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EUROPEAN COMMISSION TAKES AIM AT UK CFC TAX REGIME

The European Commission has opened an in-depth State aid probe into the group financing exemption under the UK's Controlled Foreign Companies (CFC) rules. An adverse finding at the end of the investigation, even if after the date of Brexit, could lead to the removal of the exemption, resulting in liabilities to pay extra tax for companies that have benefitted from it since its introduction in 2013.

However, previous Court of Justice of the European Union case law suggests that applying CFC rules within the EEA is contrary to the freedom of establishment unless the arrangements are "wholly artificial". This creates something of a paradox: the Commission may be requiring CFC rules to have broader scope than EU law in fact permits.

BACKGROUND

The UK's Controlled Foreign Company (CFC) rules impose a UK tax charge on certain profits of foreign companies that are controlled by UK residents. They are intended to prevent UK companies from reducing their UK tax burden by shifting profits to an offshore subsidiary that is based in a low or no tax jurisdiction. Many jurisdictions have similar CFC rules, and they have in the last few years been viewed favourably by the Commission as an effective way to combat tax avoidance. Indeed, the EU's Anti-Tax Avoidance Directive will require all EU Member States to have such rules in place by 2019.

Prior to 2013, the scope of the UK CFC rules was extremely wide, applying even in cases where no profits were diverted from the UK, and with exemptions only available in limited cases. That prompted a number of EU law challenges, with the courts eventually concluding that EU fundamental freedom of establishment meant that the UK rules could not apply in cases where a CFC was established in an EEA state and carried on genuine economic activities. That led to a wholesale rewriting of the UK CFC rules in 2013.

The Commission's State aid investigation concerns a partial exemption from the CFC rules: the "group financing exemption" that was included in the CFC rules in 2013. This exempts 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 – i.e. a rate of 4.75% instead of the usual

corporation tax rate of 19% (subject to anti-avoidance provisions). The stated justification for the partial exemption is 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.

If, on the other hand, a group is able to show that it is not in any way funded by debt finance from the UK, and is funded entirely by its own local assets or new group equity capital ("qualifying resources") then there is a complete exemption.

A key intended beneficiary of the group finance exemptions is the kind of group treasury company which is often held within a multinational group.

The Commission's position is that this exemption allows UK headquartered multinationals to avoid UK taxes that would otherwise be payable on their profits: instead of providing capital to a foreign subsidiary directly, they can do so via an offshore subsidiary which is subject to little or no tax in its home jurisdiction and – due to the group financing exemption – also subject to no tax under the UK CFC rules.

The State aid rules

EU Member States have the sovereign right to determine the appropriate level of taxation in their jurisdictions, except in certain areas – such as VAT – which are governed by EU legislation. However, EU State aid rules act to limit that freedom to the extent that a tax measure or exemption acts to grant selective competitive advantages to certain businesses.

A finding that a tax measure is State aid requires (among other things) a determination that it leads to some businesses receiving an advantage that is not available to others that are "in a comparable legal and factual situation". This is known as the selectivity test. The criteria for defining the scope of comparable businesses are notoriously vague and are applied by the Commission and the EU Courts to achieve widely varying outcomes from case to case. For instance, in one case all businesses providing services in Austria were deemed to be in a comparable situation to all businesses manufacturing products, whereas in another, London minicab drivers were considered not to be in a comparable situation to black cab drivers, despite being direct competitors.

The case against the UK reflects the recent approach of the Commission and the EU Courts of defining an aggressively broad category of comparable businesses in tax cases. In some recent cases concerning transfer pricing tax rulings (see the table below), the Commission has treated all multinational businesses as being comparable to all domestic businesses for the purposes of the tax in question. In another recent development, the ruling of the Court of Justice of the EU (CJEU) in *World Duty Free*, the CJEU held that a Spanish tax exemption was selective even though it was generally available to any Spanish businesses that chose to make a qualifying investment in a foreign business, since it was not available to Spanish taxpayers that made similar investments in a business that was taxable in Spain.

Consequently, the group finance exemption risks being found to be selective if it affords multinationals a way to reduce their overall tax burden that is not available to purely domestic businesses, or to other multinationals that finance their group companies without routing it through an offshore subsidiary. According to the Commission's approach in other cases, that will be the case even if the measure is concerned with financial transfers within multinational

groups that cannot, by definition, be carried out by purely domestic businesses, and is generally available to all multinationals.

If a measure does confer discriminatory advantages to some comparable businesses over others, it can only avoid being considered selective if it 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, such as facilitating the restructuring of failing businesses. Again, this test is vague and inconsistently applied, but is likely to be important in the determination of whether the group finance exemption amounts to State aid. In its decision to open the investigation, the Commission has expressed particular doubts "whether this exemption is consistent with the overall objective of the UK CFC rules".

THE INVESTIGATION

In-depth State investigations typically take two or three years (see the table below). However, investigations into generally applicable tax exemptions can be shorter as the Commission may not need to review detailed economic and financial evidence relating to the tax rulings of individual businesses.

If, at the end of the investigation, the measure is found to amount to State aid then, subject to the outcome of the ongoing Brexit negotiations, the Commission is likely to require the UK to recoup the value of the avoided CFC charges from companies that have benefitted from the group financing exemptions, by making them pay additional amounts of tax plus interest.

In theory, the Commission could also clear the exemption as compatible with the internal market, but it would need to be satisfied that the measure is a necessary and proportionate way to address an identified market failure, which is unlikely to be the case here.

Businesses that have allegedly benefitted from the aid – and which therefore face potential liability to repay it – have very few rights to be involved in the investigative procedure, which will be conducted between the Commission and the UK Government. However, they can submit comments and evidence in response to the Commission's opening decision, which is published at an early stage in the investigation.

BREXIT

The UK is due to leave the EU in March 2019. While the investigation might conclude shortly before then, the enforcement of any adverse decision and the conduct of any appeals would fall within the scope of whatever post-Brexit arrangements (if any) are agreed between the UK and the EU regarding State aid.

If the UK were to exit the EU with no framework or trade agreement providing for the UK's ongoing compliance with Commission State aid decisions and the EU State aid regime in general, then it is possible that any adverse decision by the Commission will be rendered irrelevant, as it would be difficult for the Commission to enforce its decision. In particular, there would be no obstacle (except, possibly, the threat of an EU action under the WTO's Agreement on Subsidies and Countermeasures) to the UK complying with the requirement to recoup the aid, and then simply giving it back to the relevant businesses.

However, potentially affected companies should assume that will not happen. The EU's guidelines for its Brexit 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 the UK's Prime Minister, Theresa May, has made reciprocal overtures that the EU and UK share a common belief "that trying to beat other countries' industries by unfairly subsidising one's own is a serious mistake". So it seems likely that the UK will accept some form of subsidy regulation, post-Brexit, as well as compliance with pre-Brexit State aid decisions of the Commission.

By opening this investigation, the Commission has signalled the EU's expectation that the UK's post-Brexit subsidy regime will impose restrictions on the UK Government's freedom to grant tax exemptions that are similar to those currently imposed by EU State aid laws, at least for the duration of any transition period. By launching the proceedings at this stage in the Brexit negotiations, the Commission has put pressure on the Government to decide early how it will respond to those expectations.

OTHER RECENT INVESTIGATIONS

The Commission's expansive interpretation of the selectivity test gives it a powerful tool to achieve a degree of harmonisation between national tax regimes as applied to multinationals and to limit Member States' ability to engage in competition to attract globally mobile businesses – an objective that it has found difficult to achieve through legislative means, given that direct tax measures require unanimity.

To date, the highest profile taxpayer affected by this approach has been Apple - which is currently under an obligation to repay up to €13 billion of back taxes to Ireland, plus interest that could add several more billion – but there have been a number of others:

European Commission State aid tax investigations to date

Country	Company	Measure	Investigation started	Decision	Liability
Luxembourg	Fiat	2012 ruling	11 June 2014	21 October 2015	€20-30 million
Netherlands	Starbucks	2008 ruling	11 June 2014	21 October 2015	€20-30 million
Belgium	At least 35 companies	2004 scheme involving rulings between 2004 and 2014	3 February 2015	11 January 2016	Over €700 million
Ireland	Apple	1991 and 2007 rulings	11 June 2014	30 August 2016	€13 billion
Luxembourg	Amazon	2003 ruling	7 October 2014	4 October 2017	Around €250 million
Luxembourg	McDonald's	2009 ruling	3 December 2015	Pending	-
Luxembourg	Engie	Several tax rulings after September 2008	19 September 2016	Pending	-

THE LEGAL ARGUMENTS

The Commission's recent application of State aid rules to tax rulings is controversial, and being contested by the States and companies concerned. However this new extension of State aid to CFC rules seems to us to take the

Commission onto even more difficult territory. Information is currently limited to a short press release, but there are serious grounds for questioning if the basis of the Commission's approach is correct both as a matter of UK tax law and a matter of EU law.

The UK tax law background

The Commission suggests that the group financing exemptions are inconsistent with the objectives of the UK CFC rules. That is highly arguable.

It is important to note that the overall objective of the UK CFC rules changed significantly in 2013, and this in part reflects conscious choice, and in part reflects successive EU law challenges.

Prior to 2009, the UK taxed corporate groups on a worldwide basis, with both UK and foreign profits generally subject to UK corporation tax (with credit for foreign tax paid). So, for example, a UK parent company receiving a dividend from a French subsidiary would be fully taxed on that dividend in the UK, subject to credit for French tax paid (the rules around which were extremely complex). In that context it made sense to have a CFC system which operated on the presumption that the profits of foreign subsidiaries would be taxed in the UK.

In 2009, however, the UK moved to a territorial system - taxing UK companies on their UK profits but not generally taxing foreign profits. So the UK parent company in the above example would only in rare cases be taxed on the dividend from its French subsidiary.

This change was partly driven by choice (with the UK seeking to become more competitive) but also partly driven by EU law – developing CJEU caselaw was making it unsustainable for the UK to continue to tax dividends UK companies received from their EEA subsidiaries.

The move to a territorial system made the UK CFC rules look anomalous. How could the UK CFC rules continue to operate on the presumption that a UK's subsidiaries' worldwide profits were subject to UK tax when this was not in fact the case? But in reality the status quo was not an option: judgments of the CJEU (*Cadbury Schweppes*) and domestic courts (*Vodafone*) had limited the ambit of the UK CFC rules so that, in the case of an EEA CFC, the rules could only apply to arrangements that were wholly artificial. That suggested the CFC rules had to be dramatically pared back if they were to be EU law compliant - but HMRC feared a potentially large loss of tax if so dramatic a change were made.

The Government therefore chose to compromise, and narrowed the CFC rules to cases where profits were diverted from the UK. We would say preventing such diversion is now the overall objective of the UK CFC rules. The paradigm case would be a UK company setting up a "cash box" in a tax haven which it capitalises with equity, invests in (e.g.) gilts, and rolls up the profits free from tax.

We would see the group financing exemptions as consistent with that overall objective. A CFC satisfying the "qualifying resources" test is by definition not diverting profits from the UK; the partial exemption is a simple heuristic that avoids having to trace the source of funds through complex intra-group structures.

The EU law background

The essence of the Commission's approach is that the UK's failure to fully apply a CFC charge to group treasury companies gives a selective advantage to multinationals. However, as noted above, EU law and the *Cadbury Schweppes* case have limited the scope of CFC rules so that, where the CFC is an EEA entity, there can only be a CFC charge if the arrangements are wholly artificial. The Commission therefore seems to be asking the UK to do something that it cannot lawfully do.

Indeed our view is that applying any CFC charge to an EEA group financing company is likely contrary to EU law (and the absence of any EU law challenge post-2013 probably reflects the relatively low cost of the 4.75% rate when compared with the high cost of litigation). Hence we would say that the breach of EU law is not that the exemption is too generous, but that there is no absolute defence for arrangements that are not wholly artificial.

How to resolve this paradox?

One possibility is that the Commission's investigation in fact only relates to the application of the group financing exemption to non-EEA CFCs and/or CFCs where the arrangements are wholly artificial. If so, we would expect the wider implications to be limited – most group financing companies are established in the EEA (not least from a withholding tax perspective) and most group financing companies carry out real transactions and cannot be said to be wholly artificial. We would, however, query if the Commission would regard pursuing such a limited case as worthwhile.

But otherwise it is difficult to see any consistency here. In its desire to apply State aid law to counter international tax planning, the Commission may have overreached.

IMPLICATIONS FOR UK HEADQUARTERED MULTINATIONALS

Historically, the UK has a strong track record of State aid compliance. For example, over the past two decades there have been twice as many in-depth probes against French measures, and over three times as many against German measures. Instances in which investigation has led to an order to recoup aid already disbursed are even rarer: only a handful of cases in the past two decades, most of which concerned the Scottish fishing sector. Accordingly, it should not be assumed that this investigation will lead to an adverse outcome for multinationals that have taken advantage of the group financing exemptions.

If it does, however, the consequences for some companies could be significant: in the worst-case scenario a retrospective CFC charge on all the previously exempt profits of group financing companies, plus interest.

Whilst the UK Government can be expected to contest the investigation, it is unlikely to pursue the line of argument we suggest: that the application of the UK CFC rules to arrangements which are not wholly artificial is contrary to EU law. Hence, given the large potential costs, affected companies may wish to consider submitting comments and evidence during the one month window after the publication of the Commission's decision to open the investigation, which is likely to be in the next few months.

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