On 12 September, the European Court of Justice gave its judgment in the Cadbury Schweppes CFC case that the UK controlled foreign companies rules (the “CFC Rules”) constitute a restriction on the freedom of establishment and that they may only be applied in the case of "wholly artificial arrangements". In a judgment that closely follows the Opinion of Advocate-General Léger delivered in May of this year, the Court held that it is for the UK courts to determine whether the CFC Rules as drafted are sufficiently narrow as to apply only to such arrangements. In our view they are not and we expect the UK courts to hold that the CFC Rules should be limited to such an extent that they are inapplicable to the vast majority of EU subsidiaries of UK companies.

Background to the case

The CFC Rules tax a UK parent company on the undistributed profits of any non-UK subsidiary which pays tax of less than ¾ of the tax which it would pay if its profits were taxed in the UK. Credit is given for foreign tax paid by the non-UK subsidiary. There are various exceptions to the CFC Rules, including the “motive test”, acceptable distribution and exempt activities.

Cadbury Schweppes set up two subsidiaries in Ireland to engage in intra-group financing transactions. Their profits were subject to Irish tax at a 10% rate applicable (at the time) to companies established in the International Financial Services Centre in Dublin. In accordance with the CFC Rules, the UK tax authorities assessed Cadbury Schweppes to tax on one of its Irish subsidiary’s profits (the other one had made a loss), finding that none of the exceptions to the CFC Rules applied. Cadbury Schweppes appealed,
arguing that the CFC Rules were incompatible with EU law (in particular, the freedom of establishment). The UK tribunal (the Special Commissioners) referred the issue to the European Court of Justice.

The Judgment

The Court’s judgment closely follows the opinion of Advocate-General Léger (released on 2 May). It holds that:

(i) Merely by choosing to set up subsidiaries in Ireland in order to benefit from the favourable tax regime there, Cadbury Schweppes was not abusing the freedom of establishment and was therefore free to rely on it.

(ii) The CFC Rules constitute a restriction on the freedom of establishment because they disadvantage a UK parent setting up a subsidiary in another Member State with a beneficial tax regime, as compared with a UK parent setting up a subsidiary in the UK or in another Member State which does not have a beneficial tax regime.

(iii) This restriction caused by the CFC Rules may be justified only to the extent they affect wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned, i.e. in escaping the tax normally due on profits generated by activities in that Member State.

Wholly Artificial Arrangements

The Court does not go as far as deciding whether the exceptions to the CFC Rules meet the requirement at (iii) above: the English courts must determine this based on a full analysis of the effect of the "motive test" as drafted.

However, the Court does give some guidance on how to identify a wholly artificial arrangement, which it equates with "a fictitious establishment not carrying out any genuine economic activity in the territory of the host member State". Wholly artificial arrangements must be shown by reference to objective factors which would be ascertainable by third parties. Such objective factors would include, in particular, "the extent to which the CFC physically exists in terms of premises, staff and equipment". The Court gives the example of a “letterbox” or “front” subsidiary as demonstrating the characteristics of a wholly artificial arrangement.

In this light, it is extremely unlikely that the motive test as drafted could be sufficiently narrow. Put simply, the ECJ is saying that a tax avoidance motive in itself is not sufficient to justify a CFC apportionment.
Implications

This judgment leaves some important issues to be resolved. A further hearing or hearings will be necessary before the Special Commissioners (and probably the higher English courts) in order to answer the question posed by the ECJ as to the interpretation of the motive test; and to decide whether, in Cadbury Schweppes’ particular circumstances, their arrangements were in fact wholly artificial.

However, the point of principle is clear: the CFC Rules (and by implication similar rules imposed by other EU jurisdictions) must not apply to EU subsidiaries except where those subsidiaries are not genuinely established and carry out no genuine economic activity in their respective jurisdictions. This is close to the English law concept of a “sham”. It is far narrower than a tax avoidance purpose test and should not be relevant wherever the CFC has been properly set up and managed.

Bearing in mind that the litigation is likely to continue, there is likely to be a period of uncertainty as regards the precise status of the CFC Rules in relation to EU CFCs. There could also be ramifications for CFCs outside the EU. Clients who have CFCs in their groups should take advice regarding pending returns and potential refund claims.

Tax authorities around the EU will regard this judgment as significantly restricting their ability to counter “tax competition” from other EU states with more favourable tax regimes. If they cannot penalise companies for moving profit-making operations to such other states, they might be expected to focus more on taxing the repatriation of the profits from those states. In this regard, the ECJ’s forthcoming judgment in the FII Group Litigation (due to be given within the next few months) - and the reaction of tax authorities to it - will be interesting. That case (together with others following it) relates to the UK’s regime for the taxation of foreign dividends and we expect the ECJ to find that this regime also is unlawful.
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