CFCs around Europe

INTRODUCTION

Mike Lane’s article titled “CFC Reform and the EU” (Tax Journal, dated 2 March 2012) discussed whether or not the new CFC regime was EU compliant. In particular, Mike looked at the UK Government’s view of EU law, and concluded that this was not justified, but instead concluded that the 2006 decision of the ECJ in the Cadbury Schweppes case (C-196/04, [2006] STC 1908) is the relevant test, which requires that any CFC regime is only EU compliant if it is restricted to “wholly artificial arrangements”.

The draft legislation has moved on since Mike wrote his article, so this article seeks to answer two questions. First, is the Finance Bill version of the UK’s new CFC regime EU compliant? Secondly, how have other EU member states sought to render their own CFC regimes EU compliant, following the Cadbury Schweppes decision and are there lessons for the UK to learn from their approaches?

EXAMPLE

Suppose a UK group sets up a financing subsidiary in Luxembourg. The subsidiary has significant equity and retained profits, and uses the funds available to it to make loans to other members of the group (including the UK business). The cyclical nature of the group’s business means that the funding requirements of the various subsidiaries fluctuate throughout the year, and the financing subsidiary therefore has to manage the changing funding requirements, which at times will involve making interest bearing deposits with third party banks. The intention is that the financing subsidiary should make a profit from its activities, but these activities are unlikely to amount to a trade for tax purposes.

The financing subsidiary has an office in Luxembourg, which has a small permanent staff with all the necessary expertise to manage the company’s finance business. The terms of the loans to group companies are negotiated by this team on arm’s length terms, and the team is also responsible for managing funding requirements.

In my view, applying the Cadbury Schweppes test, the CFC rules should not apply to the financing subsidiary. It is genuinely established in Luxembourg and is providing valuable services to the group from there, for which it is receiving an arm’s length consideration. The only question might be whether (under the terms of the EU Council Resolution of 8 June 2010) the subsidiary is overcapitalised, although arguably the subsidiary does not have more capital than it needs, it simply does not generally need to borrow to meet its business requirements.
Do the new CFC rules apply to any of the financing subsidiary’s profits, being interest income earned from both UK and non-UK group companies and from third party banks?

First, the proposed gateway “escape route” in Section 371CB TIOPA is not available, so the financing subsidiary’s profits are all potentially within the scope of Chapter 5 Part 9A TIOPA.

Secondly, the profits fall within Section 371EC TIOPA, as the funds lent by the CFC represent either equity subscribed by the UK parent company or retained profits (there is no “overcapitalised” condition in this provision). So the entire profits appear to be taxable under the CFC rules.

The financing subsidiary may of course qualify for the partial finance exemption in Section 371ID TIOPA, but only to the extent the interest is received by the financing subsidiary on “qualifying loan relationships”. This would not include the interest earned on the bank deposits or loans to the group’s UK operations. In addition, as its name suggests, this is only a partial exemption: 25% of the interest income from non-UK group companies remains subject to the CFC charge.

The full exemption in Section 371B TIOPA might have a limited application (for example, if it can be shown that loans to a group company in one jurisdiction are funded from interest previously paid by subsidiaries in that same jurisdiction) but the fact remains that most of the profits of the financing subsidiary will remain subject to a CFC charge.

WHAT CAN WE LEARN FROM OTHER MEMBER STATES?

How have the tax regimes of the other member states of the EU coped with the implications of the Cadbury Schweppes decision on their CFC regimes, and are these regimes all safe from a challenge before the ECJ? In particular, would the above example escape their rules? A quick review of the issue within our Best Friends Tax Network produced the following responses.

FRANCE

Yves Rutschmann at Bredin Prat described the very neat and robust solution adopted in 2005, when the French CFC rules were amended to include a specific exemption that prevents the rules applying to a company established in an EU member state if it can be shown that the ownership of the company does not constitute a wholly artificial arrangement intended to escape French tax that would otherwise be payable. The French tax authorities have published guidelines that state that the concept of “wholly artificial arrangement” must be assessed with regard to the objective criteria set out in the Cadbury Schweppes decision.

ITALY

Italy has two sets of CFC rules, although the tougher “Black-List” CFC rules do not generally apply to companies established in other EU jurisdictions (one exception being Luxembourg 1929 holding companies).

The newer Non Black-List CFC rules were not introduced until 2010, and therefore were supposedly drafted to take account of the Cadbury Schweppes decision. These rules include a specific exclusion (not limited to companies established in EU member states) if the Italian shareholder can demonstrate that the foreign entity is not a “wholly artificial arrangement”.

The Italian tax authorities have stated that this exclusion means that the Non Black-List CFC rules are fully compatible with the EU law. The position is, however, not quite that clear cut. In order to rely on the “wholly artificial arrangement” exclusion, the taxpayer must apply for a tax ruling (and will be subject to a penalty if it seeks to rely on the exclusion without obtaining such a ruling). This is a significant burden on the taxpayer, as the ruling process is complex and the taxpayer will incur significant cost. Andrea Silvestri at Bonelli Erede Pappalardo believes that there is a very good argument that this is inconsistent with the EU “principle of proportionality”, which states that the taxpayer should not be subject to undue administrative efforts and constraints in order to prove that the foreign entity is not an artificial arrangement.

GERMANY

Germany also made changes to its CFC regime following the Cadbury Schweppes decision. Since 2008, the German CFC rules have not applied to a company established in an EU/EEA member state to the extent they relate to income (computed on an arm's length basis) that is derived from a “genuine” economic activity carried out in its country of residence.

Friedhelm Jacob of Hengeler Mueller believes that the German CFC regime is susceptible to an EU challenge, because the “genuine” economic activity test is much more stringent than that that would be sufficient under Cadbury Schweppes principles. In addition, investment income would frequently not have a sufficient relationship to such a “genuine” activity to fall within this exclusion and the exclusion does not apply to low-taxed income of a passive non-EU/EEA subsidiary of the company or to passive low-taxed income of the company derived from a permanent establishment located outside the EU/EEA.

SPAIN

Since 2008, Spain’s CFC rules have not applied to subsidiaries resident in EU member states so long as (i) there is a valid business purpose for setting-up and operate the subsidiary and (ii) the subsidiary is engaged in business activities. Rafael Garcia Llaneza at Uría Menéndez questions whether the business purpose test goes beyond the Cadbury Schweppes test.

THE NETHERLANDS

The Netherlands does not have a classic CFC regime, but it requires a corporate taxpayer annually to mark to market for tax purposes its shareholding in certain low taxed subsidiaries. This revaluation rule therefore serves a similar purpose to a CFC regime, but taxes movements in the value of the subsidiary rather than the subsidiary’s profits.

The revaluation provision applies where the subsidiary’s assets consist of 90% or more of “free portfolio investments” (being portfolio investments that are not reasonably required for its business operations) and the subsidiary is subject to an effective tax rate of less than 10% (computed on Dutch tax principles).

Is the Dutch regime compliant with EU law? At first sight it seems difficult to see how the revaluation rule could be justifiable on Cadbury Schweppes grounds given that it is not limited to wholly artificial arrangements and it provides the taxpayer with no opportunity to produce evidence that its subsidiary’s activities are genuine. The Dutch tax authorities have, however, argued that, as the regime applies to both Dutch and non-Dutch subsidiaries
since 2007, it is EU compliant. In practice, however, Paul Sleurink at De Brauw Blackstone Westbroek thought it was difficult to imagine any real life situation where a Dutch resident subsidiary would be subject to tax at a lower level of taxation calculated in accordance with Dutch tax principles so as to be caught by these rules, and on that basis the regime is susceptible to an EU challenge.

CONCLUSION

Would the profits of the financing subsidiary in my example be caught by any of the above CFC regimes?

Whilst in Spain the subsidiary might escape, there were concerns in Germany, Italy and France that the significant equity finance, and the nature of the subsidiary’s activities, would mean that it would be caught. The more mechanical nature of the Dutch rules meant that it depended on the amount of tax paid in Luxembourg.

It is therefore clear that the UK is not alone in its struggle to craft an EU compliant CFC regime!

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