KPMG

Euro Tax Flash from KPMG's EU Tax Centre

General Court decision on the UK tax treatment of multinational groups under the CFC regime

General Court – United Kingdom – State aid – CFC regime – Group Financing Exemption - Selectivity

On June 8, 2022, the General Court of the European Union (General Court or the Court) gave its decision in the joined cases T-363/19 and T-456/19, concerning the compatibility of the UK Controlled Foreign Companies Group Finance Company Partial Exemption Rules ("Finco Exemption") with EU State aid rules.

The Court ruled that the Commission was correct to conclude that the Finco Exemption gave an unfair tax advantage to certain UK tax resident companies and therefore violated EU State aid rules. The FinCo Exemption under dispute was applicable for non-trading financing profits derived by a controlled foreign company (CFC) in circumstances where the profits arose from lending activities performed in the UK.

Background

The UK CFC regime aims at ensuring that the UK corporate tax base is not inappropriately reduced by transactions undertaken by non-UK subsidiaries of UK companies. This is achieved by allowing the UK to tax profits of foreign subsidiaries, at the level of the controlling UK shareholder, in cases where the profits are considered to be 'artificially diverted' from the UK. For non-trading finance profits, the rules outline several situations in which the foreign profit has to be taxed in the UK, including:

- a 'UK activities' test, focused on whether the profits are arising from lending activities where the significant people functions are carried out in the UK, and

- a ‘UK connected capital’ test, met if the offshore profits stem from injections of capital from the UK.

The Finco Exemption, applicable between 2013 and 2018, provided a derogation from the general CFC rules. In short, even if the foreign profits met the two tests above, the regime allowed for either a 75 percent or a full exemption from UK taxation for profits arising from qualifying loans. Qualifying loans were considered to be intra-group loans granted by the CFC to companies which were not resident in the UK.

Following an in-depth Sate aid investigation into the Finco Exemption opened on October 26, 2017, the European Commission announced its final decision (the Decision) on April 2, 2019. The Commission concluded that the ‘UK connected capital’ exemption was justified, and did not constitute illegal State aid under EU rules. However, the Commission found that multinationals claiming the Finco Exemption while meeting the ‘UK activities test’ received an unjustified preferential tax treatment that was unlawful under EU State aid rules – see ETF Issue 402. The Commission also noted that, as a result of changes implemented with effect from January 1, 2019, companies were no longer able to claim the disputed exemption and therefore, from that date onwards, the amended scheme had been compliant with the EU State aid rules. Both the UK and one of the beneficiaries of the Finco Exemption decided to appeal the Decision before the General Court[1].

The General Court decision

The General Court first recalled the conditions that are required to be fulfilled cumulatively for a national measure to be classified as prohibited State aid. Based on settled case-law, such criteria include the existence of an economic advantage as compared to a reference system, advantage which must be selective in nature in favoring certain taxpayers. Based on settled case-law a three-step approach is used to assess the existence of a selective advantage The three-step approach consists in:

i) identifying the reference system of ordinary or ‘normal’ taxation;
ii) determining if the relevant measure entails a derogation from the reference system; and
iii) assessing if the derogation is justified by the nature or general scheme of the reference system.

As both the advantage and the selectivity criteria involve determining the ‘normal’ taxation rules, the Court continued by reviewing the reference framework selected by the Commission, i.e. the rules applicable to CFCs. In this respect, the Court noted the plaintiffs’ claims that the general corporate tax system in the UK is in fact the appropriate reference system. Whilst acknowledging that the CFC rules are part of the UK’s general tax system, the Court noted that the reference framework could have a narrower scope than the general system. Based on settled case-law, this would be the case when the rules have an own legal logic, in particular as regards factors such as the tax base, the taxable persons, the taxable event and the tax rates. As the Court noted, the UK’s general tax system is based on a territoriality principle, where only profits derived by UK resident companies or permanent establishments of non-resident companies are taxed. On the other hand, the CFC

[1] At the time the Decision was issued the UK was still an EU member and the provisions of Treaty on the Functioning of the European Union (TFEU) applied. The General Court and the CJEU remained competent for judicial procedures concerning the UK registered before the end of the transition period (i.e. December 31, 2020).

system allows the UK to tax certain profits made by CFCs, which, if the principle of territoriality was followed, would not be normally taxable in the UK. Based on these facts, the Court took the view that the CFC rules are based on a distinct logic and can be severed from the general corporate system for State aid analysis purposes. The Court continued by confirming that, in its view, the CFC rules met the relevant factors – as mentioned above, to constitute a separate body of rules, and concluded by upholding the Commission's selection regarding the reference system for the State aid analysis.

The General Court continued by endorsing the Commission's analysis that an economic advantage existed. In this regard, the Court confirmed that, by allowing the 75 percent or the full exemption for financing income derived from qualifying loans, the UK provided a tax reduction when compared against its 'normal' tax system (i.e. taxing the CFC profits) and therefore created an economic advantage for companies able to claim the exemption.

Moving to the selectivity analysis, the Court noted that, in its view and contrary to the plaintiffs' claims, the objective of the CFC rules is to protect the UK tax base by taxing profits arising from UK activities and assets which are artificially diverted to the CFC jurisdiction. In that context, the profits derived by CFCs from qualifying loans should normally have been subject to tax in the hands of their UK shareholders. Moreover, in terms of profits artificially diverted as a result of significant people functions (i.e. profits which meet the 'UK activities' test), the Court viewed CFCs with qualifying loans as being in a similar situation when compared to CFCs with non-qualifying loans. The Court therefore determined that the selectivity criterion was met as the disputed exemption represented a derogation from the reference framework and its objective.

The Court also rejected the justifications brought forward by the plaintiffs, namely the justification for reasons of administrative practicability and the need to comply with the freedom of establishment. In relation to the fundamental principle of freedom of establishment, the UK argued that the Finco Exemption was adopted to comply with the Court of Justice of the European Union (CJEU)'s decision in the Cadbury Schweppes case (C-196/04). In this regard, the Cadbury Schweppes decision held that, to the extent that CFC legislation was restricted to taxing wholly artificial arrangements, it was compatible with the freedom of establishment.

The UK argued that the Commission was wrong to take the view that the objective of the UK CFC rules was limited to the taxation of artificially diverted profits, arguing instead that those rules seek to protect the UK corporation tax base from artificial diversion of profits, but also from deductions in the UK from circular arrangements. The UK therefore argued that the Finco Exemption was required to ensure that only artificially diverted profits were captured, drawing a distinction between qualifying and non-qualifying loans.

In rendering its decision, the Court rejected the arguments brought forward by the UK and determined that the requirement for significant people functions to be carried out in the UK meant that the CFC charge was targeting artificially diverted profits. On this basis, the Court found that taxing the CFC profits should not be regarded as constituting an obstacle to the freedom of establishment and, therefore, the Finco Exemption could not be justified on this ground.

The Court also rejected several other arguments put forward by the plaintiffs, including an argument alleging the breach of the principle of non-discrimination and an error of law from the application of the EU Anti-Tax Avoidance Directive (2016/1164) (ATAD).

In view of these considerations, the General Court confirmed that the Finco Exemption applicable for qualifying loans when the ‘UK activities’ test is otherwise met, represented unlawful State aid and upheld the Commission’s Decision.

EU Tax Centre comment

The current ruling is the latest in a series of cases involving the Commission’s inquiries into the compatibility of the tax ruling practices of Member States with EU law. Whilst the European Commission investigations concluded that State aid was present in the majority of key investigations, the General Court has previously generally ruled in favor of the taxpayer.

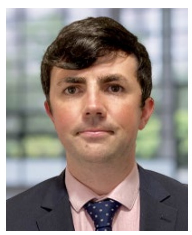
In terms of next steps, the UK and the beneficiaries of the Finco Exemption have the option to appeal the decision before the CJEU.

One interesting point is that, when analysing the freedom of establishment justification brought by the UK, the General Court accepted that the UK CFC regime was connected with artificial transactions and therefore should not be regarded as constituting an obstacle to the freedom of establishment. It remains to be seen whether, if the plaintiffs decide to appeal the decision, the CJEU would agree that the CFC legislation in force at that time is compatible with the freedom of establishment, in light of its previous case-law on abuse of law and the presumption of abuse.

Should you have any queries, please do not hesitate to contact KPMG’s EU Tax Centre, or, as appropriate, your local KPMG tax advisor or KPMG in the UK (Joe Groenen).


Robert van der Jagt
Chairman, KPMG’s EU Tax Centre and Partner, Meijburg & Co


Joe Groenen
Director
KPMG in the UK


Cormac Golden
Associate Director
KPMG’s EU Tax Centre


Ana Puscas
Manager
KPMG’s EU Tax Centre

KPMG's EU Tax Centre, Laan van Langerhuize 9, 1186 DS Amstelveen, Netherlands