Analysis

Can the UK CFC rules survive the EC's state aid investigation?

Speed read

The UK's current CFC rules were created in the light of decisions of the CJEU and EFTA Court, which suggested that in most cases involving EEA subsidiaries it will be unlawful for the then existing CFC rules to apply at all. However, the European Commission has now opened a state aid investigation into the CFC rules on the basis that they and, in particular, the group financing exemptions are too generous. If the Commission concludes that the exemptions constitute unlawful state aid, UK-headquartered multinationals which have benefited from the exemptions could face significant liabilities for historic periods. Potentially affected groups may wish to take immediate steps to protect their position.

David Harkness
Clifford Chance
David Harkness is a partner at Clifford Chance. He specialises in corporate and finance tax, advising on the tax aspects of a variety of mergers and acquisitions, corporate, commercial and financing transactions, corporate restructuring, international planning and disputes. Email: david.harkness@cliffordchance.com; tel: 020 7006 8949.

Dan Neidle
Clifford Chance
Dan Neidle is a partner at Clifford Chance, specialising in the UK and international tax treatment of corporate and financial transactions. He has particular experience advising on restructurings, corporate and portfolio disposals, acquisition and structured finance transactions. Email: dan.neidle@cliffordchance.com; tel: 020 7006 8811.

Rob Sharpe
Clifford Chance
Rob Sharpe is an associate in the tax department at Clifford Chance. He advises a wide range of domestic and overseas clients on aspects of UK, EU and international tax law, including finance and corporate transactions, tax regulatory matters and tax investigations and disputes. Email: robert.sharpe@cliffordchance.com; tel: 020 7006 2987.

For over a decade, the scope of the UK's controlled foreign companies (CFC) rules has been shaped (and reshaped) by the requirements of the EU treaties and institutions.

In *Cadbury Schweppes* (Case C-196/04), the CJEU considered the compatibility of the pre-2013 CFC rules with the EU freedom of establishment. It held that member states are prohibited from restricting the exercise of the freedom of establishment by one of its nationals in another member state, unless such restriction is specifically targeted at 'wholly artificial arrangements' which do not reflect economic reality and are conducted with a view to escaping the tax normally due on profits generated. The court explained that such a restriction must be narrowly tailored so that it goes no further than necessary to achieve that purpose; and that, therefore, in order for CFC rules to be compliant with EU law, they must not tax a CFC which is actually established in another EU member state and conducting genuine economic activities there. The significance of the CJEU's formulation of the 'wholly artificial arrangements' test is that this is a very low bar. A pure letterbox company would be at risk but any company with premises and staff should be safe.

In *Fred Olsen* (E-3/13 and E-20/13), the Court of Justice of the European Free Trade Association States (EFTA Court) confirmed that the *Cadbury Schweppes* jurisprudence also applies in respect of CFCs established in an EEA jurisdiction.

Following *Cadbury Schweppes*, the UK Court of Appeal permitted the pre-2013 CFC rules to continue to apply by 'reading in' an additional exemption from the CFC charge for companies which were actually established in another member state and carrying on genuine economic activities there (*Vodafone 2* [2009] STC 1480).

The UK government's response to these cases was to introduce new ss 751A and 751B into ICTA 1988. These provided for a reduction in chargeable profits for certain activities undertaken in other member states, though this statutory exemption was narrowly defined and differed from the *Vodafone 2* exemption. The partial nature of this remedy led the European Commission to issue a reasoned opinion to the UK (IP/11/606), explaining that in its view the government's legislative responses were inadequate as they failed to exclude all subsidiaries in member states which were not purely artificial and not involved in profit shifting transactions.

The UK government then published a consultation document in June 2011 (*Consultation on controlled foreign companies reform*), in which it proposed that a new 'general purpose exemption' would be introduced. As proposed, this would have considered whether there had been an artificial diversion of profits from the UK. This could in principle have been a reasonable proxy for the wholly artificial arrangements limitation required by EU law, though the detailed conditions to meet the exemption still meant that the net would arguably have been cast too widely. The condoc sought to justify this on the basis that the UK government considered CFC cases such as *Cadbury Schweppes,* and transfer pricing cases such as *Thin Cap GLO* [2011] STC 738 and *SGI* (Case 311/08), to constitute one body of anti-tax avoidance case law. As previous articles have explained ('Fatally flawed? Does *SCA Group Holding* hole the UK CFC rules below the waterline?', *Tax Journal*, 27 June 2014), this position looked untenable in light of the strong endorsement of *Cadbury Schweppes* by the CJEU in *SCA Group Holding BV and others* (Cases C-39/13, C-40/13 and C-41/13).

When the CFC regime was finally reformed in 2013, the proposal for a general purpose exemption was dropped. The new rules sought to reach an acceptable compromise position between the UK's desire to effectively tax CFC profits and the limitations imposed by the CJEU's case law by providing a series of exemptions for certain types of CFC income. The general principle is that all income of a CFC is brought within the scope of the CFC charge if it falls within a charging 'gateway', and is not subject to a specific exemption. Viewed together, these exemptions should cover many, but not all, arrangements involving genuine economic activities (as none of the exemptions tracks the requirements of *Cadbury Schweppes*).

Two specific exemptions relating to profits falling within the non-trading finance profits 'gateway' are included, each intended to benefit UK headquartered MNEs with a group treasury CFC:

- **The qualifying loan relationships exemption:** The first exemption (s 371ID) removes from the scope of the CFC charge three-quarters of the finance income arising on intra-group loans between non-UK members of a UK headquartered group, leaving an effective CFC charge at current corporation tax rates of 4.75% instead of 19% (subject to anti-avoidance provisions). The stated justification for this partial exemption was that it acts as a proxy for tracing the history of a multinational group's financing arrangements and determining what proportion of the finance was ultimately provided from the UK (see HMRC's *International Tax Manual* at INTM216100).
- **The qualifying resources exemption:** A complete exemption (s 371IB) was also introduced for groups able to show that their CFCs are not in any way funded by debt finance from the UK, and are funded entirely by their own local assets or new group equity capital.

As previously explained ('EU law, CFCs and the code of practice for banks', *Tax Journal*, 13 July 2012), this compromise position was plainly insufficient to meet the requirements of the CJEU in *Cadbury Schweppes*, and left the rules vulnerable to an EU law challenge on the basis that they unjustifiably treat intra-group transactions involving EEA subsidiaries as wholly artificial without affording the taxpayer an opportunity to rebut this with evidence.

HMRC is known not to share this view, but it is difficult to understand on what grounds. That no EU law challenge to the new rules appears to have resulted (yet) is not, in the authors' view, symptomatic of compliance with the freedom of establishment, but rather reflects the lack of economic incentive for many UK parented MNEs to litigate, given the low effective rate of charge on CFC finance profits. The Commission's latest intervention may well tip this balance in favour of litigation.

In the Commission's crosshairs

On 26 October 2017, the Commission published a press release explaining that it has opened an in-depth state aid investigation into what it called a 'UK tax scheme for multinationals', which concerned the group financing exemption (GFE) from the CFC rules. This exemption, the Commission explained, 'exempts from reallocation to the UK, and hence UK taxation, financing income received by [an] offshore subsidiary from another foreign group company'.

The investigation may have been prompted by the 'paradise papers' leaks concerning group financing via offshore conduits. Media coverage of the leaks has drawn attention to one structure in which loans to German group companies have been advanced from the UK via a company established in the Isle of Man. If conduit structures are the Commission's target, this is a narrow one, though the press release suggests a broader investigation in relation to the exemption.

Indeed, there is much uncertainty about what exactly the Commission is investigating, not least because the term 'group financing exemption' is not used anywhere in the CFC rules, and because the press release refers in some places to the GFE being a complete exemption and in other places to the GFE being a partial exemption. Accordingly, it is not altogether clear whether the Commission intends to investigate the qualifying loan relationships exemption or the qualifying resources exemption, though it is prudent to assume that it has both in its sights.

It is also not clear exactly why the Commission considers these exemptions to constitute unlawful state aid under article 107 of the Treaty on the Functioning of the European Union (TFEU). In order for this to be the case, among other conditions, the exemption would need to favour 'certain undertakings' when compared with other undertakings in a comparable factual and legal position in light of the objective pursued by the tax regime in question ('selectivity'). The criteria for defining the scope of comparable businesses are notoriously vague and arguably have been applied by the Commission to achieve widely varying outcomes from case to case.

The press release does not fully explain the basis on which the Commission considers the GFE to provide selective treatment, noting merely that a CFC's financing income is 'not (or only partially) reallocated to the UK for taxation due to the exemption'; and '[o]n the other hand, the CFC rules reallocate other income artificially shifted to offshore subsidiaries of UK parent companies to the UK for taxation'. This language suggests that the selectivity at hand is the differential treatment of a UK MNE with CFC financing income, which may be wholly or partly exempt from the CFC charge, compared with a UK MNE with other types of CFC income, which is not exempt from the CFC charge (by reason of the GFE). If this is the case, it could be argued that a UK MNE with a CFC group treasury company is simply not in a comparable factual and legal position to a UK MNE with another type of CFC.

It is in our view likely that the Commission has a broader view of selectivity in mind. In a series of recent decisions, the Commission and CJEU have defined aggressively broad categories of comparable businesses in state aid cases relating to tax. In various decisions concerning advance transfer pricing rulings, the Commission has treated multinational businesses as per se comparable to domestic businesses. In the recent *World Duty Free* (Case C-20/15) decision, the CJEU held that a Spanish tax exemption for investments in overseas (but not Spanish) companies was selective even though it was generally available to all Spanish businesses, contrasting the treatment of businesses investing in foreign companies against businesses investing in companies taxable in Spain. The tone of the press release suggests that the selectivity which the Commission has in mind could reflect this broader view, so that the selectivity in question is the treatment of multinationals able to reduce their overall tax burden by availing themselves of the GFE, compared with purely domestic businesses (which by definition, will not have CFCs) or other multinationals financing their group companies in other ways (which do not benefit from the GFE).

If the GFE is found to confer an advantage to some businesses over other comparable businesses (however those categories are defined), it can avoid being considered selective if the GFE is shown to be consistent with the 'nature or general structure' (or 'overall objective') of the relevant tax system. That will be the case if it pursues and implements an objective that is intrinsic to the tax system – such as the avoidance of double taxation or taxation according to ability to pay – but not if it has extrinsic aims. It could be argued that an overall objective of the current CFC rules is to tax offshore profits in a manner which is compliant with the freedom of establishment, and that the GFE does (to an extent) pursue this objective. The Commission is likely to take a different view, since the press release states that the 'general purpose' of the CFC rules is 'to prevent UK companies from using a subsidiary, based in a low or no tax jurisdiction, to avoid taxation in the UK', and the GFE exempts certain profits from the CFC charge.

Stuck in the middle

The history of the UK's CFC rules and the influence of EU law on them over time demonstrates that the GFE formed part of a package of measures in the revised 2013 CFC rules, which were intended to strike a compromise between the demands of the CJEU's freedom of establishment case law and the government's desire to protect the UK tax base. The UK government might reasonably feel aggrieved that after a decade of being told by the CJEU and the Commission that the UK CFC rules contravened EU law by applying too broadly, and attempting to act as a responsible member state by changing the law, it is now being accused by the Commission of having rules which apply too narrowly.

Moreover, if the GFE is found to constitute unlawful state aid, it is not entirely clear what the Commission expects the UK to do about it. Leaving the GFE as is would prolong the aid, and broadening the GFE to provide a complete exemption to all financing profits would exacerbate the aid. Removing the GFE would also not help, as this would subject a wide range of taxpayers conducting genuine commercial activities via a group treasury CFC in the EEA to the full UK CFC charge (at a current rate of 19%), hindering (more significantly) the freedom of establishment of a wider category of taxpayers. While strictly this would only be problematic where the CFC is established in an EEA member state, it is unlikely that many UK MNEs have genuine group treasury CFCs established outside the EEA, given withholding tax (and other) considerations. The UK is therefore in an impossible position.

The Commission ought to beware the law of unintended consequences. In the authors' view, the imposition of any CFC charge (whether at a full 19% rate, a partially exempt 4.75% rate, or a blend of the two) already breaches the freedom of establishment where the charge is referable to activities of an EEA-resident CFC which are not wholly artificial and do reflect economic reality (which will be the case for most or all group treasury companies). Freedom of establishment-based arguments would not, of course, be applicable where the CFC is established outside the EEA (such as the Isle of Man), though it is not impossible that free movement of capital-based arguments could be advanced. If the Commission concludes that the GFE constitutes unlawful state aid and the offending provisions are removed from the statute book, UK taxpayers with a profit-generating group treasury CFC conducting genuine activities in the EEA would find those profits effectively taxed at a 19% rate, unless and until the CFC rules are separately declared unlawful on freedom of establishment grounds (*Aer Lingus and Ryanair* (joined Cases C-164/15 and C-165/15), citing *Heiser* (Case C-172/03)). This is likely to provide affected taxpayers with a much more powerful incentive to litigate to secure a full exemption from the CFC rules, akin to that 'read in' in *Vodafone 2*. Ironically, such an outcome would arguably result in an even more substantial difference in treatment between multinationals and domestic enterprises.

Next steps and wider implications

The formal decision setting out the Commission's reasons for opening the investigation and the Commission's preliminary assessment should now have been sent to the UK government, and should be published in *The Official Journal of the European Union* within a matter of months. Both the government and interested third parties will then have one month from the date of publication to submit comments to the Commission. MNEs with UK parents which have benefited from the GFE to date should consider preparing comments now, in order to file their comments promptly within the deadline.

After receiving comments, the Commission will then conduct its in-depth investigation. There is no set time frame for completion of the investigation. While in many cases this has taken two to three years, this investigation is likely to be less fact dependent than others, and with Brexit fast approaching it is reasonable to assume the investigation may be concluded relatively quickly.

If the Commission concludes that the GFE constitutes unlawful state aid, the UK government would be required to recover the aid from the recipients of the aid. In practical terms, this means that UK taxpayers with offshore group treasury companies will be required to pay extra taxes on historic CFC finance profits, plus compound interest. The amount of extra taxes would be substantial, being the difference between the amount of CFC charge actually paid on the relevant CFC finance profits and the amount of CFC charge which would have been paid if those profits were not exempted by the GFE (i.e. the full CFC charge rate at the time). Brexit is unlikely to provide taxpayers with respite from these potential liabilities, since the EU's guidelines for negotiations make it clear that any trade agreement with the UK must 'ensure a level playing field, notably in terms of competition and state aid', and Theresa May has made reciprocal overtures. It is therefore prudent to assume that compliance with pre-Brexit state aid decisions will form part of any negotiated Brexit settlement.

However, it seems inevitable that any adverse decision from the Commission will be subject to an appeal by the UK to the CJEU. Whilst the UK is most unlikely to run a defence that imposing any CFC charge on EEA group financing companies is contrary to EU law, businesses facing a large retrospective tax bill will have no such qualms (and can be expected to intervene).

Ahead of this, there are protective steps that businesses with group treasury companies can be taking now:

- if they have any such companies outside the EEA, give consideration to moving them into the EEA;
- consider whether there is any question mark over the level of substance of these companies;
- submit comments for the Commission to take into account as part of its investigation (either on their own or as part of an industry body); and
- some businesses with potentially large retrospective tax exposure may wish to consider making a protective challenge on freedom of establishment grounds against the application of the CFC rules in respect of group treasury vehicles. ■

For related reading visit www.taxjournal.com

- Fatally flawed? Does SCA Group Holding hole the UK CFC rules below the waterline? (David Harkness & Robert Sharpe, 27.6.14)
- EU law, CFCs and the code of practice for banks (David Harkness & Robert Sharpe, 12.7.12)
- 20 questions on state aid and tax (Jonathan Hare, Stephen Morse & Peter Halford, 24.2.16)
- The consequences of unlawful state aid (George Peretz, 5.3.15)
- Tax rulings and state aid: why the Commission's approach is highly questionable (Conor Quigley, 6.10.16)
- Ten questions on the Apple state aid decision (Dominic Robertson & Isabel Taylor, 6.9.16)