THE LEGITIMACY OF CFC LEGISLATION WITHIN THE COMMUNITY

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Introduction: CFC Legislation within the Community – a FEE survey conducted in April 2002[1]

Of the (then) 15 Member States, nine (Denmark, Finland, France, Germany, Italy, Portugal, Spain, Sweden and the UK) were found to have schemes in operation and six (Austria, Belgium, Greece, Luxemburg, Ireland and The Netherlands) did not.

The survey revealed both material similarities and material differences between the schemes in operation. For instance, some targeted only passive income but others targeted companies according to the jurisdiction in which they are established. Of those targeting jurisdictions, some tested a rate of tax compared to the Origin State rate, one (Germany) an absolute rate and the UK, an effective rate as compared with the Origin State rate. Individuals came within the scope of the provisions in the case of seven of the schemes (excluding Denmark and UK) and, whilst Germany and Portugal tax domestic shareholders of CFCs regardless of the level of holding, the UK taxes only those corporate shareholders which, with their associates, are entitled to 25% or more of the CFC's profits.

The survey also revealed differing justifications for introducing the CFC schemes. FEE reported the following:

- Countering tax avoidance through deferral;

- Tool for obtaining international tax neutrality following the model of Capital Export Neutrality;

1 Fédération des Experts Comptables Européens: Position Paper on Controlled Foreign Company Legislations in the EU

- Defence against harmful tax competition;
- Prevention of tax erosion;

and the remedies prescribed by the country schemes varied between taxing deemed dividends and "lifting the corporate veil", that is, apportioning the CFC's profits to its shareholders and taxing the shareholders as if they had received the profits in their own accounts.

Five of the nine country schemes had express exemptions for CFCs conducting a genuine business activity although one other, Spain, taxes only passive income and Denmark taxes only financial activities. Three of the country schemes, it was reported, incorporated some form of motive test.

The legitimacy of the UK's measures has been recently examined by Advocate General Léger in relation to a reference for a preliminary ruling by the UK's Special Commissioners in connection with a tax appeal by Cadbury Schweppes[2] and the principles that the Court will ultimately identify as relevant to this case, and to the UK legislation, will apply to the schemes of all Member States.[3]

In this respect, the Court will make neither a finding of fact nor seek to interpret national law.[4] Its function is to provide the national court with an interpretation of Community law relevant to the case that it is considering[5].

It is beyond the scope of this article to describe and discuss schemes generally in operation in the Community and the discussion will focus on the UK legislation and the Advocate General's Opinion.

2 Case C-196/04 Cadbury Schweppes plc, *Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*. The Opinion was delivered on 2nd May 2006.

3 Art 10CE.

4 *Bouanich* C-265/04 , paragraphs 51 & 54.

5 Article 220CE and Case C- 471/04 Keller Holding GmbH at paragraph 26: *"...it is for the Court to provide the national court with all those elements for the interpretation of Community law which may be of assistance in adjudicating on the case pending before it, whether or not that court has specifically referred to them in its questions*"

The Code of Conduct[6], Tax Avoidance and the objectives of the UK's CFC legislation.

The status of the Code of Conduct is clearly noted in the 6th recital: it does not override the rights, obligations and freedoms in the Treaty[7]. This is repeated in Paragraph A, which sets out the scope of the Code: it applies to

> "*...measures which affect, or may affect, in a significant way, the location of business activity in the Community ...[including] all activities carried out within a group of companies.*"

Paragraph B clarifies "measures":

> "*...tax measures which provide for a significantly lower effective level of taxation ...than those levels which generally apply in the Member States...*".

It is clear from the 1st recital that such measures are considered to distort the single market and cause significant losses of tax revenue.

Similarly, the first recital of the Mutual Assistance Directive[8] records:

> "*whereas practices of tax evasion and tax avoidance extending across the frontiers of the Member States lead to budget losses and violations of the principle of fair taxation and are liable to bring about distortions of capital movements and of conditions of competition; whereas they therefore affect the operation of the common market;*".

Both of these instruments record the perceived threat of tax avoidance to the objectives set out in Art 2 CE.

It cannot be denied that the UK's CFC legislation is a domestic law device designed to neutralise the tax measures of other Member States (and third

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6 Resolution of the Council and the representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation.

7 *EMPHASIZING that the code...does not affect the Member States' rights and obligations or the respective spheres of competence of the Member States and the Community resulting from the Treaty*."

8 Council Directive of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (77\799/EEC).

countries[9]) that might be regarded as potentially harmful where exploited by UK residents using primarily artificial arrangements and to counter tax avoidance by way of deferral.

But the UK's provisions, discussed in more detail below, are carefully targeted. They can be disapplied if the CFC satisfies the conditions of any one of six defined exemptions. As will be seen, the UK provisions are designed to apply only in situations where the CFC has been established in a low tax jurisdiction to exploit that low tax regime of the Host State and to serve little other purpose.

It might be said that, if it is reasonable to assume that the Code is compatible with the Treaty and to assume that Member State measures compatible with the objectives of the Code are compatible also with the Treaty, the UK measures, if compatible with the Code, "*pursue legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest*"[10]. This is one of the tests that must be satisfied if the Origin State counter-measures cause a breach of any of the Treaty freedoms.

However, if there is such a breach, the Court requires it to be justified in accordance with the criteria set out in its case law. That is the case even if the Host State tax measures are regarded not only as harmful, but also, themselves, as in breach of the Treaty. Unilateral action by a Member State creating legislation to counter such measures that, itself, conflicts with the Treaty freedoms, is not permitted[11] unless it can be justified as aforesaid. As will be discussed later in more detail, the justification that is relied upon in this instance is that of countering *tax avoidance through the transfer of [profits to companies established in the Member States which apply the lowest rates of taxation]*[12].

The Court's case law provides three examples of *tax avoidance*: first, tax benefits obtained through "*…wholly artificial arrangements, set up to circumvent UK tax legislation..*"[13]. Secondly, exploiting tax advantages, legally, to avoid or delay tax

9 See paragraph M: "Geographical extension" placing an obligation on Member States to promote the abolition of harmful tax measures in third countries.

10 *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* Case C-446/03 at paragraph 51.

11 *Cadbury Schweppes AG* Opinion at paragraph 58.

12 See *Marks & Spencer* at paragraph 49 [adapted].

13 *ICI v Colmer* Case C-264/96 at paragraph 26

(permitted)[14]. Thirdly, the transfer of tax reliefs round a group to a company that can obtain the highest tax value for them.[15]

In the case of the first of these, "*wholly artificial*", which means that there can be no commercial purpose whatsoever, must be interpreted consistently with the Court's findings and comments in the *Halifax* case[16] (which concerned "abuse" of Community law) where the Court said (paragraph 80):

> "*To allow taxable persons to deduct all input VAT even though, in the context of their normal commercial operations, no transactions conforming with the deduction rules of the Sixth Directive or of the national legislation transposing it would have enabled them to deduct such VAT, or would have allowed them to deduct only a part, would be contrary to the principle of fiscal neutrality and, therefore, contrary to the purpose of those rules.*"

This does not say that the transactions had to be *wholly* artificial as it is evident that the structure used attained, also, a commercial end. However, had the commercial end been achieved in a less contrived way, the tax advantage sought would not have been obtained. So, *wholly artificial* might refer to steps in the transactions or aspects of them.

In the case of the latter, it would be simple to set up a transaction between two wholly owned subsidiaries in a low tax jurisdiction and ensure that one would make a large profit and the other a compensating loss (using, for instance, a derivative contract). The profit would remain taxable in the host jurisdiction but the group would arrange for the corresponding loss to be relieved in a higher tax jurisdiction.

However, even such an artificial arrangement might not be attacked under the so-called *Ramsay* principle referred to by the Advocate General in footnote 68 of his Opinion. It is respectfully suggested that the Court take evidence on the true guidance to be gleaned from the *Ramsay* series of cases or read the speech of Lord Nicholls of Birkenhead in *MacNiven (Inspector of Taxes) v Westmoreland*

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14 *Barbier* Case C-364/01 at paragraph 71.

15 *Marks & Spencer* as above, paragraph 49.

16 *Halifax plc & others v Commissioners of Customs & Excise* Case C-255/02.

Investments Ltd.[17]

The UK legislation in brief[18]

The legislation was introduced in 1984 "*to tax profits which are accumulated abroad or diverted abroad from the United Kingdom*"[19]. The legislation is now to be found in Chapter IV of Part XVII (sections 747 – 756) and Schedules 24 – 26 of Income and Corporation Taxes Act 1988. A list of countries of residence that are considered not to have a *lower level of taxation*, subject, in some cases, to stipulated conditions, is published under Regulations (SI 1998/3081) –"*excluded countries*".

The thrust of the legislation is encapsulated in the heading of the first relevant section, s.747: "*Imputation of chargeable profits and creditable tax of controlled foreign companies*". Only UK companies that fall to be assessed (aggregated with their associates) on 25% or more of the CFC's *chargeable profits* (see next paragraph) are affected. Holdings by individuals of the shares of CFCs are taken into account only for the purpose of testing whether the CFC is controlled by UK residents. Control for the purpose of this legislation has an extended meaning in the case of a joint venture company and is set at 40%. It should be noted that a UK corporate shareholder's interest (aggregated with those of its associates) could fall short of the levels of control necessary to enforce the payment of dividends or to direct or influence the nature or conduct of the business of the CFC. The legislation applies even if the interest in the CFC is held for part only of the (tax) accounting period of the CFC.

The status of a CFC is tested in each (tax) accounting period. It might be caught by the provisions in one year, might qualify for exemption the next, but may fall back into them in the period following. Unless the CFC is established in an *excluded* country, is quoted, is engaged in *exempt activities* or satisfies the *motive*

17 *MacNiven* (2001) 73 TC 1: "*In Ramsay the House did not enunciate any new legal principle. What the House did was to highlight that, confronted with new and sophisticated tax avoidance devices, the courts' duty is to determine the legal nature of the transactions in question and then relate them to the fiscal legislation...when it is sought to attach a tax consequence to a transaction... If [the legal nature of the transaction] emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded*".

18 As enacted and amended for the Financial Year 2005.

19 Ian Stewart MP, Economic Secretary to the Treasury, Hansard 14th June 1984, Standing Committee A, at 1139 sourced from The High Court Order for Reference to the Court of Justice of the European communities (The Test Claimants in the CFC and Dividend Group Litigation – "CFC GLO reference"), paragraph 11.

test, a UK tax adjusted computation of the CFC's *chargeable profits* must be made (applying the assumptions set out in Schedule 24) and the notional UK corporation tax chargeable on those profits is to be compared to the *local tax* payable on those profits. The *local tax* is adjusted proportionately for any income or expenses taxed or allowed locally that are excluded from the notional UK computation[20]. If the *local tax* payable is less than 75% of the notional UK corporation tax, the CFC is subject to a *lower level of taxation*.

It should be noted that it is not the local tax rate that is compared with the UK rate but the effective local tax rate as a percentage applied to the notional UK tax adjusted profits that is compared with the UK rate.

The exemptions are set out in section 748 and Schedule 25. There are six. If the CFC is quoted or is resident in an *excluded country*, it is exempt. If its *chargeable profits* (computation required) are less than £50,000, or if it follows *an acceptable distribution policy* (computation required), it is exempted also. That leaves the most important of the tests, the *exempt activity* test, and the *motive* test, the latter of which was considered by Advocate General Léger to take account of the particular circumstances of each taxpayer, a critical requirement enabling a taxpayer to rebut the presumptions in the legislation[21].

The *exempt activities* rules are complex[22] but, broadly, all activities are exempt *other than* investment business (which includes leasing) unless it is not the *main* business; dealing in goods for import into or export from the UK or delivering them to or taking delivery from associates, also unless it is not the *main* business; purchase or sale of goods from or to associates; wholesale or distributive financial or service business where more than half of the gross trading receipts are from UK residents or associates of various definition. There is also an exemption for local holding companies and similar. The exemption is important because it excludes all genuine non-UK trading, manufacturing or service provision operations from the provisions[23].

The *acceptable distribution policy* exemption[24] was not even mentioned by the Advocate General. Exemption from apportionment of the CFC's profits is granted if the CFC distributes not less than 90% of its UK tax adjusted profits within 18

20 ICTA 1988, S.750(1A).

21 *Cadbury Schweppes* AG Opinion at paragraphs 110 and 144-146.

22 ICTA 1988, Schedule 25, Part II.

23 See, for instance. *Cadbury Schweppes* AG Opinion paragraph 49.

24 ICTA 1988, Schedule 25, paragraphs 1-4A.

months of the end of the accounting period for which the dividend is declared. In consequence of this, even a CFC that fails the other exemption tests can obtain for its parent (assuming a large group) a tax advantage and a 24 month tax payment timing advantage

There are two legs to the so-called *motive test*, and both have to be satisfied[25]. The first leg looks at the transactions effected during the CFC's accounting period. If any, or any combination, achieved *a reduction in UK tax* (which is defined as satisfied if any person would have paid more UK tax had the transactions not been effected), and it was the, or one of the, main purposes of the transactions to achieve that reduction, the *motive test* is failed and the exemption denied.

The second leg of the *motive test* tests the reason for the very existence of the CFC in that accounting period. If the reason (or one of the main reasons) was to achieve a reduction in UK tax by a *diversion of profits from the UK*, the *motive test* is failed and exemption denied.

The first leg requires the company's transactions to be reviewed and to be justified. The second leg requires there to be some commercial reason for the existence of the company in that accounting period.

In the case of Anglo American's CFCs, the fact that they were incorporated under non-UK companies before migration of those parents to the UK was *insufficient* to obtain more than two years exemption under the *Motive Test*[26].

The Relevance of Secondary Legislation

Advocate General Léger stated briefly:

> "*I do not think that secondary legislation contains provisions relevant to this examination.*"[27]

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25 ICTA 1988, Section 748(3) and Schedule 25, Part IV.

26 See CFC GLO reference, paragraphs 44 & 47: "*Anglo American plc is a publicly-owned company, incorporated and resident in the UK...incorporated in May 1998 as the vehicle for the merger and migration TO the UK of two public companies, Anglo American Corporation of South Africa...and Minorco SA, a company incorporated and with its seat in Luxembourg...the Inland Revenue decided that for the first two accounting periods of Anglo American plc's control...the Motive Test Exemption...would apply to all CFCs other than a small number of specifically excluded companies...*"

27 *Cadbury Schweppes* AG Opinion, paragraph 6.

Conflict with the EC Treaty

The following question has been referred to the Court of Justice[28]:

> *Do Articles 43, 49 or 56...preclude national tax legislation...which provides...for the imposition of a charge [to tax] upon a company resident in that Member State in respect of the profits of a subsidiary resident in another Member State and subject to a lower level of taxation.*

Origin State Restrictions

The UK CFC legislation imposes consequences upon UK resident companies making investment in certain other companies resident in certain other jurisdictions. The UK is, in respect of these provisions, acting as an Origin State, not a Host State.

As the ECJ re-iterates in every direct taxation judgment,

> "*according to settled case-law, although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community law..*"[29].

> "*Even though...the provisions concerning [the Treaty freedoms] are directed to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering [the use of those freedoms by]...its nationals or [by companies] incorporated under its legislation..*"[30]

Accordingly, if the imposition of tax under the CFC provisions, or the imposition of the burden of compliance under those provisions, "*...is of such a kind as to hinder the exercise by the [resident company] of its [freedoms under the EC Treaty]...*"[31], those provisions would constitute a prohibited 'restriction'.

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28 See *Cadbury Schweppes* Special Commissioners' Decision 1st June 2004, paragraph 11.

29 See *Marks & Spencer* paragraph 29.

30 *Marks & Spencer*, paragraph 31 [adapted].

31 *Marks & Spencer*, paragraph 33 [adapted].

> "*Such a restriction is permissible only if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary, in such case, that its application be appropriate to ensuring the attainment of the objective thus pursued and not go beyond what is necessary to attain it...*"[32]

Articles 43 and 56

The ECJ has held that claims under Articles 43 and 56 are not exchangeable. Article 43 applies where:

> "*[the resident company's holding in the CFC gives it] definite influence over that company's decisions and allows [it] to determine its activities.*"[33]

Article 56 applies where:

> "*...Article 43 does not apply having regard to the insufficient level of participation of the [resident company] in the [CFC]...*"[34].

This article is wider in scope in that, whereas Article 43 can only apply where the CFC is resident in another Member State, Article 56 can apply where the CFC is resident in a third country.

The question put to the Court: are all three articles relevant?

The Advocate General was of the opinion that only Article 43 (freedom of establishment) was relevant to his examination.[35]

Citing the case *X & Y*[36] in considering whether Article 56 (freedom of movement of capital) is relevant, he stated that only the freedom of establishment is relevant where the investor has a holding in a company that gives him *definite influence*

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32 *Marks & Spencer*, paragraph 35. Based on the "*Gebhard* tests" Case C-55/94 *Gebhard* , paragraph 37. The first test is that the *national measures...must be applied in a non-discriminatory manner*.

33 Case C-436/00 *X, Y v Riksskatteverket*, paragraph 67 [adapted].

34 *X &Y*, paragraph 68 [adapted].

35 *Cadbury Schweppes* AG Opinion, paragraph 31.

36 *X&Y* at paragraph 37.

over that company that permits him to determine its activities[37]. A further gloss on the concept of "establishment" in the context of Article 43 CE was provided by the Court in *Bosal*[38]. The Court put its observation in these terms: "*...a parent company might be dissuaded from carrying on its activities through the intermediary of a subsidiary established in another Member State...*". Thus, investment in a joint venture or consortium company, in which the investor may not have *control*, but *through which* it may conduct its business or an aspect of its business, would fall under Article 43 rather than Article 56 (freedom of the movement of capital). It will generally be the case that there will be a shareholders' agreement between the joint venturers or the consortium members that will set out in detail the proposed business activities of the company, its distribution policy and how it is to be managed.

However, in concluding (as a general statement) that the UK provisions apply only to a "*...resident parent company [that] is linked not only by a mere holding but by control...*"[39], the Advocate General is incorrect. As has been explained earlier, the *control* requirement is control exercisable by UK resident shareholders (which can include individuals)[40] not by the company subject to being taxed on an apportionment of the CFC's UK tax adjusted profits, which can have an interest as low as 25%[41].

International GAAP[42] recognises that a holding of 20% or more of the voting rights of a company will give the holder *significant influence* but by definition that is less than *control*. However, as noted above, the combination of a 25% holding and rights under a shareholders' agreement are likely to satisfy the Court's requirement for Article 43 to apply. Accordingly, it is unlikely that Article 56 will be in point in relation to the UK legislation although it could be relevant to the legislation of other Member States.

In the case under examination, the CFCs were wholly owned subsidiaries of the Cadbury Schweppes Group and so there is no doubt that it is Article 43 that is the relevant freedom to consider.

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37 *Cadbury Schweppes* AG Opinion, paragraph 32.

38 *Bosal Holdings BV v Staatssecretaris van Financien* Case C-168/01 at paragraph 27.

39 *Cadbury Schweppes* AG Opinion, paragraph 33.

40 ICTA 1988, s.747(1)(b).

41 ICTA 1988, s.747(5).

42 International Accounting Standard 28.

Is Article 49 (freedom to provide services) in point?

The Court in the *Gebhard* case[43] confirmed that Article 49 can apply only where the freedom of establishment (and movement of capital) does not apply. However, the Advocate General discussed the issue and raised some points that need to be addressed.

Distinguishing the situation from that in *Safir*[44] and that in *Eurowings Luftverkehr*[45], the Advocate General stated:

> "*The nature of the activity carried on by [the Cadbury Schweppes CFCs] is not specifically referred to by [the UK CFC provisions]*"[46].

It is respectfully suggested that this, too, is an incorrect statement. As explained earlier, in relation to the *exempt activities* test in the UK provisions[47], exemption from the UK provisions is available for companies that are not conducting defined activities, or are conducting them but not to a sufficient degree to disentitle them from the exemption, or are conducting them (in the case of some of the specified activities) but not with the persons specified (for the most part, associates and UK resident persons or UK PEs of non-resident persons).

It is a common form for many of the UK's anti-avoidance tax provisions for all potential situations of the kind addressed by the provisions to be brought into the scope of the provisions and then for admittedly "innocent" situations to be defined and to be removed from the scope of the provisions. Accordingly, the net effect is that only the "mischievous" situations remain within the scope but the legislature is relieved of the burden of having to legislate for all possible mischievous structures and variations. Thus, for instance, a UK group that opens a retail shop in the Irish International Financial Services Centre to trade with people working in that business area is within the CFC provisions in the first instance but then removed from them because it is conducting an *exempt activity*. That was not the case, however, for the Cadbury Schweppes subsidiaries that were providing treasury

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43 *Gebhard* Case C-55/94 paragraph 22: "*The provisions of the chapter on services are subordinate to those of the chapter on the right of establishment... as the first paragraph of Article 50 specifies that the provisions relating to services apply only if those relating to the right of establishment do not apply*".

44 *Re Jessica Safir* Case C-118/96.

45 *Eurowings Luftverkehrs AG v Finanzampt Dortmund-Unna* Case C-297/97.

46 *Cadbury Schweppes* AG Opinion, paragraph 35.

47 ICTA 1988, Schedule 25 Part II.

services for Cadbury Schweppes group companies. However, had the services been provided to unrelated third parties, they may well have been able to claim the exemption. Accordingly, it was because of the identity of their customers that the Cadbury Schweppes subsidiaries fell within the scope of the provisions with the adverse consequences to their UK resident parent companies.

In the *Marks & Spencer* case, the Court identified a disadvantage but considered it unnecessary to require that disadvantage to be suffered by the UK company in the group that made the indirect investment in the non-UK subsidiaries in question. It was sufficient that the relief denied normally "*...confers a cash advantage on the group.*"[48] In the *Eurowings* case, the Court ruled that it was a restriction of the freedom to grant the recipient of services a less favourable tax treatment because the provider enjoyed a tax advantage from the low level of taxation in its Host State.[49] Accordingly, to subject the Cadbury Schweppes group to additional UK taxation because the provider of the treasury services was an in-house company that enjoyed a low tax regime in its Host State would appear to be a restriction of this freedom from the point of view of both the provider and the recipient.

Unlike the *Eurowings* case, however, the quantum of the financial disadvantage is unrelated to the quantum of the services except, in a loose manner, to the gross profit margin earned by the service providers. The disadvantage is UK tax assessed on the *profits* of the provider's activities. Accordingly, even disregarding the stipulated priority, it is thought that the better view is that the restriction should be identified as that resulting under Article 43 (or Article 56) as the Advocate General suggested[50].

Did Cadbury Schweppes "abuse" the Freedom of Establishment

The Advocate General examines this question from the national court first[51]. It was reported that the subsidiaries were set up solely to enable the internal treasury operation to enjoy the benefits of the low level of tax charged in the Irish IFSC.

The Advocate General states that he does not consider that using the Treaty freedom to enable exploitation of the tax benefits available in another Member

48 *Marks & Spencer* paragraph 32.

49 *Eurowings* paragraph 44.

50 *Cadbury Schweppes* AG Opinion, paragraph 36.

51 *Cadbury Schweppes* AG Opinion, paragraph 39.

State to be, of itself, an abuse of that freedom.[52] He cited the judgments in *Centros*[53] and in *Inspire Art*[54].

Although the judgments cited are clear on this matter, the Advocate General felt it necessary to explore the issue in some detail. In the *Inspire* Art case, the Court qualified the otherwise unconditional right to the freedom of establishment by excluding the exercise of that Treaty right to perpetrate fraud. In paragraph 49 of his Opinion, the Advocate General qualified further the right to exercise the Treaty freedom by introducing the requirement:

> "*... as long as there is genuine and actual pursuit of an activity by the controlled subsidiary in the Member State in which it was established ...*"

Firstly, it is puzzling that the Advocate General uses that description (above) of a situation that would not give rise to abuse when he uses similar words in his conclusion to describe a situation that should be exempted by the domestic legislation in order to be entitled to claim justification for creating a restriction..[55] It is puzzling because, if the CFC does not pursue such a genuine activity, abuse of the freedom might be concluded using the above test and the controlled subsidiary would be denied the protection provided in the Treaty in that circumstance. Whether or not the UK legislation could be justified would then be irrelevant.

Secondly, the Advocate General's requirement appears more onerous than that phrased by the Court in the recent *Halifax* judgment.[56] The Court said (paragraph 75) that "abuse" is not in point where: "*the economic activity carried out may have some explanation other than the mere attainment of tax advantages*". In paragraph 112 of his Opinion, the Advocate General indicated that the activities of the CFC should be judged using criteria similar to that used to judge the existence of a Permanent Establishment under International Law[57]. In contrast, the Court

52 *Cadbury Schweppes* AG Opinion, paragraph 40.

53 *Centros Ltd* Case C-212/97, paragraph 27 "*the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment.*"

54 *Re Inspire Art Ltd* Case C-167/01 paragraph 95 "The reasons for which a company chooses to be formed in a particular Member State are, save in the case of fraud, irrelevant with regard to application of the rules on freedom of establishment".

55 *Cadbury Schweppes* AG Opinion, paragraph 152.

56 *Halifax plc & others v Commissioners of Customs & Excise* Case C-255/02.

57 OECD Model Treaty, Article 5, Note 2 of the commentary on paragraph 1.

would appear just to require there to be some commercial explanation for the establishment of the CFC.

However, it is not material to the decision.

Does the UK legislation constitute a restriction to the Freedom of Establishment?

The first question to the Court concerns whether the imposition of tax on the UK resident shareholder constitutes a restriction. The Special Commissioners ask the Court both "*what comparison should be made and whether any comparison is possible*"[58]. The Special Commissioners suggested, and the Advocate General considered, two comparisons.

The first comparison is of the UK parent investing in a UK resident company. One distinct disadvantage of investing in a non-resident CFC can be identified: the profits of a UK company are assessed on that company and not on the investor, its "parent", as is the case where a CFC apportionment is made. This could constitute a cash flow disadvantage to the parent unless the parent can obtain a distribution from the CFC, although this will generally be the case where Article 43 is in point. The Advocate General considered this to be the issue to examine.[59]

However, whether, in *reality*, there is a *cash flow disadvantage* will depend upon the individual circumstances of each group of companies. The Advocate General has assumed, or made, a finding of fact that, as said earlier, the Court will not do.[60]

For large groups, the UK has a quarterly Corporation Tax payment on account system where the first of the payments is due halfway through the accounting period. By the 14th day following the end of the accounting period (assuming a 12 month period), 75% of the estimated tax due should have been paid.[61]

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58 Special Commissioners' Decision, paragraph 10.

59 *Cadbury Schweppes* paragraph 74.

60 *Bouanich* paragraphs 51 & 54.

61 Taxes Management Act 1970, s.59E & SI 1998/3175 for companies and groups (broadly speaking) having taxable profits exceeding £10 million. Reg. 5: 1st payment due 6 months + 13 days after start of period and the last is due 3 months + 14 days after the end with additional payments at 3 months after the previous one.

The relevance of this to the question of whether the parent, in being assessed to the CFC's profits, suffers a *cash flow disadvantage* is that a large group, such as Cadbury Schweppes, to minimise the usurious cost of overpayments and underpayments of tax on account[62], which is inevitable as the first three payments will be based on budgets and forecasts, and to take account of group relief forecast to be available, but not allocated until some time after the end of the accounting period, will enter into a group payment arrangement[63] under which a nominated company, probably the parent, will make payments on account on behalf of the group to the extent of the forecast net liability.

Accordingly, the parent, if such an arrangement is in place, will be paying the tax due on the (net) profits of its subsidiaries and funding the payments by calling up quarterly payments from them.

In the *Keller Holding case*[64], the Court said:

> " *...by virtue of the method of offsetting tax already paid [in respect of the subsidiary's profits], those dividends are,* ***in reality****, exempt from tax.*"

In the instance of a large group, such as Cadbury Schweppes, is there, *in reality*, any difference between calling up a quarterly dividend from a CFC, on the one hand, and of calling up a quarterly payment on account of Corporation Tax from a UK resident subsidiary under a Section 36 arrangement, on the other? The dividend will be taxable but credit relief, which will include the Corporation Tax assessed on the parent on the apportioned CFC's profits, will offset the tax assessed on the dividend. And, as the Court said in the *Bouanich* case, it is for the national court to determine whether the taxpayer has actually suffered less favourable treatment.[65]

The Advocate General gave no explanation of his conclusion that the parent would suffer a disadvantage[66] but the answer to the question based on this comparison would appear to be that the imposition of tax on the parent (in a large group) will not generally result in a disadvantage unless credit for local tax is restricted where,

62 The difference in rate between interest charged on under payments and interest paid on over payments is substantial for groups that can borrow at significantly finer margins from their bankers.

63 FA 1998, s.36.

64 *Keller Holding AG* Case C-474/04 at paragraph 31.

65 *Bouanich* C-265/04 at paragraph 55.

66 *Cadbury Schweppes* AG Opinion, paragraph 74.

exceptionally, items of income of the CFC are subject to local tax but are exempted from UK Corporation Tax in the notional computation previously referred to.

Notwithstanding this, it is not clear why the matter of this comparison was not concluded simply on the basis of the *Barbier* decision[67] mentioned above in relation to three instances of tax avoidance considered by the Court and cited by the Advocate General in paragraph 82.. The Court said:

> "*... a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State ...*".

In the case of Cadbury Schweppes, Article 43 was relied upon to profit from the low tax regime in the Irish IFSC.

The second comparison, the Advocate General defined**,** is that of investment in a non-resident company established in a Member State levying tax at a rate lower than that of the UK, but not sufficiently lower to trigger the UK's CFC provisions. The Advocate General states that the resulting *discrimination* must stand as such even if the first comparison produces a neutral result[68] and he cites the definition for *discrimination* used by the Court in the *Royal Bank of Scotland* case[69]: "*...the application of different rules to comparable situations (or in the application of the same rule to different situations)...*". Are the situations of a UK resident parent investing in a low tax Member State jurisdiction and that of a UK resident parent investing in another Member State, comparable? He states that they are.[70]

He concludes:

> "*The difference in treatment...depending on the tax rate of the [host] Member State...suffices, in my opinion, for that system to be regarded as constituting a hindrance to freedom of establishment...*".[71]

67 *Barbier* Case C-364/01 at paragraph 71.

68 *Cadbury Schweppes* AG Opinion, paragraph 77.

69 *Royal Bank of Scotland plc* Case C-311/97 at paragraph 26.

70 *Cadbury Schweppes* AG Opinion, paragraph 78.

71 *Cadbury Schweppes* AG Opinion, paragraph 83.

This comparison appears to have echoes of the *D Case*[72] despite there being no rights under a Double Tax Convention in issue. In that case, a German national was denied the personal allowances that were granted to Dutch residents by The Netherlands in their assessment to Dutch wealth tax. The Court, following its decision in *Schumacker*[73] found that D was not in a situation comparable with a Dutch resident (he had only about 10% of his wealth in The Netherlands). However, a Belgian resident in the same situation as D would be granted the allowances because of rights granted to Belgian nationals under the Netherlands/ Belgium Double Tax Treaty. The Court held that D could not claim the favourable treatment accorded to Belgian residents under the DTC.

In this situation, the second comparison need be made only if the conclusion of the first comparison is that the CFC legislation does not constitute a restriction to the freedom of establishment (or, if in point, the free movement of capital). The question then is: is the parent that establishes a subsidiary in a territory that, applying the objective criteria in the CFC legislation, triggers the rebuttable presumption of tax avoidance, in the same situation as the parent that establishes a subsidiary in a territory that does not? And, even if it is not in a comparable position, should the first parent be entitled to claim the favoured treatment of the second (even though the subsidiary of the second will have a higher local tax burden than that of the first)?

In the case of the UK provisions, it should be recalled that they apply to any UK resident company shareholder whose holding entitles it to 25% or more of the profits of a non-resident company (wherever resident) controlled by UK resident persons that bears local tax on its profits in an accounting period that is less than 75% of the UK tax that would have been chargeable had it been UK resident. For pragmatic reasons, to save on unnecessary compliance, the UK publishes a list of countries whose tax regimes will invariably yield a local tax burden that will exceed the trigger point and it presumes that a company having a local quotation will not have been established for the purpose of engaging in tax avoidance.

However, in other respects, the provisions apply evenly and will only give rise to consequences (other than compliance) if the CFC is held to be engaged in tax avoidance determined by applying objective criteria.

Accordingly, it is difficult to see how the UK legislation gives rise to discrimination unless it is the case that a person who exercises a Treaty freedom to

72 D Case C376/03.

73 *Schumacker* C-279.93.

engage in tax avoidance is in a situation comparable with a person who is not so engaged[74].

Whilst any form of additional burden arising from national legislation relating to an exercise of a freedom can give rise to a "restriction" or "hindrance", the principal issue will be whether that additional burden can be justified. As regards the question of the compliance burden arising under the UK's CFC legislation, that relating to the *exempt activities* test will be minor unless the CFC is engaged in prescribed activities as mentioned earlier. If the CFC is engaged in prescribed activities, but can demonstrate that it is mainly conducting its business with unrelated non-UK persons, its burden will not be much increased. It is only if its activities are of a type that could be designed to transfer profits out of the UK that its compliance burden will be significant but the Advocate General appears to have considered it reasonable that the CFC, or its parent, should shoulder the burden of proof to demonstrate that the CFC is *genuinely established* in the host State and that it provided "*services which were actually carried out in that State[that] were not devoid of economic purpose with regard to[the CFC's] activities.*"[75]

The imposition of a burden of proof on the taxpayer, in this case to avoid a charge, has been accepted by the Court in relation to claims for relief for losses in the cases of *Futura*[76]and *Marks & Spencer*[77].

As mentioned earlier, it does appear that the principle stated by the Court in the *Barbier* case would appear to determine a restriction under the first comparison and the second comparison does not appear to be necessary.

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74 T O'Shea: "A UK company that decides to operate in Ireland is disadvantaged compared to a similar UK parent company that opens a UK subsidiary – profits of the Irish subsidiary are taxed on an arising basis – profits of the UK subsidiary are not – that is likely to deter, discourage etc establishment – there is no need for the Court to calculate the difference !!! It's a clear restriction. Emphasis should be on the justifications put forward by the UK, ie wholly artificial arrangements – is it? Cannot the same services be legitimately purchased in Ireland from an investment bank? Or cannot the same services be legitimately provided within a group if the service provider is established in the UK?

75 *Cadbury Schweppes* Advocate General Opinion paragraph 151.

76 *Futura* Case C-250/95 Decision "*...The Member State...may...require the [claimant] to demonstrate clearly and precisely that amount of the losses which he claims to have incurred corresponds...to the amount of the losses actually incurred in that State...*"

77 *Marks & Spencer* Case C-446/03 paragraph 56 "*Where...the resident parent company demonstrates to the tax authorities that those conditions are fulfilled...*".

Can the restriction be justified?

The purpose of the legislation is to: "*tax profits which are accumulated abroad or diverted abroad from the United Kingdom*" as stated earlier. Four tests (The *Gebhard* tests[78]) must be satisfied:

1. It must be applied in a non-discriminatory manner;

2. It must be justified by imperative requirements in the general interest;

3. It must be suitable for securing the attainment of the objective which it pursues;

4. It must not go beyond what is necessary in order to attain it.

The Court has consistently held that:

> "*... reduction in tax revenue cannot be regarded as an overriding reason in the public interest which can be relied on to justify a measure which is in principle contrary to a fundamental freedom ...*"[79]

But, in the instance of "tax avoidance", the Court has recently stated:

> "*... it must be accepted that the possibility of transferring the losses incurred by a non-resident company to a resident company entails the risk that within a group of companies losses will be transferred to companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest.*"[80]

The legislation is concerned with assessment of profits not relief of losses but: "*... in tax matters profits and losses are two sides of the same coin ...*"[81] Accordingly, measures targeted at preventing the movement of profits around a group of companies from those resident in Member States applying a higher rate of taxation to those applying a lower rate of taxation may both pursue a legitimate objective compatible with the Treaty and be justified by imperative reasons in the public interest.

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78 *Gebhard* Case C-55/94 paragraph 37.

79 Case C-42/02 *Petri Manninen*, paragraph 49.

80 *Marks & Spencer* (see footnote 7) paragraph 49.

81 *Marks & Spencer* (see footnote 7) paragraph 43.

However, the measures must satisfy the tests numbered 3. and 4. above if they are to be considered to be justified. In particular, the measure must be targeted against the alleged abuse and must not apply to just any situation where a group company resides in a member State applying a lower level of taxation.[82]

In its application to corporate investors in CFCs that fail to be exempted, the legislation does not appear to be disproportionate in its result, which is to assess the CFC's profits to UK Corporation Tax subject to relief for overseas tax payable in respect of those profits, a basis that appears little different from the UK taxation of the profits of an overseas branch of a UK resident company. The Advocate General considered it to be "*indeed suitable for guaranteeing fulfilment of the purpose for which it was adopted*"[83]. But, does it go beyond what is necessary to achieve that purpose?

In this respect, having regard for the exemptions provided in the UK legislation and, in particular, to the one based upon the activities pursued by the CFC, it is clear that the measures do not have the type of general application objected to by the Court in the *Lankhorst-Hohorst* case. The Advocate General took this view also. He viewed the legislation as "*...designed to apply only in very specific circumstances which correspond to cases in which the probability of the risk of tax avoidance is highest*"[84]. Indeed, he indicated approval for its defined structure as "*contributing to the legal certainty of economic operators.*"[85] Additionally, the Advocate General could see no objection to the legislation being structured to provide a rebuttable presumption of tax avoidance[86].

The legislation does provide one further opportunity for CFCs to prove their *bona fides*: the *Motive Test*. This provides a case by case examination of each situation caught under the provisions to properly identify artificial arrangements, which the Advocate General stated to be of importance.[87] He stressed also the need to examine *objective factors* only[88] and to pay no regard to any stated purpose as the

82 See Case C-324/00 *Lankhorst-Hahorst GmbH v Finanzamt Steinfurt* at paragraph 37.

83 *Cadbury Schweppes* Advocate General Opinion paragraph 125.

84 *Cadbury Schweppes* Advocate General Opinion paragraph 137.

85 *Cadbury Schweppes* Advocate General Opinion paragraph 141.

86 *Cadbury Schweppes* Advocate General Opinion paragraph 140.

87 *Cadbury Schweppes* Advocate General Opinion paragraph 110.

88 *Cadbury Schweppes* Advocate General Opinion paragraph 117.

subjective intentions "*would be difficult to prove and would give rise to legal uncertainty*"[89].

Whether the legislation is sufficiently targeted to be justified must be a matter for the national court to decide. It is possible that the conditions to be satisfied in the *Motive Test* may be considered to be too severe and, thus, disproportionate to the objective of the measures.[90] The test requires the review of individual transactions[91] *and* review of the purpose of the existence of the CFC (in each accounting period), which includes the formulation of a hypothetical situation in which the company does not exist[92]. It is possible that the Court will hold that the objectives of the legislation might be achieved through means that are less onerous than these test requirements as was held in the *Futura* case[93].

Does the UK legislation constitute a restriction to the Freedom of Movement of Capital?

The Advocate General had no need to consider this question in relation to the Cadbury Schweppes case. The provisions of Articles 43 and 48 take priority over Articles 56 and 58[94].

> "*In the light of the answer given to the question as regards [Article 43]…that question need be considered only to the extent that…the national provision at issue is such as to involve a separate restriction (under Article 56)…[which will be only where there is an] insufficient level of participation of the transferor in the transferee*"[95]

Article 56 will apply to UK corporate investors in situations where:

1. The CFC is established in another Member State and the investors have an interest in the CFC greater than 25% but falling short of that level

89 *Cadbury Schweppes* Advocate General Opinion paragraph 119.

90 *Cadbury Schweppes* Advocate General Opinion paragraph 150.

91 ICTA 1988, Schedule 25, paragraphs 16 – 18.

92 ICTA 1988, Schedule 25, paragraph 19.

93 *Futura* Case C-250/95 at paragraph 39.

94 Art 58.2 CE.

95 *X & Y* Case C-436/00 paragraphs 66 - 68.

necessary to provide it with: "*...definite influence over [its] decisions and [of] its activities...*". In particular, the Article will apply to investments where the investor has insufficient control to ensure payment of dividends by the CFC to mitigate or eliminate the adverse cash flow consequences of being assessed to UK Corporation Tax on the CFC's profits. Similar consideration must be given to the ability of the investor to obtain the information required for the compliance obligations; <u>or</u>

2. The CFC is established in a third country.

As discussed earlier in this article, an investor having an interest of 20% or more is regarded under UK and International GAAP as having significant influence in the company concerned. By definition, for the UK legislation to apply, the CFC will be an unquoted company and an investor could secure his position by ensuring that there is a binding agreement in place between the shareholders, if not in the formal documents of incorporation, regarding dividend distributions to prevent the application of the UK CFC legislation (to qualify for the Acceptable Distribution Policy exemption[96]) or to prevent cash flow disadvantage on the investor in the case an apportionment of the CFC's profits under the legislation.

As regards the ability of the investor to obtain information from the CFC that is required by the investor to discharge its compliance obligations, the same solution is available and, in any case, it could be noted that the information requirements are comparable to those for a claim for relief from UK Corporation Tax for overseas "underlying tax" paid by the payor of a dividend to a UK investor holding an interest of 10% or more in the payor and, further, that the Court has held that a Member State may require a claimant to "*...demonstrate clearly and precisely...under its domestic rules governing the calculation...*"[97] the amount of the relief claimed. Accordingly, it is not thought that any additional restriction is likely to arise in the situation of a non-controlling interest in a CFC established in a Member State.

The freedom of Movement of Capital will be relevant to all levels of investment and control of a CFC established in a third country.

96 ICTA 1988, s.748(1)(a) and Schedule 25, Part I.

97 *Futura* (see footnote 13) at paragraph 43.

Conclusions

It is considered that the use by the Court of the word "*wholly*" in the phrase "*wholly artificial arrangements*" is singularly unhelpful to the English courts and is in contradiction with, for instance, the Advocate General's approval of the onus of proof that CFCs and their UK parents should bear, when the presumption of avoidance is triggered, to demonstrate genuine establishment and economic purpose for the intra-group transactions.[98] "*Wholly*" means precisely that, which is why UK anti-avoidance legislation generally uses the phrase "*wholly or mainly*". It means that if the CFC or its parent can demonstrate a scintilla of commercial purpose, the UK legislation cannot be justified. That would give the green light to carefully crafted arrangements that could be used by groups to "*...transfer their profits...from one Member State to another to suit their convenience.*"[99] That, the Advocate General observed, is not the purpose of the Treaty freedoms. Furthermore, he specifically approved the form and construction of the UK legislation.[100] It must be hoped that the Court will be more sensitive to the meaning of the words that it uses in relation to this critical point so that uncertainty can be avoided.

That apart, there appears to be a clear signal that the Court distinguishes between taking advantage of the freedoms to reduce the costs of conducting business, on the one hand[101], and groups, or consortia, establishing special purpose companies in low tax jurisdictions to primarily conduct intra-group transactions with a view to obtaining tax advantages, on the other.

To the extent that national legislation is constructed to neutralise the advantage gained in the latter case, whilst avoiding interference with companies using the freedoms in the manner intended, the Advocate General has clearly indicated that any hindrance identified can be justified, if only because it would be a hindrance to the use of the freedoms in a manner that was not intended by the Treaty.

On the face of it, it is a very simple rule. It does not require any modification to the Community law definition of "abuse" and it leaves the protection of their national tax bases to the Member States and their national legislation.

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98 *Cadbury Schweppes* Advocate General Opinion paragraph 151.

99 *Cadbury Schweppes* Advocate General Opinion paragraph 102.

100 *Cadbury Schweppes* Advocate General Opinion paragraph 137.

101 Such as in the case of *Centros* C-212/97 or *Barbier* Case C-364/01.

Accordingly, it could be said that carefully targeted CFC legislation that does no more than neutralise the benefits obtained through primarily artificial arrangements is legitimate within the Community.