

# CADBURY SCHWEPPEES: A CRITICAL LOOK AT THE FUTURE AND FUTILITY OF U.K. CONTROLLED FOREIGN COMPANY LEGISLATION

## I. INTRODUCTION

Countries worldwide, including European Union Member States, lower their levels of direct taxation to attract foreign investment.<sup>1</sup> This in turn lowers the source country's tax base, thereby creating a conflict between countries that wish to attract foreign investment and those that wish to prevent the loss of tax revenue.<sup>2</sup> One common way of counteracting the effects of such tax competition is through controlled foreign company ("CFC") legislation, which seeks to prevent income shifting and tax deferral by using a foreign subsidiary that is subject to a lower level of taxation.<sup>3</sup> CFC legislation is designed to prevent the accumulation of income and profits abroad by preventing corporations that operate abroad from retaining earnings.<sup>4</sup>

In *Cadbury Schweppes plc v. Inland Revenue Commissioners*, a case of first impression, the Court of Justice of the European Communities, commonly referred to as the European Court of Justice ("ECJ"), examined the compatibility of the United Kingdom's (U.K.) CFC rules with the fundamental freedoms guaranteed by the Treaty Establishing the European Economic Community ("EC Treaty"), specifically the freedom of establishment.<sup>5</sup> Under the U.K. CFC legislation, the profits of a foreign company (or subsidiary) in which the resident company has a majority holding are attributed to the resident company and taxed domestically.<sup>6</sup> The ECJ held that the rules did not violate the freedom of establishment to the extent that they applied only to "wholly artificial" arrangements intended to circumvent national tax laws.<sup>7</sup> The ECJ further held that such legislation did not constitute an outright violation of European Community law because the prevention of tax avoidance is a justifiable basis for a restriction of the freedom of establishment.<sup>8</sup> The rules, however, were invalid to the extent that they applied to

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1. Birgitta Glad, *New Challenges to CFC Legislation in Norway – Developing EC Law*, 34 TAX NOTES INT'L 843, 850 (2004).

2. *Id.*

3. *Id.*

4. Brett Bumeter, *Comparison of CFC Legislation between Germany and the United States*, INTERNATIONAL TAX ARTICLES, June 2, 2001, <http://internationaltaxarticles.blogspot.com/2001/06/comparison-of-cfc-legislation-between.html>.

5. Case C-196/04, *Cadbury Schweppes, plc v. Inland Comm'rs*, 2006 E.C.R. I-7995.

6. *Id.* ¶ 6.

7. *Id.* ¶ 75.

8. *Id.*

genuine economic activity carried out by a resident company in another E.U. Member State.<sup>9</sup>

In reaction to the decision, the U.K. government changed its CFC rules to allow the U.K. parent company to apply to Her Majesty's Revenue & Customs ("HMRC") for a reduction in the profits of the foreign CFC that are apportioned and taxed to the parent company.<sup>10</sup> The apportioned amount can be reduced up to the amount of "net economic value" generated directly by the employees of the CFC in the relevant Member State.<sup>11</sup> The reduction is narrowly tailored and applies only to profits from labor and not to profits from capital, or purely intra-group activities.

This note concludes that the U.K. laws did not go far enough to apply the ECJ's decision, because nowhere in its decision did the ECJ distinguish between profits from capital and profits from labor. It is therefore likely that the law will face further challenges. This note also concludes that the United Kingdom has a long way to go before it solves the problem of lost tax revenue. Despite the attempts of the U.K. government to undermine the attractiveness of low-tax countries, Ireland remains an attractive destination for foreign investment. Instead of relying on defensive measures like CFC rules, the United Kingdom should focus on making itself more attractive to resident companies. CFC rules can only discourage resident companies from establishing foreign subsidiaries. Unfortunately, not only do CFC rules have no effect on relocation by the parent company itself, which poses an even greater risk of loss, but also may encourage relocation of the parent company to a country with less restrictive tax policies.

## II. PRIOR LAW

The primary source of community law in the European Union is the EC Treaty.<sup>12</sup> Signed in Rome in 1957, the Treaty established the European Common Market by "eliminat[ing] the barriers which divide[d] Europe."<sup>13</sup> The creators of the Treaty "intended a lack of inter-Member State competition and free movement of capital, labor, and goods to promote the social goals of economic stability and an increased standard of living"<sup>14</sup> and thus provided for "a system ensuring that competition . . . shall not be distorted" in the Common Market.<sup>15</sup> This free movement, combined with the freedom of establishment, constitutes the fundamental freedoms of the European Union.<sup>16</sup> These fundamental principles are

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9. *Id.*

10. HM REVENUE AND CUSTOMS, CHANGES TO CONTROLLED FOREIGN COMPANY RULES (2007), available at <http://www.hmrc.gov.uk/legislation/second-draft-cfc-guidance-fb07.pdf>.

11. *Id.* at 4.

12. Treaty Establishing the European Economic Community, Mar. 25, 1957, PmbL., 258 U.N.T.S. 11; 2002 O.J. (C 325/33) (Consolidated Text) [hereinafter EC Treaty].

13. *Id.*

14. Julia R. Blue, Note, *The Celtic Tiger Roars Defiantly: Corporation Tax in Ireland and Competition Within the European Union*, 10 DUKE J. COMP. & INT'L. L. 443, 444 (2000).

15. EC Treaty, *supra* note 12, art 3(g).

16. GEORGE BERMAN ET AL., CASES AND MATERIALS ON EUROPEAN COMMUNITY LAW 451 (2d ed. 2002). The four freedoms are referred to as "fundamental principles of Community

found in Articles 39, 43, 48, 49, and 56 of the EC Treaty. Article 39 provides for the freedom of movement of workers within the European Union<sup>17</sup> and calls for the abolition of discrimination based on nationality.<sup>18</sup> Article 43 prohibits restrictions on the freedom of establishment which applies to “restrictions on the setting-up of agencies, branches, or subsidiaries by nationals of any [m]ember [s]tate established in the territory of any [m]ember [s]tate.”<sup>19</sup> The freedom of establishment includes,

the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected.<sup>20</sup>

Article 49 prohibits restrictions on freedom to provide services within the E.U. “in respect of nationals of Member States who are established in a [member state] other than that of the person for whom the services are intended.”<sup>21</sup> Article 56 prohibits restrictions on the movement of capital between, or on payments to E.U. Member States, and between E.U. Member States and third countries.<sup>22</sup>

The ECJ, as the E.U.’s judicial organ, introduced the principle of direct effect of community law in Member States.<sup>23</sup> This enabled E.U. citizens to rely directly on community law in national courts.<sup>24</sup> The ECJ also introduced the primacy of community law over national law, which requires Member States to apply community law in full and to protect the rights conferred on citizens by that law.<sup>25</sup> Furthermore, Member States are required to repeal any national law that conflicts with community law.<sup>26</sup> E.U. law thus takes precedence over all forms of domestic law, including tax law. Irrespective of E.U. Directives and Regulations, Member States’ tax systems and treaties may not violate the fundamental freedoms guaranteed by the EC Treaty.<sup>27</sup>

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law’ whose substance must be interpreted widely and exceptions narrowly.” Tracy A. Kaye, *Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches*, 7 FLA. TAX REV. 47, 50 n.10 (2005) (quoting SERVAAS VAN THIEL, FREE MOVEMENT OF PERSONS AND INCOME TAX LAW: THE EUROPEAN COURT IN SEARCH OF PRINCIPLES 5 n.17 (2002)).

17. EC Treaty, *supra* note 12, art. 39.

18. *Id.*

19. *Id.* art. 43.

20. *Id.*

21. EC Treaty, *supra* note 12, art. 49.

22. *Id.* art. 56.

23. The Court of Justice of the European Communities, [http://curia.europa.eu/en/instit/presentationfr/index\\_cje.htm](http://curia.europa.eu/en/instit/presentationfr/index_cje.htm) (last visited Mar. 21, 2008).

24. *Id.*

25. *Id.*

26. *Id.*

27. EU Tax Policy Strategy, [http://ec.europa.eu/taxation\\_customs/taxation/gen\\_info/tax\\_policy/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/gen_info/tax_policy/index_en.htm) (last visited Mar. 21, 2008). The fundamental Treaty principles are found in four Articles: Article 39 (Free movement of labor); Article 43 (Freedom of establishment); Article 49 (Free movement of services); Article 56 (Free movement of capital).

By submitting a “reference for a preliminary ruling,” a national court can ask the ECJ to rule on a question regarding the interpretation or validity of a provision of Community law.<sup>28</sup> Although only national courts can refer cases to the ECJ, all parties to the proceedings before the national court, the Member States, and European institutions may take part in the proceedings before the ECJ.<sup>29</sup>

Under Article 234 of the EC Treaty, the ECJ must take every case Member States refer to it.<sup>30</sup> The goal of this system is to ensure uniform interpretation and application of the Treaty within Member States.<sup>31</sup> The preliminary ruling handed out by the Court is legally binding on the national court.<sup>32</sup> The Court’s decision, however, is limited to the interpretation or validity of the referred question of Community law, and does not touch the merits of the particular case.<sup>33</sup>

Many foreign branches and subsidiaries have brought tax cases before the ECJ.<sup>34</sup> Although the ECJ has never before addressed the validity of a Member State’s legislation on CFCs, the ECJ has faced approximately one hundred direct tax cases dealing with the compatibility of various national tax provisions with the fundamental principles of the Treaty.<sup>35</sup> Under the supremacy doctrine, Community law trumps the law of an individual Member State.<sup>36</sup> Therefore, although direct taxation is a power reserved to the Member States, this power must be exercised in

EC Treaty, *supra* note 12, arts. 39, 43, 49, 56.

28. The Court of Justice of the European Communities, *supra* note 23. The ECJ also deals with actions for failure to fulfill obligations, actions for annulments (of a measure adopted by an institution), appeals for failure to act, appeals, and reviews. *Id.* The ECJ must also hear cases from the Commission pursuant to its obligation to enforce the EC Treaty. *See* EC Treaty, *supra* note 12, art. 220. The Court’s role is to “ensure that in the interpretation and application of this Treaty the law is observed.” *Id.* Article 234 provides,

The Court of Justice shall have jurisdiction to give preliminary rulings concerning: a. the interpretation of this Treaty; b. the validity and interpretation of acts of the institutions of the Community and of the ECB; c. the interpretation of the statutes of bodies established by an act of the Council, where those statutes so provide. Where such a question is raised before any court or tribunal of a Member State, that court or tribunal may, if it considers that a decision on the question is necessary to enable it to give judgment, request the Court of Justice to give a ruling thereon. Where any such question is raised in a case pending before a court or tribunal of a Member State against whose decisions there is no judicial remedy under national law, that court or tribunal shall bring the matter before the Court of Justice.

EC Treaty, *supra* note 12, art. 234.

29. The Court of Justice of the European Communities, *supra* note 23.

30. EC Treaty, *supra* note 12, art. 234. “A request for a preliminary ruling from a national court may be rejected only if it is manifest that the interpretation of Community law or the examination of the validity of a rule of Community law sought by that court bears no relation to the true facts or the subject-matter of the main proceedings.” Case C-264/96, *Imperial Chemical Indus. plc (ICI) v. Colmer (Her Majesty’s Inspector of Taxes)*, 1998 ECR I-4695, ¶ 15 (citing Case C-62/93, *BP Supergas v. Greek State*, 1995 ECR I-1883, ¶ 10, and Case C-143/94, *Furlanis v. Anas*, 1995 ECR I-3633, ¶ 12).

31. Kaye, *supra* note 16, at 55 (citing Case 26/62 *van Gend & Loos v. Nederlandse Administratie Der Belastingen* [Netherlands Inland Revenue Administration] 1963 ECR 1, ¶ 10).

32. EC Treaty, *supra* note 12, art. 234.

33. Kaye, *supra* note 16, at 72-73.

34. *Id.* at 97.

35. *Id.* at 52-53.

36. Blue, *supra* note 14, at 452.

harmony with Community law.<sup>37</sup> Accordingly, national tax regimes must be consistent with the provisions of the EC Treaty.<sup>38</sup>

Because tax laws tend to make distinctions based on residency and place of permanent establishment, taxpayers often challenge Member States' tax laws as being incompatible with the Treaty.<sup>39</sup> The Court has conceded that, for the purposes of direct taxation, the situations of residents and non-residents are not necessarily the same.<sup>40</sup> Discrimination occurs, however, where a difference in treatment of two groups of taxpayers is not supported by an objective difference.<sup>41</sup> The ECJ has determined that discrimination consists of "the application of different rules to comparable situations, or the application of the same rule to different situations."<sup>42</sup>

In *Cadbury Schweppes plc v. Inland Revenue Commissioners*,<sup>43</sup> the taxpayer challenged the U.K. CFC law as an unjustified restriction on the freedom of establishment as guaranteed by the EC Treaty.<sup>44</sup> The freedom of establishment guarantees the right to "set up and manage undertakings, in particular companies or firms, in an E.U. Member State by a national of another Member State."<sup>45</sup> Thus, when a national tax system results in unequal treatment of individuals or companies from other Member States, that system is incompatible with the freedom of establishment and must be struck down, unless the Member State can justify the unequal treatment.<sup>46</sup> Accordingly, the ECJ has struck down tax laws

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37. Case C-264/96, *Imperial Chemical Indus. plc (ICI) v. Colmer*, 1998 ECR I-4695 (citing Case C-279/93 *Finanzamt Koeln-Altstadt v. Schumacker*, 1995 E.C.R. I-225, ¶ 21; Case C-80/94, *Wielockx v. Inspecteur der Directe Belastingen* 1995 E.C.R. I-2493, ¶ 16; Case C-107/94, *Asscher*, 1996 E.C.R. I-3089, ¶ 36; and Case C-250/95 *Futura Participations and Singer*, 1997 E.C.R. I-2471, ¶ 1).

38. See, e.g., *Schumacker*, 1995 E.C.R. I-225 at ¶ 21.

39. Kaye, *supra* note 16, at 74.

40. *Schumacker*, 1995 E.C.R. I-225 at ¶ 27.

41. *Id.* ¶ 28.

42. Case C-311/97, *Royal Bank of Scotland plc v. Elliniko Dimosio (Greek State)*, 1999 E.C.R. I-2651, ¶ 26.

43. Case C-196/04, *Cadbury Schweppes, plc v. Inland Comm'rs*, 2006 E.C.R. I-7995, ¶ 21.

44. *Id.*

45. Case C-251/98, *Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, 2000 E.C.R. I-2787, ¶ 22.

46. Kaye, *supra* note 16, at 74 (citing Case 270/83, *Comm'n of the European Communities v. France*, 1986 E.C.R. 273 (holding that the failure of French law to extend a tax credit granted to French companies for French-source dividends to the permanent establishments of foreign companies constituted a restriction on their freedom of establishment); Case C-330/91 *The Queen v. Inland Revenue Commissioners, ex parte Commerzbank* 1993 ECR I-4017 (holding that a U.K. law prohibiting nonresident companies from obtaining interest on tax repayments was incompatible with Articles 52 and 58 of the EC Treaty); *Schumacker*, 1995 E.C.R. I-225 (holding that a German law denying nonresident taxpayers special tax deductions allowed residents for family circumstances was incompatible with Article 48 when the nonresident worker receives almost all his income from that Member State)). With regards to Companies, their corporate seat serves the same function as nationality in the case of natural persons. *ICI*, 1998 E.C.R. I-4695, ¶ 20 (citing *Comm'n v. France*, 1986 E.C.R. 273, ¶ 18; *Commerzbank*, 1993 E.C.R. I-4017, ¶ 13).

that create distinctions based on the country of origin.<sup>47</sup> This includes both explicit<sup>48</sup> and implicit<sup>49</sup> nationality-based discrimination. The ECJ has also held that a Member State must grant the same tax advantages to permanent establishments of non-resident companies as those that apply to resident companies.<sup>50</sup>

In *Commission v. France*,<sup>51</sup> the Court held that a Member State could not treat a resident branch of a company with its registered office in another Member State equally for the purposes of taxing their profits with a company whose registered office is in the national territory, while treating the two differently for tax advantage purposes.<sup>52</sup> Such legislation is discriminatory and therefore void under Article 52. The Court held that the EC Treaty prohibits Member States from creating rules that apply to individuals or corporations exercising their freedom of establishment in that Member State that differ from the rules applied to a Member State's own nationals.<sup>53</sup> The fact that a tax rule is unfavorable to branches and agencies of foreign companies established in other Member States indirectly restricts the freedom of companies to establish themselves in that Member State through a subsidiary, branch, or agency.<sup>54</sup> In such cases, it is not necessary to determine the extent of the disadvantage suffered because the Treaty prohibits all discrimination, even if only of a limited nature.<sup>55</sup> Although the freedom of establishment is most often raised in relation to differential treatment of a foreign national in another Member State, it also prohibits the Member State of origin from restricting the right of its own nationals to establish themselves in another Member State.<sup>56</sup>

Despite the extremely high rate of successful challenges to domestic tax measures,<sup>57</sup> the Court maintains that the freedom of establishment is not absolute.<sup>58</sup> A Member State can justify a restriction on the fundamental freedoms if the tax measures in question satisfy four requirements: "(1) they must be applied in a non-discriminatory manner; (2) they must be justified by imperative requirements in the general interest; (3) they must be suitably designed to attain the objective they

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47. *Baars*, 2000 E.C.R. I- 2787, ¶ 30.

48. *Commerzbank*, 1993 E.C.R. I-4017, ¶ 20.

49. Case C-175/88, *Biehl v. Admin des Contributions du Grand-Duche de Luxembourg*, 1990 E.C.R. I-1779, ¶ 13.

50. Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, 1999 E.C.R. I-6161.

51. *Comm'n v. France*, 1986 E.C.R. 273, ¶ 28.

52. *Id.*

53. *Id.* ¶ 24.

54. *Id.* ¶ 11

55. *Id.* ¶ 21

56. See Case 81/87, *Daily Mail & Gen. Trust*, 1988 E.C.R. 5483, ¶ 16; *ICI*, 1998 E.C.R. I-4695, ¶ 21; Case C-200/98, *X & Y*, 1999 E.C.R. I-0000, ¶ 26.

57. To date, the Court has upheld the national tax measures in only seven of these cases. See Cordia Scott, *Europe's Changing View of Nondiscrimination May Color Future Tax Treaty Talks*, 33 TAX NOTES INT'L 851, 852 (2004).

58. Case C-212/97, *Centros Ltd v. Erhvervs-og Selskabsstyrelsen*, 1999 E.C.R. I-1459, ¶ 18.

pursue; (4) they must not go beyond what is necessary to attain their objective.”<sup>59</sup> Thus, rules that restrict the fundamental freedoms are considered discriminatory unless they serve a legitimate purpose *and* are proportionate to that end.<sup>60</sup> Even if the measure pursues a legitimate aim compatible with the Treaty and is justified by a pressing reason of public interest,<sup>61</sup> the measure must be “of such a nature as to ensure achievement of the aim in question and not go beyond what was necessary for that purpose.”<sup>62</sup>

For a justification to apply, there must be a “compelling case of damage to the country’s state of affairs” which is more than simple profit sharing or tax deferral through a CFC.<sup>63</sup> For example, a restrictive tax law is valid if it is necessary for the cohesion of the domestic tax system.<sup>64</sup> Effectiveness of fiscal supervision constitutes “an overriding requirement of general interest” and therefore constitutes a justifiable basis for a restriction of a fundamental freedom.<sup>65</sup> A Member State is also entitled to implement measures to prevent the circumvention of national legislation or nationals from fraudulently taking advantage of community law.<sup>66</sup> In such circumstances, conduct must be assessed in light of the objectives pursued by the provisions of community law on which they rely.<sup>67</sup>

The ECJ, however, has refused to recognize certain justifications. The ECJ held that possible tax losses are not a sufficient justification for the violation of a fundamental freedom.<sup>68</sup> Reduction of income that may result from conferring a tax advantage equally is not one of the grounds listed in Article 46 of the EC Treaty and is not a matter of overriding general interest.<sup>69</sup> Such an interest is “purely economic” and therefore cannot constitute an overriding reason in the general interest.<sup>70</sup> Furthermore, as recognized in *Commission v. France*, “the fact that the laws on corporation tax have not been harmonized cannot justify the difference of treatment.”<sup>71</sup> Although tax avoidance is an acceptable justification for a restriction

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59. Catherine Holst, *European Company Law after Centros: Is the EU on the Road to Delaware?*, 8 COLUM. J. EUR. L. 323, 325 (2002). The most fundamental defense that a Member State can make is that the fundamental freedoms conferred by the Treaty do not apply to the case because it concerns matters that are internal to the Member State. See Case C-112/91, *Werner*, 1993 E.C.R. I-429.

60. Paul Farmer, *The Court's Case Law on Taxation: A Castle Built on Shifting Sands?*, 12 EC TAX REV. 75, 76 (2003).

61. *Futura*, 1997 E.C.R. I-2471, ¶ 26.

62. *Id.* (citing Case C-55/94, *Gebhard*, 1995 E.C.R. I-4165, ¶ 37; in Case C-19/92 *Kraus*, 1993 E.C.R. I-1663, ¶ 32; and in Case C-415/93, *Bosman*, 1995 E.C.R. I-4921, ¶ 104).

63. Glad, *supra* note 1, at 856.

64. Kaye, *supra* note 16, at 115.

65. *Futura*, 1997 E.C.R. I-2471, ¶ 31 (citing Case 120/78, *REWE-Zentral* (‘Cassis de Dijon’), 1979 E.C.R. 649, ¶ 8).

66. *Centros*, 1999 E.C.R. I-1459, ¶ 24.

67. *Id.* ¶ 25.

68. Gerard T.K. Meussen, *Cross-Border Loss Relief in the European Union Following the Advocate General's Opinion in the Marks & Spencer case*, 45 EUR. TAX’N 282, 284 (2005).

69. *X & Y*, 2002 E.C.R. I-10829, ¶ 50.

70. *Verkooijen*, 2000 E.C.R. I-4071, ¶ 48.

71. *Comm’n v. France*, 1986 E.C.R. 273, ¶ 24.

of the freedom of establishment under certain circumstances, the ECJ rejected the justification where the legislation in question “does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent [the Member State’s] tax legislation, from attracting tax benefits,” but the legislation applies generally to companies with a majority of subsidiaries established outside of the Member State.<sup>72</sup>

Thus, E.U. Member States’ domestic tax measures must not violate the fundamental freedoms of the EC Treaty, which includes the free movement of labor, capital, goods, and the freedom of establishment. If the ECJ determines that a measure restricts a fundamental freedom, such a restriction is justified only if it serves a legitimate purpose and is proportionate to that end.

### III. THE FACTS OF THE CASE

The Cadbury Schweppes group established and incorporated two subsidiaries, Cadbury Schweppes Treasury Services (“CSTS”) and Cadbury Schweppes Treasury International (“CSTI”), in the International Financial Services Center in Dublin, Ireland (“IFSC”).<sup>73</sup> Cadbury Schweppes plc (“CS”), the parent company of the Cadbury Schweppes Group, owns the subsidiaries indirectly through a chain of subsidiaries headed by Cadbury Schweppes Overseas Ltd (“CSO”). CS is incorporated and resident in the United Kingdom.<sup>74</sup> It is also the parent company of subsidiaries in the United Kingdom, in other E.U. Member States, and in many countries worldwide.<sup>75</sup>

The national court referred to the ECJ for a preliminary ruling in proceedings concerning the taxation of CSO with respect to the profits made in 1996 by its Irish subsidiaries.<sup>76</sup> The two subsidiaries were subject to a tax rate of 10% during the year in question.<sup>77</sup> The subsidiaries performed financial functions and provided the profits to other subsidiaries across the Cadbury Schweppes Group.<sup>78</sup> According to the national court’s decision, it is “common ground” that the

subsidiaries were established in Dublin in order to benefit from the favorable tax regime of the IFSC.<sup>79</sup>

Under U.K. tax law, a company that has been incorporated in accordance with U.K. legislation and established in the United Kingdom (called a resident company) is subject to a corporation tax in the United Kingdom on its worldwide profits. These profits include the profits of permanent establishments outside the

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72. *ICI*, 1998 E.C.R. I-4695, ¶ 26.

73. *Cadbury Schweppes*, 2006 All ER (D), ¶¶ 2, 13.

74. *Cadbury Schweppes, plc v. Inland Revenue Comm’rs* (Order for reference to the Court of Justice), SpC 415, [2004] STC (SCD) 342, ¶ 1.

75. *Id.*

76. *Cadbury Schweppes*, 2006 All ER (D), ¶ 2.

77. *Id.* ¶ 14.

78. *Id.* ¶ 15.

79. *Id.* ¶ 18.

United Kingdom.<sup>80</sup> The resident company, however, is generally not taxed on the profits of its subsidiaries.<sup>81</sup> An exception to this rule exists in the form of legislation on CFCs.<sup>82</sup> Under that legislation, a CFC is a foreign company (or subsidiary) in which the resident company has a majority holding.<sup>83</sup> Although the income has not been received by the parent company, the profits of the CFC are attributed to the resident company and taxed domestically. In order to prevent double taxation, a tax credit is afforded to the resident company for any taxes paid by the CFC to its country of residence.<sup>84</sup>

The U.K. CFC legislation applies only to CFCs that are established in states where the tax paid by the CFC is less than 75% of the tax that would have been due if the company had been established in the United Kingdom.<sup>85</sup> The CFC legislation also provides several exceptions where the taxation does not apply.<sup>86</sup> The taxation is avoided if (1) the CFC pursues an “acceptable distribution policy,”<sup>87</sup> (2) it is engaged in “exempt activities,”<sup>88</sup> (3) if it satisfies the “public quotation condition,”<sup>89</sup> (4) if its chargeable profits are no more than £50,000, or (5) if it satisfied the “motive test.”

The motive test contains two elements, both of which must be satisfied, and is considered unique to the U.K. legislation.<sup>90</sup> The first part of the test involves the discovery of whether the activity of the CFC resulted in a reduction in U.K. tax, as compared to what the tax would have been in the absence of the activity. If the reduction is more than minimal, the company must show that the reduction was not the main purpose of the activity. The second part of the test requires the company to show that the main reason for the CFC’s existence was not to effect a reduction in U.K. tax by diversion of profits that would have been received by a U.K. resident.<sup>91</sup> U.K. tax authorities have also published a list of acceptable countries where establishment of a CFC would be regarded as having met the requirements

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80. *Inland Revenue*, SpC 415, [2004] STC (SCD) 342, ¶ 3.

81. *Cadbury Schweppes*, 2006 All ER (D), ¶ 4.

82. *Id.* ¶ 5. The U.K. CFC legislation is contained in Section 747 to 756 and Schedule 34 to 26 of the Income and Corporation Taxes Act, 1998, available at <http://www.ukincorp.co.uk/s-BO-to-act-2Z-imputation-of-chargeable-profits-and-creditable-tax-of-controlled-foreign-companies.html#mdiv747>.

83. *Cadbury Schweppes*, 2006 All ER (D), ¶ 6.

84. *Id.*

85. *Id.* ¶ 7.

86. *Id.* ¶ 8.

87. In 1996, this required that 90% of the CFC’s profits are distributed to the U.K. resident company within 18 months and taxed accordingly. *Inland Revenue*, SpC 415, [2004] STC (SCD) 342, ¶ 6.

88. “Exempt activities” were set out in the legislation, and included certain trading activities. *Id.*

89. The “public quotation condition” requires that 35% of the voting power is owned by the public and that the CFC is listed on the stock market. *Id.*

90. *Id.*

91. *Id.*

for exemption from the tax imposed by the CFC legislation.<sup>92</sup>

According to the U.K. tax authorities, with respect to the profits for the 1996 financial year, the subsidiaries did not meet the requirements for exemption from the tax imposed by the legislation on CFCs. The Commissioner of Inland Revenue determined that under the CFC legislation, CSO owed U.K.£8,638,633.54 in corporation tax on the profits of its Irish subsidiaries for 1996.<sup>93</sup> CS and CSO appealed the tax notice to the Special Commissioners of Income Tax, on the basis that the CFC legislation was contrary to Articles 43, 49 and 56 of the EC Treaty.<sup>94</sup> The Special Commissioners then referred the question to the ECJ.<sup>95</sup>

#### IV. THE COURT'S ANALYSIS

In the reference to a preliminary ruling, the national court stated that it is faced with several uncertainties with regard to the interpretation and application of community law to the facts of *Cadbury Schweppes, PLC v. Inland Revenue Commissioners*.<sup>96</sup> Accordingly, the Special Commissioners referred a single question to the EJC:

Do articles 43 EC, 49 EC and 56 EC [of the EC Treaty] preclude national tax legislation such as that in issue in the main proceedings, which provides in specified circumstances for the imposition of a charge upon a company resident in that member state in respect of the profits of a subsidiary company resident in another Member State and subject to a lower level of taxation?<sup>97</sup>

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92. *Cadbury Schweppes*, 2006 All ER (D), ¶ 12.

93. *Id.* ¶ 20. This tax is solely on the profits of CSTI because, in 1996, CSTS operated at a loss. *Id.*

94. *Id.* ¶ 21.

95. *See Inland Revenue*, SpC 415, [2004] STC (SCD) 342, ¶ 2.

96. *Cadbury Schweppes*, 2006 All ER (D), ¶ 22. The national court identified five points of uncertainty. First, whether CS, in establishing a company in another member state solely because of a more favorable tax regime in that member state, is exercising a fundamental freedom afforded by the EC Treaty, or whether it constitutes an abuse of such freedoms. Second, if CS is exercising fundamental freedoms, whether the CFC legislation constitutes a restriction on the exercise of those freedoms, or whether it involves discrimination. Third, whether the fact that CS may pay no more tax than what the subsidiaries would have paid if they had been established in the United Kingdom means that the CFC legislation does not constitute such a restriction. Also, 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 United Kingdom 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)." Fourth, in relation to the question of discrimination, whether comparison should be made between the facts in the main proceedings and the establishment by CS of subsidiaries in the United Kingdom or in a member state without a sufficiently low tax rate to qualify for the CFC legislation. Fifth, if there is discrimination or a restriction on the freedom of establishment, whether the CFC legislation is justified as preventing tax avoidance and whether it is a proportionate measure. *Id.* ¶¶ 22-27.

97. *Id.* ¶ 28. The court concluded that this question necessarily also involves Article 48 of the EC Treaty, which provides that companies formed in accordance with the law of a member state shall be treated in the same way as natural persons who are nationals of member states. *Id.* ¶

The court stated,

national provisions which apply to holdings by nationals of the Member State concerned in the capital of a company established in another Member State, giving them definite influence on the company's decisions and allowing them to determine whether its activities come within the substantive scope of the provisions of the Treaty on freedom of establishment.<sup>98</sup>

Articles 43 and 48 of the EC Treaty are, therefore, relevant to the examination of the CFC legislation at hand.<sup>99</sup> The court stated, however, that restrictive effects on the free movement of services and capital are unavoidable consequences of any restriction on freedom of establishment and “do not justify, in any event, an independent examination of that legislation in the light of Articles 49 EC and 56 EC.”<sup>100</sup>

The Court conceded that nationals of a Member State cannot “improperly or fraudulently take advantage of provisions of community law” by using their rights under the EC Treaty to circumvent domestic legislation.<sup>101</sup> The Court went on to state that the fact that a company establishes itself in a Member State to benefit from a favorable tax regime does not, by itself, constitute an abuse of the freedom of establishment.<sup>102</sup> Thus, the fact that CS established CSTS and CSTI in the IFSC to benefit from the favorable tax regime does not necessarily constitute abuse. It also does not preclude reliance by CS on the rights afforded by Articles 43 and 48 of the EC Treaty.<sup>103</sup>

Having established that CS has standing to rely on the freedom of

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30. Article 48 is referred to in Article 43 in the context of the freedom of establishment.

98. *Id.* ¶ 31 (citing C-251/98, *Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, 2000 ECR-I-2787, ¶ 22; C-436/00, *X & Y v. Riksskatteverket*, 2002 ECR I-10829, ¶ 37).

99. *Id.* ¶ 32.

100. *Id.* ¶ 33 (citing C-36/02, *Omega Spielhallen- und Automatenaufstellungs-GmbH v. Oberbürgermeisterin der Bundesstadt Bonn*, 2004 SCR I-9609, ¶ 27). Article 49 of the EC Treaty provides that restrictions on freedom to provide services within the EU be prohibited in respect of nationals of EU member states who are established in a member state other than that of the person for whom the services are intended. Article 56 prohibits restrictions on movement of capital between EU member states and between member states and third countries. Article 56 also prohibits restrictions on payments between EU member states and between member states and third countries.

101. *Id.* ¶ 35 (citing C-115/78, *Knooks v. Secretary of State for Economic Affairs*, 1979 ECR 399, ¶ 25; C-61/89, *Bouchoucha*, 1990 ECR I-3551, ¶ 14; C-212/97, *Centros Ltd. V. Erhvervs-og Selskabsstyrelsen*, 1999 ECR I-1459, ¶ 24).

102. *Cadbury Schweppes*, 2006 All ER (D), ¶ 37 (citing *Centros*, 1999 ECR I-1459, ¶ 27; C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art*, 2003 ECR I-10155, ¶ 96).

103. *Id.* ¶ 38 (citing *Centros*, 1999 ECR I-1459, at ¶ 18; *Inspire Art*, 2003 ECR I-10155, at ¶ 98).

establishment, the court then examined whether Articles 43 and 48 of the EC Treaty preclude the application of the U.K. CFC legislation.<sup>104</sup> As previously mentioned, direct domestic tax legislation must be consistent with community law.<sup>105</sup> Article 43 prohibits restrictions on the setting-up of agencies, branches, or subsidiaries by nationals of any Member State established in the territory of any Member State.<sup>106</sup> The freedom of establishment includes,

the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected . . .<sup>107</sup>

This right allows companies formed in accordance with the law of a Member State the right to exercise their activity in another Member State through a subsidiary, branch, or agency.<sup>108</sup> The prohibition on restrictions of the freedom of establishment applies not only to the host Member State, but also to the Member State of origin.<sup>109</sup>

The Court stated that, in the instant case, the CFC legislation involves a difference in the treatment of resident companies, which creates a tax disadvantage for the resident company that comes under the scope of the legislation.<sup>110</sup> It is irrelevant that such a company may not pay more tax on the profits of a CFC under such legislation than had the subsidiary been established in the United Kingdom. The court made the important distinction that under the CFC legislation, the resident company is taxed on profits of another legal person.<sup>111</sup> This is not the case with a subsidiary established in the United Kingdom, or a subsidiary established in another Member State without a sufficiently low rate of tax to bring it within the scope of the legislation on CFCs.<sup>112</sup> The Court thus concluded that the CFC legislation hinders the exercise of freedom of establishment by dissuading such companies from “establishing, acquiring, or maintaining a subsidiary in a Member State in which [the company would be] subject to such a level of taxation.”<sup>113</sup>

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104. *Id.* ¶ 39.

105. *Id.* ¶ 40 (citing C-311/97, *Royal Bank of Scotland v. Elliniko Dimosio*, 1999 ECT I-2651, ¶ 19; C-319/02, *Manninen*, 2004 ECR I-7477, ¶ 19; C-446/03, *Marks & Spencer v. David Halsey*, 2005 ECR I-10837, ¶ 29).

106. EC Treaty, *supra* note 12, art. 43

107. *Id.*

108. *Cadbury Schweppes*, 2006 All ER (D), ¶ 41 (citing C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, 1999 ECR I-6161, ¶ 35; *Marks & Spencer*, 2005 ECR I-10837, ¶ 30; C-471/04, *Finanzamt Offenbach am Main-Land v. Keller Holding GmbH*, 2006 ECR I-00000, ¶ 29).

109. *Id.* ¶ 42 (citing C-264/96, *Imperial Chemical Industries v. Kenneth Hall Colmer*, 1998 ECR I-4695, ¶ 21; *Marks & Spencer*, 2005 ECR I-10837, ¶ 31).

110. *Id.* ¶¶ 44-45.

111. *Id.* ¶ 45.

112. *Id.*

113. *Id.* ¶ 46.

Having established that the CFC legislation does involve a restriction on the freedom of establishment, the Court then looked at whether the restriction is permissible.<sup>114</sup> The Court stated that such a restriction is “permissible only if it is justified by overriding reasons of public interest” and if it is an appropriate and proportionate measure to further this interest.<sup>115</sup> The United Kingdom, supported by the Danish, German, French, Portuguese, Finnish, and Swedish governments, contends the purpose of the CFC legislation is to counter tax avoidance involving the artificial transfer of profits earned in one member state to a subsidiary established in a lower tax state.<sup>116</sup> The Court replied by stating that the mere fact that a subsidiary established in another Member State receives an advantage from a lower rate of taxation does not authorize the member state in which the parent company is established to offset that advantage by subjecting the parent company to less favorable tax treatment.<sup>117</sup> The Court also stated that the prevention of reduction in tax revenue is neither one of the grounds listed in Article 46(1) of the EC Treaty nor a “matter of overriding general interest” that would justify a restriction on the freedom of establishment.<sup>118</sup> The Court also pointed out that a resident company establishing a subsidiary in another member state does not create a presumption of tax evasion that would justify a restriction on the exercise of a fundamental freedom guaranteed by the Treaty.<sup>119</sup>

The Court conceded, however, that a restriction on the freedom of establishment may be justified where the measure specifically relates only to “wholly artificial arrangements” designed to circumvent the Member State’s national legislation.<sup>120</sup> The court held that the purpose of the freedom of establishment is to “assist economic and social interpenetration within the Community” by allowing a national of a Member State to set up a secondary establishment in another Member State to carry on activities there as a self-

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114. *Cadbury Schweppes*, 2006 All ER (D), ¶ 46.

115. *Id.* ¶ 47 (citing C-250/95, *Futura Participations SA v. Administration des Contributions*, 1997 ECR I-2471, ¶ 26; C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l’Économie, des Finances et de l’Industrie*, 2004 ECR I-2409, ¶ 49; *Marks & Spencer*, 2005 ECR I-10837, ¶ 35).

116. *Id.* ¶ 48.

117. *Id.* ¶ 49 (citing C-270/83, *Comm’n v. France*, 1986 ECR 273, ¶ 21; *Cf.* C-294/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna*, 1999 ECR I-7447, ¶ 44; C-422/01, *Skandia v. Swedish National Tax Board*, 2003 ECR I-6817, ¶ 52).

118. *Id.* (citing C-136/00, *Danner*, 2002 ECR I-8147, ¶ 56; *Skandia*, 2003 ECR I-6817, ¶ 53). Article 46(1) of the EC Treaty provides that “The provisions of this chapter and measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health.” EC Treaty, *supra* note 12, art. 46.

119. *Cadbury Schweppes*, 2006 All ER (D), ¶ 50 (citing *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes)*, 1998 ECR I-4695, ¶ 26; Case C-478/98, *Comm’n v. Belgium*, 2000 ECR I-7587, ¶ 45; *X & Y*, 2002 ECR I-10829, ¶ 62; Case C-334/02, *Comm’n v. France*, 2004 ECR I-2229, ¶ 27).

120. *Id.* ¶ 51 (citing *ICI*, 1998 ECR I-4695, ¶ 26; Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 ECR I-11779, ¶ 37; *De Lasteyrie du Saillant*, 2004 ECR I-2409, ¶ 50; *Marks & Spencer*, 2005 ECR I-10837, ¶ 57).

employed person.<sup>121</sup> Thus, the freedom of establishment is intended to allow a national of a Member State to profit from and participate “on a stable and continuing basis, in the economic life” of another Member State.<sup>122</sup> The Court reasoned that the concept of establishment necessarily involves “the actual pursuit of an economic activity through a fixed establishment in that [s]tate for an indefinite period”<sup>123</sup> and thus “presupposes actual establishment . . . and the pursuit of genuine economic activity there.”<sup>124</sup> Accordingly, the Court concluded that restrictions on the freedom of establishment designed to prevent abusive practices are justified only if the specific objective of the restriction is to prevent conduct involving “wholly artificial arrangements” which “do not reflect economic reality” and are aimed only at escaping the tax that would be normally due if their activities were carried out on national territory.<sup>125</sup>

The Court then turned to the question of whether the CFC legislation is justified on these grounds, and whether it is proportionate in relation to its objective.<sup>126</sup> The Court first agreed with the French, Finnish, and Swedish governments that CFC legislation is an appropriate measure to prevent practices that have no purpose other than to avoid tax normally due.<sup>127</sup> The Court then addressed whether the U.K.’s CFC legislation “goes beyond what is necessary to achieve that purpose.”<sup>128</sup> The Court noted that the U.K. CFC legislation contains several exceptions, including a “motive test,” and that none of these exceptions apply to Cadbury Schweppes.<sup>129</sup> The Court stated, however, that the fact that no exception applies and that the purpose of the incorporation of the CFC was to obtain tax relief does not by itself prove that there is a wholly artificial arrangement.<sup>130</sup> The Court reasoned that in addition to a subjective intent to obtain tax relief, there must also be objective circumstances showing that, although the company was formed in accordance with community law, the purpose and objectives of the freedom of establishment were not furthered by such actions.<sup>131</sup>

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121. *Cadbury Schweppes*, 2006 All ER (D) ¶ 53 (citing Case 2/74, *Reyners v. Belgium*, 1974 ECR 631, ¶ 21).

122. *Id.* (citing Case C-55/94, *Gebhard v. Consiglio dell’Ordine degli Avvocati e Procuratori di Milano*, 1995 ECR I-4165, ¶ 25).

123. *Id.* ¶ 54 (citing Case C-221/89, *The Queen v. Secretary of State for Transport, ex parte Factortame Ltd and others*, 1991 ECR I-3905, ¶ 20; Case C-246/89, *Comm’n v. United Kingdom*, 1991 ECR I-4585, ¶ 21).

124. *Id.*

125. *Id.* ¶ 55.

126. *Id.* ¶ 57.

127. *Cadbury Schweppes*, 2006 All ER (D), ¶ 59.

128. *Id.* ¶ 60

129. *Id.* ¶¶ 61-63.

130. *Id.* ¶ 63.

131. *Cadbury Schweppes*, 2006 All ER (D), ¶ 64 (citing Case C-110/99, *Emsland-Stärke GmbH v. Hauptzollamt Hamburg-Jonas*, 2000 ECR I-11569, ¶¶ 52-53; Case C-255/02, *Halifax and Others v. Commissioners of Customs and Excise*, 2006 ECR I-0000, ¶ 74-75). Thus, the CFC rules must provide exceptions for circumstances where, regardless of motives, the incorporation of a CFC “reflects economic reality” and “genuine economic activities” in the member state. *Id.* ¶¶ 66-67. The Court also notes that just because activities of the CFC could just as easily have been carried out had the company been established in the original Member

The resident company must, therefore, be provided with an opportunity to produce sufficient evidence to show that the CFC is “actually established” and engaged in genuine economic activity in the host state.<sup>132</sup>

The Court did not conclude whether the U.K. legislation violates community law.<sup>133</sup> Instead, the Court concluded that it is now up to the national court to determine whether the legislation on CFC, in particular the “motive test,” is limited to wholly artificial arrangements or the legislation applies to resident parent companies despite the absence of objective evidence of an arrangement of that nature.<sup>134</sup>

## V. PERSONAL ANALYSIS

In the 2006 Pre-Budget Report, the U.K. government announced the changes it viewed as necessary to bring the CFC legislation in line with the ECJ’s decision.<sup>135</sup> Under the updated laws, U.K. companies can apply to Her Majesty’s Revenue & Customs (“HMRC”) to disregard CFC profits that arise from *genuine economic activity* by a business establishment in another Member State.<sup>136</sup> The CFC charge in 747(4) of the Income and Corporation Taxes Act 1988 (“ICTA”) is calculated based on the amount of chargeable profits of a CFC apportioned to a U.K. company under 747(3).<sup>137</sup> A U.K. company can now apply for a reduction in this amount to the extent that it relates to the “net economic value” created directly by work carried out by employees of the CFC working in the relevant Member State.<sup>138</sup> The guidance notes accompanying the report indicate that the “net economic value” should equal the cost to pay a third-party to do the work of the CFC in the relevant Member State over and above the actual cost.<sup>139</sup>

There are three conditions for the reduction: (1) no other exceptions under § 748 ICTA 1998 apply, (2) the CFC has a business establishment in another Member State or EEA State with individuals working for it, and (3) the CFC has

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State does not prove that there is a wholly artificial arrangement. *Id.* ¶ 69.

132. *Cadbury Schweppes*, 2006 All ER (D), ¶ 70.

133. *Id.* ¶ 72.

134. *Id.*

135. HM REVENUE & CUSTOMS, PRE BUDGET REPORT, PBNR01, 2006, available at <http://www.hmrc.gov.uk/pbr2006/pbrn1.htm> [hereinafter Pre-Budget Report].

136. *Id.* A new “effectively managed” condition will apply to the Exempt Activities exemption provided for in Section 748(1)(b) and Part II of Schedule 25 ICTA. *Id.* at 4. To be considered “effectively managed,” a CFC must have sufficient staff working in the EU or EEA Member State who has the competence and authority to undertake all, or substantially all, of the CFC’s business. The change also applies to CFCs resident in an EEA state with which the United Kingdom has International Tax Enforcement Arrangements. The public quotation exemption provided for in Section 748(1)(c) ICTA will be abolished because the government sees it as a highly artificial avoidance scheme. *Id.*

137. *Id.* at 3.

138. *Id.*

139. Deloitte UK, *Changes to the UK rules on Controlled Foreign Companies (CFC)*, available at [http://www.ukbudget.co.uk/PreBudget2006/AntiAvoidance/PBR06\\_changestotheUKrulesonCFCs.cfm](http://www.ukbudget.co.uk/PreBudget2006/AntiAvoidance/PBR06_changestotheUKrulesonCFCs.cfm), (last visited Mar. 21, 2008).

genuine economic activities.<sup>140</sup> To qualify as an individual working for the CFC, the individual must be employed by the CFC in the Member State.<sup>141</sup> This does not include self-employed individuals, employees, or contractors, or individuals that are effectively working for, or taking directions from, another group company.<sup>142</sup>

The exclusion of profits allowed by the new rules is narrowly tailored and applies only to those profits “created” by local manpower.<sup>143</sup> The guidance notes distinguish between profits from labor and capital; “genuine economic activities” are only those created by the labor of employees in the CFC’s business establishment in the Member State.<sup>144</sup> Thus, profits from capital will rarely qualify for a reduction in CFC profits.<sup>145</sup> The guidance notes also look to the profits of the group as a whole, so profits from intra-group activities will not meet the “genuine economic activities” requirement.<sup>146</sup> The distinction, therefore, means that a shared services center, for example, will fall outside the CFC rules, but a finance company or an intellectual property management company will not.<sup>147</sup>

The changes to the CFC rules are estimated to cost the U.K. £100 million for 2007-2008, and this number will rise to U.K. £250 million the following year.<sup>148</sup> This is far less than what was expected after the ECJ handed its decision down in the *Cadbury* case.<sup>149</sup> The minor changes surprised many commentators who concluded, from the long time it took the government to respond to the decision, that the government was planning more far-reaching changes to the taxing of foreign company profits.<sup>150</sup>

These minor changes represent the U.K. government’s point of view that the original CFC legislation did not violate any of the fundamental freedoms and that the changes are simply to remove any doubt as to the validity of the law.<sup>151</sup> This conclusion is based primarily on the reference in the *Cadbury Schweppes* decision to “objective factors . . . with regard, in particular, to the extent to which the CFC

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140. *Id.*

141. *Id.*

142. *Id.*

143. Allen & Overy, *Areas of Expertise - UK Pre-budget report 2006: Tiptoeing to No. 10* (on file with author).

144. Deloitte UK, *supra* note 139.

145. Bourne Business Consulting LLP, *Pre Budget Report 2006*, [http://www.bournebc.com/bournebc/documents/Pre\\_Budget\\_Report\\_2006.pdf](http://www.bournebc.com/bournebc/documents/Pre_Budget_Report_2006.pdf).

146. Deloitte UK, *supra* note 139. For example, profits arising from intragroup loans will remain within the CFC legislation if the work performed by the employees has not created value that benefits the group as a whole. Peter Nias & James Ross, *United Kingdom Makes Minimal Changes to CFC Rules*, TAX ANALYSTS, Dec. 22, 2006, <http://services.taxanalysts.com/taxbase/tbnews.nsf/Go?OpenAgent&2006+WTD+246-2>.

147. KPMG UK News, <http://www.kpmg.co.uk/news/detail.cfm?pr=2740> (last visited, Mar. 21, 2008)

148. Nias & Ross, *supra* note 146.

149. *Id.*

150. Baker Tilly, *The Pre-Budget Report 2006*, Dec. 6, 2006, <http://www.bakertilly.co.uk/default.aspx?page=2595>.

151. Nias & Ross, *supra* note 146.

physically exists in terms of premises, staff, and equipment” as a means of determining whether a CFC reflects economic reality.<sup>152</sup> The U.K. government views CFC’s without directly employed staff as essentially artificial, even if the CFC’s are residents in the Member State of incorporation and are effectively managed in that Member State by a properly constituted boards of directors.<sup>153</sup> This conclusion is not generally supported by commentators,<sup>154</sup> who assumed that more radical changes would be necessary.<sup>155</sup> Commentators have concluded that these changes are intended solely as a stopgap until the CFC legislation is either completely revamped or abolished as part of a general review of the taxation of foreign income.<sup>156</sup>

By applying the changes to profits from labor but not from capital, the U.K. government has not gone far enough to satisfy the ECJ ruling.<sup>157</sup> The changes, in fact, seem to have little direct relation to the ECJ’s decision.<sup>158</sup> The new rules contemplate some kind of third-party assessment of the value of the CFC’s employee labor, similar to that proposed by the Advocate General, which the ECJ expressly rejected.<sup>159</sup> Furthermore, the ECJ made no distinction between profits from capital and profits from labor<sup>160</sup> and did not conclude that profits from capital or intra-group activity would be “incapable of representing ‘genuine economic activities.’”<sup>161</sup> Given that the subsidiaries involved were financing companies, it is likely that the ECJ would have made this distinction had it been seen as appropriate.<sup>162</sup>

Some see these changes as a “marker in the sand” on the *Cadbury Schweppes* decision.<sup>163</sup> The U.K. government seems to be acting in defiance of the ECJ and is imposing its own narrow definition of what constitutes a “wholly artificial arrangement” or “genuine economic activity.”<sup>164</sup> The government is thus trying to reassert its right to tax the foreign profits of its companies and wants to make it clear to U.K. companies that they cannot hide behind the ECJ’s decision.<sup>165</sup>

The ECJ’s decision is facially positive for Ireland because it resulted in a narrowing of the CFC rules. Although the CFC rules may still apply to artificial

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152. *Id.* (quoting *Cadbury Schweppes, plc v. Inland Comm’rs*, 2006 E.C.R. I-7995).

153. *Id.*

154. *Id.*

155. *Id.*

156. Allen & Overy, *supra* note 143.

157. Baker Tilly, *supra* note 150.

158. Dorsey & Whitney LLP, *Dorsey London Tax Update/Pre Budget Report and EU Cases*, Dec. 6, 2006, [http://www.dorsey.com/publications/legal\\_detail.aspx?FlashNavID=pubs\\_legal&pubid=242012903](http://www.dorsey.com/publications/legal_detail.aspx?FlashNavID=pubs_legal&pubid=242012903).

159. *Id.*

160. *Id.*

161. Ernst & Young, *Pre-Budget Report – Immediate Measures* (on file with author).

162. *Id.*

163. *Id.*

164. *Id.*

165. *Id.*

arrangements, a large portion of companies now have a clear green light to move to Ireland. Most importantly, the Court's holding guarantees companies the opportunity to put forth objective evidence of their genuine economic activity, and companies no longer have to be concerned with the reasons behind their establishment in Ireland.

Although the limited scope of the resulting changes in U.K. law means that the profits that actually qualify for exemptions are likely to be low,<sup>166</sup> this is unlikely to persuade Ireland to change its corporate tax rate, which would have to be almost doubled to avoid the U.K. CFC rules. Ireland now has the second highest gross domestic product ("GDP") per capita in the E.U., one-third higher than the average.<sup>167</sup> Tax rates and tax incentives have enormous effects on business decision making,<sup>168</sup> and commentators generally agree that one of the primary reasons for this recent economic growth is Ireland's low rate of corporation tax, one of the lowest in Europe.<sup>169</sup>

Ireland has retained this low rate of corporate tax despite feeling considerable pressure from the E.U. and other Member States to raise it.<sup>170</sup> Despite the opposition, Ireland is justified in resisting, as there is no E.U. law that prohibits a low tax rate. The E.U. Commission has stated that there is no need for complete harmonization of tax systems across Member States.<sup>171</sup> E.U. Member States differ greatly in terms of economic and social environments and have varying levels of public spending.<sup>172</sup> These factors determine what level of corporate taxation the economy needs in order to function. Thus, direct taxation is the province of the individual Members States,<sup>173</sup> who are free to choose whatever tax systems they feel are appropriate, so long as the system is in accordance with community rules.<sup>174</sup> Ireland's low rate of tax does not violate E.U. law because it is equally applicable to all taxpayers.<sup>175</sup> A low flat tax that applies equally to all does not constitute harmful tax competition because no distortion of the internal market

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166. *Id.*

167. Sean Dorgan, *How Ireland Became the Celtic Tiger*, THE HERITAGE FOUNDATION, June 23, 2006, <http://www.heritage.org/Research/WorldwideFreedom/bg1945.cfm>.

168. BEN TERRA & PETER WATTEL, *EUROPEAN TAX LAW* 69-71 (Aspen Publishers, 4<sup>th</sup> ed. 2005) (1993).

169. Blue, *supra* note 14, at 443.

170. *Id.* at 460 (citing Eur. Comm'n Press Release IP/98/691/B, Comm'n Addresses Recommendations to Ir. Regarding Corporate Tax (July 1998)).

171. EU Tax Policy Strategy, *supra* note 27.

172. See Sandrine Degreve & Roger Molitor, *Tax Competition – Current Trends for Company Taxation in Europe*, TAX ANALYSTS, Jan. 25, 2006, available at <http://services.taxanalysts.com/taxbase/tbnews.nsf/Go?OpenAgent&2006+WTD+16-12>.

173. Kaye, *supra* note 16, at 51 ("The sanctity of the Member States' power to levy direct taxes . . . is illustrated by the EC Treaty's almost complete silence on this subject."). *Id.* at n. 13 (citing Jan Wouters, *The Case-Law of the European Court of Justice on Direct Taxes: Variations upon a Theme*, 1 MAASTRICHT J. EUR. & COMP. L. 179, 180 (1994)). The only explicit reference to direct taxes occurs in Article 293, which directs Member States to prevent double taxation. EC Treaty, *supra* note 12, art. 293.

174. Kaye, *supra* note 16, at 51.

175. Degreve & Molitor, *supra* note 172.

would take place if all Member States were to apply the same rules.<sup>176</sup>

Thus, simply because a Member State believes that a higher rate of taxation is in the best interests of its economy, it does not justify a restriction on the ability of companies to take advantage of the lower rates in other States.<sup>177</sup> Member States should instead focus on making themselves more attractive to investors. The high rate of corporation tax, combined with the increasing complexity of the tax system, is causing U.K.-domiciled companies to contemplate relocation.<sup>178</sup> U.K.-based companies may have to move to low-tax countries to stay in line with their global competitors.<sup>179</sup> Although the U.K. corporate tax rate has dropped from 33% in 1997 to 30% today, an increase in national insurance contributions and other business taxes has increased the gross amount of tax that companies pay.<sup>180</sup> Furthermore, the emphasis placed on tax rates is misguided because it is the tax base that determines the amount of income to which this rate will be applied.<sup>181</sup> Although the U.K. taxes corporations at a lower rate than France and Germany, U.K. companies pay higher taxes.<sup>182</sup>

A survey of eighty-seven FTSE-350 finance directors revealed that twice as many respondents preferred other E.U. Member's regimes to the United Kingdom's regime and that 39% either had relocated or were considering doing

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176. *Id.* In 1997, the Council of Economics and Finance Ministers [ECOFIN] set out the Code of Conduct for Business Taxation [the Code], which addressed the anti-competitive effects of Member States' corporate tax policies. Eur. Comm'n, Code of Good Conduct in the Field of Direct Company Taxation, Official Document No. 2061, Dec. 3, 1997, available at [http://ec.europa.eu/taxation\\_customs/resources/documents/COC\\_EN.pdf](http://ec.europa.eu/taxation_customs/resources/documents/COC_EN.pdf) [hereinafter Code of Good Conduct]. While recognizing the benefits of fair competition, the Council designed the Code to specifically detect domestic measures that "unduly affect the location of business activity" in the EU by "providing [non-residents] with a more favorable tax treatment than that which is generally available in the Member State concerned." Press Release, ECOFIN, Economic and Financial Affairs (June 3, 2008) [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ecofin/100885.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/100885.pdf) (last visited Nov. 9, 2008) [hereinafter Harmful Tax Competition]. The Code sets out criteria for identifying whether a tax measure "affect[s], or may affect, in a significant way the location of business activity in the Community." Code of Good Conduct, *supra*. These criteria include: "an effective level of taxation which is significantly lower than the general level of taxation in the country concerned; tax benefits reserved for non-residents; tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base; granting of tax advantages even in the absence of any real economic activity; the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD; lack of transparency." Harmful Tax Competition, *supra*.

177. Harmful Tax Competition, *supra* note 176.

178. David Rae, *UK Tax Competitiveness: Haven Can't Wait*, IT WEEK, Jan. 24 2007, <http://www.computing.co.uk/financial-director/features/2173294/haven-wait>.

179. *Id.*

180. *Id.*

181. Blue, *supra* note 14, at 466.

182. Kevin Brown & Jim Kelly, *Tax Harmony? No Thanks: Attempts to Reform Taxation Across the EU Will Meet Huge Resistance*, FIN. TIMES (London), Mar. 1, 1999, at 19.

so.<sup>183</sup> Research by the Confederation of British Industry showed a strong preference for countries like Ireland.<sup>184</sup> Reasons for this preference included the low tax rate, ability to get advance rulings, a lack of complications in the system, low compliance burden, and an understanding of “the needs of businesses.”<sup>185</sup>

More importantly, respondents to the survey also listed the lack of CFC rules in Ireland as an attractive feature.<sup>186</sup> By steadfastly clinging to its CFC legislation, the United Kingdom is ignoring the preferences of its resident companies.<sup>187</sup> The government does not seem to realize that CFC legislation not only discourages resident companies from setting up subsidiaries in low-tax companies, but also discourages companies from setting up in the United Kingdom altogether. The changes also promote uncertainty by failing to provide any advance clearing mechanism.<sup>188</sup>

By focusing all of its attention on other Member States with low rates of corporate tax, the U.K. government also ignores many other factors that determine where a company will locate. Although the low corporate tax rate contributed greatly to Ireland’s economic growth in the past, there are other reasons for Ireland’s current economic attractiveness to foreign investment. For example, Ireland is the only English-speaking common-law country in the Euro zone, which makes it broadly similar to the legal systems of the United Kingdom and United States.<sup>189</sup> It also has a pro-business regulatory environment, governmental support for business, and excellent professional services.<sup>190</sup> Furthermore, Ireland has a strong economy, a young and educated workforce, and modern infrastructure.<sup>191</sup> Ireland has also invested heavily in higher education, creating a reputation for highly-skilled workers.<sup>192</sup> There are also several other tax-related incentives besides the corporate tax rate, including “exemption from withholding tax on interest paid to non-residents, tax exemption for collective investment/life assurance funds, and no net asset value tax on funds.”<sup>193</sup> In addition, Ireland has double taxation agreements with 41 countries.<sup>194</sup> Thus, the success of the IFSC and Ireland in general is not simply the result of low corporation tax, but is a result of taxation, regulatory, and legal frameworks<sup>195</sup> combined with “business-friendly commercial policies [and] a general openness to new business.”<sup>196</sup>

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183. Rae, *supra* note 178.

184. *Id.*

185. *Id.*

186. *Id.*

187. *See id.*

188. Deloitte UK, *supra* note 139.

189. The International Financial Services Centre, *Key Reasons for Investing in Ireland*, <http://www.ifsconline.ie/reasons.html> (last visited Mar. 21, 2008).

190. *Id.*

191. *Id.*

192. Dorgan, *supra* note 167.

193. The International Financial Services Centre, *supra* note 189.

194. *Id.* (such agreements prevent the same income from being taxed in more than one country).

195. *Id.*

196. *Id.*

Several intangible factors also contributed such as the Irish people's innate creativity and openness to the world.<sup>197</sup> Furthermore, the majority of direct investment in Ireland comes from the United States.<sup>198</sup> Therefore, an alternative explanation for this investment may be the cultural affinity between Ireland and the United States, which makes U.S. businesses more likely to relocate there.<sup>199</sup>

The U.K. government did not see the prevention of wholly artificial establishments as a departure from the purpose of the current rules, and therefore initiated only minor changes, simply to put the question to rest.<sup>200</sup> As many commentators have suggested, these changes did not go far enough to put the ECJ's decision into practice. Instead, the U.K. government imposed its own meaning upon the terms "genuine economic activity" and "wholly artificial arrangement."<sup>201</sup> Although the government did itself no favors by imposing such a narrow interpretation on the ECJ's decision, it did not make it any less attractive for companies who wish to establish subsidiaries in Ireland to do so. On the other hand, it made it less attractive for companies to locate their parent establishment in the United Kingdom.<sup>202</sup> The government should look to more proactive means of attracting investment and retaining U.K. resident companies, rather than relying on defensive measures like CFC rules, which do more harm than good.

## VI. CONCLUSION

In *Cadbury Schweppes plc v. Inland Revenue Commissioners*, the ECJ decided that CFC legislation constitutes an unjustified restriction on the freedom of establishment when applied to genuine economic activity. Such legislation is acceptable only if designed to prevent those arrangements that are "wholly artificial." The taxpayer will now have the chance to put forth objective evidence to prove the genuineness of the establishment in the Member State and the taxpayer's intentions in setting up a subsidiary in a low-tax country are not dispositive of the validity of the establishment. Although this decision is directly binding on Member States, the United Kingdom seems resistant to applying this ruling, choosing instead to assert its right to tax the profits of U.K.-owned foreign subsidiaries. The changes put forth by the United Kingdom embody neither the spirit, nor the word, of the Court's decision. Instead, the United Kingdom relies on its own interpretation of the type of economic activity that freedom of establishment *should* protect. It bases this reliance, not on interpretation of the EC Treaty, but on the type of activity that is most likely to lead to lost tax revenue. In doing so, the United Kingdom ignores the economic reality that business decision-making considers factors other than low-tax rates.

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197. Dorgan, *supra* note 167.

198. Blue, *supra* note 14, at 465 (citing L.G.M. Stevens, *Introduction and Summary, in HARMONIZATION OF COMPANY TAXATION IN THE EUROPEAN COMMUNITY: SOME COMMENTS ON THE RUDING COMMITTEE REPORT 5, 19* (A.L. Bovenberg et al. eds., 1992)).

199. *Id.*

200. *Id.*

201. *See id.*

202. *Id.*

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