Analysis

# Why the EC regards the group financing exemptions as state aid

Speed read

**The European Commission has published its preliminary decision finding the non-trading financing profits exemptions in the UK's controlled foreign companies (CFC) rules to amount to unlawful state aid. The published decision appears to differ somewhat from the earlier short press release of 26 October 2017. It is now clear that the Commission is challenging both the full and partial exemptions in TIOPA 2010 Part 9A Chapter 9. According to the Commission, it is inconsistent with the logic of the UK's rules to provide exemptions where the profits are earned from overseas lending in comparison with non-trading finance income which generates UK interest deductions or involves third party lending. Taken to its logical conclusion, the Commission appears to be saying that all financing profits should be taxed in the home state, even where the profits are not generated by home state funds. In doing so, the Commission seems to challenge current case law on the freedom of establishment, which is not addressed at all in its decision.**

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The European Commission has published its preliminary decision that certain provisions of the UK's controlled foreign company (CFC) rules (set out in the Taxation (International and Other Provisions) Act (TIOPA) 2010 Part 9A Chapter 9) constitute state aid. These reasons were set out in a decision letter addressed to the UK, which was published in the *Official Journal of the European Union* on 24 November 2017.

The earlier excellent article in this journal ('Can the UK CFC rules survive the EC's state aid investigation?' (David Harkness, Dan Neidle & Rob Sharpe), *Tax Journal*, 9 November 2017) regarding the Commission's investigation preceded publication of the decision and commented on the press release the Commission had issued. That press release, however, was vague, identifying the 'group financing exemption' in the CFC rules as the subject of the newly opened investigation. As the earlier article noted, two exemptions potentially fall within that category:

- the 'qualifying loan relationships exemption' and;
- the 'the qualifying resources exemption' (or the 'partial exemption' and 'full exemption' respectively).

The Commission's press release did not identify which of the two exemptions contained in Chapter 9 of the CFC rules the Commission was targeting; or explain in any detail why the group financing exemption was considered to provide a selective advantage to certain undertakings.

It is now apparent from the Commission's decision letter that the Commission believes both the partial and the full exemption to constitute state aid. The Commission has now also given its reasons. Those reasons were not at all obvious from the earlier short press release.

In terms of the selectivity analysis, the Commission's focus appears to be on differential treatment between those companies with CFCs receiving non-trading finance profits (NTFPs) falling within Chapter 5 and those with CFCs receiving NTFPs falling within Chapter 9. The press release had hinted at a much broader focus, perhaps even extending to other categories of profits (such as business profits falling within Chapter 4).

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The reasoning in the decision letter is not always easy to follow, and focuses on arguments which have been raised by the UK in the course of correspondence relating to the CFC rules and in other contexts. Given the opportunities for interested parties to provide their comments on the decision, it can be anticipated that the arguments made on both sides will develop considerably in due course.

Although the Commission dealt with all of the elements of the test for determining whether there is state aid in its decision letter, the main focus of its decision is on the selectivity element of the state aid analysis.

### Why does the Commission consider the Chapter 9 exemptions to constitute unlawful state aid?

The three main elements of the state aid selectivity test as applicable in a tax context are as follows:

- Firstly, a suitable reference system should be identified.
- Secondly, it should be considered whether undertakings that are in a comparable position, in light of the aims of the reference system, are treated differently.
- Thirdly, it should be considered whether any selective treatment is justified by the nature and scheme of the reference system. (However, as the earlier article notes, it is not relevant that differential treatment might be justified by extrinsic factors.)

In its decision, the Commission identifies the relevant reference system as the entire CFC regime (at para 60). However, in contrast to the press release, the Commission's specific concern as set out in its decision appears to be that non-trading finance profits are dealt with differently depending on whether they fall within Chapter 5 or Chapter 9 of the CFC rules. Broadly, Chapter 5 applies to NTFPS from loans to UK related companies or third parties, and Chapter 9 applies to



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NTFPs from loans to foreign related companies. In particular, the Commission states (at para 87) that:

> 'More specifically, the group financing exemption treats operators which carry out finance transactions involving certain related foreign debtors better than operators which carry out finance transactions involving related UK debtors or finance transactions involving (UK or foreign) third party debtors, whereas all are in a comparable legal and factual situation in light of the objective of the reference system.' (See also para 84.)

Generally, the Commission takes the view that the CFC regime applies different rules to different types of profit received by a CFC, according to the extent to which there is a risk that those profits have been artificially diverted. The Commission notes that certain types of income present an objectively higher risk of artificial diversion when compared with others. The Commission's position is that non-trading finance income and, in particular, inter-company non-trading finance income present a high risk of artificial diversion, and that therefore that all CFCs receiving NTFPs are in a similar factual position for the purposes of the CFC charge (at paras 82 to 87). This is in part due to the relative mobility of NTFPs when compared to other types of profit (see paras 67 and 85). The Commission's analysis of the level of risk posed by NTFPs is relatively superficial, and does not really consider the possibility that there might be differences in risk level as between different types of NTFPs.

So far as is apparent from the Commission's decision, one of the main justifications provided by the UK for applying different provisions to different types of NTFPs is that, where the NTFPs received by a CFC derive from a foreign subsidiary, the UK company or companies controlling the CFC could instead have funded the foreign subsidiary directly with equity (at para 72). If so, dividends received from that foreign subsidiary would be exempt from tax in the UK. The Commission was unconvinced by this argument, noting that the UK does not regard equity and debt financing as equivalent for tax purposes (at paras 74 to 76). Furthermore, the Commission commented that similar counterfactuals involving equity funding could be identified in relation to those NTFPs falling within Chapter 5 (at paras 77 to 78). The Commission also noted that this analysis is not consistent with the partial exemption, as if correct it would follow that a full exemption was appropriate in all cases (at para 79). Finally, the Commission also commented that the UK's argument would have the effect that any derogation could instead be considered as an adjustment of the scope of the reference system (at para 80).

### Why does the Commission consider the Chapter 9 exemptions not to be justified in light of the nature and scheme of the legislation?

When considering whether the CFC rules are justified, the Commission notes again that the CFC rules are risk-based and that it would be contrary to the nature and scheme of the CFC rules to exempt income which objectively belongs in a high risk category (at para 93).

Moreover, the Commission contrasts what it understands to be the types of activities targeted by Chapter 5 with those that appear to be targeted by Chapter 9. The extent to which such arguments are correct will depend on whether the Commission is correct in its understanding of what Chapter 5 and Chapter 9 aim to do.

The Commission also comments that the CFC rules besides Chapter 9 are concerned with the nature of the income received by the CFC and not its source, and that Chapter 9 is inconsistent with the rest of the CFC regime as a result (at para 94). Moreover, the Commission does not appreciate the distinction drawn by the UK between a CFC being used as a 'money box' by receiving NTFPs from third parties and a CFC receiving NTFPs from a related foreign company (at para 96). In relation to both points, it is interesting to note that the Commission does not consider the CJEU's case law relating to the application of CFC rules to genuine economic arrangements abroad. This jurisprudence could potentially explain the apparent difference in treatment noted by the Commission.

It is notable more generally that the Commission does not address the issue of how ensuring compatibility with the EU law principle of freedom of establishment may have influenced the objectives and provisions of the UK's current CFC regime, when considering the nature and scheme of that regime. This is particularly surprising given the history of CFC rules being analysed from this perspective (for example, in *Cadbury Schweppes* (Case C-196/04)). The earlier *Tax Journal* article considers in further depth the potential significance of ensuring compliance with freedom of establishment to the state aid analysis.

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It is also notable that the UK does not appear so far to have put forward any arguments relating to this limb of the test for determining whether there is state aid (at para 90). Instead, the Commission has anticipated what the UK might be expected to argue. It is therefore unclear what the UK's eventual position will be in this regard.

The Commission goes on to look at the partial exemption and full exemption individually (at paras 97 to 109 and 110 to 115 respectively). As far as the partial exemption is concerned, the Commission notes that Chapter 5 and Chapter 9 tests appear to adopt different criteria for targeting artificial diversion. Whilst Chapter 5 appears to capture all NTFPs derived from UK capital, the partial exemption in Chapter 9 is aimed at NTFPs derived from excess UK capital. This view of the basis for the 75% exemption is derived from the UK's comments on the purpose of the 75% exemption. In particular, the UK is said in the Commission's decision to have taken the view that the 75% exemption represents a debt to equity ratio of 25% debt to 75% equity, which the UK considers to be the funding ratio which could be expected were it not for the group relationship (at paras 42 to 44). As CFCs are generally fully equity funded, the 25% CFC charge represents the amount of the CFC's NTFPs which are deemed to result from the over-capitalisation of the CFC. It is interesting to note that a different



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justification appears to have been put forward in HMRC's *International Tax Manual*, which suggests that the partial exemption is a proxy for the UK capital funding analysis to be applied under Chapter 5.

The Commission notes that Chapter 6 of the CFC rules also appears to target NTFPs derived from over-capitalisation, but considers this to be acceptable on the basis that the over-capitalisation test is applied consistently and that in any event these profits are lower risk, being less mobile than NTFPs.

The Commission also doubts whether a test based on over-capitalisation is appropriate, for a number of reasons. First, the Commission considers that there is artificial diversion to the extent that a CFC is equity financed from the UK, not just to the extent that a CFC is over-capitalised. Secondly, the Commission rejected the argument that the use of debt to equity ratio would be equivalent to the use of fixed ratios and percentages in similar contexts (such as in the recent Anti-Tax Avoidance Directives). This was for the reason that such measures attempt to exempt income involving a low risk of artificial diversion, whereas the partial exemption exempts income which in the Commission's opinion presents a high risk of artificial diversion. The Commission also commented that there was no domestic equivalent to the partial exemption applicable to companies in the UK, and also cast doubt on the accuracy of the debt to equity ratio relied on by the UK by contrasting this with those used for the purposes of identifying where a company is under-capitalised.

In relation to the full exemption, the Commission referred to the UK's understanding of the purpose of this exemption; namely, to not apply a CFC charge in situations where there is no interest deduction in the UK arising from receipt of NTFPs by a CFC. Similarly to its position in relation to the partial exemption, the Commission's primary argument was that this appeared to be a different approach to that taken in Chapter 5, which in the Commission's view was not limited to situations where NTFPs were associated with an interest deduction in the UK. Moreover, the Commission also noted that there was no equivalent provision applicable to UK taxpayers.

## Conclusion

The Commission's decision letter expands significantly on its initial press release, and has a narrower focus than that document indicated. However, it remains to be seen how the Commission will address the issue of compatibility with freedom of establishment. ■

- Can the UK CFC rules survive the EC's state aid investigation? (David Harkness, Dan Neidle & Rob Sharpe, 9.11.17)
- 20 questions on state aid and tax (Jonathan Hare, Stephen Morse & Peter Halford, 25.2.16)
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