Analysis

The CFC group finance exemption: EC's final decision

Speed read

The group financing exemption in TIOPA 2010 Part 9A Chapter 9 involves unlawful state aid, according to the European Commission's final decision. The non-trading finance profits (NTFP) exemptions give an advantage to controlled foreign companies (CFCs) earning NTFP from qualifying loan relationships, as these exemptions are not available for upstream or third-party loans. In a three-stage test, the Commission considered: the selection of the appropriate reference system; the group financing exemption as a derogation from the general CFC regime; and whether the group financing exemption is justified. The Commission has given the UK only two months to identify the beneficiaries of the aid, determine the amount of the aid in each case, and order repayment of those amounts, and only four months to complete full recovery of the aid.

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The European Commission has published its final decision finding that the group financing exemption in TIOPA 2010 Part 9A Chapter 9 ('Chapter 9') involves unlawful state aid. The main change from its initial decision is that it now accepts that the exemption is justified as a proxy for the complex tracing exercise required by the UK capital criterion in TIOPA 2010 Part 9A Chapter 5 ('Chapter 5'). It remains of the view, however, that the exemption from the application of the 'significant people functions' (SPF) criterion in Chapter 5 is unlawful.

Does the group financing exemption provide an advantage?

The Commission concluded that the exemption allowed UK companies with a controlled foreign company (CFC) earning non-trading finance profits (NTFP) from loans made to foreign group companies (qualifying loan relationships) either to:

- eliminate their CFC charge (full exemption); or
- reduce it to 25% of the CFC's NTFP (partial exemption).

In both cases, the NTFP exemptions gave an advantage to CFCs earning NTFP from qualifying loan relationships over CFCs earning NTFP from loans made to UK companies (upstream loans) or from loans made to third parties (money boxes). This is because the NTFP exemptions are not available for NTFP from upstream or third party loans.

The three-stage test to establish whether the advantage is selective

1. The appropriate reference system

The first stage of the selectivity analysis is to choose the reference system. Here, the main choice was between the general corporate tax regime (as the UK government argued) and the CFC regime (chosen by the Commission in its initial decision). The Commission adhered to its initial choice. The consequence of that choice and the way the aid is defined is that the relevant comparison is a narrow one between CFCs with different types of lending.

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The narrower reference system allows the Commission to focus on the specific aims of the CFC regime in assessing the different treatment. At the same time, it means that the analysis is dependent on the Commission making a convincing case that the different types of NTFP are comparable. It has the oddity that, in practice, the supposed recipients of the aid are likely to represent the vast majority of taxpayers, while the disadvantaged group which is subject (as a matter of legislative drafting) to the general rule are probably a minority of cases.

Given the structure of the legislation, the Commission followed its normal practice of ordering recovery from those benefiting from the exemption. However, given the narrow definition of the advantage granted, one is left wondering whether in theory a retrospective revamp of the legislation might not be an alternative way of removing the selectivity for the past. It is unclear what the practical impact would be as presumably most taxpayers will have done all they could to bring themselves within the exemption.

2. The group financing exemption as a derogation from the general CFC regime

The Commission's view is that the NTFP exemptions constitute a derogation from the general UK CFC

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regime because they relieve UK entities with a CFC earning NTFP from a qualifying loan relationship, which have made a claim under Chapter 9, from the CFC charge otherwise borne by UK entities with a CFC earning NTFP from upstream or third party loans. The Commission considered that NTFP earned from qualifying loan relationships represent a higher risk category than NTFP earned from upstream or third party loans, and rejected the UK's arguments that the three different sub-types of NTFP were not comparable. Also, the Commission rejected the UK's argument that, if the NTFP exemptions did constitute a derogation, it was justified by the intertwined objectives of the CFC regime:

- combating tax avoidance;
- ensuring that the regime applies only to 'wholly artificial arrangements' (*Cadbury Schweppes* (Case C-196/04)); and
- limiting administrative and compliance burdens on taxpayers.

As regards comparability between NTFP earned from qualifying loan relationships and NTFP earned from upstream loans, the Commission's analysis follows from what it believes to be the objective of the UK's CFC regime, based on a distinction between 'base erosion' and 'profit shifting'. The argument is that base erosion can be distinguished from profit shifting in that the former 'deals with erosion of the payer's tax base', whereas the 'latter deals with the recipient of the income who reduces his tax base by artificially diverting that income abroad'.

The Commission's distinction seems rather artificial. CFC rules (according to the BEPS Action 3 report) 'respond to the risk that taxpayers' with a CFC can '*strip the base* of their county of residence' by '*shifting income* into a CFC' (emphasis added). Put at its lowest, base erosion and profit shifting are two concepts belonging to the same phenomenon. This is demonstrated by upstream lending. When it comes to such lending, the Commission arguably misses the point. The obvious risk in the case of upstream lending is that UK capital could be diverted from the UK and then lent back to the UK through a set of arrangements masterminded by UK SPFs, resulting in an interest deduction and no UK taxation.

Contrary to what the Commission appears to assume, the UK rules limiting interest deductions would not help, as there is a loss of UK tax base whatever the amount of the loan and the terms of the lending. The problem is that such a loan should not be made by the CFC at all in such circumstances. The capital lent by the CFC is *prima facie* surplus to the operational requirements of the group's overseas business, suggesting diversion of funds from the UK. There is therefore a serious *prima facie* BEPS concern with such lending not existing in the case of lending to the group's CFCs. The Commission rightly rejects the argument that upstream lending *per se* involves diversion of profits (for example, there may simply be a timing issue while new financing arrangements are being set up), but the risk is arguably such as to justify requiring the Chapter 5 process to be gone through to show there is no BEPS. The same applies to third party lending.

Notwithstanding the way the legislation was drafted, the reality was that the general default rule applicable to almost all CFCs earning NTFP was a 25% charge (most taxpayers being content to accept the partial charge, rather than to undertake the exercises needed to gain full exemption). The exclusions from that rule were intended to protect the UK tax base from arrangements where there was a *prima facie* risk of BEPS.

The Commission further took the view that compliance with EU law was a condition applicable to all legislation enacted by EU member states, rather than an objective of the UK CFC rules. The Commission has a point but perhaps fails to take sufficient account of the fact that CFC charges and CFC compliance rules inherently entail different treatment, and hence a restriction on the freedom of establishment. They are therefore unlawful unless justified and proportionate to recognised general interests and are consistent with general principles such as legal certainty.

Against that background, and leaving aside the issue of the SPF criterion and *Cadbury Schweppes* (discussed by the Commission under justification), it is understandable that the UK government had compliance with EU law as a specific aim (as is apparent from preparatory documents) and wished, as a matter of policy, to err on the side of caution in providing rules that were proportionate, certain in their application and workable in practice. Workability for both the taxpayer and HMRC is, of course, an important aim in itself, irrespective of the legal constraints.

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3. Whether the group financing exemption is justified

The Commission noted that, under Chapter 5, NTFP will be subject to a CFC charge if either:

- the SPF activities are located in the UK; or
- the loans or deposits generating the NTFP have been financed with funds sourced from the UK part of the group (UK connected capital).

The Commission accepted the UK's argument that the NTFP exemptions were justified, in relation to the UK connected capital test, as it avoided the 'disproportionally burdensome tracing exercises' that would be required to determine the portion of the NTFP funded with UK connected capital. However, the Commission found that the NTFP exemptions were not justified where the SPF linked to the assets and risks giving rise to the NTFP from qualifying loan relationships were located in the UK. This was on the basis that a proxy rule was not justified because, in the Commission's view, determining the localisation of the SPF is not an unduly complex or burdensome exercise, since profit attribution of SPF is 'well recognised both in international and in EU regulations' concerning CFC provisions. The decision refers to: the work in the BEPS Action 3 report; the 'principles' of the authorised OECD approach (AOA) adopted in the OECD's 2008 and 2010 reports on the attribution of profits to permanent establishments; and the EU's Anti-Tax Avoidance Directive (ATAD).

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It may well be that the arguments made by the UK and other parties focused mainly on the UK capital criterion. The reality is that few taxpayers, if any, will have attempted the SPF analysis either. It may not be as straightforward as the Commission assumes.

First, the AOA (despite its authoritative sounding title) is not widely recognised across the OECD, and the practical application of the 'key entrepreneurial risk-taking function' for the attribution of risks and assets included in the 2008 and 2010 reports is far from straightforward.

Secondly, the design of CFC rules is not an area in which the OECD had done significant work before 2015 (this is acknowledged at page 9 of the BEPS Action 3 report); and the recommendations (which are not minimum standards) in the BEPS Action 3 are deliberately wide to accommodate an array of policy objectives across the OECD.

Thirdly, before ATAD, there was no obligation on EU member states to adopt CFC regimes, and the requirement under ATAD to impose tax in accordance with its terms only applies from 1 January 2019. At its minimum, this means that, before ATAD, EU law was silent on the design of CFC rules, and that the OECD had not produced significant guidance on CFC rules before 2015.

Cadbury Schweppes and compatibility with the Fundamental Freedoms and EU law

The Commission deals with *Cadbury Schweppes* under justification. It concludes that taxing the profits of foreign subsidiaries on the basis of SPF performed in the UK does not constitute a restriction to the freedom of establishment because it follows the 'same principles' underlying the AOA approach for the attribution of profits to permanent establishments. The Commission took the view that this conclusion is consistent with the requirement in ATAD for EU member states to adopt a CFC regime. The argument is that ATAD allows member states two options for the design of their CFC rule. The first is to target specific types of profit which are taxed under the CFC rule with an exception where the CFC carries on a 'substantive economic activity'. That exception is known as the 'escape clause'. The second option for a CFC rule is to adopt a SPF test so that profits derived from SPF carried out in the relevant member state are subject to a CFC charge. The escape clause does not apply to the second option because, according to the Commission, 'the EU legislature concluded that there was no need for such an escape clause to ensure compliance with the Union freedoms for an SPF based CFC rule'.

It may be correct that a CFC charge based on the SPF criterion, although a restriction on the freedom of establishment, might be justified on grounds of preventing tax avoidance and preserving the balanced allocation of taxing powers. If there are no local SPFs then in principle no profits would be attributable to the CFC, regardless of whether the CFC is properly established. However, had the legislation relied entirely on allocating profits by reference to the SPF criterion, involving a relatively novel and untested exercise, the result, almost inevitably, would have been endless transfer pricing disputes and challenges to test compliance with the EU law principles of legal certainty and proportionality.

This was at a time when the government was faced with numerous major domestic and EU law challenges. It is therefore not surprising that the legislator preferred a more straightforward solution for the vast majority of taxpayers which provided a partial CFC charge in the large majority of cases. As noted above under selectivity, this was part of the legitimate aims pursued by the UK legislator.

Does the group financing exemption affect intra-EU trade?

The Commission's reasoning on this issue is hard to follow, given the narrow way the aid has been defined. Ultimately, though, the requirement of an effect on trade is easily met and, if the Commission is right on the other parts of its analysis, it is unlikely that it will fail here.

No legitimate expectations

The Commission concluded that there are no general principles of EU law preventing or limiting the recovery of the aid, noting that its exchange of formal letters with the UK, dealing with compliance of the UK's pre-2013 CFC rules with *Cadbury Schweppes*, did not raise any legitimate expectations that the NTFP exemptions were not state aid.

> The Commission has given the UK only two months (from 2 April) to identify the beneficiaries of the aid, determine the amount of the aid in each case, and order repayment of those amounts

Recovery and next steps

Formal publication of the decision in the *Official Journal* is still to follow. Notably, however, the Commission has given the UK only two months (from 2 April) to identify the beneficiaries of the aid, determine the amount of the aid in each case, and order repayment of those amounts. The UK is required to complete full recovery of the aid within four months (from 2 April).

At the time of writing, it is understood that while HMRC has contacted some taxpayers, it is still reflecting on next steps. UK groups can, however, expect case by case conversations with HMRC on their SPF position (and, possibly, also on the availability of other exemptions outside the scope of the Commission's challenge).

Alongside any domestic discussions and procedures, taxpayers will doubtless also be considering the need for a direct challenge to the decision in the EU General Court in order to be sure of preserving their right to contest the validity of the decision itself. ■

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