

## European Court of Justice's Decision in Cadbury Schweppes: UK CFC Rules Too Restrictive

London  
September 13, 2006

The European Court of Justice ("ECJ") delivered its judgment in the Cadbury Schweppes tax case yesterday. The issues concerned the validity of the UK's Controlled Foreign Companies ("CFC") Legislation, which was first introduced in 1984, in the context of EU law. Given that the Advocate-General's opinion in the case was only delivered in May of this year, the ECJ's decision has been made sooner than originally anticipated<sup>1</sup>.

The ECJ have broadly accepted the Advocate-General's Opinion and concluded that the UK legislation was restrictive to the extent that it purported to apply to a UK parent company establishing a subsidiary in another Member State in circumstances other than those which involved "wholly artificial arrangements" designed to avoid UK tax. The fact that there may be tax motives involved in setting up a potential CFC was not sufficient if, applying an objective test, it could be shown that the CFC carried on genuine economic activities in its Member State.

In the parent-subsidary scenario, the CFC legislation applies to attribute to the UK parent the profits of the overseas subsidiary if it is located in a low tax jurisdiction. There are specific exemptions from the application of the CFC attribution of profits as well as a more general "motive" test under which the legislation will not apply in circumstances where the "main" purpose or reason for the arrangements was not to achieve a reduction in UK tax or diversion of taxable profits from the UK. The ECJ said it was for the national court to determine whether the "motive" exclusion was wide enough to ensure that the CFC legislation was applicable to only "wholly artificial arrangements".

It is expected that the English Courts will conclude that the legislation is too wide, since it was certainly not the intention of the UK Inland Revenue in the early 1980s for the legislation to catch only "wholly artificial arrangements", and the statutory provisions do not have such narrow wording.

<sup>1</sup> For a discussion of the facts and issues in Cadbury Schweppes, and the Advocate-General's Opinion, please see the alert memorandum from 16 May 2006.

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## UK's CFC Rules: Advocate-General's Opinion in Cadbury Schweppes

London  
May 16, 2006

The UK's controlled foreign companies rules (the "**CFC Rules**") have been considered in the light of EU law this month in the Cadbury Schweppes plc v Commissioners of Inland Revenue<sup>2</sup> case currently before the European Court of Justice. Advocate-General Léger, in his opinion released on May 2, 2006, stated that while the CFC Rules do constitute a restriction on freedom of establishment, this restriction may be justified to counteract tax avoidance in the case of "wholly artificial arrangements". In the Advocate-General's opinion whether the CFC Rules contain a justifiable restriction on tax avoidance grounds is a question for the domestic courts to decide.

### Background of the case

Cadbury Schweppes set up two group financing subsidiaries in the Republic of Ireland. The Irish subsidiaries were taxed at 10% under the International Financial Centre regime.

If the subsidiaries were CFCs for UK tax purposes, the lower level of taxation payable in Ireland would have resulted in a CFC attribution to the UK parent. There are a number of exemptions from the CFC Rules, which are broadly aimed at limiting a CFC assessment to cases where tax avoidance is present. Where none of the fact-based exemptions is available, no CFC assessment will be made if the taxpayer satisfies the motive test. To do so, the taxpayer must establish both that the reduction of tax resulting from transactions between the parent and the subsidiary was not a main purpose of such transactions and that the subsidiary was not established with a main reason of diverting profits from the UK. HM Revenue & Customs assessed Cadbury Schweppes to tax under the CFC Rules on the one Irish subsidiary making profits, denying the benefit of the motive test or any other exemption. Cadbury Schweppes appealed, arguing that the CFC Rules were incompatible with EU law and particularly in breach of the freedom of establishment. The Special Commissioners referred the case to the ECJ.

<sup>2</sup> Case C-196/04, delivered on May 2, 2006.

## Opinion

In the Advocate-General's opinion establishing subsidiaries in another Member State with the purpose of enjoying a more favourable tax regime is not of itself, an abuse of freedom of establishment. The CFC Rules restrict this freedom as they discriminate against a UK parent setting up a subsidiary in another Member State with a beneficial tax regime, as compared with a UK parent establishing a subsidiary in the UK or in another Member State which does not have a beneficial tax regime. It was not relevant that the overall UK tax burden of the group would be no higher if a UK parent were assessed in respect of its CFC's profits than if a UK subsidiary itself had paid tax on such profits as it is necessary to consider the position of the UK parent as a stand alone entity. However, the Advocate-General acknowledged that the restrictions to the freedom of establishment may be justified by the need to prevent tax avoidance, being an overriding reason in the public interest, provided the restriction is sufficiently targeted. He suggests that a purposive interpretation must be given to the objective of the freedom of establishment and the crucial factor is whether the restriction to the freedom in the CFC Rules applies only to a "wholly artificial arrangement aimed at circumventing local law".

### What is a "wholly artificial arrangement"?

In the Advocate-General's opinion, the restriction on the freedom of establishment created by the CFC rules can only be justified if the legislation enables the domestic courts to deny the freedom only to a case before them that is wholly artificial, when viewed objectively. The key is whether the CFC Rules permit a domestic court to deny a CFC assessment where there is "proof that the controlled subsidiary is genuinely established in the State of establishment and that the transactions which have resulted in a reduction in the taxation of the parent company reflect services which were actually carried out in that State and were not devoid of economic purpose with regard to that company's activities".

The Advocate-General has advised that the ECJ should remit the case back to the domestic courts for a decision on whether the CFC rules permit this objective test.

The ECJ is expected to deliver its judgment in around six to nine months' time. If the Advocate General's opinion is followed, the UK domestic courts will need to determine whether the motive test is sufficiently narrow that only wholly artificial arrangements will fail it. If it is not, and so the CFC Rules do breach EU law, following the recent decision in the Marks and Spencer case,<sup>3</sup> it seems likely that the CFC rules will have to be interpreted by permitting a restriction on the freedom of establishment only to the extent that the restriction is proportionate to the justification of preventing tax avoidance. The Advocate-General does not specifically address the concept of

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<sup>3</sup> See 'ECJ Judgment in Marks and Spencer: An Uneasy Compromise?' CGSH client bulletin dated December 13, 2005.

proportionality, but suggests that the motive test will be acceptable only if it results in no CFC assessment where the subsidiary (a) has sufficient physical presence in the host State, (b) carries on genuine activities and (c) delivers real economic value to the parent. This could result in no CFC assessment being permitted in respect of EU subsidiaries, provided they have true economic substance in terms of staff and other resources, have sufficient competence in the host State to make requisite business decisions and provide a service that is genuinely required by the parent. The potential impact of this may be far-reaching as the case could have a similar impact in other EU jurisdictions with CFC regimes.

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