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£1 BILLION+ STATE AID TO BE RECOVERED FROM UK CORPORATES WITH FINANCE SUBSIDIARIES - HOW SHOULD BUSINESSES REACT?

The Commission has now issued its final decision in its State aid investigation into the Group Finance Exemptions from the UK's controlled foreign companies (CFC) rules, concluding that the exemptions constitute unlawful State aid.

UK parented groups which benefitted now face significant retrospective tax bills dating back to 2013 and should take immediate steps to protect their position. Groups with finance companies in EU/EEA states will have a stronger basis to resist enforcement against them, based on EU law.

The UK's CFC rules seek to prevent the diversion of UK profits to low tax jurisdictions by imposing a CFC charge on UK parent companies by reference to the profits of their non-UK subsidiaries (subject to a number of exemptions). The CFC rules were substantially revised in 2013, following developments before the Court of Justice of the European Union (CJEU) and European Commission which suggested that the rules applied too broadly and were contrary to EU law.

THE GROUP FINANCE EXEMPTIONS

The reforms to the UK's CFC rules in 2013 introduced a number of specific exemptions to the CFC charge. Among these, two exemptions relating to profits falling within the non-trading finance profits 'gateway' were included, each intended to benefit UK headquartered companies with a group treasury CFC (the "group finance exemptions"):

- **The qualifying loan relationships exemption:** This reduced the CFC charge by three-quarters, leaving an effective CFC charge at current corporation tax rates of 4.75% instead of 19% (subject to anti-avoidance provisions).
- **The qualifying resources exemption:** A complete exemption was also available to groups which were able to show that their CFCs were not in any way funded by debt finance from the UK and were funded entirely by their own local assets or new group equity capital.

In October 2017 the European Commission announced that it had opened a State aid investigation into the group finance exemptions on the basis that they provide a selective advantage to UK parented groups carrying out finance transactions with non-UK CFC treasury companies instead of UK subsidiaries or UK or foreign third party debtors.

Key issues

- The European Commission has concluded that the Group Finance Exemptions from the UK's CFC rules constitute illegal State aid.
- Commission determines that UK-headquartered groups with non-UK finance income falling within Group Finance Exemptions should have been subject to UK CFC charge on that income, at rates between 23% and 19%.
- HMRC required under EU law to recover the tax, regardless of whether the UK appeals the decision to the EU Courts.
- UK corporates now face tax bills totalling £1 billion+.

FINAL DECISION

On 2 April 2019 the European Commission issued its final decision that the group finance exemptions constitute unlawful State aid, in some circumstances. To that extent, the Commission concluded that the group finance exemptions provide a selective and unjustified advantage to UK parented groups with a non-UK finance subsidiary, when compared with wholly domestic taxpayer groups and other groups whose activities are financed through alternative structures.

In particular, the Commission concluded that when financing income from a foreign group company is received by an offshore subsidiary, and the income relates to loans which were financed using funds or assets deriving from capital contributions in the UK, the group finance exemptions were justified and therefore did not constitute illegal State aid. This is on the basis that the exemptions are a "clear proxy" which "avoids complex and disproportionately burdensome intra-group tracing exercises" which would be required to assess the percentage of profits funded with UK assets.

However, the Commission also concluded that when financing income from a foreign group company is received by an offshore subsidiary, and the most relevant activities to managing the financing activities and thus generating the financing income are located in the UK, the group finance exemptions were not justified and therefore constituted illegal State aid. This is on the basis that a proxy rule in these cases is not justified, as the exercise to assess to what extent the financing income derives from UK activities is, in the Commission's view, not unduly burdensome or complex.

Unless a successful appeal is made to the Court of Justice of the European Union (CJEU), the UK government is now required under EU law to recover the State aid from all recipients. For UK taxpayers with group treasury CFCs, this means all of the finance profits of the CFC dating back to 2013 which were generated by UK activities and previously fell within the group finance exemptions, are now retrospectively subject to the full CFC charge (at a rate of between 23% and 19%), plus compound interest (unless otherwise indicated in the decision).

It has been estimated that HMRC is now required to recover over £1 billion from taxpayers who previously benefitted from the group finance exemptions.

WHAT CAN AFFECTED GROUPS DO?

Groups which benefitted from the group finance exemptions now have a range of options to respond to the Commission's decision – some of which are immediate; others of which are decisions for the medium-to-longer term.

Affected groups should take immediate steps to determine the extent to which UK-located personnel were involved in decisions relating to lending, managing and servicing relevant intra-group debt arrangements.

It seems likely that the UK Government will appeal the decision to the CJEU. The Court may well overturn the Commission's decision, though any appeal would inevitably take years and would not generally suspend recovery of the tax in the interim.

A taxpayer may also appeal the Commission's final decision themselves to the General Court of the EU, being an interested person to whom the decision is of "direct and individual concern". Groups with a significant retrospective tax exposure may want to consider this for a number of reasons, including the opportunity to put their best arguments forward before the General Court.

There is a time limit of just over two months to institute proceedings, commencing with the publication of the Commission's final decision in the *Official Journal* (which typically occurs within a few months of the decision being issued).

RESISTING RECOVERY

HMRC is now required to recover the aid from all taxpayers who previously benefitted from the group finance exemptions where the income derived from UK activities. Any appeal that is brought will not suspend that obligation, unless the parties also succeed in obtaining interim relief from the General Court, which is rarely granted.

The ability of taxpayers to resist recovery of the tax will generally be extremely limited. A recovery order by the Commission binds both Member States and their courts, which must set aside any constitutional or procedural impediments to the recovery. Only where recovery would conflict with EU law itself would there be scope to challenge the recovery.

However, in our experience most UK parents have their group finance companies established in EU/EEA Member States, which means they should have a much stronger basis to resist recovery. This is because those taxpayers should be able to rely upon the freedom of establishment enshrined in EU law.

In *Cadbury-Schweppes* (Case C-196/04), the CJEU considered the UK's pre-2013 CFC regime. 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 CJEU's "wholly artificial arrangements" formulation sets a low threshold and, while a mere letterbox company would be at risk, any EU/EEA company with genuine premises and staff should be safe.

The CJEU also explained that such a restriction must go no further than necessary to achieve that purpose; and so in order for CFC rules to be compliant with EU law, they must not impose tax by reference to a CFC which is actually established in another EU/EEA Member State and conducting genuine economic activities there. Moreover, taxpayers must also be given an opportunity to demonstrate that such arrangements are not wholly artificial.

Accordingly, even if the group finance exemptions constitute State aid, *Cadbury-Schweppes* suggests that imposing *any* CFC charge on a UK company by reference to a CFC which is actually established in another EU/EEA state is contrary to EU law. This should provide such companies with a powerful argument to rebut any State aid recovery action.

This argument could be raised as part of a judicial review against an HMRC recovery action (although the strict 3 month time limit for such claims would apply) or by simply disputing a subsequent tax assessment.

Ahead of this, UK parented groups with non-UK group treasury companies should carefully consider whether protective steps should be taken now:

- Determine the extent to which UK personnel were involved in decisions to lend and managing and servicing the relevant offshore financing income;
- Consider whether to appeal against the Commission's final State aid decision (within the 2 month time limit);

- If the group treasury company is established in the EU/EEA:
  - Assess whether there is any question mark over the level of substance of these companies; and
  - Begin preparing a challenge on freedom of establishment grounds against the application of the CFC rules on the basis that their arrangements were not "wholly artificial"; and
- In the less usual case of a group treasury company established outside the EU/EEA, consider whether other arguments could be raised (including a breach of general principles of EU law, such as legitimate expectations) to resist recovery of the tax.

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