Executive summary

On 16 November 2017, the decision of the European Commission (the Commission) opening a formal State aid investigation into the group financing exemption within the United Kingdom's (UK's) controlled foreign company (CFC) rules was made public. This opening decision sets out the scope of the Commission's investigation and provides more detail of its position.

Detailed discussion

What is the Commission challenging?

The challenge made by the Commission is in relation to the group financing exemption contained within Chapter 9 of Part 9A TIOPA 2010, which is the part of the UK's CFC legislation that may reduce the chargeable profits of a CFC, and therefore the tax payable in the UK on the CFC's income, by way of an election for full and/or partial exemption for profits from certain strictly defined group financing transactions.

The UK has CFC legislation as an anti-abuse measure to prevent the avoidance of UK tax. The CFC provisions were substantially revised from 1 January 2013, with the UK's intention for the provisions being to only bring into the UK tax charge profits that have been artificially diverted from the UK.
The rules operate on a risk-based approach - there are a number of gateways and exemptions, the purpose of which is to identify transactions where there is a high risk of artificial diversion and then test and tax those transactions accordingly.

**What are the implications?**

If the provisions of the group financing exemption are found to constitute illegal State aid then the Commission would require the UK to recover the aid. The calculation of the aid to be recovered may be complex because, absent the election into the group financing exemption, it is possible that in some cases more tax and in some cases less tax would be due as a result of the operation of other aspects of the CFC rules.

**How can the Commission challenge anti-avoidance rules?**

The Commission's opening decision acknowledges the UK's, or any Member States', right to introduce CFC legislation and to design and introduce the anti-avoidance provisions which that Member State considers necessary to protect the tax base, provided that these provisions are consistent with European Union (EU) law.

The challenge set out by the Commission is that if anti-avoidance rules are introduced that include only some companies and transactions, and not others that are in a legally and factually comparable situation, then those rules will be contrary to State aid rules if there is no valid justification within the internal logic of the relevant rule system.

**What is the Commission's position?**

There are a number of tests to be met when assessing whether a measure constitutes State aid.

Key to the Commission's position is whether the group financing exemption provides a selective advantage. There are three parts to this analysis:

- Identify the "normal" regime - this is the reference system
- Assess whether the measure derogates from the reference system, in as much as it differentiates between economic operators who, in the context of the objective of the reference system, are in a comparable legal and factual situation
- If a deviation from the reference system is justified by the nature and general scheme of that tax system, the derogation is not selective

**What is the reference system?**

In the Commission's view, the reference system being considered is the UK CFC legislation.

**Is there a derogation from the system?**

The Commission sees the group financing exemption as a derogation from the reference system on the basis that it considers some artificially diverted finance profits are exempted from UK taxation while other artificially diverted profits are taxed.

More specifically, the result of the group financing exemption is regarded by the Commission as treating companies which carry out financing transactions involving certain related foreign debtors better than companies which carry out financing transactions involving related UK debtors or third party debtors, as the latter transactions cannot benefit from the group finance exemption. The Commission sees these as being in a legally and factually comparable position under the UK's CFC regime. The key question is whether the two categories of transactions both present a similar risk of profit shifting out of the UK, which the UK's CFC rules aim to prevent.

**Is the derogation justified?**

In view of the objective of the CFC rules, the Commission sees no need or logic to partially or fully exclude from the scope of the CFC regime specific types of non-trading finance profits which the Commission considers have been artificially diverted from the UK.

**What is the UK authorities' position?**

The Commission's opening decision sets out its understanding of the UK position, which is that the provisions of the group financing exemption do not constitute illegal State aid.

The UK authorities see the exemptions contained within the CFC provisions, including the group financing exemption, as intrinsic and inherent parts of the overall framework of the legislation, not as derogations.

The opening decision explains that in the UK's view, given the fundamental difficulties involved in identifying diverted profits associated with non-trading financing transactions, the system identifies transactions with an increased risk of artificial diversion of profits from the UK (being lending to third parties and to UK related borrowers) and treats these differently to transactions with a lower level of risk of artificially diverted profits (lending to overseas subsidiaries).
in a pragmatic and acceptable way. This assessment of and approach to risk is consistent with the overall framework of the UK CFC regime.

Based upon the opening decision, it would appear that the Commission is focused upon where the income within the CFC should sit, assuming that the financing income would remain unchanged if the loan was made directly from the UK. However, the UK’s position is based upon an assessment of what the most likely financing structure would have been if the UK company had provided the funding directly to a subsidiary, with the artificially diverted financing profits being determined accordingly. As a UK company would be taxable on interest income but would be able to benefit from the UK’s dividend exemption for returns on equity, the UK authorities consider that the debt to equity ratio for direct funding from the UK would have taken this into account, with a correspondingly reduced amount of interest income. As such, the UK authorities and the Commission are currently approaching the group financing exemption from two fundamentally different positions.

What will happen now?
The next steps in the State aid investigation process are as follows:

- 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)
- A summary of the opening decision and the full text of the English version of the decision will be published in the Official Journal of the EU (typically two to three months after the non-confidential version of the opening decision’s publication on the Commission’s website)
- 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 may be 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 Court of Justice of the EU (on points of law only). The appeal process before the Court of Justice of the EU typically takes around two years.

What is the impact of Brexit on the process?
The impact of Brexit is unpredictable. There is a possibility that the UK will exit the EU before the case is determined. The extent of continuing primacy of EU law over UK law will depend on the precise terms of any agreement related to Brexit.

What should groups be doing?
Now that the Commission has published details of its concerns on the UK’s group financing exemption, groups should be carefully assessing their offshore financing structures and undertaking impact assessments together with considering any options they may have to defend against a potential liability.

Assessing the situation
Assessing what the taxable profits might have been under the application of the CFC rules without a claim under the group financing exemption will require looking at the facts and circumstances of the group’s lending, including the sources of the capital that funded loans and the significant people functions and key entrepreneurial risk-taking functions that are associated with the relevant financing activities.

The amount of the benefit of such aid would also depend upon a number of factors, including group tax attributes (such as losses) and interactions with other parts of the UK tax legislation, such as the worldwide debt cap or the new corporate interest restriction regime. The analysis may also be complicated by the different positions taken by the Commission and the UK authorities on what exactly the profits under consideration should be.

Our experience is that the majority of low-tax entities to which the group financing exemption is applied are based in EU Member States. The ability for the UK to recover any CFC tax will therefore need to be evaluated in the context of the EU fundamental freedoms. State aid decisions of
the Commission are required to be consistent with primary EU law, including the fundamental freedoms, such that it may be advisable to assess and document substance in the lending jurisdiction in light of the decision in the Cadbury-Schweppes case, where the Court of Justice of the EU considered that CFC legislation within the EU could be challenged if profits are targeted that do not arise from wholly artificial arrangements.

Even less straightforward is the assessment of the level of risk associated with the investigation and how that applies to the range of potential liabilities. Where groups have made a claim for full or partial exemption under the group financing exemption it will be necessary to consider the approach to disclosure for public companies.

Defending the position
There are various actions a group can take in order to minimize or defend against the potential benefit they may have received under the group financing exemption. This includes exploring the possibilities available to reduce any CFC apportionment without the group financing exemption.

Practical issues, such as identifying where tax years are still open and whether it would be possible or advisable to amend computations to file on a different basis, may also require consideration.

Groups may also want to consider their structures going forward and how the investigation may impact their wider financing strategy.

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