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Accountants and Consultants

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## Subject:

### UK CFC Rules – ECJ Decision in the Cadbury Schweppes Case

# International Tax Alert

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## Background

Cadbury Schweppes Plc (“Cadbury”) is a UK public company. The Cadbury group had established finance companies in Ireland that were subject to a tax rate of 10 percent.

HM Revenue & Customs (“HMRC”) sought UK corporation tax (30%) from the UK parent on the attributed profits of the one profitable Irish subsidiary under the UK’s Controlled Foreign Companies (“CFC”) provisions. The CFC rules apply to tax the profits of a foreign resident company which a UK resident company “controls” (“control” is extended to include the situation where two persons each hold a 40% interest in the CFC) where the corporation tax borne on the profits concerned in the foreign country is less than 75% of the corresponding UK tax on those profits *unless* certain exemptions from apportionment apply. The UK resident company receives a credit for the foreign tax paid by the CFC against its UK corporation tax liability corresponding to the same profits. The effect of the CFC legislation is therefore that the resident company pays the difference between the tax paid in the foreign country and the tax which would have been paid if the company had been resident in the UK.

HMRC sought to charge corporation tax under the CFC legislation on the profits of one of the Irish finance companies. The apportionment was appealed by Cadbury on the premise that the application of the UK’s CFC legislation to its Irish finance subsidiaries was contrary to EC law and that, in particular, an exemption from attribution – under the UK’s “motive test” – should apply. The case was referred to the European Court of Justice (“ECJ”), which issued its ruling on September 12, 2006.

## Ruling

The ECJ has held that the operation of provisions in a Member State which provide for “the inclusion in the tax base of a resident company established in ... [that state] ... of profits made by a CFC in another Member State” at a lower level of tax is contrary to European Community law, unless such a law operates “*only to wholly artificial arrangements*”. The Court held that, accordingly, such a tax measure cannot be applied, regardless of the existence of tax motives, if the “*CFC is actually established in the host Member State and carries on genuine economic activity there.*”

The ECJ held that the UK CFC legislation represented a restriction on “freedom of establishment” – one of the fundamental “freedoms” provided for by the EC Treaty. It further held that the fact that the Irish finance companies had been established for the sole purpose of benefiting from the favorable tax regime in the Dublin IFSC (Cadbury never disputed this) did not, in itself, constitute a valid justification, as provided by the EC Treaty, for an EU member state denying a fundamental freedom, although a “wholly artificial arrangement” might be a justifiable reason for the application of a targeted anti-abuse measure.

The ECJ has referred the case back to the UK courts to establish as a matter of fact how the UK motive test operates i.e. whether its application is predicated by objective factors (such as the absence of overseas substance/activity) and is therefore targeted at “wholly artificial arrangements” or whether, as would appear to be the case, it looks to the purpose of the taxpayer (to achieve a reduction in UK tax).

## Implications

Firstly, the language used by the court in expressing the circumstances in which a CFC law can be justified in an EU context would seem extremely narrow. The words “*only to wholly artificial arrangements*”, “*established in the host Member State*”, “*carries on genuine economic activity there*” would seem to indicate that a reasonably high level of abuse is required for European CFC rules to apply in an intra-EU context and therefore possibly only a very low level of economic activity would be necessary in the jurisdiction of the CFC for CFC attribution to be avoided.

Secondly, if the motive test is held to apply more widely than to only wholly artificial arrangements then, is it possible that the whole of the current UK CFC provisions are in breach of community law? Is the consequence of this therefore that the CFC provisions do not apply at all or will it be held that one must read the existing statute in a manner that would make it compliant with EU law?

Thirdly, what is the likely reaction of the UK government? Certainly, it seems reasonable to expect that the case will proceed to the UK courts very quickly. It also seems more than likely that we will see a number of other (possibly far-reaching) changes in the UK’s international tax provisions. One obvious area is the UK’s taxation of dividends (or at least EU dividends). Following the Advocate General opinion in the *Test Claimants in the FII Group Litigation v the Commissioners of the Inland Revenue test case*, the Cadbury judgment provides further support for the view that UK law is non-EU compliant in this respect. More worryingly, if the UK Revenue is forced to go down the route of introducing EU-compliant CFC provisions and an exemption system it is possible that they will take a closer look at the whole issue of interest relief. The introduction of some form of interest allocation involving potential restrictions on interest relief seems an obvious option (although anything of this nature will be difficult to work).

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## What Should UK Corporate Taxpayers Do as a Result of the Case?

Clearly, if companies have filed UK tax returns incorporating CFC income, they will need to consider whether they should (and can) file amended returns. If the corporate taxpayer is still within time limit to amend its returns, they should do so as soon as possible given the possibility of the imposition of temporal limitations to claims.

There will, however, be circumstances where an amendment to a return cannot be made or where there is some other “loss” as a result of compliance with what has now been found to be bad law. Those circumstances will include where there is a consequential impact of having made a CFC profit attribution which cannot now be amended, or the taxpayer has incurred associated or other irrecoverable costs arising from the mistake in law. The only remedy here is by way of a claim for restitution for damages, one option being to join the appropriate Group Litigation Order (the CFC/EU Dividend GLO in this instance).

**Please note that there are other countries in Europe which have similar CFC-type rules with a comparable impact to those of the UK. These jurisdictions should be reviewed where relevant.**

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