The EU Commission has concluded that the finance company exemption ("FCE") from the UK controlled foreign company ("CFC") rules constitutes illegal state aid in part. The UK is now required to recover the illegal aid by collecting the additional amounts of tax which would have otherwise been payable from relevant multi-nationals.

More specifically, the Commission has found that:

> the FCE does constitute illegal state aid to the extent that it exempts non-trading finance profits deriving from UK activities (i.e. attributable to UK significant people functions or "SPFs") from the CFC charge; but

> the FCE does not constitute illegal state aid to the extent that it exempts non-trading finance profits deriving from capital investment from the UK from the CFC charge, so long as there are no UK SPFs involved.

The Commission released a press release summarising its findings in early April 2019 and has now released its full decision.

Multi-nationals that benefited from the FCE will need to consider next steps. Whilst the Commission’s decision is carefully reasoned and deals with (and dismisses) many of the potential areas of appeal, the decision’s classification of the FCE as “partially selective” under the state aid rules, as well as its assessment of the implications of the EU fundamental freedoms, give rise to potential grounds for challenge.

Whether it is worth a particular taxpayer challenging the decision will depend on how much tax is at stake - which will be determined by the extent to which the non-trading finance profits received by their CFCs are referable to UK SPFs. Assessing this will be challenging, but the process may already be underway in some multi-national groups due to the changes to the FCE which took effect from 1 January 2019. If the state aid ruling is not challenged, negotiation with HMRC (and potentially litigation) as to how it applies in a given case will be key.

The UK’s CFC rules and the finance company exemption

In common with many other jurisdictions, the UK’s corporate tax system contains CFC rules. The rules are an exception to the normal territorial scope of UK corporation tax, and impose tax on a UK-resident company by reference...
to the profits of its foreign subsidiaries. Their purpose is to prevent the shifting of profits from the UK to foreign subsidiaries based in low- or no-tax jurisdictions.

The current version of UK’s CFC rules - of which the FCE is part - have been in force since 2013. A key driver in the design of the rules was a need to ensure that they were compliant with the CJEU’s decision in *Cadbury Schweppes* (in which the court had found that the UK’s prior CFC rules infringed the EU freedom of establishment because they did not only target “wholly artificial” arrangements). As anticipated, the implications of *Cadbury Schweppes* remained a key point to consider in the state aid analysis.

The UK CFC rules target specific types of revenue received by a CFC, including non-trading finance profits. However, profits will only be subject to a CFC charge if they fall through one of the so-called “gateways”. In the case of non-trading finance profits, this will be the case if those profits:

- Derive from UK activities (i.e. are attributable to UK SPFs); or
- Derive from capital investment from the UK (referred to as “UK connected capital”).

The final piece of the jigsaw is the FCE. This provides either a partial (from 75%) or a full exemption from the CFC charge on non-trading finance profits in certain circumstances. In particular, the FCE is only available in respect of revenues from qualifying intercompany loans made by CFCs to other non-UK related companies.

The state aid challenge related specifically to the FCE.

**Finding of *prima facie* selective advantage**

A number of factors must be present before state aid is found to exist. The challenge to the FCE was largely focused on whether it provided a “selective advantage” to certain operators. The Commission found that, *prima facie*, the FCE did provide a selective advantage (subject to the justifications discussed below).

It is worth considering the Commission’s analysis on this point further, as it does leave some open questions.

A “selective advantage” only arises in the context of a tax scheme if it differentiates between economic operators that are, in the light of the objectives pursued by the reference system (in this case, according to the Commission, the CFC regime), in a comparable legal and factual situation. The Commission considered that the FCE was selective as it was only available to operators carrying out finance transactions involving foreign related-party debtors, and not those involving UK related-party debtors or third-party debtors.

The UK argued that “upstream” loans from CFCs (i.e. to UK related-party debtors) or loans from CFCs that were “money box” companies (i.e. to third-party debtors) were not comparable with loans from CFCs to foreign related-party debtors, on the basis that they presented a greater risk of artificial
diversion. The Commission rejected this blunt approach, considering that it was not possible to be definitive on the risks posed by each scenario. The Commission also rejected the UK’s argument that loans to the different types of debtors were not comparable because the potential risk of infringement of the EU fundamental freedoms was different - it saw nothing in the CJEU decision Cadbury Schweppes which supported the view that the fundamental freedoms would apply differently depending on the nature and quality of the debtor.

Overall, the Commission’s analysis seems detailed and logical and, moreover, consistent with the direction of recent case law which has moved towards finding comparability in more situations than previously. Nevertheless, a couple of points warrant further attention:

> The Commission found that the CFC rules are designed to prevent base erosion though the artificial diversion of profits from the UK. The fact that an upstream loan might lead to base erosion from interest deductions was therefore not relevant to the assessment of comparability, which had to be carried out in the light of the objective pursued by the CFC rules (this being the appropriate reference system). It is possible that the conclusion on this point might be different if the reference system had been taken as the UK corporate tax system as a whole (which is designed to prevent base erosion in any form). However, the UK’s argument that the UK corporate tax system as a whole was the correct reference system was rejected (although note that there has been some recent success before the EU courts in challenging the reference system selected by the Commission in state aid investigations).

> The Commission did not seem to consider the fact that, where a CFC lends to a non-UK related-party debtor, that non-UK related-party debtor (which, by definition, will be controlled by the same UK parent) will also potentially be within the scope of the UK CFC rules. The same would not be true of a third-party debtor.

These points indicate that the Commission’s reasoning on the issue of comparability may not be entirely watertight, and potentially leaves open some avenues of challenge.

**Possible justifications for the FCE**

Given the *prima facie* finding of selectivity, the crux of the decision related to whether the FCE could be justified by reference to the nature and overall structure of the CFC rules. To the extent that the FCE could be justified, it would not constitute state aid.

The UK put forward two possible justifications:

> First, the FCE is aimed at ensuring that the CFC rules are manageable and administrable for HMRC and taxpayers.

> Second, the FCE ensures compliance with the EU case law on the fundamental freedoms (i.e. *Cadbury Schweppes*, as discussed above).
Administrative simplification: a justification where profits stem from UK connected capital

The Commission agreed with the UK that, where the profits of the CFC have fallen within the scope of the CFC rules only as a result of the UK connected capital limb of the gateway for non-trading finance profits, the FCE can be justified as an administrative simplification.

This is because, to determine whether the UK connected capital limb applies, it is necessary to trace whether the funds used to finance the loans made by the CFC have a UK origin. The Commission accepted the UK’s arguments that this tracing exercise could be complex, costly and burdensome for taxpayers and HMRC. Accordingly, it agreed that using general percentages and mechanical rules based on standard ratios is a permissible simplification (so long as the percentages and ratios used comply with the principle of proportionality - and the Commission was unable to show that the 75% exemption chosen by the UK was inappropriate).

In conclusion on this point, therefore, the Commission accepted that the FCE could be justified as an administrative simplification to the extent that it exempted profits which fell within the CFC gateway only because they derived from UK connected capital. However, this justification was not relevant where the profits fell within the CFC gateway because they derived from UK SPFs. In that case, the Commission did not consider that any administrative simplification was necessary: as discussed further below the general assumption is that the SPFs relating to non-trading finance profits would rest with the group’s finance function, and there would be no particular difficulty in tracing this.

Compatibility with the fundamental freedoms: no justification where UK SPFs

The second justification put forward by the UK was perhaps the most interesting. It is also the point on which the Commission spent the least time.

In essence, the UK argued that the FCE was necessary to ensure that the CFC rules were compatible with the EU fundamental freedoms. As noted above, the CJEU had held in Cadbury Schweppes that the CFC rules would only be compatible with the EU principle of freedom of establishment if they targeted “wholly artificial” arrangements. The UK argued that the FCE was therefore necessary to ensure that the CFC rules were not over-inclusive, in the sense of applying to arrangements that were not “wholly artificial”.

Somewhat surprisingly, given the careful approach it adopted elsewhere, the Commission dealt with this argument briefly. Essentially it said that where profits are received by a CFC which are derived from UK SPFs, taxing those profits under the CFC rules will not violate the EU fundamental freedoms. Although it did not say so explicitly, it therefore seems that in the Commission’s view the arrangements in these circumstances will be “wholly artificial” within the meaning of Cadbury Schweppes. In other words, the SPF test perfectly
dovetails with the need to respect the fundamental freedoms. We consider below whether this is a legitimate approach.

The result of the Commission’s conclusion is that (absent an appeal) the FCE does constitute state aid to the extent that the SPFs relevant to the profits in question can be identified and are located in the UK (whether or not the profits also derive from UK connected capital).

**International and EU context**

One of the reasons the Commission considered that there is no risk of the CFC rules violating the fundamental freedoms where the relevant SPFs are located in the UK is because it considered that such an approach followed the same principles as those mandated by the OECD and EU, in particular those set out in the EU Anti-Tax Avoidance Directive (ATAD) (Directive 2016/1164).

The position under ATAD, however, is perhaps more nuanced than the Commission’s decision indicated. Under Article 7(2)(b) of the ATAD, one of the approaches to CFC rules that member states may adopt is to bring within the CFC charge income arising to a CFC from “non-genuine activities”, which are defined to mean activities where the SPFs are carried on elsewhere. However, there is a second condition which means the charge will only arise where the arrangements “have been put in place for the essential purpose of obtaining a tax advantage”. This second condition was clearly intended to add something to the SPF test - and presumably ensure that the ATAD provisions are more aligned with the Cadbury Schweppes “wholly artificial” test. The Commission, however, seems to ignore this.

Interestingly the UK government seems to share the Commission’s view. This year’s Finance Act made changes to the FCE, ostensibly to comply with the ATAD, with effect from 1 January 2019. The effect of these changes is that the FCE is only available in respect of profits deriving from capital investment from the UK (and is not available in respect of profits deriving from UK SPFs). Presumably the thinking was that the ATAD required member states to implement a test based on SPFs, without exemptions that could cut across this.

An additional effect of the change, of course, is that the FCE is now state aid compliant.

**Recovery of aid**

In principle, the UK is now required to recover the state aid illegally given, within four months following notification of the decision (i.e. early August). The initial steps to begin the recovery process must be carried out on an even shorter timetable; the UK is required to provide relevant information to the Commission within two months following notification of the decision (i.e. early June). In practice, recovery deadlines are rarely met in complex cases such as this - we anticipate that it might take 10 to 12 months. That said, the Commission will put the UK under pressure to make sure that progress is being made and a reasonable deadline is being observed.
By way of guidance on quantification, the Commission has directed that the amount of aid to be recovered should take into account the amount of tax saved as a consequence of the illegal aid, together with compound interest.

The real cost of this recovery will need to be assessed by multi-nationals on a case-by-case basis. For example, the aid to be recovered may be reduced by reference to any other tax assets which would have been available to the taxpayer absent the application of the FCE. In addition, we have had experience in other jurisdictions of the Commission accepting that the compound interest due is fully tax deductible, which has mitigated the impact of the recovery somewhat.

**Next steps for multi-nationals**

The first step for multi-nationals that benefited from the FCE will now be to calculate their potential exposure as a result of this decision. This will entail revisiting the non-trading finance profits received by their CFC finance companies and establishing which profits are referable to UK SPFs. Assessing this will be challenging, but the process may already be underway in some groups due to the changes to the FCE which took effect from 1 January 2019.

In terms of the principles that apply to this assessment, multi-nationals should bear in mind HMRC’s current published guidance (which was cited by the Commission in its decision) which states that the general assumption is that the SPFs relating to a loan will generally rest with the group’s finance function. The guidance goes on to state that assertions to the contrary will be subject to careful scrutiny.

Depending on the level of potential exposure faced by a multi-national, additional steps may then be appropriate. These could include:

**Challenges at an EU level to the substance of the Commission decision**

- There are various aspects of the Commission’s decision which may be susceptible to challenge at an EU level. Taxpayers that are significantly adversely impacted by the decision may therefore consider taking a challenge to the EU’s General Court.

- As noted above, there were some aspects of the Commission’s analysis on selectivity which seem doubtful, including substituting its own judgment in place of the UK’s for determining when the application of complicated tax measures is likely to be overly burdensome and when it is not likely to be the case.

- Moreover, the Commission’s reasoning on the compatibility of a state aid ruling with the EU fundamental freedoms was perhaps an oversimplification: is it really the case that where profits are earned by a CFC that derive from UK SPFs the arrangements will always be “wholly artificial” within the meaning of Cadbury Schweppes? In our view there may be scope for challenging this conclusion and arguing, on the basis of the EU fundamental freedoms, that there is no state aid in cases
where there is no "wholly artificial" diversion (regardless of the location of any SPFs).

> Related to this, we note that the Commission concluded the FCE was a (partial) aid scheme, without examining any underlying individual cases. This was contrary to its approach in many other recent state aid and taxation cases where individual tax rulings were assessed. In light of the fact-specific "wholly artificial" test, arguably this all or nothing approach was flawed. The Commission should have examined individual cases instead of considering the FCE as a whole - which in turn should have resulted in the Commission leaving room for exceptions in its recovery order.

**Wait and see whether the UK (or another beneficiary) seeks to challenge the Commission’s decision at an EU level**

> It is open to the UK to challenge the Commission’s decision at an EU level, for example on the grounds outlined above. Nevertheless, given that the Commission has concluded that the FCE is state aid compliant from 1 January 2019 onwards, the UK may not be minded to continue to litigate the historical position. Moreover, given the tight timetable for recovery, multi-nationals are unlikely to have time to "wait and see" before deciding what next steps to take.

**Robust conversations with HMRC about the level of SPFs located in the UK**

> As noted above, the UK is now required to recover the state aid illegally given - which will depend on the level of SPFs located in the UK.

> Determining the level of SPFs located in the UK will be a matter for discussion between taxpayers and HMRC. Although the Commission’s decision cited, by way of example, HMRC’s current published guidance on this point (which takes an extremely broad approach) it is important to note that (i) this guidance was produced at a time when the FCE was taken to be fully lawful (and so it was less important whether or not there was a UK SPF), and (ii) there is an argument that (in order to ensure compatibility with the fundamental freedoms) any SPF analysis will now need to take into account the added “gloss” that it is being used as a proxy to assess artificiality. Multi-nationals that are confident their CFC arrangements are not “wholly artificial” (on a Cadbury Schweppes analysis) may therefore plan to have robust conversations with HMRC on this point.

> That said, our experience is that the Commission will be keeping a very close eye on the recovery proceedings and will not hesitate to challenge positions adopted by the UK (for example with respect to the presence of SPFs) in individual cases.

> If a multi-national and HMRC are unable to agree on the level of SPFs located in the UK, such groups may challenge recovery (before the national courts) on an individual basis.