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The General Court's flawed decision on CFC state aid

*On 8 June 2022, the General Court (**GC**) of the Court of Justice of the European Union (**CJEU**) dismissed the UK and ITV's applications to annul the European Commission's decision on the UK controlled foreign companies (**CFC**) group financing exemption. The applicants' pleas were entirely rejected by the General Court, so the UK must, for now, retain the tax and interest it was ordered to recover from affected UK groups. Running through the judgment is a flawed and over-simplified analysis of the way the relevant bits of the CFC rules were put together, and in particular of the significance of the concept of UK significant people functions (**SPFs**). The General Court's account of the design of the CFC rules is at odds with the UK and ITV's explanations (and the consensus view among practitioners) of the risk-based approach of the CFC rules generally, and the 'group financing exemption' in particular. The judgment has already been criticised by commentators and large amounts of tax are at stake across all affected groups, so an appeal to the Court of Justice seems likely, assuming the UK is willing to continue defending its legislation from EU attack.*

On 2 April 2019, with Brexit looming, the EU Commission controversially published Decision SA.44896 (the ***Decision***), concluding that aspects of the UK's CFC rules constituted unlawful state aid. The Commission ordered the UK to recover tens of millions of pounds of alleged aid from affected UK groups which had claimed the benefit of the CFC group financing exemption in TIOPA 2010 Part 9A Chapter 9. The UK and many of the affected groups vehemently disagreed with the Commission's reasoning and applied to the GC of the CJEU to annul the Decision. ITV was selected as a test case and applications made by all other affected groups were stayed behind ITV's. The UK and ITV cases (T-363/19 and T-456/19 respectively) were joined for the oral hearing which took place in person in Luxembourg on two separate days in October and November 2021. Now, three years after the Decision was published, the GC has entirely rejected the UK and ITV applications, with the result that the Decision stands in its entirety (pending further appeal to the CJEU).

Summary of the judgment

The GC dealt with jointly, and dismissed entirely, the pleas in law made by the UK and ITV in their respective applications to annul the Decision. The consequence is that the Decision stands and the UK must, for now, retain the state aid recovered from affected groups, notwithstanding the many applications and appeals made by those groups, both to the GC and the First-tier Tribunal (***FTT***).

The GC's key findings relate to the reference framework, the selectivity analysis and the arguments on justification.

The CFC rules as the correct 'reference framework': The identification of the reference framework is the first step in a state aid assessment of a tax measure. The reference framework is the normal system of taxation against which the contested measure has to be compared. The GC found that the CFC rules are based on a logic distinct from the rest of the UK corporation tax system, with the sole objective of taxing profits that are 'artificially diverted' from the UK. As such, the GC agreed with the Commission that the CFC rules themselves were the reference framework and the group financing exemption was a derogation from that framework. This sits in contrast to the UK and ITV argument that the CFC rules form part of the wider

UK corporation tax system, and operate together with other parts of that system to protect the UK tax base from profit shifting and base erosion involving CFCs.

Comparability of qualifying loan relationships (QLRs) with moneybox lending and upstream loans: The second step in a state aid analysis assesses whether the tax measure at issue (here the group financing exemption) is a derogation from the reference framework insofar as it differentiates between operators in a comparable legal and factual situation. This was the key part of the state aid analysis in this case and tests whether the QLRs which benefit from the group financing exemption in Chapter 9 are legally and factually comparable with moneybox and upstream lending arrangements, as the paradigm examples of cases that don't. The GC focused on the fact that, in the TIOPA 2010 s 371EB case, the reason profits are brought within the Chapter 5 gateway for non-trading finance profits (***NTFP***) is that relevant SPFs are or may be located in the UK. Therefore, the GC upheld the Commission's analysis that QLRs, moneybox lending and upstream loans were comparable because in each case SPFs may be located in the UK.

Justification (of the apparent advantage): The third step in a state aid analysis gives the member state an opportunity to justify the differentiation introduced by the tax measure. In broad terms, the GC found that because (it thought) the Chapter 5 gateway was intended to capture all NTFP arising from loans with UK SPFs, any such profits were necessarily 'artificially diverted', meaning that no exemption or derogation from that position could be justified. As regards the UK and ITV's arguments that the rules could be justified by a need to comply with *Cadbury Schweppes*, the GC said (in a very cursory way) that Chapter 5 identified artificially diverted profits, and so was straightforwardly *Cadbury Schweppes* compliant without any need for the Chapter 9 exemptions.

Observations on the judgment

Overall, the judgment reads as something of a 'whitewash', supporting the Commission on every ground. This is surprising, as the hearing had appeared to go well for the UK and ITV; and the Commission's arguments (particularly on the reference system) came under heavy fire.

The UK's and ITV's criticisms of the Commission's analysis in the Decision largely carry over to the GC's judgment. The UK and ITV criticised the Commission Decision for betraying an over-simplistic understanding of the UK corporation tax system and failing to acknowledge the different ways in which the UK corporation tax base can be eroded. This leads to its over-emphasis on the location of SPFs, and therefore its conclusion that QLRs, moneybox lending and upstream loans are comparable. The same is true of the GC's decision. The key to this conclusion is the GC's finding that the location of SPFs is the determining factor for the application of the Chapter 5 gateway and thus for meeting the CFC rules' objective of taxing artificially diverted profits. In making this finding:

- The GC has apparently ignored the points (which were pleaded by the UK and ITV) that the CFC rules also seek to counteract base erosion (i.e. an Upstream Lending case);
- The GC has apparently not appreciated that SPFs are not a key factor in determining whether the generation of NTFP in a CFC poses a risk to the UK corporation tax base; on the contrary, in most cases, it is the sources and uses of capital that really matter; and
- The GC has been overly influenced by the legislative structure of the CFC rules, in that it considered that the Chapter 5 gateway constituted the 'normal' way in which NTFP were taxed, with the Chapter 9 group financing 'exemptions' constituting derogations from that normal system applying irrespective of the location of SPFs. In fact (and as argued) they need to be read together to properly understand the intended scope of the Chapter 5 gateway.

The judgment also recasts the decision in *Cadbury Schweppes* (Case C-196/04), in which the ECJ (now CJEU) had held that a restriction on the freedom of establishment could be justified if it *only* applied to 'wholly artificial' arrangements. In a sense, the GC inverts the decision in *Cadbury Schweppes* in the way that it takes at face value the background materials (consultation documents etc) saying that the post-*Cadbury Schweppes* CFC rules would be focused on capturing artificially-diverted profits. The judgment here is brief, but it is almost as though the GC is saying: (a) the UK has said that the new FA 2012 rules were intended to comply with *Cadbury Schweppes* and to target only artificially diverted profits; (b) the

Chapter 5 gateway on its own (without regard to the Chapter 9 exemptions) represents the UK's decision on what constituted artificially diverted profits; and therefore (c) the NTFP rules in Chapter 5 were indeed *Cadbury Schweppes*-compliant.

This ignores the fact that Chapter 5 on its own clearly overreaches in taxing *all* NTFP generated by a loan with UK SPFs or UK connected capital, without regard to whether the NTFP were generated from wholly commercial or wholly artificial arrangements. To take a simple example: imagine that a UK parent company equity-capitalises an Irish CFC, which uses the funds to earn NTFP from a loan asset that is managed (in SPFs terms) by the group's treasury centre in Switzerland. On a source-of-the-capital basis, if the NTFP are artificially diverted from anywhere, then it is the UK; but on a location of- the SPFs basis, seemingly they are artificially diverted from Switzerland. Plainly they can't be both! In reality, the UK's CFC rules represented a much more sophisticated, risk-based and nuanced assessment of the circumstances in which (and the extent to which) NTFP and other types of profit should be viewed as posing a risk to the UK tax base and should therefore be caught by the CFC rules. This is why the CFC rules introduced in FA 2012 took the UK five years to craft. The Commission's and GC's over-simplistic analysis simply doesn't do them justice.

What next?

The UK and ITV have until mid-August 2022 to decide whether to appeal the GC judgment. Given that the GC disagreed with them on, well, everything, there are a number of grounds of appeal. Certainly, practitioners reading the judgment are also likely to disagree with the GC's (and the Commission's) exposition of the principles underpinning the UK CFC rules.

If ITV appeals, it will be open to the other affected groups with appeals stood behind ITV's to intervene (with permission). There may be some groups who have been thinking that, if the EU annulment proceedings fail, then in UK domestic proceedings they would (alongside arguments on whether their facts really did involve UK SPFs) argue that the relevant bits of Chapter 5 do indeed infringe EU Treaty freedoms. The GC's superficial commentary on *Cadbury Schweppes* is unlikely to dissuade those taxpayers from pursuing the point; but it might make them re-consider whether to intervene in any further appeal at the EU level.

Any appeal at EU level would need to be on a point of (EU) law. In that context, the GC's analysis of national law, in this case UK tax law (including the CFC rules), is strictly a question of fact. As a result, challenging aspects of that analysis may be difficult, unless the GC's analysis can be shown to be a demonstrably manifest error in assessing the relevant provisions. (To a UK tax practitioner, it sounds a bit like the *Edwards v Bairstow* [1956] AC 14 threshold for intervening in a FTT's findings of fact on appeal.) Having said that, the CJEU has overturned GC decisions in favour of taxpayers in the past – the recent *Heitkamp* case (C-203/16 P) (dealing with the application of German loss forfeiture rules on restructurings) being a prominent example. In any event, the UK and ITV will readily identify errors of EU law in the GC's decision, so there will be grounds of appeal should they wish to do so.

As things stand, the UK's recovery obligation under the Commission Decision endures. We understand that the recovery process is essentially complete (subject to taxpayer domestic appeals to the FTT regarding the amounts recovered, all of which are currently stayed pending further EU-level appeals) and so the UK must, for now, retain the tax and interest recovered. In effect this means that there is no substantive change at the UK level if an appeal is made to the CJEU.

If there is no appeal of the GC judgment, the EU proceedings will be closed. That would re-focus attention on the domestic UK recovery proceedings, which would be unstayed; the FTT would be invited to decide which of HMRC and the taxpayer cohort has done its Chapter 5 SPFs analysis correctly (for each taxpayer appeal) and, potentially, if the CFC rules over-reached and thereby infringed EU Treaty freedoms.

A related point is on provisioning: those groups which have booked a contingent receivable for the amounts of alleged aid recovered by the UK will need to consider (with their auditors) whether the GC judgment changes anything. That will be in part be influenced by whether the UK and ITV appeal. Given the number of affected UK groups, it is hoped that this is something the UK will be in a position to confirm quickly.

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