FÉDÉRATION DES EXPERTS
COMPTABLES EUROPÉENS

FEE OBSERVATIONS ON

EUROPEAN COURT OF JUSTICE PENDING CASE C – 196/04
CADBURY SCHWEPPES PLC AND CADBURY SCHWEPPES OVERSEAS LTD
V.
THE COMMISSIONERS OF UK INLAND REVENUE

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1. INTRODUCTION TO FEE

The Fédération des Experts Comptables Européens (FEE) is the representative organisation for the accountancy profession in Europe. FEE's membership consists of 44 professional institutes of accountants from 32 countries. FEE Member Bodies represent more than 500,000 accountants in Europe.

Professional accountants are the major providers of tax advice and services in Europe.

FEE Direct Tax Working Party has established a Subgroup with the aim of analysing European Court of Justice (ECJ) pending and decided cases that could have a significant impact on EU Member States tax systems.

2. THE FACTS OF THE CASE

FEE has been involved with the issue the issue of CFC legislation for some time. In 2002, the FEE Position Paper on Controlled Foreign Company Legislations in the EU analysed differences and similarities of national CFC laws, together with the consistency of the legislation with the fundamental principles of the EC Treaty, which is central to the case discussed below.

Cadbury Schweppes Plc (PLC) is incorporated and resident in the UK. Two of its 100% subsidiaries, Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI), have the business to raise and provide finance to the group and were established in Ireland in order to benefit from International Financial Services Centre regime for group treasury companies (10% company income tax rate) and not taxed in the UK.

The UK Inland Revenue directed that CFC (Controlled Foreign Company) legislation applied for both CSTS and CSTI, *i.e.* the profits of the subsidiaries were attributed to the parent company PLC and subject to UK tax.

Cadbury Schweppes PLC appealed to the UK Special Commissioners (UK Tax Tribunal), contending that applying CFC legislation in these circumstances constituted a breach of:

- Freedom of establishment principles ex article 43 of the EC Treaty;
- Freedom to provide services under article 49; and
- Freedom of movement of capital and payments under article 56.

The UK Special Commissioners referred the case to the (ECJ)[1]. The case is still pending at the time of the publication of FEE comments.

[1] Order for reference to the ECJ, Special commissioners Dr John F Avery Jones CBE and Malcom Gammie QC, Appelants: Cadbury Schweppes PLC and Cadbury Schweppes Overseas Limited, 2004

3. THE LEGAL ISSUES

As a general rule, a UK resident parent company is taxed on its worldwide profits, including foreign permanent establishments (PEs), but is not taxed on the profits of its foreign subsidiaries as they arise, because they are separate legal entities. Such profits are taxed only if and when they are distributed to the parent company in form of dividends. The UK follows the credit method adhering to the principle of capital export neutrality, according to which the state of residence should tax foreign–source income of its residents so that they are neither encouraged to invest nor discouraged from investing abroad (home neutrality)[2].

By way of exception to this general rule, where UK CFC legislation applies, the income of foreign subsidiaries is attributed to the parent company and taxed with credit for the foreign tax paid by the subsidiaries in the fiscal year in which it arises.

In the UK a company can be defined as CFC when it is resident outside the UK, controlled by UK residents, and subject to a level of taxation which is less than three-quarters of what that company would be subject to were it resident in the UK. As in the UK company tax rate is 30%, any country with a rate of less than 22,5% is potentially within the CFC legislation of the UK.

The main legal issue to consider in this case is whether the application of UK CFC legislation is against the principles of the EC Treaty.

4. FEE POSITION

In its Position paper on CFC legislation in the EU[3] FEE concluded that CFC legislation should not be applicable within the Internal Market, provided that the tax regime of the country where the subsidiary is situated is in line with the prescriptions of the Code of Conduct against harmful tax competition in the EU. In FEE's view such taxation does not appear to be consistent with the principles of non- discrimination and of freedom of establishment.

The special commissioners of UK Inland Revenue in referring this case to the ECJ[4] stated that there are a considerable number of uncertainties in the application of the EU law in the case of Cadbury Schweppes, and namely:

1) "Whether Cadbury Schweppes Plc, in establishing and capitalising companies in another Member State solely because of a more favourable tax regime available in that Member State (as compared to the United Kingdom's tax regime), is exercising the fundamental freedoms, or whether it is an abuse of such freedoms".

[2] While taxpayers resident in *credit* countries compete on foreign markets on *home*-State conditions, taxpayers resident in *exemption* countries compete on foreign markets on *source*-State conditions.

[3] FEE Position paper on Controlled Foreign Company Legislations in the EU, Brussels, April 2002

[4] Order for reference to the ECJ, Special commissioners Dr. John F Avery Jones CBE and Malcom Gammie QC, Appellants: Cadbury Schweppes PLC and Cadbury Schweppes Overseas Limited, 2004, point 10.

FEE considers that there are the following reasons not to regard this as an abuse:

a) *Case C-212/97 – Centros:*
The ECJ stated in this case that incorporating a company in a foreign jurisdiction in order to avoid strict regulation on minimal capital requirements in the domestic jurisdiction is in line with Community law and cannot be considered as an abuse. FEE believes that this reasoning could be extended by analogy to the tax field.

b) *Transfer pricing legislation:*
Transfer pricing legislation has the aim of preventing abusive reduction of taxes by transferring profits abroad; Member States are allowed by transfer price legislation to recapture and tax profits which have been abusively transferred to low-tax jurisdictions. FEE therefore considers that taking advantage of the freedom of establishment by setting up a company in another Member State and allocating profits to it on an arm's- length basis should not be considered an abuse.

c) *Criteria to determine fiscal residence of companies:*
According to the OECD model tax convention, a company established in one State and managed in another State is considered to be resident for tax purposes in the other State. Therefore, if a company established in State A incorporates a subsidiary in State B, which is a low-tax jurisdiction, the group will benefit from a tax saving (State A having no right to tax the undistributed profit of the subsidiary established in State B) as long as the company established in State B is managed in State B (*i.e.* fiscally resident in State B). As a result, the State of the parent company can consider the foreign subsidiary as a domestic taxpayer when it is a pure 'mail-box company' managed from the first State. However, when the subsidiary is managed in the State in which it is located, the parent company's State cannot tax its profits because it has no jurisdiction to do so.

2) "if it is exercising the fundamental freedoms, whether the correct approach in the circumstances of this case is to consider whether the United Kingdom's controlled foreign companies' legislation may be viewed as a restriction on the exercise of those freedoms, or whether it involves discrimination".

In FEE's view, UK CFC legislation could be considered as a restriction on the exercise of fundamental freedoms, rather than discrimination. Each Member State has the full freedom to fix its level of income taxation, provided that, as defined in the Code of Conduct, no harmful tax competition takes place or illegitimate tax State-aid is involved. If a State obtains a tax competitive advantage owing to its fiscal policy, other jurisdictions cannot create obstacles to the free movement of economic resources (goods, capital, labour and companies) within the Internal Market, even if it is wholly tax- driven. Hence, CFC legislation could be seen as a restriction of the freedom of movement of economic resources.

3) "in relation to whether the legislation should be viewed as a restriction, whether the fact that PLC may pay no more tax than what CSTS and CSTI would have paid if they had been established in the United Kingdom means that there is no such restriction; and whether it is relevant that (a) the rules for calculating the tax liability in respect of CSTS and CSTI's income differ in some respects from the ordinary rules applicable to UK subsidiaries of PLC and (b) there is no relief for losses of one subsidiary against the profits of the other or against the profits of plc and its United Kingdom subsidiaries (such relief for losses would have been available if CSTS and CSTI had been established in the United Kingdom rather than Ireland)".

FEE believes that legislation in this case could be seen as a *restriction* to the freedom of establishment.

In addition, FEE has doubts about the validity of the argument according to which if the two Irish companies were resident in the UK, they would pay no more tax than they pay according the UK CFC legislation. FEE doubts are based on the following reasons:

a) If the Irish companies were resident in the UK, they would pay tax according to UK general tax principles. According to UK CFC legislation, the tax burden is transferred from the company to the shareholders: while the company pays taxes using its cash flows, the shareholders will have to pay tax on the subsidiary profits even if not receiving any dividends.

b) A restriction to the freedom of establishment has to be examined from both the home country (UK) and the host country (Ireland) perspectives. FEE believes that there may be a restriction owing to the apparent violation of the *capital import principle*, as the Irish subsidiaries profits would be taxed more than the profits of competitors resident in Ireland and not being part of a UK group. Additionally, in case CFC legislation is applied, the cost of capital is higher, due to the fact that the return for shareholders is negatively influenced by this additional tax burden.

   FEE argues that it should not be possible to make reference to general level of tax in the State of the parent company when the parent company chooses to make use of its freedom of establishment and sets up subsidiaries in low-tax jurisdictions.

c) The existence of different rules between CFCs and domestic companies for the calculation of the taxable base could be considered as an additional element of restriction of the freedom of establishment, as well as the denial of loss offset to the CFCs parent company (which is allowed at domestic level). However, even if these differences would be abolished following the ECJ decision on Marks and Spencer case, the restriction of the freedom of establishment would still exist.

4) "in relation to whether the legislation should be viewed as involving discrimination, what comparison should be made and whether any comparison is possible; in particular, whether the facts should be compared to PLC establishing subsidiaries in the United Kingdom (accepting that PLC's profits cannot include the profits of its UK subsidiaries) or in a Member State which does not charge a lower rate of tax".

FEE believes that differences in treatment arise because of the following:

a) It can be observed that the tax burden of Cadbury subsidiaries is transferred to the shareholders and this would not be the case for a purely domestic UK group.

b) Comparing the Cadbury situation with a group having subsidiaries in a non-low-tax jurisdiction, no additional tax is levied on the parent company. In the case of non-low-tax jurisdiction, the tax collected by the State of the parent company would be the same as if CFC legislation had not been in place.

Even if this will not constitute discrimination *'strictu sensu'*, *i.e.* according to EU law, nevertheless it could be have some weight in the '*rationes decidendi'* of the ECJ, *i.e.* it could be one of the main reasons on which the ECJ might base its final decision.

Moreover, from an economic policy perspective, Member States aiming at stimulating economic growth by a decrease in taxes could be jeopardised by the application of CFC legislation.

5) "if there is either a restriction on establishment or discrimination, whether the legislation can be justified as preventing tax avoidance, given the objective of the legislation to prevent the reduction or diversion of profits liable to UK tax; and, if it can be so justified, whether the legislation is in fact justified as a proportionate measure achieving that legitimate objective having regard to the scope of the legislation and the exemptions and in particular to the opportunity that the motive test offers for PLC to demonstrate that it did not have a tax-avoiding purpose by satisfying both limbs of the motive test as described above, which PLC is unable to do".

FEE does not agree that there is a possible *justification* of the CFC legislation in that it prevents tax avoidance for the following reasons:

a) According to constant ECJ case Law, the mere prevention of tax avoidance is not a justification. According to Advocate General's opinion on *Marks and Spencer* case 'reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom'[5].

b) The *Centros Case C-212/97* judgment is support for the proposition that a motive test cannot be seen as a good argument to prevent the establishment of a subsidiary in a low-tax jurisdiction.

Conclusions:

Based on the issues discussed in this paper, FEE questions whether:

National tax legislations on CFCs imposing upon a company resident in a Member State a tax charge for the profits of its subsidiaries, which are resident in another Member State and subject to a lower level of taxation, are consistent with the principles of articles 43, 49 and 56 of the EC Treaty.

[5] C-446/03 Marks & Spencer Plc v. David Halsey (HM Inspector of taxes), point 56.

5. POSSIBLE IMPLICATIONS FOR MEMBER STATES

FEE carried out a survey on the existence of CFC legislation in the EU Member States. From the answers received, it appears that the following countries apply CFC legislation: Estonia, Finland, France, Germany, Hungary, Italy, Latvia, Norway, Poland, Slovenia, Spain, Sweden and UK.

Of the above countries, Finland, UK, Germany, Hungary, Italy[6], Poland, Spain, and Sweden apply CFC legislation regardless of the residence of the subsidiary in another EU Member State.

There is currently no CFC legislation in Austria, Belgium, Cyprus, Czech Republic, Ireland, Luxemburg, Malta and the Netherlands.

The decision taken by the ECJ on Cadbury Schweppes case is likely to influence further pending cases on CFC legislation, and namely:

- Vodafone 2 v. Her Majesty's Revenue and Customs (UK), C-203/05,
- Test claimants in the F II Group Litigation v. Commissioner of Inland revenue (UK), C-446/04.

It can be reasonably expected that a decision of the ECJ favourable to Cadbury Schweppes will restrict the application of the CFC legislation to subsidiaries established in non – EU Member States. If a subsidiary based in any Member State is owned or created for tax avoidance purposes only and without any business purpose, then Member States can react according to the general principles of tax law, without limiting Treaty freedoms by imposing any CFC legislation.

[6] Italy had already in place a CFC legislation with a 'black list' of countries, including Cyprus and Malta, at the time of the EU Enlargement to 25 Member States (May 2004); such list was not amended after the Enlargement. There is currently an open debate on whether the black list has to be interpreted as implicitly amended or not. Hence, the scope of application of Italian CFC legislation towards Cyprus and Malta is currently unclear.