

## Banking

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#### The Legality of the UK Controlled Foreign Company Rules: The Advocate-General's Opinion in the Case of Cadbury Schweppes

The question whether the UK Controlled Foreign Company (CFC) Rules are compatible with Community law may be closer to being answered as Advocate-General Léger has delivered his opinion in the case of Cadbury Schweppes plc, Cadbury Schweppes Overseas Limited v Commissioners of Inland Revenue (Case C-196/04). A question which is ultimately for the national court to decide, the Advocate-General has opined that if the Rules are applied objectively so as to catch only those taxpayers who have made an artificial arrangement for the purpose of avoiding tax, the Rules will be compatible with Community law.

The CFC Rules are contained in Chapter 4 of Part 17 of the Income and Corporation Taxes Act and are designed to prevent UK companies avoiding tax in this country by diverting income to subsidiaries in low tax régimes. A low tax régime is one in which the tax paid by the foreign subsidiary is less than three quarters of the amount of tax it would have paid if its profits had been taxed here. Where the subsidiary is established in such a régime, the CFC Rules operate so as to require the parent company to pay an amount of tax equal to that which would otherwise be avoided.

On the other hand, the CFC Rules provide for a number of exemptions which, if they apply, render the Rules redundant. For the purposes of the case at hand, the most important exception derives from the so-called "motive test", pursuant to which a charge to tax is only applied to those companies that are deliberately diverting UK income to a low tax régime.

The motive test comprises two limbs. The first relates to transactions routed between the subsidiary and its parent and requires the parent to show that the reduction in UK tax was not the main purpose, or one of the main purposes, of those transactions. The second limb relates to the setting up of the subsidiary and requires the parent to show that it was not the main reason, or one of the main reasons, for the subsidiary's existence to achieve a reduction in UK tax by means of the diversion of profits outside the UK. So, whilst the purpose of the Rules is to tax those profits that are either accumulated abroad or diverted abroad from the UK, the charge can be avoided where such an outcome is incidental to the subsidiary's existence.

The facts of the case were that Cadbury, a UK resident company, set up a number of subsidiaries in Ireland under the International Financial Services Centre (IFSC) regime. The subsidiaries' purpose was to raise finance and provide that finance to subsidiaries in the worldwide Cadbury Group. The Special Commissioners found that the purpose of establishing the subsidiaries in the IFSC was to avoid tax and at the material time the subsidiaries were taxed at a rate of 10%. Accordingly, they were subject to a 'lower level of taxation' such that the CFC Rules applied and the authorities took the view that, for the financial year in question, none of the exemptions applied.

Cadbury were served with a tax notice and appealed to the Special Commissioners on the basis that the legislation was contrary to its rights under the EC Treaty. Specifically, Cadbury argued that the CFC Rules ran counter to the freedom of establishment, the freedom to provide services and the free movement of capital as enshrined in Articles 43, 49 and 56 of the Treaty.

Faced with a number of uncertainties and unable to decide the case, the Special Commissioners referred a number of questions to the European Court of Justice (ECJ) for a Preliminary Ruling.

At the heart of their uncertainties was whether Cadbury, in establishing the subsidiaries in IFSC, was simply exercising its fundamental freedoms or whether it was, in fact, abusing those freedoms. If it was simply exercising its freedoms, the question was whether the CFC Rules acted as a restriction on those freedoms or served to discriminate against companies like Cadbury. If they did, they wished to know whether the Rules could be justified in terms of counteraction of tax avoidance.

The Preliminary Ruling Procedure referred to above is enshrined in Article 234 of the Treaty and allows, and in some cases requires, a national court to refer questions to the ECJ on the interpretation of a rule of Community law where this is necessary to resolve a given case. It is for the national court to then apply the law to the factual situation at hand. For sure, the national court must still decide the issues of fact in the case as well as resolve any differences of opinion on the interpretation or application of rules of national law.

Recalling the reference in the instant case, the first question for Advocate-General Léger was whether Cadbury, in establishing subsidiaries in the IFSC, was acting within the scope of the Treaty. While the question was asked in relation to a number of fundamental freedoms, the Advocate-General took the view that it was Cadbury's freedom of establishment that was at issue in the case. More precisely, it was the freedom to establish a subsidiary in another Member State that was at the core of the main proceedings.

The Advocate-General was clear that those companies that met the requirements set out in Articles 43 and 48 EC had the right to set up a subsidiary in another Member State and on the same terms as the nationals of that State. For Advocate-General Léger, the *raison d'être* of the freedom of establishment is the exercise of an economic activity in the host Member State. Moreover, the fact that a company may have been seeking to take advantage of a more favourable tax regime was not, in itself, an abuse of that freedom. It followed that so long as there was a 'genuine and actual' pursuit of an activity by the subsidiary in the host member state, the exalted freedom of establishment could not be called into question.

The question whether the subsidiaries in the instant case were conducting genuine and actual business in Ireland is a question that remains for the national court to decide. If they were then it cannot be said that Cadbury, by establishing subsidiaries in the IFSC, was abusing its freedom of establishment.

On the basis that Cadbury was simply exercising its freedom, the next question was whether the CFC Rules served to hinder that freedom, as prohibited by Article 43 EC. Noting that discrimination may take a variety of forms, the Advocate-General sought to establish whether operation of the Rules resulted in differentiated tax treatment in two comparable situations.

Certainly, the Rules did not apply to every parent setting up a subsidiary in another Member State. The Advocate-General noted that they were inapplicable to subsidiaries established in the UK, as well as those established in Member States without low tax regimes. Comparatively speaking, this put companies like Cadbury at a disadvantage and it was concluded that such differentiated tax treatment amounted to discrimination. Moreover, such discrimination sufficed for the UK legislation to be deemed a hindrance to the freedom of establishment. The net result, the Advocate-General concluded, was that the compatibility of the Rules with the Treaty must be reviewed by the ECJ.

On the other hand, the Advocate-General went on to point out that in tax matters, a difference in treatment by reason of a company's seat was justifiable by an overriding reason in the public interest. However, this was only so where the legislation was designed to exclude from a tax advantage arrangements that were wholly artificial.

An assessment of whether there was such an arrangement in place required, said the Advocate-General, a case-by-case examination of whether the subsidiary was genuinely established in the host state. In other words, an examination of whether the subsidiary was providing its parent with genuine services.

Endorsing the submissions of both the UK government and the Commission, the Advocate-General opined that such an assessment depended on the presence of three factors, namely:

- i) the subsidiary's degree of physical presence in the host state;
- ii) the genuine nature of the activity it provided; and
- iii) the economic value of that activity vis-à-vis both the parent company and the group as a whole.

The Opinion sets out the kinds of consideration that may be taken into account in deciding whether these factors are present and reinforces the point that a parent's motives for establishing a subsidiary and the choice of country in which it establishes it cannot constitute a relevant criterion. The question whether the UK Rules can be justified in terms of tax avoidance, then, depends on whether they allow for an examination of purely objective factors in assessing a subsidiary's authenticity. If they do not, they may be regarded as going beyond what is necessary, and hence an unjustifiable restriction on the freedom of establishment.

Recalling the specific circumstances in which the CFC Rules apply, Advocate-General Léger highlighted the presumption of tax avoidance that they import. However, he went on to stress that what was important was that this presumption can be rebutted. He agreed that in cases such as this where none of the first four exceptions apply, this requirement may be satisfied by employing the motive test. For the Advocate-General, the motive test should be the tool that enables the national authorities to examine each case on its merits.

Prima facie, the case of the Special Commissioners looks strong. So long as the motive test is applied on a case-by-case and objective basis, the hindrance on freedom of establishment imposed by the Rules can be justified by reference to the public interest. However, Advocate-General Léger was in no way certain that the motive test is applied in this way. Whether it is satisfied upon proof of genuine establishment or whether parties' subjective intentions are taken into account is a question for the national court to decide. However, if the motive test can indeed be given an interpretation which makes it possible to limit the application of the Rules to wholly artificial arrangements that are intended to circumvent tax, the Rules will most likely be found to be compatible with Community law.

It is noteworthy that the Advocate-General's role is to propose a legal solution to the ECJ, although his Opinion does not bind the Court. The ECJ must still consider the reference before it and it will deliver its judgment in the instant case in due course. Even so, whilst falling short of law, the Advocate-General's Opinion has historically been very persuasive on the Court and can generally be regarded as a telling precursor to its decision.

This article is correct to the best of our knowledge and belief at the time of going to press. It is however written as a general guide, so it is recommended that specific professional advice is sought before any action is taken. We are required by law to protect personal data.

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