

## ***“CONTROLLED FOREIGN COMPANY RULES AND COMMUNITY LAW”***

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### **Introduction**

In the World and between the Member States of the European Union (EU) there is a strong tax competition. This tax competition has developed itself mostly because of the globalization. On the one hand the States try to attract the foreign investments by granting tax advantages. However on the other hand they tend to set up tax rules hindering tax avoidance.

Among those anti-avoidance tax rules there are the so called “Controlled Foreign Company” regimes (CFC). Those latter are a way to counter the transfer of profits to low-tax jurisdictions.

The United States were the first to implement such rules in their “Sub Part F” from 1962. Then a lot of countries, among them the United Kingdom (UK) and France, have followed the United States and have implemented the same regime.

The CFC legislation has to deal often with the concept of “tax haven”. Those countries with very low tax rates or no taxation at all are used for tax avoidance purposes. For instance in the Caymans Islands there are around 10 000 companies for 60 000 residents. For the OECD “tax competition in the form of harmful tax practices can distort trade and investment patterns, erode national tax bases and shift part of the tax burden onto less mobile tax bases, such as labour and consumption, thus adversely affecting employment and undermining the fairness of tax structures<sup>2</sup>”. The 1998 OECD report – “Harmful Tax Competition: An Emerging Global Issue” tried to identify tax haven jurisdictions. However this report did not offer a clear-cut definition of tax haven. It suggested some criteria such as very low or no imposition, laws or administrative practices which prevent effective exchange

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<sup>2</sup> 1998 OECD report – “Harmful Tax Competition: An Emerging Global Issue”

of information with other governments, lack of transparency and no requirement of a substantial activity.

The concept of low or no imposition is very important in the application of CFC rules.

Basically the CFC regime applies when a parent company of the Home State establishes an entity (the controlled foreign company or CFC) in a low-tax jurisdiction. When there is no CFC legislation the income earned by the foreign entity is not taxed in the Home State until it is repatriated by a distribution of dividends from the CFC to the parent company. In this scheme the parent company will let the profits in the foreign entity to avoid the Home State taxation. Thus the CFC rules give the possibility for the Home State to tax the foreign profits located in CFC established in low-tax jurisdictions.

The CFC rules apply when the parent company has the control of a CFC. It could be the majority of the shares or the voting rights. Most of the time, this regime applies to resident taxpayers. In some countries CFC rules apply to individuals. In the UK's and French CFC rules only legal entities are covered by the regime.

This kind of anti-abuse rules has put some questions forward. The first step took place in the context of the OECD Model Convention. Most of the countries of the OECD have adopted CFC rules. The question of the compatibility between CFC rules and double tax treaties has occurred. For instance the compatibility was examined in a situation involving the France-Switzerland tax treaty in a case called "Schneider Electric"<sup>3</sup>. In this case the Conseil d'Etat, the Supreme Administrative Court, had to deal with the interpretation of the Article 7 of the OECD Model and the application of the French CFC rules regarding this article. For the Conseil d'Etat the profits which were taxed under the French CFC legislation fell under the Article 7 of the double tax treaty. Therefore the French CFC rules were incompatible with the Article 7 and could not apply to profits of a CFC protected by a double tax treaty following the OECD Model. That is why now the profits of CFC are assimilated to distributions.

The same question occurred in the area of the Community Law. The European Union is an important place from a tax point of view. In the *Cadbury Schweppes* Case<sup>4</sup> the European Court of Justice (ECJ) has assessed the compatibility between the UK's CFC rules and the fundamental freedoms, especially the freedom of establishment, protected under the EC Treaty. As many Member States have adopted CFC regimes the ruling of the ECJ was expected. Before the judgment France decided to amend its CFC legislation because it was obviously in breach of Community law.

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<sup>3</sup> Conseil d'Etat, 28 June 2002, *SA Schneider Electric*

<sup>4</sup> ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc*

The ECJ held that the UK’s CFC rules were incompatible with the freedom of establishment.

A discussion of the *Cadbury Schweppes* case and the UK’s CFC rules will take place first) and then an analysis of the UK’s and French CFC rules and their compatibility with the Community law will be developed.

## **Discussion of the *Cadbury Schweppes* Case and the UK’s CFC rules**

It is important to understand first the issue arising from the UK’s CFC rules (I) and then to analyse the solutions given by the ECJ to fix the incompatibility between the CFC legislation and the fundamental freedoms (II).

### **I. The issue arising from the UK’s CFC rules**

The ECJ in its *Cadbury Schweppes* judgment held that the UK’s CFC rules (A) were incompatible with the freedom of establishment (B).

#### **A. UK’s CFC legislation**

Before analysing the *Cadbury Schweppes* Case itself, the UK’s CFC legislation at issue should be described.

This legislation is an anti-avoidance provision set out to “counter the diversion of capital to low-tax jurisdictions”<sup>5</sup> by establishing a CFC in those jurisdictions. In fact a company resident in the UK is subject to corporation tax on its worldwide income, including the profits realized by branches or agencies. Those latter are used by companies resident in the UK to carry on activities outside the UK. The dividends distributed to a UK parent company by a subsidiary established abroad are taxed in the hand of the parent company. However if the foreign subsidiary does not distribute any dividends, no tax is due.

The scheme is to leave the most possible money in subsidiaries established in low-tax jurisdictions. If they do not distribute dividends, the UK will never tax those incomes.

The UK’s CFC legislation is contained in Sec. 747 to Sec. 756 and in Sch. 24 to Sch. 26 of the UK’s Income and Corporation Taxes Act 1988. In order for the UK’s CFC legislation to be applied, a UK resident company must hold more than 50% of the foreign subsidiary. The subsidiary must be subject to a “lower level of taxation”

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<sup>5</sup> *The Uncertain Future of CFC Regimes in the Member States of the European Union – Part I*, Renata Fontana, in *European Taxation* June 2006

which means that the CFC has paid less than three quarters of the amount of tax that would have been paid in the UK on the taxable profits.

There are a number of exemptions to the application of the UK's CFC legislation. The first exemption is when a CFC adopts an "acceptable distribution policy", this CFC is excluded from the UK's CFC regime. The CFC must pay a dividend of 90% of the profits within 18 months of arising and those profits must be taxed in the hand of the UK company<sup>6</sup>.

The second exemption is the "*exempt activities test*". This provision is intended to exclude from the UK's CFC regime active income derived from a CFC engaged in real commercial transactions with unconnected parties, other than in the course of an investment business<sup>7</sup>. Under the exempt activities test, a CFC is assumed not to be used for reducing UK corporate income tax when it is resident and effectively managed in the Host State.

The third exemption is called the "*de minimis exemption*". It applies if the CFC's chargeable profits do not exceed GBP 50,000<sup>8</sup>.

The fourth exemption applies when the CFC satisfies the "*public quotation test*". This test means that 35% of the voting rights are held by the public and the shares are quoted on the official list of a recognized stock exchange in the state in which the company is resident<sup>9</sup>.

The last exemption is the "*motive test*" which comprises two cumulative conditions to fulfil for a taxpayer. In fact, this exemption applies if it can be demonstrated that the activities of the CFC were carried on for "bona fide commercial reasons" and that if there is any reduction in tax, the reduction is not the purpose or one of the main purposes of the transactions. Moreover the taxpayer must demonstrate that the diversion of profits from the UK to the subsidiary is not the main reason or one of the main reasons of the existence of the subsidiary<sup>10</sup>. The UK tax authority's Manual on CFC states that "the intended result of this exemption is that only overseas subsidiaries that exist, or carry out transactions, with the aim of avoiding UK tax will be subject to charge under the controlled foreign companies' rules"<sup>11</sup>.

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6 Part I, Sch. 25 ICTA

7 Part II, Sch. 25 ICTA

8 Sec. 748 (1)(d) ICTA

9 Part III, Sch. 25 ICTA

10 Sec. 748(3) ICTA

11 Para 208010 of the UK tax authority's Manual

This regime was challenged in the *Cadbury Schweppes* case<sup>12</sup> regarding to the compatibility with the freedom of establishment.

***B. Restriction of the freedom of establishment illustrated by the Cadbury Schweppes Case***

The UK's CFC legislation is an obstacle to the freedom of establishment (1). The French CFC rules have some similarities with the UK one (2).

*1. The UK's CFC legislation hindering the freedom of establishment*

Cadbury Schweppes plc, a UK incorporated and resident company is the parent company of the Cadbury Schweppes group. Cadbury Schweppes has established two indirect 100% wholly owned subsidiaries in the International Financial Services Centre in Dublin to benefit from a low corporate income tax rate of 10%.

In its ruling the European Court of Justice examines first whether there is an abuse of law. It holds that the tax competition among the Member States through corporate income tax rates is allowed. Taking advantage of a lower tax rate, in itself, cannot be qualified as an abuse of Community Law<sup>13</sup>.

Then the ECJ examines whether there is a tax rule rendering less attractive the exercise of the freedom of establishment. It held that the freedom of establishment prohibits the Member State of origin from hindering the establishment in another Member State of one of its nationals or a company incorporated under its legislation<sup>14</sup>.

The difference of treatment of Cadbury Schweppes disadvantages this company from establishing a subsidiary in another Member State where CFC rules do not apply. This restriction of the freedom of establishment is clear because in a UK-UK situation or in a UK-Member State situation where the CFC legislation do not apply, the UK parent company is never taxed on the profits of its subsidiary.

Pursuant to the “migrant/non-migrant test”<sup>15</sup> developed by Dr Tom O'Shea, it is demonstrated that a UK company establishing a subsidiary in the UK or in another Member State where the CFC rules do not apply and a UK company establishing a subsidiary in a Member State where the CFC rules potentially apply are not treated in the same way. The Court in its rulings clearly hold that the Origin State could not

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<sup>12</sup> ECJ, 12 septembre 2006, Case C-196/04, *Cadbury Schweppes plc*

<sup>13</sup> ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc*, Para 37

<sup>14</sup> ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc*, Para 42

<sup>15</sup> Tom O'Shea, *The UK's CFC rules and the freedom of establishment : Cadbury Schweppes plc and its IFSC subsidiaries-tax avoidance or tax mitigation*, EC Tax Review 2007-1

treat differently its resident companies which establish subsidiaries in other Member States depending on the tax rate applicable in the Host state.

In his article<sup>16</sup> Dr Tom O'Shea refers to a number of cases<sup>17</sup> in which the ECJ has applied the migrant/non-migrant test. In each case the Court compares the person exercising the freedom with the person staying at home. Those two persons should be treated in the same way by the Origin State.

In *Cadbury Schweppes* a difference of treatment is found through the application of the migrant/non-migrant test. Therefore the UK's CFC rules constitute a hindrance to the freedom of establishment.

Such anti-abuse rules can be found in the French tax system and could make such questions arising.

## 2. *Comparison between the French rules and the challenge in Cadbury*

The French CFC rules were challenged the first time in international tax law in a case involving the France-Switzerland tax treaty<sup>18</sup>. In fact it was the compatibility of the French CFC legislation with the article 7 of the OECD Model which was challenged.

In this case the company Schneider Electric held 100% of a Swiss company (Paramer). Schneider Electric is a French resident company liable to taxation in France. The Swiss company holds shares and the profits are made through distributions of dividends and capital gains on cessions of shares. This company has no other genuine economic activity on the Swiss market. Moreover the Swiss company benefits from a very low corporate tax rate. Thus the French tax authorities have considered that the conditions of the application of the CFC regime were fulfilled.

The Conseil d'Etat had to assess the compatibility of the article 209B of the French Tax Code with the article 7 of the OECD Model. Many authors had already pointed out this issue<sup>19</sup> and it was the first time that the Supreme Administrative Court had the possibility to rule on this point.

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16 Tom O'Shea, *The UK's CFC rules and the freedom of establishment : Cadbury Schweppes plc and its IFSC subsidiaries-tax avoidance or tax mitigation*, EC Tax Review 2007-1, section 4.4.2.1

17 *Bosman*, C-415/93 ; *Baars*, C-251/98 ; *Verkooijen*, C-35/98

18 *The Uncertain Future of CFC Regimes in the Member States of the European Union – Part I*, Renata Fontana, in *European Taxation* June 2006

19 For instance Professor Patrick Dibout, "La compatibilité de l'article 209 B du CGI avec les conventions fiscales internationales en question", Dr. fisc. 18/97 p. 600

The Court has demonstrated first that the consequence of the article 209B was to make liable to the French taxation companies established out of France. Thus it was directly incompatible with article 7 of the France-Switzerland tax treaty. The only way to tax in France incomes earned by a non-resident company is when this company has a permanent establishment in France. In the *Schneider Electric* case the Swiss company had no permanent establishment in France within the meaning of the article 5 of the tax treaty. That is why France had no right to tax the profits of the Swiss company even through the CFC legislation.

After this case the general thought was that France should amend its legislation. Instead of amending the CFC rules the French Government decided to renegotiate its Tax Treaties. Now when there is a tax treaty containing the article 7 of the OECD Model the CFC rules can apply only if in the tax treaty it is expressly mentioned so.

As the CFC regime has not been amended some authors considered that another issue could come up regarding to the Community Law<sup>20</sup>. In fact when the *Cadbury Schweppes* case was brought to the ECJ, a comparison between the French CFC rules and the challenge in this case could let appear that the French regime was incompatible with the fundamental freedoms protected under the EC Treaty.

For instance a company A, French resident for tax purposes, owns more than 10% of the shares of a subsidiary established in the International Financial Services Centre in Dublin. The subsidiary is subject to a low corporate tax rate.

Given the tax rate in the International Financial Services Centre and the threshold of 10%, the subsidiary could qualify for the CFC regime of the article 209B. The income of the CFC would be taxed in France in the hand of the French parent company.

It would be a perfect application of that anti-avoidance tax rule. However in a pure European situation, the French parent company could argue, as it had been done in *Cadbury Schweppes*, that the tax rule hinders the exercise of the freedom of establishment through a subsidiary.

Pursuant to the migrant/non-migrant test a French parent company establishing a subsidiary in France or in another Member State where the CFC rules do not apply and a French company establishing a subsidiary in a Member State where the CFC rules potentially apply are not treated in the same way.

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<sup>20</sup> Jérôme Turot, “ L'article 209 B est-il soluble dans le droit communautaire ? ” : RJF 12/98 p. 940 ; Patrick Dibout, “Territorialité de l'impôt, répression de l'évasion fiscale et liberté d'établissement dans la Communauté européenne”, Dr. fis. 48/98 p. 1475 ; Bruno Gouthière, “ Les impôts dans les affaires internationales ”, 5e édition n° 2525-1.

According to this example, the French CFC rules did not comply with the Community Law. That is why the French Government in the Finance Law 2005 decided to amend the legislation before the ruling in *Cadbury Schweppes*.

However there was an important difference between the UK's and the French CFC rules. In the French legislation there was no general presumption and the company was given the possibility to prove that the CFC had a genuine economic activity. Many commentaries on the amended legislation have underlined this point and maybe the French Government has been too fast to change the legislation and should have waited for the solutions given by the ECJ in its judgment.

## **II. Solutions to fix the incompatibility with the Community Law**

The ECJ has given in its ruling some clue to avoid the incompatibility between CFC rules and the fundamental freedoms protected under the EC Treaty (A). The UK has taken into account the judgment and has amended its CFC legislation (B).

### **A. In *Cadbury Schweppes***

The UK's CFC rules were found to be clearly incompatible with the freedom of establishment. However in certain circumstances those rules could apply anyway.

#### **1. Justifications**

The UK's CFC regime represents a breach of Community Law. However it is necessary to verify whether or not there are some justifications under EC law to justify such rules. The UK wanted to justify the CFC regime as a measure to counter tax avoidance by the diversion of capital to low-tax jurisdictions by establishing a CFC in these jurisdictions.

The settled ECJ case law says that an anti-avoidance provision can only justify the breach of Community Law if it is particularly intended to counter an abuse and on a case-by-case basis<sup>21</sup>.

According to the jurisprudence of the Court, the Advocate General accepted the justification of preventing tax avoidance as being capable to justify the restriction. However the Advocate General specified in the Paragraphs 88 and 89 of the Opinion that "the application of Community Law may be refused only when a company has set up a wholly artificial arrangement to avoid tax and that the anti-abuse legislation cannot be defined too generally in order for the national courts to assess the

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<sup>21</sup> ECJ, 28 January 1986, Case C-270/83, *Avoir Fiscal*, Para 25; ECJ, 9 March 1999, Case C-212/97, *Centros Ltd*, Para 25.



taxpayer’s conduct on a case-by-case basis” and for the taxpayers to have the opportunity to demonstrate that their conduct is normal.

## 2. *Proportionality*

Even if the UK’s CFC regime is justified by the aim of countering tax avoidance, it still has to meet the proportionality test. The measure at issue “has to be such nature as to ensure achievement of the aim in question and not go beyond what was necessary for that purpose”.<sup>22</sup>

The UK’s rules achieve their goal because they tax the profits made by the CFC in the hand of the UK parent company and thus cancel any tax avoidance. But for the ECJ the provisions went too far as they set up a general presumption of tax avoidance which cannot be rebutted by the taxpayer. It is clear that it should be possible to rebut the presumption. Moreover the application of the CFC rules must be restricted to wholly artificial arrangements intended to circumvent national tax law.

## 3. *Wholly artificial arrangement*

The ECJ has determined the conditions to assess whether a wholly artificial arrangement or not was involved. As the Court has said in the *Halifax* case<sup>23</sup> there are two ways to qualify a wholly artificial arrangement.

First there exists a subjective test where there must be an intention to obtain a tax advantage. The second one is an objective test. There must be “objective circumstances showing that the objective pursued by freedom of establishment has not been achieved”.<sup>24</sup>

By the application of those two tests, the UK’s CFC rules must apply only to wholly artificial arrangements. That means that to comply with the Community Law, the CFC legislation cannot apply where “the incorporation of the CFC reflects economic reality”.<sup>25</sup> There must be an actual establishment intended to carry on genuine economic activities in the Host Member State.

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<sup>22</sup> ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA*, Para 26 ; ECJ, 16 July 1998, *Imperial Chemical Industrie plc*, Para 26.

<sup>23</sup> ECJ, 21st February 2006, Case C-255/02, *Halifax*, para 74-75.

<sup>24</sup> In *Cadbury Schweppes*, para 64 ; Case C-110/99 *Emsland-Stärke*, para 52-53; Case C-255/02, *Halifax*, para 74-75.

<sup>25</sup> In *Cadbury Schweppes*, para 65.

The assessment of the CFC must be based on objective factors like a physical presence in the Host State with staff and equipments. The ECJ wants to avoid the common practice of "letterbox" or "front company"<sup>26</sup>.

However the important point is that the legislation cannot set up a general presumption. The UK parent company must be given the opportunity to demonstrate and to bring evidence that the CFC is actually established and carries on genuine economic activities.

As the UK's CFC rules are obviously incompatible with the Community Law, the UK has decided to make changes in its domestic law.

### **B. New UK's CFC legislation**

The *Cadbury Schweppes* case held that the existence of the UK's CFC rules constituted a restriction of the freedom of establishment. A restriction could be justified only to counter "wholly artificial arrangements" set up to avoid the UK taxation.

The Pre-Budget Report of the 6<sup>th</sup> December 2006<sup>27</sup> announced the new UK's CFC rules to make them compliant with the Community Law.

If a UK parent company has a CFC in the EU or in a State part of the European Economic Area, the legislation gives the right to apply to Her Majesty's Revenue & Customs (HMRC) for a reduction in the profits of the CFC that are allocated to the UK parent company<sup>28</sup>. The reduction of the profits represents the "net economic value created by work carried out by individuals working for the CFC in business establishments within the EEA"<sup>29</sup>.

A CFC resident in an EEA territory will be exempt if its activities can be regarded as effectively managed in that territory and if there are sufficient individuals working for the company in the territory who have the competence and authority to undertake the company's business.

HMRC draft guidance<sup>30</sup> states that "...the net economic value should equate to what the group would be prepared to pay to a third party to undertake the work done by

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<sup>26</sup> In *Cadbury Schweppes*, para 68.

<sup>27</sup> <http://www.hmrc.gov.uk/pbr2006/pbrn-all.pdf>

<sup>28</sup> [http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object\\_id/a72f0fea-b5e6-430b-84be-f86057db67d5.cfm](http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/a72f0fea-b5e6-430b-84be-f86057db67d5.cfm)

<sup>29</sup> Pre-Budget Report of the 6th December 2006

<sup>30</sup> HMRC draft legislation and guidance notes 28 February 2007

staff working for the CFC in the relevant state, over and above the full economic costs of undertaking the work”. From this statement it is clear that some intra-group activities cannot qualify.

The procedure to get the tax back depends on the UK parent company. In fact the latter has to ask HMRC for reducing the apportioned chargeable profits of the CFC by the net economic value of work undertaken by the individuals for the CFC

### **Issues arising from the new UK’s CFC rules**

There are some doubts on the amended UK’s CFC rules. Some authors think that the changes do not fully meet the requirements of the ECJ judgment in *Cadbury Schweppes*. In fact the ECJ in its ruling focuses on the existence of genuine economic activity whereas the new legislation focuses on the profit realised by individuals working for the company who have the competence and authority to undertake the company's business. This is the interpretation of the UK government of what should be considered as a genuine economic activity.

HMRC said<sup>31</sup> that intra-group activities and activities that add no value to the group, such as intra-group lending, cannot give rise to genuine economic activities.

Some examples taken by the authors can illustrate this issue<sup>32</sup>.

For instance if a UK company sets up a CFC to hold intellectual property rights, then any profits arising from the IP rights will be excluded from the new exemption. This is the case even if the CFC pays a normal market value for the IP rights.

However, if a UK parent company decides to set up a CFC to provide for the group treasury operations in another member state and if the CFC has sufficient individuals working for the company who have the competence and authority to undertake the company's business, the exemption will apply to the profits generated by the individuals' activities.

It is clear that the changes in the UK’s CFC rules are controversial and it is doubtful that those changes go far enough to make the UK’s CFC regime compatible with the Community Law.

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<sup>31</sup> HMRC draft legislation and guidance notes 28 February 2007

<sup>32</sup> [http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object\\_id/a72f0fea-b5e6-430b-84be-f86057db67d5.cfm](http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/a72f0fea-b5e6-430b-84be-f86057db67d5.cfm)