Executive summary

On 26 October 2017, the European Competition Policy Commissioner, Margrethe Vestager, announced that the European Commission (the Commission) has opened an in-depth probe into aspects of the United Kingdom’s (UK’s) controlled foreign company (CFC) rules. The particular focus of the investigation centers on what the Commission describes as the “Group Financing Exemption,” or more accurately, the UK’s finance company exemption provisions.

The Alert incorporates our insights based on the design of the CFC rules, the EU Anti-Tax Avoidance Directive, analysis of the existing European Commission State aid cases and observations from our European network.

Detailed discussion

The Commission’s concerns

The Commission notes that the UK’s so-called Group Financing Exemption exempts financing income received by an offshore financing company, payable by another foreign group company, from being reallocated to the UK under the CFC rules. According to the Commission, the exemption means that a multinational active in the UK pays little or no tax on the profits from these transactions, because the offshore subsidiary pays little or no tax in the territory
in which it is based while the subsidiary’s financing income is not (or is only partially) subject to tax in the UK under the CFC rules due to the exemption. It contrasts this against the wider UK CFC regime, which it considers reallocates other income artificially shifted to offshore subsidiaries. The Commission has doubts whether the Group Financing Exemption is consistent with the overall objective of the CFC rules. Although not clear from what has been published so far, it is possible that the target of the Commission’s review is the partial 75% exemption rather than the alternative exemption that can allow 100% of the financing income to be exempted.

The Commission’s investigation aims to identify whether the UK rules give some companies a better tax treatment than others, noting that EU case law makes it clear that an exemption from an anti-avoidance provision can amount to such a selective advantage.

If the UK CFC rules are found to constitute illegal State aid, the UK may be required to seek repayment of the lost tax from relevant companies, as has been seen from recent State aid decisions. The opening of the investigation gives the UK and other interested parties the opportunity to submit comments, however the Commission stresses that no judgment has yet been made. It is understood that a spokesperson for HM Treasury has stated that the UK does not believe that its CFC rules are incompatible with EU law, but that HM Treasury will cooperate with the Commission’s investigation.

State aid investigations consider the historic application of the rules in question to identify if there have been any selective advantages. However, it is unclear whether the investigation will be complete before the UK leaves the EU on 29 March 2019. The issues relating to ongoing State aid investigations and pending cases before the Court of Justice of the EU (CJEU) are still to be determined as part of the UK’s withdrawal agreement from the EU, although the EU wants all outstanding investigations to be completed under EU law, even if the UK has already left. The UK may also need to abide by the EU rules during any transition period following the UK’s departure.

It is noted that the Commission’s press release outlines that the EU Anti-Tax Avoidance Directive, which will require all Member States to introduce CFC rules from 1 January 2019, does not provide for specific exemptions like the finance company exemption, although the Directive does provide an exemption where the relevant offshore entity carries on substantive economic activity supported by staff, equipment, assets and premises, as evidenced by facts and circumstances, which is in line with established EU case law.

How the UK rules apply

The UK’s CFC rules are anti-avoidance provisions designed to prevent the artificial diversion of UK profits to low tax territories. The regime operates by applying a series of charge gateways to different types of profits to identify any that have been diverted from the UK, which will then be apportioned and charged to tax on the relevant UK corporate interest-holders.

The main test (contained within Chapter 4 of the rules) looks to identify profits attributable to UK activities by considering the key entrepreneurial risk taking (KERT) functions undertaken, where these occur and by whom. Where the majority of the KERT functions arise outside the UK, the UK CFC rules do not generally seek to subject the profits to UK tax. Alongside this test that looks to identify the involvement of UK activities, there are also several other gateways that seek to tackle specific types of profit, such as finance profits and captive insurance profits.

The UK’s CFC rules for non-trading finance income of an overseas subsidiary are tougher than for other forms of income in two key respects. Where capital is contributed from the UK it is treated as a UK diversion and ANY UK KERT functions lead to a UK attribution as opposed to the 50% threshold for other types of income. It is important to note that in many cases it is not necessary to rely on the finance company exemption if it can be demonstrated that there is limited UK functionality in relation to intra-group finance profits and that the CFC’s income is not funded from UK capital, such that no CFC charge should arise in the first place under the gateways. As a separate matter, the majority of CFCs subject to charge after the application of the 75% finance company exemption are incorporated in the EU and a charge might be precluded by the fundamental freedoms.

The finance company exemption recognizes that quantifying whether there has been a diversion of profits for passive finance companies is highly subjective. Consequently, an elective regime is available to simplify the application of the rules to such companies. Where the requirements of the finance company exemption are met, the taxable finance profits can be reduced so that only 25% or less needs to be brought into account under the CFC rules. In very broad terms, most UK outbound multinationals have tended to utilize the finance company exemption (albeit that some do claim full exemption under the base rules) and most non-UK headquartered multinationals with sub-groups under the UK tend to claim the full exemption (although some do elect for the finance company exemption). The reasons for these
different approaches are partly technical/factual and partly behavioral. The finance company exemption often leads to a higher tax liability and may have been viewed as the lower risk approach by many companies.

To prevent abuse, the finance company exemption has contained, from the start, anti-avoidance provisions that prevent loans ultimately funding UK companies from being able to benefit from the exemption. An anti-avoidance measure was also included shortly after the regime was introduced to prevent the exemption from applying to financing receivables previously held by a UK company, to minimize the risk of existing onshore profits being diverted into low-tax CFCs.

The default election under the finance company exemption for many groups is that 25% of the relevant financing income will be taxable, although it is possible to reduce this to a lower amount (or exclude it completely), if it can be demonstrated that the financing income was derived from “qualifying resources,” which looks at the source of the funding to determine if it has placed demands on the group’s resources outside the borrower’s own jurisdiction or not. A less than 25% apportionment also arises where there is limited net interest expense at the UK level (the matched interest exemption).

As noted above, the basic framework of the UK CFC rules looks to the location of the KERT functions in order to identify if there has been any artificial diversion of profits out of the UK. The location of KERT functions in relation to financing income is harder to assess due to the limited activities that are required and is also intrinsically more mobile than the location of functions associated with other types of business activity. The elective regime eliminates the need for complex and subjective analyses related to the split of KERT functions. A corollary of this is that a detailed KERT function analysis could mean that less than 25% of the income should be taxable, which could mean that the finance company exemption that taxes 25% of the income could become more defensible and/or the consequences of a finding of illegal State aid would be less significant.

In cases where the capital is not sourced from UK funds, groups may wish to build a defense file to demonstrate that at least 75% of the relevant KERT functions have been exercised outside of the UK, in order to help support that the result of applying the exemption was consistent with the wider application of the rules, as well as with existing EU case law which has considered the application of CFC rules within the EU in light of the fundamental freedoms enshrined in EU law. In particular, EU case law has held that CFC rules should not be applied where the overseas EU company carries on a substantive economic activity and the arrangements are not wholly artificial (whether an arrangement is “wholly artificial” is a subjective concept, subject to both historic and current litigation before the CJEU).

Next steps in the State aid investigation process

- Upon opening the investigation, the Commission has adopted a so-called “opening decision” which sets out its preliminary State aid analysis of the tax measures at issue.
- The UK authorities have to submit their observations on the opening decision within one month of the notification of the decision to them (i.e., before 26 November 2017).
- The opening decision will be published on the Commission’s website as soon as it has been cleansed of confidential information (expected to be within four to eight weeks of the announcement of the investigation).
- Subsequently, a summary of the opening decision and the full text of the English version will be published in the Official Journal of the EU (probably two to three months after the website publication of the non-confidential version).
- Interested third-parties can submit observations on the opening decision within one month from the publication in the Official Journal.
- All the third-party observations will be forwarded to the UK authorities, who will be given the opportunity to comment on these observations.
- There are likely to be several further exchanges between the Commission and the UK authorities (i.e., requests for additional information, position papers, state of play meetings etc.).
- The entire investigation is likely to take at least one year and will result in a final decision: either a “non-aid decision” (finding that there is no State aid) or a “negative decision” (finding that there is State aid and ordering the UK to recover the relevant amounts).
- A negative decision can be appealed before the General Court by both the UK authorities and taxpayers that have made use of the alleged tax scheme. The appeal process before the General Court (which will deal with issues of fact and law) typically takes around two to three years. Judgments of the General Court can be appealed to the CJEU (on points of law only). The appeal process before the CJEU typically takes around two years.
Implications

For financial reporting purposes, the opening of a State aid investigation may not require a tax provision to be made under the relevant recognition criteria, although this should be assessed further. However, there may be potential disclosure requirements and we would expect that auditors will be asking to see an analysis of the group’s position.

Groups should be carefully assessing their offshore financing structures and identifying where the source of funding has arisen. In order to mitigate the exposure to the outcome of the investigation, groups that have offshore financing that has not been derived from UK capital should consider reinforcing existing documentation demonstrating that the majority of the relevant KERT functions have been undertaken outside the UK, which could support arguments that the finance company exemption has provided a result that is consistent with the base operation of the rules.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax Services, London
- Craig Hillier  chiller@uk.ey.com
- David Evans  devans@uk.ey.com
- Mat Mealey  mmealey@uk.ey.com

Ernst & Young LLP (United Kingdom), Head of Tax Technical Policy & Knowledge, London
- Claire Hooper  chooper@uk.ey.com

Ernst & Young LLP, UK Tax Desk, New York
- James A. Taylor  james.taylor1@ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2017 EYGM Limited. All Rights Reserved.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.