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Are the 2006 amendments to the CFC legislation compatible with Community law?

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Case: Cadbury Schweppes Plc v Inland Revenue Commissioners (C-196/04) [2006] E.C.R. I-7995 (ECJ (Grand Chamber))

ON September 12, 2006, the Grand Chamber of the European Court of Justice handed down its judgment in *Cadbury Schweppes.*[1] The ECJ remitted the case to the Special Commissioners to determine whether the UK controlled foreign companies (CFC) legislation was compatible with Community law, specifically whether the motive test lends itself to an interpretation which restricts the legislation to wholly artificial arrangements aimed at circumventing the application of the UK tax legislation. Thus the compatibility of the UK CFC legislation with Community law has yet to be determined in respect of this particular case.

It was a little surprising, therefore, that one of the written announcements at the time of the Pre-Budget Report on December 6, announced changes to the CFC legislation to ensure compatibility with Community law.[2] The amendments take effect from December 6. Draft Guidance accompanying the announcement confirms HMRC's position that:

"The Government is satisfied that the UK's CFC legislation is compatible with European law as interpreted by the ECJ in *Cadbury Schweppes.* But the Government recognises that there may be circumstances at the margins where it may not be entirely clear."

It seems, therefore, that it is HMRC's position that the existing legislation does not require amendment to make it compatible with Community law. However, the proposed amendments are intended to make this conclusion beyond doubt even in some marginal cases.

As will be seen, however, it is by no means certain that the 2006 amendments are themselves compatible with Community law.

The announcement of the amendments was also somewhat surprising given that there is an ongoing review of the UK system of taxation of foreign profits, partly driven by a policy of ensuring that the UK taxation of foreign income is compatible with Community law. It is anticipated that this review will involve a more thorough-going examination of the UK CFC legislation, with possibly a complete change to that legislation so that it operates on a "tainted income" basis rather than the current approach (under which the income of a CFC is subject to attribution to the UK-resident parent, unless one of the exemptions applies).

Since the proposed amendment draws its inspiration heavily from the judgment of the ECJ in *Cadbury Schweppes,* it is appropriate to say something more about the detail of that judgment.[3] The Grand Chamber accepted that the CFC legislation could operate as a restriction on the exercise of the freedom of establishment by dissuading UK-resident companies from establishing, acquiring or maintaining a subsidiary in another Member State in which the subsidiary would be subject to a lower level of taxation.[4] The provision could be justified, however, if it was shown that it was intended to counter tax avoidance.[5] Such a justification may be made out where the legislation is intended to counteract wholly artificial arrangements aimed at circumventing the application of the UK tax legislation.[6] In assessing whether there was a wholly artificial arrangement, it is necessary to consider the conduct of the taxpayer, particularly in the light of the objectives pursued by the freedom of establishment.[7] The freedom of establishment is "intended to allow a Community national to participate, on a stable and continuing basis, in the economic life of a Member State other than his State of origin and to profit therefrom".[8] The concept of establishment for the purposes of this freedom "involves the active pursuit of an economic activity through a fixed establishment in [the Host State] for an indefinite period".[9] The subjective intention on the part of the taxpayer of obtaining a tax advantage by establishing itself in another Member State is not incompatible with the exercise of that freedom.[10] Rather, it is necessary to see whether there are objective circumstances which demonstrate that the objective pursued by the freedom of establishment has not been achieved.[11] The objective circumstances must show that there is an actual establishment intended to carry on genuine economic activities in the host state, and the finding of genuine economic activities must be based on objective factors, in particular, the extent to which the CFC physically exists in terms of premises, staff and equipment.[12] The UK-parent company "must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine".[13]

It will be for the Special Commissioners to determine whether the motive test in the CFC legislation, as correctly interpreted, allows the UK-parent in *Cadbury Schweppes* an opportunity to demonstrate the genuineness of the establishment.

These statements from the ECJ have clearly influenced the drafting of the 2006 proposed amendments to the CFC legislation.

There are three changes proposed in the PBR Notes, two of which relate to Community law. The third change--the removal of the public quotation exemption--arises, apparently because the exemption had given rise to a "highly artificial avoidance scheme".[14] There are also certain consequential amendments.

The other two amendments considered here involve, first, the introduction of a new mechanism to exclude from the legislation part or all of the chargeable profits of a CFC having a business establishment in an EEA territory. Secondly, an amendment to the exempt activities test to introduce a different definition of "effective management" for companies resident in an EEA territory.

A preliminary point might be made about the geographical scope of both these amendments. They both apply to the European Economic Area. However, a territory within the EEA, which is not a Member State of the European Union, is not covered by the legislation if there are no "international tax enforcement arrangements" in force with that territory at the time.[15] In practice, this includes Iceland and Norway but excludes Liechtenstein as there are no international tax enforcement arrangements currently in force with that territory.

Of itself, the geographical scope of the amended legislation is not uncontroversial. International tax enforcement arrangements are arrangements for the exchange of information, for mutual assistance in the recovery of unpaid taxes, or for mutual assistance in the service of tax-related documents. The legislation proceeds on the assumption that it is compatible with the EEA Agreements to apply anti-avoidance legislation to an EEA territory with which no such arrangements are in force, in circumstances where it could not be applied to a Member State or another EEA territory with which such arrangements exist. In effect, this draws a distinction between Member States on the one hand and EEA states on the other, and between those EEA states with which international tax enforcement arrangements exist and those with which none exist. Presumably the view taken by HMRC is that it is justifiable to deny the new exemptions to territories that do not enter into tax enforcement arrangements. However, it is at least controversial whether such discrimination between different EEA territories is justifiable.

The first of the amendments to the legislation involves the introduction of a procedure by which the UK-resident parent company may apply to HMRC for the chargeable profits of the CFC to be reduced by a "specified amount" (which can have the effect of reducing those profits to nil).[16] The result is to reduce the amount of chargeable profits of the CFC which are subject to apportionment (and to reduce the amount of creditable foreign tax proportionately). The procedure only applies where the CFC has a business establishment in an EEA territory (as discussed above) and there are individuals who work for the CFC in that territory throughout the relevant accounting period.[17]

Central to the provisions is this concept of the "specified amount", which must not exceed the amount of the chargeable profits which could be regarded as representing the "net economic value" to the company (or group of companies) which "is created directly by qualifying work".[18]

"Qualifying work" is work done in the EEA territory in which the CFC has a business establishment, and is done by individuals working for the CFC[19]; this includes individuals employed by the CFC and those working under the direction of the CFC.

Underlying the new provision is an assumption that only work carried out by individuals based in the EEA territory can generate net economic value which Community law requires to be excluded from a CFC apportionment. Implicit in the new legislation is, therefore, a concept of freedom of establishment which focuses on the employment of individuals to carry out work in the territory concerned. The availability of equipment, or capital in that territory is, consequently, only relevant insofar as it allows the individuals employed there to generate net economic value.

Clearly, this new provision has been inspired by some of the dicta of the ECJ in *Cadbury Schweppes.* However, a rather narrow view has been taken of the objective circumstances which prove that the freedom of establishment is being genuinely exercised. In effect, only the presence of employed individuals in the territory is given full weight as evidence of a genuine establishment. At this stage of the development of Community law one cannot be categorical on the point, but there is at least some uncertainty whether this view of the objective circumstances is itself too narrow to be compatible with Community law. There is a danger that the new legislation has lost sight of the fact that CFC-style legislation can only be justified if it targets wholly artificial arrangements designed to circumvent the UK tax legislation. The existence of employees in a territory may be one objective factor establishing that there has been a genuine exercise of the freedom of establishment. However it is not the only factor which proves that the arrangements are not wholly artificial.

The Draft Guidance issued alongside the new legislation gives several examples of how the "net economic value" might be viewed. One example concerns "diverting profits to a CFC by locating intellectual property in the CFC". It takes the scenario of a CFC established to own intellectual property and to receive royalties: the CFC opens an office and appoints a small team of staff. The Guidance indicates that little of the income from the intellectual property would be considered to constitute net economic value, so that the specified amount is likely to reflect only the arm's length return for the administrative work undertaken by the employees of the CFC.

One is left asking of this example why this should not be a genuine exercise of the freedom of establishment.

If a UK resident company or group decides to centralise the management and exploitation of its intellectual property in a controlled subsidiary in an EEA state, it may do so explicitly because of a lower tax rate there. That, of itself, does not make the arrangements wholly artificial. If the CFC establishes an office, and employs some staff to carry out its work, there may be sufficient objective evidence to show that freedom of establishment is being genuinely exercised. In those circumstance--where there is a genuine exercise of the freedom of establishment, and not wholly artificial arrangements--what is the basis in Community law for applying CFC legislation to all but the net economic value generated by the administrative work carried out by the employees?

Clearly there may be different factual circumstances and different views on this point. At the very least, one can say that it is not beyond doubt that this new provision will be regarded as compatible with Community law.

That observation, of itself, is significant: if the purpose of this new provision was to put beyond doubt that the UK CFC legislation was compatible with Community law, then it is doubtful whether it has achieved its purpose.

Placing the onus on the UK parent company to prove the net economic value generated by the work of individuals introduces new procedural work which would not otherwise arise. The judgment of the ECJ in *Cadburys Schweppes* stated expressly that the UK-resident company should have an opportunity to present objective evidence that there has been a genuine exercise of the freedom of establishment. One is also left wondering if the administrative burden which the new provision places on the UK-company to identify the net economic value goes beyond what was intended by the Court.

The second change outlined in the PBR Note relates to the exempt activities test. One element of that test[20] is that the business affairs in the territory where the CFC is resident must be effectively managed there. A new provision inserted into the exempt activities test[21] confirms that all parts of the test apply equally to a company resident in an EEA territory as to any other company, with one exception: the definition of "effective management" for EEA-resident companies is now different from all other companies.

For all other companies, effective management is established if the number of persons employed by the company in the territory is adequate to deal with the volume of the company's business, and any services provided by the company for persons resident outside the territory must not be performed in the United Kingdom (subject to certain exceptions such as services provided from a taxable UK permanent establishment, or incidental services performed in the UK).[22] In the case of a company resident in an EEA territory, however, the effective management condition will not be regarded as fulfilled unless there are "sufficient individuals working for the company in the territory who have the competence and authority to undertake all, or substantially all of the company's business".[23] Individuals are regarded as working for the company if they are employed by it or work under the direction of the company.

It is not immediately clear why a separate definition of effective management for CFCs resident in an EEA territory was necessary. The explanation accompanying the draft legislation is not particularly full on the point. It is also not entirely clear whether the test of effective management for EEA-resident CFCs is wider or narrower than that for other CFCs. It may depend upon the circumstances. In the case of EEA-resident CFCs, the exempt activities test will only be fulfilled if all, or substantially all, of the company's business is carried out by individuals working for the company in that territory. In the case of non-EEA-resident CFCs it is only necessary to have an adequate number of persons employed to deal with the volume of the company's business. On the other hand, in the case of EEA-resident CFCs no question arises as to whether services are performed in the United Kingdom.

In practice, one suspects that the test for EEA-resident CFCs may prove more stringent in practice than for non-EEA-resident CFCs. Take this example: suppose that a UK-resident company establishes a CFC in a jurisdiction with a lower level of taxation: there are employees of the CFC based in that jurisdiction, but the CFC also has a permanent establishment in another Member State and this will carry out a substantial part of the company's business. In this scenario, the effective management criterion will not be fulfilled by the EEA-resident CFC: it may be fulfilled by a non-EEA-resident CFC.

Again there is a puzzle. If this change was intended to put beyond doubt that the UK CFC legislation was compatible with Community law, then it is far from certain that it has achieved this purpose. To the contrary, the introduction of two separate tests for effective management in an EEA and a non-EEA context runs the clear risk that the new legislation is not compatible with Community law.

Overall, the two changes to the CFC legislation give the impression of a short-term patch. They are not a substitute for a thorough-going review of the CFC provisions, with an emphasis on ensuring that those provisions are clearly and incontrovertibly compatible with Community law.

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1.Case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioner of Inland Revenue.* The Opinion of Advocate General Léger had been handed down on May 2, 2006.
2.See Pre-Budget Report Note, PBRN 01. The announcement was accompanied by a draft clause and Schedule, and also by Draft Guidance.
3.Also noted by P. Simpson in this *Review* at [2006] BTR 677.
4.*Cadbury Schweppes* judgment, fn.1, [46].
5.*Cadbury Schweppes* judgment, fn.1, [47] and [48].
6.See [51] of the judgment, referring to the *ICI* case, case C-264/96, [1998] ECR I-4695 in particular.
7.*Cadbury Schweppes* judgment, fn.1, [52].
8.*Cadbury Schweppes* judgment,fn.1, [53].
9.*Cadbury Schweppes* judgment, fn.1, [54].
10.*Cadbury Schweppes* judgment, fn.1, [49].
11.*Cadbury Schweppes* judgment, fn.1, [64].
12.*Cadbury Schweppes* judgment, fn.1, [66] and [67].
13.*Cadbury Schweppes* judgment, fn.1, [70].
14.PBRN 01, para.4.
15."International Tax Enforcement Arrangement" is defined in Finance Act 2006, s.173.
16.See Income and Corporation Taxes Act 1988 (ICTA), new s.751A, to be inserted by Finance Act 2007.
17.ICTA, new s.751A(1) (b) and (c).
18.See ICTA, new s.751A(4).
19.ICTA, s.751A(7).
20.Found in ICTA, Sched.25 para.6(1)(b).
21.New para.5(1A), inserted into ICTA, Sched.25.
22.ICTA, Sched.25, para.8(1) to (4).
23.New paras 5(5) and (6) inserted into ICTA, Sched.25.
24.Gray's Inn Tax Chambers.
25.Controlled foreign companies; Corporation tax; EC law; Freedom of establishment; Pre-Budget report; Tax avoidance