhodesia Metals*, above fn.21, [1940] AC 774 at 789):

> "A doubt may be expressed whether the words borrowed by Stratford, C. J., from Innes, C. J., in the *Overseas Trust* Case (supra) 'productive employment of capital' really help to define the situation. Is capital productively employed in the place where it purchases stock which is profitably sold elsewhere, or in the place where the stock which now represents the capital is sold, or for purposes of the test must both purchases and sales occur in the same place; or is it sufficient that the place of the direction of the employment of the capital in purchasing or selling should denote where the capital is productively employed? Perhaps in other words it may be said, does it mean more than carrying on business in a place?"

against Arden LJ's explanation (cited above[109]) as to why the facts in *Ardmore CA*[110] were consistent with the interest paid by Ardmore CL to the trustees in Gibraltar having a UK source. A taxpayer (or professional advisor) seeking to work out whether, in a slightly differently scenario, interest has a UK source is left to wonder what difference (if any) it would have made if the facts had fallen out a little differently? For example: what sort of activity on a lender's part would constitute sufficient activity to carry materially more weight; would it have made a material difference if collateral had been held in Gibraltar to secure the borrower's obligation to pay interest; would it have altered the position if there had been a default? If the "immediate search" is for the source of the interest (rather than, indirectly, for the source of the loan) at what point (if at all) is it legitimate to consider the source of the loan?

A focus on a "practical hard matter of fact" may be said to come very close to creating what is akin to law without content. Although there should be no difficulty, in principle, with factors being "weighed", in the absence of guidance beyond an appeal to what a "practical person" would make of a particular fact pattern, the taxpayer contemplating making a payment may have little option but to "guess" and keep his, her, or its fingers tightly crossed while waiting until HMRC are out of time to issue a discovery assessment (not least because HMRC have for many years refused to, and are understood to continue to refuse to, issue any non-statutory clearances with respect to source). Although there is no suggestion in *Ardmore CA* that an increase in uncertainty was something the Court of Appeal sought to achieve (even if HMRC may have perceived such a result, or at the very least the maintenance of doubt, as desirable), it is hard to see how, short of applying to the FTT for a finding of fact, the taxpayer is to know how to approach the weighing exercise.

Professor Judith Freedman, albeit writing in a slightly different context, has drawn attention to the dangers of taxing by reference to a business meaning of words (and, if we are to heed a "practical person" on a "practical hard matter of fact", then such a person would presumably take a business person's approach)[111]:

> "We might think that we should tax on a basis approaching something as near to reality as possible but, as Lord Hoffmann has pointed out, there are dangers in talking about reality in this context.[112] As he states, 'Something may be real for one purpose but not for another.'…The tax system is not founded purely on *economic reality*, even if we were to know what that was. It has to be about *legal reality*…because that is the only practical and operable way to construct a tax system. What we decide to tax may be something quite artificial; income, for example, is an artificial construct. In the business context it bears some relation to the accounting concept of profit but how real is that? Accounting profit is based on a set of standards designed to give a true and fair view of the profits, but it is one view, seen from one perspective: just one other version of 'reality'.…
>
> Legal reality may often be trying to reflect some sort of commercial or economic reality but it will not achieve this in every case. This does not mean that the legal distinctions

[109] See fn.43 of this article and accompanying text.
[110] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.
[111] J. Freedman, "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle" [2004] BTR 332, 343.
[112] Freedman's footnote: "*Westmoreland v MacNiven* [[2001] STC 237] at p.251."

> created are unreasonable…since the entire system is based on legal distinctions and needs to be in order to operate."

The reliance, advocated in *Ardmore CA*, on identifying source as a "practical hard matter of fact" suffers from difficulties that are in many ways not dissimilar from those associated with the distinction famously drawn by Lord Hoffmann in *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd* (*MacNiven*) where he said[113]:

> "Taxing statutes often refer to purely legal concepts. They use expressions of which a commercial man, asked what they meant, would say 'You had better ask a lawyer'."

Turning again to Professor Freedman, writing this time in light of the House of Lord's landmark decisions in *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* (*BMBF*)[114] and *IRC v Scottish Provident Institution* (*Scottish Provident*)[115] (and before the introduction of the General Anti-Abuse Rule (GAAR)),[116] the importance of the law being clear even if it is not always certain is emphasised:

> "It is questionable whether their Lordships have achieved their expressed aim of clarification in *BMBF* and in the accompanying opinion in *Scottish Provident*. Despite their intention of producing *clarity* it should be noted that their Lordships do not purport to be aiming at *certainty*. For obvious reasons, *certainty*, in the sense of a precise road map for those designing tax avoidance schemes, would not be desirable.[Footnote omitted] What is needed is *clarity* in the sense of knowing the principles to be applied and their constitutional source and authority."

It is suggested that the central problem with the approach taken by the Court of Appeal in *Ardmore CA*,[117] when excised from the facts of *Ardmore* and projected onto other real-world scenarios, is that clarity seems a more distant goal. If every factor is relevant, then absent some means of attaching weight to those factors or an objectively rationalised methodology, the application of the multifactorial test seems to be in danger of being reduced to the outcome of a particular process (carried on by the relevant FTT).

Where next?

The dangers of the approach signposted by the Court of Appeal's judgment in *Ardmore CA*[118] should now be apparent: a "practical person", identifying a "practical hard matter of fact", has never made a constructive contribution to South African tax law relating to source; the alternative route preferred by the South African courts from *Overseas Trust*[119] (via *Lever Brothers*[120]) until

[113] *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd* [2001] UKHL 6 at [58].
[114] *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UKHL 51.
[115] *IRC v Scottish Provident Institution* [2004] UKHL 52.
[116] See J. Freedman, "Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament" (2007) 123 *Law Quarterly Review* 53, 62–63.
[117] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.
[118] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.
[119] *Overseas Trust*, above fn.56, 1926 AD 444.
[120] *Lever Brothers*, above fn.22, 14 SATC 1; [1946] AD 441.

legislative intervention in 2011 proved unfit for purpose; and the Australian Federal Court has recently found it necessary to look to a "proximate cause" test to address perceived shortcomings in the "practical hard matter of fact" test.

What, then, is the alternative? It is suggested that two alternative approaches may constructively be considered, each of which is examined below.

Statutory reform

One approach which could provide greater clarity would be to revisit a proposal floated by the Inland Revenue in a 2003 consultative document, *Income tax: Meaning of UK Source for Payments of Interest and Royalties* (the Consultation Document)[121] which raised the possibility of the introduction of a statutory definition of a UK source of interest. The Consultation Document noted[122]:

> "The current tests…are unclear and cause confusion. The statutory rules date back a long way and do not take account of modern financial practice. They have been subject to judicial interpretation, which has not always been easy to apply in practice."

At that time, the proposal was to introduce a general definition of the source of interest in line with that which applies for the purposes of the Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (the Interest and Royalties Directive), namely the residence of the payer or of the branch of the payer making the payment.[123] When the time came to introduce the Finance Bill 2004 this proposal failed to make the cut. However, the world has moved on since then.[124] As noted above, South Africa has adopted a statutory definition of source drawing upon OECD principles and, given the Government's enthusiasm for the BEPS Project evidenced by a host of measures from the hybrid mismatch rules to the amendment made by the Finance Act 2019 to the definition of "permanent establishment",[125] it would seem consistent with an openness to adopting OECD principles to adopt an OECD blessed statutory definition of source. Moreover,

[121] Inland Revenue, *Income tax: Meaning of UK Source for Payments of Interest and Royalties* (Inland Revenue, 10 December 2003).

[122] Consultation Document, above fn.121, para.1.1.

[123] Consultation Document, above fn.121, paras 4.1 and 5.1. 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 [2003] OJ L157/49 Art.1(2) provides that a payment made by a company or permanent establishment resident in a Member State is deemed to arise in that state.

[124] Albeit, not always helpfully. The approach taken by the European Court of Justice in *N Luxembourg 1 and others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) EU:C:2019:134 may be thought to have muddied the water too much for the Interest and Royalties Directive, above fn.123, at least as construed by the European Court of Justice in those conjoined cases, to serve as a model for UK domestic legislation.

[125] FA 2019 s.21. HM Treasury, *Finance (No. 3) Bill Explanatory Notes* (7 November 2018), 86, para.12, states: "This clause is an outcome of the OECD and G20 programme to tackle the erosion of the tax base by multinationals. It deals with their avoidance of permanent establishment by the splitting up of activities between locations or between related parties to take advantage of the exemption for preparatory or auxiliary-type activities. It makes effective the same change to the UK's tax treaties which the UK has adopted through the Multilateral Instrument and which took effect on 1 October 2018." For further evidence of the UK Government's enthusiasm for the OECD's BEPS Project, published just before this article went to press, see HM Government, *The Future Relationship with the EU: The UK's Approach to Negotiations* (CP211, 27 February 2020), 21 at para.79.

the development since 2003 of a more muscular approach to statutory construction heralded by the House of Lords judgment in *BMBF*[126] and the introduction of a GAAR ought to provide HMRC with considerable reassurance that the scope for abuse of a statutory definition should be minimal.

Guidance from the courts

Given the amount of ink spilt over the years attempting to read the runes in Lord Hailsham's judgment in the *National Bank of Greece HL* case,[127] and for lack of a better starting point, the nub of his judgment, it is suggested, lies in the following short passage:

> "In my view, the bond itself is a foreign document, and the *obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document*."[128] (Emphasis added.)

This approach starts, therefore, with the obligation itself and leads to the document (and, presumably, the terms of the obligation) leaving one to discern how that document should be read. The reasoning appears to have been that, where interest arises from an obligation, the question of whether the interest falls within Schedule D Case III depends on where that obligation is located. The basic premise could be said to be that the "source" of the interest is the obligation itself.

Lord Hailsham's starting point, as he stated, was that some territorial limitation must apply following the principle set out by Lord Herschell in *Colquhoun v Brooks*[129]:

> "The Income Tax Acts, however, themselves impose a territorial limit, either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there."

Lord Hailsham identified the key question as being[130] "whether or not the source of the payments by the [successor guarantor]…was…situated within the United Kingdom" and concluded that, on the facts, the "source of the obligation in question" (which he took to be the obligation of the principal debtor to make payments of interest under the bonds) was situated outside the UK.

This focus on the source of obligation appears to have been, at least implicitly, accepted by the Court of Appeal in *Ardmore CA* when Arden LJ stated that "[t]he *immediate* search is for the source of the interest *rather than* a search indirectly for the source of the loan"[131] (emphasis added).

[126] *BMBF*, above fn.114, [2004] UKHL 51.
[127] *National Bank of Greece HL*, above fn.8, [1971] AC 945.
[128] *National Bank of Greece HL*, above fn.8, [1971] AC 945 at 955. The UT was of the view, in *Ardmore UT*, above fn.18, [2015] UKUT 633 (TCC) at [29], that Lord Hailsham was, in this sentence, "emphasising that the source had not changed" as a result of the change in guarantor and that he is to be understood as saying "not that the nationality of the loan instrument falls to be ascertained by reference to all relevant factors, but that it is the source of the obligation that must be so ascertained".
[129] *Colquhoun*, above fn.39, (1889) 2 TC 490 at 499H.
[130] *National Bank of Greece HL*, above fn.8, [1971] AC 945 at 954.
[131] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [42].

It seems that once this is accepted, it is difficult, even if it were desirable to do so, to escape from the basic question of construction posed by UK statute so as to move, for example, to a more general discussion of "what is the source of the credit?" However, the rather more fundamental point this raises is that a "practical" view (here in the sense of "realistic view" as required by *BMBF*[132]) of all the factors bearing on the source of an obligation invites consideration of legal concepts and, indeed, requires a balanced understanding of those legal concepts.

Bringing the analysis back to core legal concepts is important because those concepts necessarily provide the foundation for any "practical" assessment of the source of an obligation (which is, itself, inherently a "legal" concept because it carries with it the connotation that an obligation is something that the law will enforce). Recognising the importance of concepts that have been developed through their use in the courts can offer rigour (and a structure) by virtue of which the law can be (as surely it ought to be) clear (if not, necessarily, always quite certain). Such an approach requires, as the House of Lords put it in *BMBF*, an unblinkered approach to the analysis of the facts when asking the ultimate question, which is "whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically".[133]

An obvious place to look for such a legal concept lies in the private international law approach to the residence of the debtor. Ever since the *National Bank of Greece HL* case,[134] the courts have flirted with this type of approach. Private international law principles were, for example, cited before the Court of Appeal in *Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA*[135] itself and, indeed, in *Lever Brothers*[136] Watermeyer CJ considered and then rejected such principles. Furthermore, in November 1993[137] the Inland Revenue identified the debtor's residence as one of four of the most important factors determining residence and HMRC's SAIM Manual,[138] prior to amendments made in June 2019 in response to the Court of Appeal's judgment in *Ardmore CA*,[139] listed "residence" as being a "principal" factor (a view which at every stage of the proceedings Counsel for HMRC, ultimately successfully, sought to persuade the Tribunals and Court of Appeal not to endorse). However, the extent to which this resistance is well conceived may, it is suggested, be open to question on four fronts.

First, if the starting point as a matter of statutory construction is how to answer the question "what is the source of an obligation to pay interest", there seems to be a natural logic in drawing on the approach taken by the general law to such a question and, therefore, to the private international law concept of "residence".

[132] *BMBF*, above fn.114, [2004] UKHL 51.
[133] *BMBF*, above fn.114, [2004] UKHL 51 at [36], referring to Ribeiro PJ in *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46 at [35]: "[T]he driving principle in the Ramsay line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically."
[134] *National Bank of Greece HL*, above fn.8, [1971] AC 945.
[135] *National Bank of Greece CA*, above fn.39, [1970] 1 QB 256.
[136] *Lever Brothers*, above fn.22, 14 SATC 1; [1946] AD 441.
[137] Revenue Interpretation, RI 58; originally published in the *Inland Revenue Tax Bulletin*, "Meaning of 'Source'", Issue 9, November 1993.
[138] HMRC, SAIM, above fn.6.
[139] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438.

Secondly, HMRC's (and, prior to 2005, the Inland Revenue's) approach to "residence" for many years showed a tendency to confuse "residence" with "enforcement", as evidenced by the Inland Revenue's reference in November 1993 to the "the residence of the debtor, i.e. the place in which the debt will be enforced".[140] The position was explained back in 1931 by Romer LJ in *Deutsche Bank und Disconto Gesellschaft v Banque des Marchands de Moscou* where he described the position as follows[141]:

> "The reason for assigning this locality to a simple contract debt was that the place where the debtor resides was in nearly every case the place where it was recoverable. Even in earlier times, it might, of course, occasionally have happened that judgment could be obtained against a debtor in a country where he did not reside. But it was probably thought desirable for the sake of uniformity to adopt in all cases the test of residence rather than the test of recoverability."

This dictum encapsulates the point which emerges from the authorities, that the principal test for the situs of a debt is the residence of the debtor (rather than the place where the debt may be enforced). As Romer LJ observed, the place of enforceability may originally have been the rationale for taking the debtor's residence as the applicable criterion, but residence of the debtor, rather than place of enforceability, has become the governing principle.[142] More recently, in *Société Eram Shipping Co Ltd and others (Respondents) v Hong Kong and Shanghai Banking Corp Ltd (Appellants)* (*Société Eram Shipping Co Ltd*)[143] Lord Hobhouse, in a passage subsequently reaffirmed by the Supreme Court,[144] explained the relationship between situs and residence (which renders situs incapable of being applied independently of residence) thus[145]:

> "In the present case there is no dispute that the *situs* of the relevant debt is Hong Kong and not England.…But it is still necessary to understand why this is so. Stirling L.J. in *Martin v Nadel* [1906] 2 KB 26 at 31, like others before and since, found it most appropriate to refer to the work *Dicey: Conflict of Laws*. I will do the same, using the 13th edition (2000).[146]
>
> Rule 112 states that 'choses in action generally are situate in the country where they are properly recoverable or can be enforced'. The text amplifies this in relation to debts, saying, 'a debt is [generally] situate in the country where the debtor resides.…It may not, however, be the only place: English courts may take jurisdiction against non-residents on the basis of temporary presence', or under the CPR or the Brussels or Lugano Conventions. Nevertheless, this possibility does not make the debt situate in England if the debtor is not

[140] Revenue Interpretation, RI 58, above fn.137.

[141] *Deutsche Bank und Disconto Gesellschaft v Banque des Marchands de Moscou* 14 December 1931 (158 LT 1115-1116) (CA) as quoted by Roxburgh J in *Re Banque des Marchands de Moscou (Koupetschesky) (No.2)* [1954] 2 All ER 746; [1954] 1 WLR 1108 (Ch).

[142] See also L. Collins and R. Harris (eds), *Dicey, Morris and Collins on the Conflict of Laws*, 15th edn (London: Sweet and Maxwell, 2012), para.22-029.

[143] *Société Eram Shipping Co Ltd and others (Respondents) v Hong Kong and Shanghai Banking Corp Ltd (Appellants)* [2003] UKHL 30; [2004] 1 AC 260 at 287–288 per Lord Hobhouse.

[144] *Taurus Petroleum Ltd (Appellant) v State Oil Marketing Co of the Ministry of Oil, Republic of Iraq (Respondent)* (*Taurus Petroleum Ltd*) [2017] UKSC 64 at [30].

[145] *Société Eram Shipping Co Ltd*, above fn.143, [2003] UKHL 30 at [71]–[72]; [2004] 1 AC 260 at 287–288.

[146] L. Collins (ed.), *Dicey and Morris on the Conflict of Laws*, 13th edn (Sweet & Maxwell, 2000).

resident here. But, generally speaking, 'for the purpose of determining situs, a corporation is resident wherever it carries on business': pp.925-926).

'Where…the debtor has two or more places of residence and the creditor either expressly or impliedly stipulates for payment at one of them, then the debt will be there situate. This refinement is important in connection with bank accounts where (as in English law) under the applicable law of the contract between banker and customer the bank's obligation to repay is performable primarily at the branch where the account is kept, and accordingly in such a case all accounts kept at a particular branch are to be held there situate….Where the debtor has more than one place of residence but there is no express or implied promise to pay at any one of them then the debt is situate at that place of residence where it would be paid in the ordinary course of business.' (pp.926-927)"[147]

Thirdly, private international law has itself matured.[148] The current rules dealing with conflicts of jurisdiction, at least as between EU Member States, are set out in Regulation 1215/2012/EU on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.[149] Regulation 1215/2012/EU provides that "domicile" is the main ground for jurisdiction and the editors of the 15th edition of *Dicey, Morris and Collins on the Conflict of Laws* suggest that it is appropriate to interpret the test of residence, as applied in determining *situs* of debts, so as to take account of any developments in the law on choice of jurisdiction.[150] So, in short, there is a well-established body of case law identifying the place where a debtor is resident as the place where an obligation is located. Hence it is suggested that this is at least a very helpful starting point, where an obligation is to pay interest, for the purposes of determining the source of that interest.

Fourthly, the modern approach taken by private international law to ascertaining residence is not dictated by a rigid formalism, but by substantive considerations[151] and, therefore, looks to

[147] This, it is suggested, represents a much more logical and appealing approach than that pressed on the Court of Appeal by HMRC's Counsel in *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438, where it was suggested that dual residence should lessen the weighting given to the debtor's residence in determining the source of an interest payment.

[148] The impact of Brexit is not (as of late February 2020) known. However, Withdrawal Agreement Art.67(2)(a) published by the HM Government and presented to Parliament on 19 October 2019 (HM Government, *Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community* (19 October 2019)) provided that in the UK, as well as in the Member States in situations involving the UK, Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters [2012] OJ L351/1 (Regulation 1215/2012/EU), should "apply to the recognition and enforcement of judgments given in legal proceedings instituted before the end of the transition period, and to authentic instruments formally drawn up or registered and court settlements approved or concluded before the end of the transition period". This does not address the position where legal proceedings are not begun before the end of the implementation period (prospectively, 31 December 2020). However, the European Union (Withdrawal) Act 2018 ss.2–7 (and, in particular, s.3) (as amended by the European Union (Withdrawal Agreement) Act 2020) seem designed to enable English law to remain substantively unaltered from the position established under the aegis of Regulation 1215/2012/EU where a conflict arises in relation to jurisdiction and needs to be resolved on or after "exit day".

[149] Regulation 1215/2012/EU, above fn.148, deals with choice of jurisdiction, rather than choice of law, by the court which has jurisdiction (which is the question that has been answered, in past case law, by looking at the situs of a debt based in turn on the residence of a debtor).

[150] Collins and Harris (eds), *Dicey, Morris and Collins on the Conflict of Laws*, 15th edn, above fn.142, para.22-032.

[151] By way of example, see *Taurus Petroleum Ltd*, above fn.144, [2017] UKSC 64 where the Supreme Court overruled a prior decision by the majority of the Court of Appeal in *Power Curber International Ltd v National Bank of Kuwait*

factors which are not apt to be distorted for the purposes of contrived abuse and thereby "go with the flow" of tax law in recent years. This can perhaps best be illustrated by the approach taken by the courts to dual residence, not least because this was considered by the Court of Appeal in *Ardmore CA*: Counsel for HMRC put it to the Court of Appeal in *Ardmore CA* that dual residence ought not to detract from the relevance of "residence" because where dual residence occurs this can be reflected in the weighting accorded to that factor; a view with which Arden LJ appeared inclined to agree, expressing the view that this was "consistent with an approach based on a commercial basis rather than on legal factors".[152] However, the private international law approach that where a debtor has more than one place of residence but there is no express or implied promise to pay at any one of them, then the debt is situated (and the debtor is treated as being resident) where that debt would be paid in the ordinary course of business, seems a rather sensible way of resolving such a question in relation to dual residence (at least in the case of a financial institution offering its customers accounts in different jurisdictions).

If "residence" is allowed to serve as a starting point, the question that this leaves unanswered is to what extent other factors should be taken into consideration, and, for that, no simple answer presents itself. But, as should be apparent from what has been said above, delegating the responsibility for identifying source as a "practical hard matter of fact" to a "practical person" is more of an unhelpful distraction than a panacea.

Conclusion

To the extent that the "practical approach", and the treatment of source, as a "practical hard matter of fact" is taken to be fairly much synonymous with the view of the "practical man" referred to by Isaacs J in *Nathan*,[153] that practical man (prior to *Ardmore CA*) may be said to have originally sported an Australian domicile, then emigrated to South Africa by the mid-1920s and finally passed away (at least as a diviner of the source of interest) on 1 January 2012. His substantive achievements in South Africa, other than as a Loki-like spreader of confusion, were non-existent despite a number of attempts to find a gainful use for his talents, whether as a benign patron of, or as a moderating influence on, the otherwise potentially unfair consequences of the doctrine of "originating source" adopted by the South African courts in *Lever Brothers*[154] (and subsequently refined by reference to the concept of a "dominant" source). Eddie Broomberg SC, referring to what he termed the "meme merchants" who handed down South African income tax judgments from the late 1960s to the early 1980s,[155] concluded that

> "…this generation of jurists proved to be the master of the catchphrase, coining or purloining aphorisms which sometimes virtually assumed the status of legal principal…
>
> Some of these juristic maxims are not home-grown…

SAK [1981] 1 WLR 1233 and held, unanimously, that the *situs* rule is no different for a letter of credit than it is for any other debt.

[152] *Ardmore CA*, above fn.1, [2018] EWCA Civ 1438 at [30].

[153] *Nathan*, above fn.85, [1918] HCA 45; 25 CLR 183.

[154] *Lever Brothers*, above fn.22, 14 SATC 1; [1946] AD 441.

[155] E. Broomberg SC, "A century of income tax jurisprudence in South Africa" in Hattingh, Roeleveld and West, above fn.48, 202–203.

> …these aphorisms may be downright misleading, such as the frequently quoted observation by Isaacs J. in *Nathan v F. Commissioner of Taxes*, to the effect that the source of a given amount of income is a 'practical hard matter of fact'. A moment's reflection will reveal that in reality it is none of those things; it is a fuzzy rather than a hard concept and as long as the approach…in *Lever Brothers* holds good, namely that the origin of all income must be attributed to the services rendered by the taxpayer, it is certainly not practical."

It is a further reflection of the difficulties created by the approach advocated by Isaacs J that other commentators, seeking to draw upon the subtle differences in the arguments of each of the judgments handed down in *Lever Brothers*,[156] have argued that the "practical man" principle should be applied not in lieu of legal theory, but to restrain its unbridled use when unjust results would ensue.[157]

It is, hopefully, apparent from what has been said above that a focus on a "practical hard matter of fact" is not required as a matter of authority following the *National Bank of Greece HL* case,[158] that to seek to rely upon the viewpoint of a "practical person" is to ignore the experience gained (painfully, as South African case law indicates) in South Africa as well as in Australia, and (if the law is to provide clarity) is not to be recommended. ☙

[156] Foreshadowed, perhaps, by Davis AJA's observation that "the person whom Lord Atkin had in mind was the practical man and not the legal theorist who, by resolutely shutting his eyes to all the facts, could prove that black was white": *Lever Brothers*, above fn.22, [1946] AD 441; 14 SATC 1 at 23–24.
[157] E.M. Stack, D. Grenville, R. Poole, H. Harnett and E. Horn, "Commissioner for Inland Revenue v Lever Brothers: A practical problem of source" (2015) 19 *South African Business Review Special Edition Tax Stories* 161.
[158] *National Bank of Greece HL*, above fn.8, [1971] AC 945.

☙ Australia; Comparative law; Income tax; Interest; Loans; Place; South Africa

Book Reviews

Selectivity in State Aid Law and the Methods for the Allocation of the Corporate Tax Base, by J. Monsenego, (Kluwer Law International, 2018), 272pp., £111, ISBN: 978-90-411-9413-8.

The "State of Nature" is a concept used by philosophers to imagine a time before civil society as part of a thought experiment. For instance, were we to start from a State of Nature, what would we think most essential to sustaining society? Most notably in a State of Nature, there is no government. A State of Nature then is the free-est of free markets: there is no state intervention here in the provision of goods or services.

We do not live in a State of Nature. We have governments and we have markets, but it is fundamentally incorrect to view these as mutually exclusive. Where governments act, markets respond. Where markets act, governments respond. Markets cannot be sustained without government assistance and protection, whilst governments cannot function without the receipt of taxes generated by markets. The relationship is symbiotic. But if competition between private actors is taken to be a desirable objective, it follows that government intervention should be in some way limited.

At an international level there is good reason meanwhile to regulate such market intervention: without regulation of some sort, governments would freely give advantages to favoured actors and sectors thereby undermining the process of competition and ultimately leading to a race to the bottom as governments strive to out-intervene each other.

Against this background, state aid rules have been agreed upon at the international level to regulate, but not eliminate, government intervention in the market. Member States of the EU are bound by the state aid provisions to be found in Articles 107 and 108 of the Treaty on the Functioning of the European Union.

As tax is a means by which governments can intervene in the market, it should come as no surprise that the EU state aid rules limit the sovereignty of Member States to design their own tax policies. In recent times it has become abundantly clear that Member States will be limited in respect of how they administer these policies also. Where states act in relation to tax, there will be those actors that are advantaged and those that are disadvantaged. The state aid rules then cannot function so as to eliminate disparity in treatment. Instead, the EU state aid rules try to find a line between those interventions by the state that are legitimate (for instance, tax relief which is open to all) and those that are not (such as tax relief which is available only to one particular operator). The line is principally drawn by the test for "selective advantage",[1] wherein three questions are asked[2]:

[1] See for instance R. Mason, "An American View of State Aid" (2017) 157 *Tax Notes* 645, 655–660; J.L. Buendía Sierra, "Finding Selectivity or the Art of Comparison" (2018) 17(1) *European State Aid Law Quarterly* 85, 85.

[2] *Adria-Wien Pipeline GmbH v Finanzlandesdirektion für Kärnten* (C-143/99) [2001] ECR I-8365 at [41]–[42]. Technically, this formulation conflates the distinct tests for "advantage" and "selective" (*European Commission v MOL Magyar Olaj- és Gázipari Nyrt* (*MOL Magyar*) (C-15/14 P) EU:C:2015:362 (ECJ, 4 June 2015) at [59]), but that is not important for present purposes.

- What is the reference framework?
- Has there been a deviation from this framework through the favouring of certain undertakings or the production of certain goods in comparison with other undertakings which are comparable in light of the objective pursued by the measure?
- Is any deviation nevertheless justified by the nature or general scheme of the tax system of which it is part?

The second question conflates the distinct notions of "advantage" and "selectivity",[3] as an advantage arises where there is favouritism by reason of a departure from the "normal" regime, whilst selectivity arises where this advantage discriminates between similar undertakings.

The recent book from Jérôme Monsenego, *Selectivity in State Aid Law and the Methods for the Allocation of the Corporate Tax Base*, seeks to investigate how the test for selectivity manifests itself in respect of the methods for the allocation of the corporate tax base. As Monsenego correctly identifies early in his book: "[I]t remains difficult to precisely determine where and how to draw a line between general and selective tax measures".[4] Given the marriage between these difficulties in delineating the boundaries of the selectivity test and the ongoing debates about the future direction of corporation tax, Monsenego's study is timely.

At the heart of the book is a simple proposition: that inherent in the EU state aid rules is the principle of equal treatment: equality of treatment of those undertakings that are in a comparable position. The breadth that is given to the scope of comparable undertakings is critical as it impacts directly on the sovereignty of Member States to design and administer their own tax policies: the broader the scope, the narrower the range of options for Member States and vice versa. But comparability does not, and indeed could not, arise in the abstract and must be tethered to some objective that is pursed by a measure. In the case of corporate income tax, Monsenego assures us that the objective is to tax the net income of corporations, reminding the reviewer of Lord MacNaghten's notorious quip in *London CC v Attorney General* that the "income tax, if I may be pardoned for saying so, is a tax on income".[5] As the objective is to tax corporate income, then the relevant comparators for the purpose of state aid analysis must, as a starting point, be those entities that are subject to corporate income tax. Monsenego to that end contends that despite obvious differences, members of multinational enterprises, independent enterprises and members of domestic groups are in a comparable situation (assuming that they all have a commercial objective).

There is a subtle point hidden here: on the face of it, Monsenego is proposing that the EU state aid rules complement the non-discrimination principle inherent in the rules on free movement. But Monsenego's thesis, by focusing on the objective of corporate income tax, avoids the principal shortcoming of a pure discrimination analysis, which is that there is no discrimination where there is simply no tax. By insisting that the objective must be to tax corporate income, the state aid rules insist that there is in fact a tax.

[3] *MOL Magyar* (C-15/14 P), above fn.2, EU:C:2015:362 at [59].
[4] J. Monsenego, *Selectivity in State Aid Law and the Methods for the Allocation of the Corporate Tax Base* (Alphen aan den Rijn: Kluwer Law International, 2018), 7.
[5] *London CC v Attorney General* [1901] AC 26 (HL) at 35.

If nothing more then, this book accordingly highlights the critical importance of what is designated as the objective of the measure as well as the resulting scope of comparability in state aid assessment.

But the book does offer much more. Comparability is analysed in respect of three tests for the allocation of the corporate tax base: the arm's length principle; transfer pricing safe harbours; and systems of formula apportionment. The forensic analyses of these methods of allocation lead to important findings. First, each of these methods contains features which give rise to selectivity issues. Secondly, the least problematic method is the transfer pricing safe harbour that implements the arm's length principle. It is less problematic even than a generally formulated arm's length provision, due to its strong connection to the effects on the open market (which are at times purposefully ignored in the case of a multinational enterprise using the arm's length principle). Thirdly, a general system of formula apportionment with firm-specific factors is most likely prima facie selective.

Chapter 1 gives important background detail on the law and the importance of the research questions. Chapter 2 proceeds to investigate the scope and nature of the reference framework when it comes to the corporate income tax and includes a robust argument that the *Forum 187*[6] case does not elevate the arm's length principle into an autonomous principle of EU law. Chapter 3 assesses the relevance of the "Market Economy Operator Test" concluding that it "cannot oblige the Member States to include in their domestic tax laws a given allocation method".[7] Further, this test and the arm's length principle are not the same, as the peculiarities of states, on the one hand, and of integrated but private multinational groups, on the other hand, place them in different positions.[8] Chapter 4 elaborates upon the comparability analysis. Monsenego identifies the corporate income tax as the relevant reference system and thus the comparability of undertakings takes place in light of the objective of this tax. Of course, one could push back against Monsenego and ask why the reference framework should be corporate income tax at all; could it not instead be the taxes that are imposed on business profits? The objective of the system of business taxation, it follows, is to tax the net income of businesses regardless of legal classification. The comparators would not just be incorporated and unincorporated entities that are subject to corporation tax, but also sole traders and partnerships for instance. Monsenego would no doubt in response point to the long line of jurisprudence to support his choice of the reference framework where corporate income tax is involved and indeed, without engaging in the particular argument advanced by the reviewer here, he does engage at length with the relevant cases that could be used to support his identification of corporate income tax.[9]

The assessment of the prima facie selectivity of the different allocation methods takes place in Chapter 5 (generally formulated arm's length provision), Chapter 6 (transfer pricing safe harbours) and Chapter 7 (formula apportionment with firm-specific factors). Chapter 8 meanwhile considers the application of the justification and proportionality tests to these methods of allocation, whilst Chapter 9 finally summarises the findings in the book.

[6] *Kingdom of Belgium and Forum 187 ASBL v Commission of the European Communities* (Joined Cases C-182/03 and C-217/03) [2006] ECR I-5479.
[7] Monsenego, above fn.4, 62.
[8] Monsenego, above fn.4, 71.
[9] Monsenego, above fn.4, 75–82.

Notably, the book purposefully is not focused on the recent state aid cases which concern tax rulings provided by the tax authorities of Member States to multinationals. To the extent that these cases are engaged in this study it is insofar as they arise organically. For instance, the book highlights the intrinsic features of the arm's length principle which are problematic from a selectivity perspective and the difficulty in elevating it into an autonomous principle of EU law. Choosing not to engage in depth with these tax ruling cases is to be commended, as it is not as if the academic world is light on material covering them!

The study is of critical relevance to the lawmakers who need to reconcile the imperatives of state aid law with tax policy design, as well as those tasked with applying the state aid rules to tax provisions. It is a seriously worthwhile contribution to a rapidly developing area where reflection (and in this case 211 pages of rich analysis) on the fundamentals of the selectivity test is very much merited.

Stephen Daly

Transfer Pricing and Intangibles, by M. Lang, A. Storck, R. Petruzzi and R. Risse (eds), (Linde, 2019), 158pp., €58.00, ISBN: 978-3-7073-4032-7.

This book is based on papers presented and discussed at the Transfer Pricing Symposium in October 2018 at the Institute for Austrian and International Tax Law (WU) in Vienna.[1] As the title of the symposium suggests,[2] the contributing authors examine important topics relating to intangibles which affect transfer pricing practices.

The book comprises of just four chapters which contain not just academic analysis but also case studies and a useful summary of conference proceedings. Each chapter is divided into two parts and each part is written by different authors. The first part of each chapter tackles the topic from a more academic perspective offering textbook analysis, whilst the second part of each chapter focuses on the symposium's panel discussions of the topic.

The first chapter gives a very thorough overview of the concept of intangibles and what it covers especially in the post-BEPS world. The analysis is then followed by practical analysis based on the case study which was discussed at the symposium, as well as other recent case law. In referring to the panel discussion, the views of tax authorities, advisors, participants and MNEs are anonymously set out, in what seems to be a refined version of the transcripts. The same innovative (to the reviewer) approach is followed in subsequent chapters. Chapter 2 deals with the attribution of intangible-related returns, whilst Chapter 3 deals with the structuring of intangibles. The last chapter considers the valuation of intangibles and focuses on hard to value intangibles.

Although this area is very technical and contains many uncertainties, the authors of each chapter manage to give a very succinct and comprehensive account of the important issues pertaining to each topic. The format is also unique as it combines academic analysis and conference reporting. Notwithstanding the fact that this is a relatively small book, it contains

[1] WU Transfer Pricing Symposium, *Transfer Pricing and Intangibles: Current Developments, Relevant Issues, and Possible Solutions* (Vienna: WU, 29 October 2018).
[2] *Transfer Pricing and Intangibles: Current Developments, Relevant Issues, and Possible Solutions*, above fn.1.

invaluable knowledge and is likely to provide a very useful point of reference for tax academics and practitioners.

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