European Commission Opens State Aid Investigation Into Finance Company Exemption From UK CFC Rules

Skadden

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Four Times Square
New York, NY 10036
212.735.3000

skadden.com

On 26 October 2017, the European Commission (the Commission) opened an in-depth investigation into UK statutory rules that exempt certain financing income earned by foreign subsidiaries of UK corporate taxpayers from UK tax. The Commission's investigation will focus on whether the UK Controlled Foreign Company (CFC) rules allow multinational groups a more beneficial tax treatment than others in breach of the European Union rules on state subsidies.

UK CFC Rules

The UK CFC rules are primarily an anti-avoidance measure aimed at ensuring that the UK corporate tax base is not inappropriately eroded or diminished by or through transactions undertaken by non-UK subsidiaries of UK corporate taxpayers. CFC rules in general are an important element of many EU national tax systems to address perceived tax avoidance and specifically feature as a mandatory provision within the Anti-Tax Avoidance Directive (EU 2016/1164).

The UK CFC rules were revised significantly following the European Court of Justice's finding in *Cadbury Schweppes* that, save in the case of wholly artificial arrangements, they violated the EU's fundamental freedom of establishment principles. The reformed rules, in force since 2013, include a number of exceptions for certain financing income (*i.e.*, interest payments received from loans) of subsidiaries of UK corporate taxpayers. Under those exceptions, certain financing income received by non-UK subsidiaries from other non-UK affiliated group companies is exempt from, or only partially subjected to, UK taxation through the UK CFC charge. As a result, a multinational active in the UK can in certain circumstances provide financing to non-UK group companies via a non-UK subsidiary of a UK group member without triggering inclusion of the financing income in the UK. These exemptions are not available in respect of financing income of subsidiaries that lend to UK affiliates or that do not have a minimum level of business presence in their jurisdiction of residence.

The State Aid Investigation

The EU does not have competence over direct tax systems of the EU member states, so the Commission does not question the UK's right to introduce CFC rules or to determine the appropriate level of taxation. However, under the EU rules on state aid, the Commission has the power to investigate whether those systems grant unfair advantages. The EU courts have ruled that an exemption from an anti-tax avoidance provision can amount to a selective advantage in breach of the EU rules on state aid if selected businesses are effectively exempted from their tax obligations as a result.

Under the Treaty on the Functioning of the EU (TFEU), the EU member states are prohibited from granting economic support (through financial assistance or in any other form) to companies to the disadvantage of others in a way that would distort competition and trade within the EU. State aid rules are exclusively governed by the TFEU and enforced by the Commission. State aid must be notified to the Commission and approved by it before it can be implemented, unless it meets certain exemption criteria.

The EU rules on state aid can have an impact on any transaction or arrangement involving state resources. If the state or state bodies provide any unfair assistance to companies and that assistance distorts or threatens to distort competition by favoring those companies or the production of certain goods, the aid could be illegal and the recipient could have to repay the value of the aid, plus interest, to the state.

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Since June 2013, the Commission has been investigating individual tax rulings and other tax advantages granted under national tax schemes. In October 2015, the Commission concluded that Luxembourg and the Netherlands had granted selective tax advantages to Fiat and Starbucks, respectively. In January 2016, the Commission concluded that selective tax advantages granted by Belgium to at least 35 multinationals under its "excess profit" tax scheme were illegal under EU state aid rules. In August 2016, the Commission concluded that Ireland granted selective tax advantages of up to €13 billion to Apple. Finally, in October 2017, the Commission concluded that Luxembourg granted selective tax advantages of up to €250 million to Amazon.

Legal Implications of the Investigation for Brexit

The opening of the investigation, which may go beyond March 2019 and therefore beyond the currently scheduled date for the UK to leave the EU, is a reminder of the principles that underlie the EU's approach to negotiating a potential future trade deal with the UK. These principles were set out in the Article 50 guidelines that formally define the EU's position for the Brexit negotiations: "Any free trade agreement should be balanced, ambitious and wide-ranging. It cannot, however, amount to participation in the Single Market or parts thereof, as this would undermine its integrity and proper functioning. It must ensure a level playing field, notably in terms of competition and state aid, and in this regard encompass safeguards against unfair competitive advantages through, *inter alia*, tax, social, environmental and regulatory measures and practices."[1]

While EU state aid law is not currently expected to apply to the UK upon Brexit — and there remains great uncertainty as to the type of trade agreement that the EU and the UK may ultimately reach (if any) — it is anticipated that some rules on state aid will continue to apply in the near future and possibly for many more years after that even without a deal, either because of bespoke transition terms or World Trade Organization rules.

[1] Paragraph 20, European Council guidelines adopted on 29 April 2017.

Next Steps

The decision to open an in-depth state aid investigation does not prejudge the Commission's final conclusion. However, given the recent trend of decisions, any multinationals that may be affected by the investigation or the operation of the CFC rules would be well-advised to carefully assess their potential exposure and consider how to best defend their case. The Commission's in-depth investigation is directed against the UK government, and the potentially affected multinationals are not a party to the proceedings. Multinationals thus need to be proactive in determining how to engage with the UK government and with the Commission to protect their interests.

If the Commission finds that the UK CFC rules breach EU state aid rules because they have given a selective advantage in reducing the amount of UK tax payable in certain circumstances, companies that have benefited from that advantage can be made to repay the value of the advantage received with interest. The total amount that may need to be repaid could be substantial.

Following a Commission decision ordering recovery, the UK government would need to determine the precise amount of illegal state aid and recover that amount from the affected multinationals under UK law, through UK court proceedings if necessary. If the UK government refuses or delays to recover, it can be sued by the Commission before the EU courts.

Under EU state aid law, the affected multinationals would have the right to challenge the validity of the Commission's recovery decision before the EU courts. However, as long as the Commission's in-depth investigation remains pending, multinationals will need to devise other engagement strategies with the UK government and the Commission to mitigate their exposure.

There is no statutory time frame in which the Commission is required to complete its investigation but, depending on the complexity of the case, it typically takes the Commission no less than 12 months for it to reach a final decision. Given the complexity of the UK CFC rules, the investigation may take longer to complete and could continue after the UK leaves the EU.

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Contacts

James Anderson
Partner / London
44.20.7519.7060
james.anderson@skadden.com

Frederic Depoortere
Partner / Brussels
32.2.639.0334
frederic.depoortere@skadden.com

Alex Jupp
Partner / London
44.20.7519.7224
alex.jupp@skadden.com

Giorgio Motta
Partner / Brussels
32.2.639.0314
giorgio.motta@skadden.com

Ingrid Vandenborre
Partner / Brussels
32.2.639.0336
ingrid.vandenborre@skadden.com

Jonathon J. Egerton-Peters
Counsel / London
44.20.7519.7159
jonathon.egerton-peters@skadden.com

Niels Baeten
Associate / Brussels
32.2.639.0321
niels.baeten@skadden.com