CFC focus – CFC reform and the EU

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After two decades of seeing domestic UK tax legislation regularly challenged before the ECJ, the importance of ensuring that the new CFC regime is EU compliant from the outset is all too clear. So how do the proposed new rules stack up?

THE EU LAW PRINCIPLES

To answer that question, it is first necessary to identify what the relevant EU law principles are. The obvious starting point here is the ECJ’s decision in Cadbury-Schweppes (Case C-196/04, [2006] STC 1908). To recap, that judgment:

- reaffirmed that exercising a fundamental freedom in order to benefit from more favourable legislation, including a more favourable tax regime, does not constitute abuse of that freedom;
- established that simply treating the UK parent of a subsidiary established in a low tax Member State differently from the UK parent of a subsidiary established in the UK was sufficient to constitute a restriction on the freedom of establishment notwithstanding that the aggregate tax burden on parent and subsidiary might be no greater;
- noted that “the need to prevent the reduction of tax revenue” was not capable of justifying a restriction on a fundamental freedom;
- found that CFC rules could be a justified restriction on the freedom of establishment "on the ground of prevention of wholly artificial arrangements" but only if they were proportionate to that objective, meaning that they must only apply to wholly artificial arrangements; and
- held that in order to determine whether an arrangement were wholly artificial it would be necessary to ascertain by reference to objective factors, in particular “the extent to which the CFC physically exists in terms of premises, staff and equipment”, whether the CFC is “a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State”.

The Cadbury-Schweppes judgment was of course considered by the Court of Appeal in Vodafone 2 ([2009] STC 1480) where it was held that an additional exception could be read into the UK’s CFC rules as a matter of conforming interpretation. Consequently no charge currently arises in relation to a CFC if, in the relevant accounting period, it is actually established in another Member State of the EEA and carries on genuine economic activities there.
Having said above that Cadbury-Schweppes is the obvious starting point for EU law on CFC rules, before last June most tax advisers would probably have said it was the obvious finishing point too. In that respect Annex I to the June 2011 CFC Reform Condoc (Consultation on CFC reform) was something of a revelation setting out publicly for the first time the Government’s understanding of the relevant EU law. It was surprising because, in addition to Cadbury-Schweppes, it drew heavily on Thin Cap GLO ([2011] STC 738)) and SGI (Société De Gestion Industrielle (SGI) v Belgian State (Case C-311/08, [2010] 2 CMLR 1017)), both transfer pricing cases.

DIFFERING VIEWS

The Government took the view that these three cases together show the ECJ establishing a consistent set of principles for determining the circumstances in which tax rules aimed at preventing the artificial transfer of profits from one tax jurisdiction to another may constitute a proportionately justified restriction on the freedom of establishment. Those principles are that “such rules represent a proportionately justified restriction if and to the extent that they only tax profits (or, as the case may be, disallow expenditure) that differ from that which would have been made by an independent enterprise under the arm’s length principle”. That view echoes the conclusions of Stanley Burton LJ delivering the majority judgment of the Court of Appeal in the Thin Cap GLO. But is it right?

Stanley Burton LJ noted that, since the ECJ had delivered its judgment in Thin Cap GLO, it had also delivered its judgment in two other cases which he considered relevant, namely Oy AA (Case C-231/05, [2008] STC 991) and SGI, and which he found hard to reconcile with its earlier judgment. In particular, he noted that whilst the ECJ in Thin Cap GLO had focussed on the objective of preventing tax avoidance, in Oy AA it had focused on the objective of safeguarding the balanced allocation of taxing powers between Member States and held that the Finnish tax rule in question could be regarded as proportionate by reference to that objective notwithstanding the fact that it “did not target, and was not restricted in its application to, ‘purely artificial arrangements’”. He noted that the Belgian legislation which was the subject of SGI was also not so targeted and restricted but was equally upheld.

So one can see two views emerging here. The first is that Cadbury-Schweppes stands alone as the only time the ECJ has considered CFC rules and, as such, any CFC rules which are not restricted entirely to wholly artificial arrangements are not EU compliant. The second is that Cadbury-Schweppes forms part of a wider body of ECJ case law on the interaction between anti-avoidance provisions and the freedom of establishment and that the principles have evolved such that a CFC regime which is not so restricted is not necessarily unjustifiable.

I believe it is the first view which should prevail. First, as Arden LJ noted in her dissenting judgment in Thin Cap GLO, it is not at all clear that the relevant provisions in SGI were not restricted to wholly artificial arrangements. The ECJ appeared to attach some significance to the Belgian government’s submission that under national legislation the taxpayer did have the opportunity to establish that the transaction had a commercial justification. But, more importantly, the thin capitalisation cases, and Oy AA, deal with different tax rules the objectives of which are not on all fours with CFC rules.

The relevant tax rules in both Oy AA and SGI (and, indeed, in Thin Cap GLO) had the aim not just of preventing tax avoidance but also of preserving the balanced allocation of taxing rights and it was this second objective by reference to which they were justified notwithstanding that they were (arguably) not restricted to wholly artificial arrangements. The ECJ in those cases was concerned to preserve the ability of the relevant Member State to exercise tax jurisdiction “in relation to activities carried out in its territory” (per paragraph 61 of the SGI judgment). Allowing a Finnish company to make a deductible transfer of profits to its UK parent would reduce the Finnish tax payable on profits arising from Finnish activities (Oy AA). Likewise, allowing a Belgian company to pay an excessive service fee or not to receive interest income on a loan it had made would reduce the Belgian tax payable on profits arising from Belgian activities (SGI). But the purpose of the CFC rules is much more clearly the prevention of tax avoidance than it is preserving the UK’s right to tax UK activities. The CFC rules generally seek to tax activities
which have been carried on in a low tax jurisdiction and not in the UK. As such a rule which only bites if the activities have not really been carried on outside the UK makes sense.

Against that backdrop it is certainly not obvious that the proposed new rules (last draft published on 31 January, 2012) are wholly EU compliant. There is neither a motive or purpose test nor a general exemption for EEA based CFCs. That is arguably a step back from both the existing rules, which have the (much maligned but useful as a last resort) motive test and Vodafone 2 exception, the draft rules published on 28 June, 2011 which incorporated a “general purpose exemption” and the approach adopted by other high tax Member States such as France and Germany.

In many respects Chapters 8 through 13 of the proposed new rules follow the recommendation in the EC Council Resolution of 8 June 2010 on CFC and thin cap rules (2010/C 156/01) of providing a series of safe harbours and risk factors to identify areas with a high risk of artificial diversion although they stop short of the last part of that recommendation, namely to allow the taxpayer opportunity to produce evidence to the contrary. That said, the “gateway” test does appear largely to reflect the Government’s view of EU law (and the majority of profits derived from UK SPF criterion is not a million miles away from asking where the activity is really carried on).

If the test in Chapter 11 for picking up amounts paid to EEA captive insurers really is that the insured has no significant reason for entering into the insurance contract other than a UK tax one, which I read as effectively asking whether the insured really wants to insure their risk or just to pay a deductible premium, that seems to me tantamount to catching only artificial arrangements in any event.

The finance rules in Chapters 9, 10 and 17 are hardest to reconcile from an EU perspective, not least because of the obvious parallel with Cadbury-Schweppes. It is rather hard to see why, if a group finance company is genuinely established in, and carrying on economic activity in, another Member State, all of its finance income, whether that is derived or funded from the UK or not, should not be fully exempt. Or at least it is if one sets aside considerations of revenue protection and affordability. I have certainly heard tax directors muttering that 5.75% is a tax rise not a tax break.

WHERE DOES THAT LEAVE US?

The Government has repeatedly described the finance exemptions as a “pragmatic” approach and that seems an apt epithet for the new rules more generally. They certainly leave me with the feeling they are not EU compliant in all respects. But by the time the consultation process is complete they are likely to be sufficiently EU compliant, and sufficiently sensible and territorial in approach, for that not to matter to most businesses most of the time.

Challenging the new rules is likely to be costly (both in terms of time and money), uncertain and, in the current climate, may well generate unwelcome publicity from organisations such as UK Uncut. Consequently I expect that most groups will be willing to try to live within the new rules. Challenges are most likely to come from one of two camps. The first will be a group which has sought, and failed, to live within the new rules but does not consider their circumstances to constitute a wholly artificial arrangement. The second will be a group which currently relies on the Vodafone 2 exception – for their group finance company, for example – and for which the new rules would result in a tax rise.

As long as Cadbury-Schweppes stands as good law, the argument that a Member State cannot tax a parent on the genuine economic activities of a subsidiary carried out in another Member State where it is actually established will always be in a taxpayer’s back pocket regardless of whether it is expressly written into the rules or not.

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