

Commission Decision (EU) 2019/1352 of 2 April 2019 on the State aid SA.44896 implemented by the United Kingdom concerning CFC Group Financing Exemption (notified under document C(2019) 2526) (Only the English version is authentic) (Text with EEA relevance)

COMMISSION DECISION (EU) 2019/1352

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THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union, and in particular the first subparagraph of Article 108(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1) (a) thereof,

Having given notice to the parties concerned to submit their comments pursuant to those provisions⁽¹⁾ and having regard to their comments,

Whereas:

1. **PROCEDURE**

- (1) By letter of 26 April 2013, the Commission requested the authorities of the United Kingdom ('UK authorities') to provide information on the reform of its Controlled Foreign Company ('CFC') rules, which had entered into force on 1 January 2013. The UK authorities submitted the information on 14 June 2013 and, following further requests for information⁽²⁾, supplied additional information on 10 April 2014, on 10 July 2014, on 24 July 2015 and on 1 February 2017.
- (2) By letter of 26 October 2017, the Commission informed the UK that it had decided to initiate the procedure laid down in Article 108(2) of the Treaty in respect of the group financing exemption provided for in the CFC rules ('the Opening Decision').
- (3) On 24 November 2017, the Opening Decision was published in the *Official Journal of the European Union*. In the Opening Decision, the Commission invited interested parties to submit their comments on the Opening Decision.

- (4) Following an extension of the deadline for providing comments, the UK authorities submitted their comments on the Opening Decision on 15 January 2018.
- (5) Between 19 December 2017 and 2 January 2018, eight interested parties submitted comments on the Opening Decision. The comments were forwarded to the UK authorities. On 23 February 2018, the UK authorities submitted observations on the comments made by interested parties.
- (6) On 7 February 2018, a meeting took place between the Commission services and the UK authorities. Following that meeting, the UK submitted additional comments on 22 March 2018. A further meeting between the Commission services and the UK authorities took place on 31 May 2018, followed by additional comments submitted by the UK authorities on 3 July 2018, and then a further meeting took place on 13 July 2018.

2. DESCRIPTION OF THE SCHEME

2.1. The UK Corporate Tax System and the UK CFC rules

2.1.1. *Introduction and Background*

- (7) Under UK corporate tax law, companies are taxed on their profits arising from UK activities and assets. It applies to UK resident companies and to non-resident companies that carry on business in the UK through a UK permanent establishment.
- (8) The UK reformed its corporate tax system to align more closely with a territorial corporate tax system⁽³⁾, focusing on taxation of profits from UK activities and assets, rather than the worldwide income of a taxpayer⁽⁴⁾.
- (9) The largely territorial character of the UK corporate tax system means that company profits which arise outside the UK are not generally subject to UK tax. In line with this, the UK distribution exemption rules exempt the profits of overseas companies that are distributed back to the UK. Similarly, the foreign branch exemption rules ensure that the profits attributable to foreign permanent establishments are exempt from UK corporate tax. These features could make it attractive for UK companies to set up a subsidiary (a CFC) in a low-tax jurisdiction and to artificially divert profits from the UK to the CFC. The UK CFC rules aim to protect the UK corporate tax base by removing the tax advantage that arises from these arrangements through the imposition of a CFC charge on the UK resident company controlling the CFC⁽⁵⁾.
- (10) Consequently, while the objective of the UK corporate tax system is to tax profits arising from UK activities and assets, the objective of the UK CFC rules is to protect the UK corporate tax base. It achieves this objective not by levying a general UK tax charge on certain types of profit of low-taxed overseas subsidiaries of UK companies, but by levying a CFC charge at the same rate as the UK corporate tax rate only on those profits of the CFC which

have been artificially diverted away from the UK. In this regard, it is important to note that a stated aim of the current CFC regime was to target and impose a charge so that UK activity and profits would be fairly taxed but also that no tax would be levied on profits arising from genuine economic activities of the CFC⁽⁶⁾. In view of that aim, the UK authorities chose the current CFC rules over a regime that would tax all the profits or the entire income stream of low-taxed CFCs as that would ‘not be appropriately targeted’ at taxing UK activity and UK profit⁽⁷⁾.

- (11) The current UK CFC regime was enacted by the UK Parliament as part of the Finance Act 2012⁽⁸⁾. The regime is incorporated into the Taxes Acts as Part 9A of the Taxation (International and Other Provisions) Act 2010 (hereafter referred to as ‘Part 9A of TIOPA’), which contains 22 Chapters. The current regime applies to accounting periods beginning on or after 1 January 2013⁽⁹⁾. In January 2019, several amendments were introduced (Section 2.3).
- (12) In addition to the CFC framework laid down in Part 9A of TIOPA, the UK has published extensive guidance relating to the CFC rules. That guidance includes an introduction to the rules, a general overview, guidance on the application and interpretation of specific rules chapter by chapter, and a series of practical examples⁽¹⁰⁾.

2.1.2. *The current UK CFC regime*

- (13) In line with the objective mentioned in recital 10, the current UK CFC rules work by imposing a CFC charge on a UK resident company for some or all of a CFC's profits. The CFC charge is due on a CFC's chargeable profits less the CFC's creditable tax (i.e. the tax paid in the CFC's country of residence). For any accounting period, a CFC's chargeable profits are its assumed taxable total profits that pass through the CFC charge gateway (see recitals 23 to 25)⁽¹¹⁾. It is apportioned to all UK resident companies which hold at least a 25 % interest in the CFC (referred to as ‘the chargeable entities’). The CFC charge is levied at the same rate as the UK corporation tax rate and charged as if it were an amount of corporation tax charged to the chargeable entity for the relevant corporation tax accounting period.
- (14) The CFC charge gateway sets out the circumstances and extent to which a CFC's assumed taxable total profits are chargeable profits.
- (15) In line with the aim of the CFC rules — examining whether a CFC earns profits from UK assets or activities that are earned by a company that is neither resident nor has a permanent establishment in the UK — the CFC regime broadly assesses whether profits of a CFC relate to assets and risks that are managed and controlled in the UK and on that basis are considered *artificially diverted*. This requires consideration of whether any of the ‘significant people functions’ (or ‘SPF’)⁽¹²⁾, relevant to the assumption of risks or to the economic ownership of assets that give rise to the profits of a CFC, are actually

undertaken in the UK, so that the company *realising* the profits is different from the company *generating* those profits⁽¹³⁾.

- (16) According to the consultation, which was carried out by the British authorities before adopting the CFC rules, these CFC rules also sought to comply with Union law by not impinging upon taxpayers' freedom of establishment as well as reflecting the balance required to deliver a regime that protects the UK corporate tax base and that can be applied in practice, keeping administrative and compliance burdens to a minimum.
- (17) The UK authorities also sought to increase UK tax competitiveness⁽¹⁴⁾. This was a stated aim of the CFC rules, which 'together with the reduction in the rate of corporation tax to 22 % in 2014 and the introduction of the patent box, (...) are another step towards [the UK Government] aim of creating the most competitive corporate tax system in the G20'⁽¹⁵⁾.
- (18) Chapter 2 of Part 9A of TIOPA sets out the steps for determining if a CFC charge is due on (part of) the profits earned by a foreign company once it is established that the foreign company is a CFC. Accordingly, a CFC charge arises if:
- none of the CFC entity level exemptions applies (see recital 19);
 - there is a UK 'interest holder', in other words a UK resident company that (together with connected companies) holds an interest of at least 25 % in the CFC; and
 - the CFC has 'chargeable profits' as set out in the provisions forming the CFC charge gateway.
- (19) The aim to limit the administrative and compliance burdens is reflected in the design of the CFC rules, which focuses on situations objectively posing the highest risk to the UK Treasury. This is achieved by providing for certain upfront exclusions where the risk of profits being artificially diverted is considered low, i.e. where a case-by-case assessment would be likely to reveal either no artificiality or no diversion. These are the so-called entity level exemptions included in Chapters 10 to 14 of Part 9A of TIOPA:
- the *exempted period exemption* is included in Chapter 10 of Part 9A of TIOPA and contains a temporary (usually 12 month) exemption for CFCs that have come under UK control for the first time;
 - the *excluded territories exemption* is included in Chapter 11 of Part 9A of TIOPA and exempts CFCs that pose a foreseeable, low risk of artificial diversion due to their territory of residence and the type of profits earned;
 - the *low profits exemption*, a *de minimis* rule, is included in Chapter 12 of Part 9A of TIOPA and exempts CFCs with low levels of profits in an accounting period (generally no more than GBP 500 000, of which no more than GBP 50 000 is non-trading profits);
 - the *low profit margin exemption* is included in Chapter 13 of Part 9A of TIOPA and exempts CFCs where profits are no more than 10 per cent of operating

- expenditure. The exemption relates to CFCs that perform relatively low value added functions;
- the *tax exemption* is included in Chapter 14 of Part 9A of TIOPA and exempts CFCs that pay a normal to high level of effective tax in their territory of residence (at least 75 % of the tax that would have been due if its profits had been subject to UK tax and measured on UK rules).
- (20) The entity level exemptions reflect the fact that the majority of foreign subsidiaries will be set up for genuine commercial reasons. In practice, this means that UK companies will in the majority of cases not need to apply the CFC rules beyond satisfying one of the entity exemptions. Therefore, application of the detailed charging provisions forming the CFC charge gateway and the need to identify the chargeable profits of a CFC is confined to situations where none of the entity level exemptions apply.
- (21) If none of the entity level exemptions apply, the UK CFC rules apportion a CFC's 'chargeable profits' to the UK 'interest holder'. These are identified by applying the criteria and conditions laid down in Chapters 3 to 8 of Part 9A of TIOPA, together forming the 'CFC charge gateway'⁽¹⁶⁾.
- (22) Those Chapters are fundamental to the operation of the CFC regime. They are designed to act as targeted tests with the aim of assessing whether the assumed total profits of the CFC pass through the gateway and consequently become 'chargeable profits'.
- (23) The CFC charge gateway starts with an initial filter in Chapter 3 of Part 9A of TIOPA, which contains general tests to establish whether any of the more detailed gateway rules in Chapters 4 to 9 of Part 9A of TIOPA need to be applied at all⁽¹⁷⁾.
- (24) As regards the specific charging chapters, Chapter 4 of Part 9A of TIOPA ('Chapter 4') is a general provision and applies to all CFCs regardless of the type of profits they earn, except CFCs that exclusively earn property business profits⁽¹⁸⁾ or non-trading finance profits ('NTFP'). Chapter 5 of Part 9A of TIOPA ('Chapter 5') in conjunction with Chapter 9 of Part 9A of TIOPA ('Chapter 9') deals with CFCs that earn NTFP. Chapter 6 of Part 9A of TIOPA ('Chapter 6') deals with CFCs earning trading finance profits⁽¹⁹⁾.
- (25) The CFC charge gateway aims to identify circumstances where there has been artificial diversion of UK profits, which generally means that 'there is a significant mismatch between key business activities undertaken in the UK and the profits arising from those activities which are allocated outside the UK'⁽²⁰⁾. This is most prominent in Chapter 4⁽²¹⁾. Under that Chapter, assumed total profits of a CFC from assets that are legally owned by the CFC and from risks contractually allocated to the CFC become chargeable profits if and to the extent that the management of those assets and risks is exercised from the UK⁽²²⁾. This requires consideration of whether any of the significant people functions, that are relevant to the assumption of risks or to

the economic ownership of assets that give rise to the profits of a CFC, are actually undertaken in the UK⁽²³⁾. As such, the proportion of UK SPF to non-UK SPF is an essential criterion in identifying chargeable profits, which is applied not only in the general charging provision (Chapter 4) but also for example in Chapter 5 (NTFP)⁽²⁴⁾.

- (26) The UK CFC rules recognise, however, that in the case of finance profits, relying solely on the SPF test may not always provide sufficient protection to the UK tax base. Therefore, Chapters 5 to 9 contain additional tests for NTFP and other types of passive profits. Profits of a CFC may be subject to a CFC charge on the basis of more than one charging chapter, but profits can be subject to a CFC charge only once⁽²⁵⁾.

2.1.3. *CFC charge on Non-Trading Finance Profit*

- (27) NTFP includes all finance profits that are not trading finance profits. Trading finance profits are dealt with in Chapter 6. NTFP may include both finance profits from intercompany loans and finance profits from external loans (including deposits), provided they are not derived from trading activities⁽²⁶⁾.
- (28) The CFC charge gateway test for NTFP is in Chapter 5 or alternatively — subject to election and certain conditions — Chapter 9⁽²⁷⁾. Chapter 5 contains two general tests and two tests specifically targeted at certain abusive situations not covered by those general tests. Chapter 5 contains an SPF test, which examines the existence of UK activities and which is largely based on the SPF test contained in Chapter 4. However, Chapter 5 does not solely rely on that test because generating finance profits is largely a capital-intensive activity which may not always require the presence of SPF.
- (29) Thus, the tests in Chapter 5 to identify chargeable profits for NTFP are the following:
- first, NTFP of a CFC are considered to pass through the CFC charge gateway to the extent they are derived from assets and risks in relation to which any relevant SPF⁽²⁸⁾ are carried out in the UK (Section 371EB of TIOPA). In accordance with the general logic of the CFC rules, the logic of applying a CFC charge in this case is that the UK should be able to tax profits which are earned due to activities undertaken in the UK⁽²⁹⁾;
 - second, an alternative test looks at how the loans or deposits generating the NTFP have been financed. Accordingly and regardless of the SPF location, NTFP are considered to pass through the CFC charge gateway to the extent they are funded from relevant UK funds (Section 371EC of TIOPA). Relevant UK funds are any funds or assets which represent or derive (directly or indirectly) from ‘UK connected capital’⁽³⁰⁾. The logic of applying a CFC charge in this case is that passive revenues from UK connected capital should not escape UK taxation following a simple contribution to a CFC.

- (30) The two tests are alternatives, which means that NTFP are considered to pass through the CFC charge gateway to the extent that either the first or the second test is met. Chapter 5 also contains two further alternative tests that target specifically identified types of tax-motivated arrangements. If NTFP come within those two specific tests, a CFC charge will apply even if there is no UK SPF or UK connected capital⁽³¹⁾.

2.1.4. *CFC charge on Trading Finance Profit*

- (31) Trading finance profits of a CFC, typically profits from active banking or insurance activities, are considered to pass through the CFC charge gateway not only if they meet the general SPF test in Chapter 4, but also if they meet the specific test of Chapter 6⁽³²⁾.

- (32) The Chapter 6 test does not distinguish between trading finance profits derived from intercompany financial transactions and those derived from transactions with unrelated counterparts. Multinational groups frequently centralise finance functions in treasury companies. The operations of such companies may constitute a financial trade, so the profits from that trade would fall under Chapters 4 and 6 (trading finance profits) rather than Chapters 5 and 9 (NTFP)⁽³³⁾. However, if a CFC is a group treasury company⁽³⁴⁾, it can choose to have its trading finance profits treated as if they were NTFP (by giving notice to an officer of Her Majesty's Revenue and Customs)⁽³⁵⁾. If this election is made, Chapter 5 will apply to establish whether the 'deemed' NTFP are subject to a CFC charge and the chargeable entity is entitled to claim the exemption under Chapter 9.

2.2. **The contested measure: the Group Financing Exemption**

- (33) Whether and to what extent a CFC charge is levied on a CFC's NTFP is not determined solely on the basis of the tests in Chapter 5. Under Chapter 9, if a CFC accrues NTFP that come within the Chapter 5 criteria, a partial (75 %) or full (up to 100 %) exemption may apply to establish the CFC charge for NTFP derived from a loan to a foreign group company. In this decision, this provision is referred to as 'the Group Financing Exemption' or as 'the contested measure'.

- (34) The Group Financing Exemption applies only to those profits covered by Chapter 5. It operates by substituting the charging provisions of Chapter 5 with a mechanical rule that sets the CFC charge at an amount equalling 25 % of NTFP arising from qualifying loan relationships⁽³⁶⁾ (the partial (75 %) exemption) or down to 0 % in certain circumstances (the full exemption). The partial exemption is the default rule. To the extent that the relevant loan is funded out of so-called 'qualifying resources'⁽³⁷⁾, the profits of the CFC will be entitled to an exemption of up to 100 % of the relevant NTFP. Moreover, the remaining part of the relevant NTFP which, depending on whether it is a partial or full exemption, would still pass through the CFC charge gateway

may nonetheless be fully exempted from the CFC charge under the so-called 'matched interest' rule⁽³⁸⁾.

- (35) The HMRC⁽³⁹⁾ Guidance in the introductory comments to Chapter 9 states that the 'exemptions for NTFPs provided within Chapter 9 have been introduced to address the difficult issues which arise as a result of the fungibility of money within a multinational group'⁽⁴⁰⁾. The UK authorities have explained that the 25 % inclusion rate (75 % exemption) is based on the assumption that — in the absence of tax considerations — a wholly equity funded CFC earning NTFP would be funded from the UK through a higher proportion of debt and a lower proportion of equity, leading to additional finance profits at the level of the UK parent⁽⁴¹⁾. The rate of the exemption has been discussed with UK business representatives during the drafting of the reformed CFC regime. The minutes of the consultation indicate that initially a 50 % exemption was considered (leading to an effective tax rate of 10 %). Business representatives insisted on a higher 75 % exemption leading to an effective tax rate of 2-6 %⁽⁴²⁾.
- (36) The contested measure only applies to NTFP that the CFC derives from loans to foreign group companies that are under the control of the same UK resident company controlling the CFC. These loan relationships are referred to as 'qualifying loan relationships'⁽⁴³⁾. The Group Financing Exemption represents a proxy for the UK connection of the funding of the qualifying loan relationship, so that multinational groups do not need to trace the exact source or history of the group's finance arrangements and the extent to which they are borne by the UK⁽⁴⁴⁾.
- (37) By making a claim under Chapter 9 in their corporate tax assessment, all potentially chargeable entities with a CFC earning NTFP from a loan that is the subject of a qualifying loan relationship can choose to apply the special rules in Chapter 9 instead of the general rules in Chapter 5, provided the CFC meets a business premises test. That test is met if the CFC has at its disposal in the territory in which it is resident for tax purposes premises which are (or are intended to be) occupied and used with a reasonable degree of permanence, and from which the CFC's activities in that territory are wholly or mainly carried on⁽⁴⁵⁾.

2.3. Amendments to the UK CFC rules

- (38) On 6 July 2018, the UK announced that the Finance Bill 2018-2019 would include changes in the CFC rules in order to implement Council Directive (EU) 2016/1164⁽⁴⁶⁾ (the 'Anti Tax Avoidance Directive'). Those changes concern, first, the definition of control, which affects all profits subject to a CFC charge, and, second, the presence of SPF in the UK for the purpose of applying the Group Financing Exemption for NTFP. The first change is thus of a more general nature, but the second specifically affects the scope of the contested measure.

- (39) The second change limits access to the Group Financing Exemption so that chargeable entities will no longer be allowed to claim the exemption under Chapter 9 for NTFP from qualifying loan relationships, instead of applying Chapter 5, to the extent that the NTFP are derived from assets and risks in relation to which relevant SPF are carried out in the UK. The said amendments were enacted as part of the Finance Act 2019 under Section 20 (Controlled foreign companies: finance company exemption and control), paragraph 2 and took effect on 1 January 2019⁽⁴⁷⁾.

2.4. **International and EU context**

- (40) Many countries have introduced CFC rules to prevent taxpayers from avoiding or deferring taxes by shifting profits to low-taxed foreign subsidiaries. All CFC rules tax profits of certain non-resident entities at the level of tax resident shareholders of the non-resident entity in certain circumstances. However, the exact operating rules in different countries may vary significantly⁽⁴⁸⁾, because the rules and criteria setting these elements will need to both be aligned with the domestic corporate tax system of which they are part and reflect the tax policy objectives of the relevant country.

2.4.1. *OECD guidance (BEPS Project)*

- (41) In its ‘Action Plan on Base Erosion and Profit Shifting’⁽⁴⁹⁾, the Organisation for Economic Cooperation and Development (‘OECD’) notes that CFC rules have been introduced in many countries to address one of the sources of Base Erosion and Profit Shifting (‘BEPS’) concerns, notably the possibility of creating affiliated non-resident taxpayers and routing profits of a resident enterprise through the non-resident affiliate. The final BEPS report on Action 3 concerning the use of CFC rules sets out recommendations for OECD and non-OECD Member States for use in designing effective CFC rules⁽⁵⁰⁾. The report was prepared to ensure that jurisdictions that choose to apply CFC rules can do so in a manner that will be effective to prevent taxpayers from shifting profits into foreign subsidiaries to avoid taxation. The report mentions the UK CFC rules as an example of rules which use the concepts developed by the OECD to identify the group's SPF associated with each asset to establish the scope of the rules⁽⁵¹⁾.

2.4.2. *The Anti Tax Avoidance Directive*

- (42) At Union level, the Council adopted the Anti Tax Avoidance Directive on 12 July 2016⁽⁵²⁾. The recitals of that Directive explicitly refer to the final reports on the 15 OECD Action Items against BEPS and the Council Conclusions of 8 December 2015 underlining the need to find common, flexible solutions at Union level consistent with the OECD BEPS conclusions. The recitals also state:

Controlled foreign company (CFC) rules have the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company. Then, the parent company

becomes taxable on this attributed income in the State where it is resident for tax purposes. Depending on the policy priorities of that State, CFC rules may target an entire low-taxed subsidiary, specific categories of income or be limited to income which has artificially been diverted to the subsidiary.

- (43) The actual CFC rule is laid down in Article 7 of the Anti Tax Avoidance Directive and gives Member States the choice between two different types of CFC rules. The standard rule, listing types of profit which — if subject to low tax — should be taxed under the CFC rule, is included in paragraphs 1, 2(a) and 3 of Article 7. An alternative rule based on a SPF test is included in paragraphs 1, 2(b) and 4 of Article 7, stating that a CFC's profits arising from SPF carried out in the controlling Member State is to be subject to a CFC charge⁽⁵³⁾.
- (44) The most relevant parts of Article 7 read as follows:

Article 7

Controlled foreign company rule

1 The Member State of a taxpayer shall treat an entity (...) as a controlled foreign company where the following conditions are met: (...)

2 Where an entity (...) is treated as a controlled foreign company under paragraph 1, the Member State of the taxpayer shall include in the tax base:

a the non-distributed income of the entity or the income of the permanent establishment which is derived from the following categories:

(i) interest or any other income generated by financial assets;

(...)

This point shall not apply where the controlled foreign company carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances.

(...)

or:

b the non-distributed income of the entity or permanent establishment arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

For the purposes of this point, an arrangement or a series thereof shall be regarded as non-genuine to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.

- 3 Where, under the rules of a Member State, the tax base of a taxpayer is calculated according to point (a) of paragraph 2, the Member State may opt not to treat an entity or permanent establishment as a controlled foreign company under paragraph 1 if one third or less of the income accruing to the entity or permanent establishment falls within the categories under point (a) of paragraph 2.

Where, under the rules of a Member State, the tax base of a taxpayer is calculated according to point (a) of paragraph 2, the Member State may opt not to treat financial undertakings as controlled foreign companies if one third or less of the entity's income from the categories under point (a) of paragraph 2 comes from transactions with the taxpayer or its associated enterprises.

(...)

2.5. **Scope of the exemption**

- (45) The Group Financing Exemption has been in force since 1 January 2013. The taxpayers that can benefit from the Group Financing Exemption are UK resident corporate taxpayers — or chargeable entities — that control a CFC earning NTFP derived from a qualifying loan relationship and have made a claim in their corporate tax return to apply Chapter 9 for the computation of the CFC charge in relation to those profits, instead of computing the CFC charge under the rules in Chapter 5. Those taxpayers are part of a multinational group that includes, as a minimum, the UK resident chargeable entity, the CFC and the foreign subsidiary financed through the qualifying loan relationship and also controlled by that chargeable entity. As stated at recital 38, from 1 January 2019 it no longer applies to NTFP where the relevant SPF are in the UK.
- (46) There is no compulsory prior approval or advance clearance procedure. The UK's non-statutory clearance service concerning the correct interpretation of tax legislation is also available for the CFC rules. The Commission requested and received a list of the non-statutory clearances related to the reformed CFC provisions issued by the UK authorities from the introduction of the reformed CFC rules up to 31 March 2014. These included both situations where a chargeable entity requested non-statutory clearance for a claim under Chapter 9, claiming either the partial or the full exemption, as well as interpretation issues involving other aspects of the UK CFC rules such as the applicability of an entity-level exemption. As all non-statutory clearances issued by HMRC, they provide advice in case of a genuine uncertainty in the interpretation of a specific legal provision.

3. **GROUNDS FOR INITIATING THE PROCEDURE**

- (47) The Commission decided to initiate the formal investigation procedure because it took the preliminary view that the Group Financing Exemption constituted State aid within the meaning of Article 107(1) of the Treaty and it had doubts as to whether the Group Financing Exemption could be considered compatible with the internal market.

- (48) The Commission expressed the preliminary view that the Group Financing Exemption constituted an aid *scheme* within the meaning of Article 1(d) of Council Regulation (EU) 2015/1589⁽⁵⁴⁾, insofar as it operated, without further implementing measures being required, to exempt UK group companies of multinational groups from a CFC charge that would otherwise be chargeable on certain NTFP earned by CFCs controlled by them.
- (49) The Commission took the preliminary view that the contested measure allowed for a selective advantage. It considered that the Group Financing Exemption constituted a derogation from the UK CFC rules (which the Commission considered to be the reference system in this case) since it exempted some NTFP from the CFC charge.
- (50) The Commission also took the preliminary view that the advantage granted by the contested measure was selective given that it was only available to operators carrying out finance transactions involving related foreign debtors and was not available to operators carrying out other finance transactions involving either related UK debtors or third party debtors, be it UK or foreign-based, despite the fact that they all seemed to be in a comparable legal and factual situation in the light of the objective of the UK CFC rules.
- (51) The Commission further took the preliminary view that the Group Financing Exemption could not be justified by the nature or general scheme of the UK CFC rules, since it did not consider NTFP from qualifying loan relationships to represent a lower risk of artificial diversion of profits, as compared with other types of NTFP in the light of the objective of the UK CFC rules. The Commission held that the contested measure did not seem necessary to pursue a logical or legitimate aim and, even if it did, the Commission considered it disproportionate.
- (52) With all the other conditions of Article 107(1) of the Treaty being fulfilled, the Commission reached the preliminary conclusion that the Group Financing Exemption constituted State aid. As the UK authorities did not present any argument to indicate that any of the exceptions provided for in Article 107(2) or (3) of the Treaty could apply, and in the light of the operating aid nature of the measure, the Commission had doubts as to whether the measure could be considered compatible with the internal market. On those grounds, the Commission decided to initiate the procedure laid down in Article 108(2) of the Treaty with respect to the contested measure.

4. COMMENTS FROM THE UNITED KINGDOM

- (53) The UK authorities do not agree with the concerns expressed by the Commission in the Opening Decision. In their letter of response to the Opening Decision of 15 January 2018, they raise four arguments to support their view that the Group Financing Exemption does not entail aid within the meaning of Article 107(1) of the Treaty:

- (a) the Group Financing Exemption does not favour any undertaking or constitute an advantage. It is designed to set the boundaries of the corporate tax base by defining artificially diverted profit rather than providing an exemption from an already established tax base;
- (b) the appropriate reference system should be the UK corporate tax system⁽⁵⁵⁾;
- (c) the Group Financing Exemption is not a derogation from the reference system as it does not differentiate between economic operators that are, in light of the objectives of the reference system, in a factually and legally comparable position;
- (d) if the Group Financing Exemption does constitute a derogation from the reference system, this derogation can be justified by the basic and guiding principles of that reference system.

The UK authorities submitted additional argumentation in a subsequent letter dated 22 March 2018, comments on the input from interested parties in a letter dated 23 February 2018 and further clarification on the application of its CFC rules to finance profits in a letter dated 3 July 2018.

4.1. **Comments on the existence of an advantage**

- (54) The UK authorities argue that the Group Financing Exemption does not improve the financial position of an undertaking by mitigating charges that would normally be included in its budget, or reducing tax that would normally be due and therefore does not confer a selective advantage on an undertaking. They recall that the 2013 corporate tax reform gave the tax system a more territorial nature which means that the profits of a non-resident company are usually not taxed by the UK (unless there is a permanent establishment) and that a UK resident company is usually not taxed on the profits of its (non-)UK resident subsidiaries. The CFC regime is the exception to these general principles. It aims to tax a UK resident company on the profits of its non-resident subsidiaries insofar as those profits have been artificially diverted from the UK.
- (55) The UK authorities argue that, since the purpose of the CFC regime is to protect the UK corporate tax base, what is meant by artificial diversion from the UK is necessarily dependent upon what the UK considers should be included in that base, as long as the definition complies with Union law.
- (56) The UK authorities state that Chapter 5 together with Chapter 9 define the scope of the CFC regime by identifying which NTFP are to be considered artificially diverted. Chapter 5 sets out initial filters for identifying NTFP which have potentially been artificially diverted and Chapter 9 ensures that no profits are brought within scope of the charge where, based on additional criteria, it is unreasonable to conclude that they have been artificially diverted.

- (57) Profits that fall within the Group Financing Exemption, according to the UK authorities, are thus not considered artificially diverted profits. This means the general principles of the corporate tax system apply and the profits earned by a non-resident subsidiary should not be taxed. The non-taxation of those profits therefore does not constitute an advantage.
- (58) The UK authorities also recall that the General Court in the *Sanierungsklausel* case⁽⁵⁶⁾ ruled that an exemption from an anti-avoidance provision that is inconsistent with the objective of that provision constitutes a derogation. According to the UK authorities, however, the Group Financing Exemption does not constitute such an exemption since it does not dis-apply the CFC regime to certain economic operators, but rather determines whether and to what extent profits arising from intra-group lending can be said to have been artificially diverted from the UK. The exemption, according to the UK authorities, is thus consistent with the objective of the CFC regime.

4.2. **Comments on selectivity**

4.2.1. *The reference system should be the UK corporate tax regime*

- (59) The UK authorities disagree with the Commission's position in the Opening Decision that the UK CFC regime is the reference system, identifying instead the UK corporate tax system as the correct reference system. The UK authorities state that the purpose and design of the CFC regime can only be understood in the context of the overall UK approach to taxing corporate profit.
- (60) The UK authorities state that understanding the definition of corporate profit, including the treatment of different items of income and expenditure and the timing of their recognition under the wider UK corporate tax regime, is crucial to understand the specific opportunities for abuse that the CFC regime is designed to protect against.
- (61) The UK authorities outline that the CFC regime is only one of a number of anti-avoidance measures that seek to protect the UK tax base and that the approach taken in the UK corporate tax regime to the pricing of intra-group dealings and its wider base protection measures such as the 'diverted profits tax' and the 'hybrid mismatch' rules, provides important context in understanding the CFC regime as one part of the UK's defence against artificial diversion of profit.
- (62) According to the UK authorities, an appreciation of these wider policy considerations underlying the UK corporate tax regime helps to understand the detailed design of the CFC rules — namely the necessity for an administrable regime that achieves proportionate results for different types of companies within the UK corporate tax system whilst also complying with Union law on fundamental freedoms⁽⁵⁷⁾.

(63) In the event that the CFC regime is identified as the reference system, the UK authorities argue that the objective of the CFC regime has to be defined in relation to the corporate tax regime in which it operates. In this case, the objective of the CFC regime itself can be described as ‘protecting the UK corporate tax base by seeking to identify and bring within scope of UK tax profits for which it is reasonable to assume they have been artificially diverted from the UK, through an administrable set of rules that comply with European law’⁽⁵⁸⁾.

4.2.2. *The Group Financing Exemption is not a derogation*

(64) The UK authorities do not believe that the Group Financing Exemption contained in Chapter 9 provides an advantage that is *prima facie* selective on the basis that it does not differentiate between economic operators that are, in light of the objectives pursued by the reference system, in a comparable legal and factual situation.

(65) The UK authorities compare the situation covered by the Group Financing Exemption — a CFC receiving NTFP from a qualifying loan relationship — to the situations that are not covered by the Group Financing Exemption, in which CFCs receive NTFP from lending to UK-related parties or to third parties.

(66) The UK authorities take the position that these three types of passive lending — i.e. qualifying loan relationships, lending to UK-related parties (referred to by the UK authorities as ‘upstream loans’) and lending to third parties (referred to by the UK authorities as ‘money boxes’) — are fundamentally different situations creating different opportunities for avoidance and different risks of artificial diversion and therefore are not factually and legally comparable.

(67) The UK authorities believe that upstream loans and money boxes clearly lack commercial justification and create an obvious indication of artificial diversion⁽⁵⁹⁾. The position is less obvious in the case of a qualifying loan relationship, whereby, in the context of financing companies engaging in foreign group lending, there may be a clearer commercial justification and it may be more difficult to objectively show that arrangements involve the artificial diversion of profits. On this basis, the UK asserts that the three types of lending are not factually and legally comparable⁽⁶⁰⁾.

(68) In addition, the UK authorities recall that the Commission in past decisions regarding the Dutch Groepsrentebox⁽⁶¹⁾ scheme and the Hungarian group interest tax regime⁽⁶²⁾ acknowledged that differences exist between interest from related group companies and third-party companies⁽⁶³⁾.

(69) The UK authorities do not share the view of the Commission that the highest risk for tax motivated structures, especially where it concerns finance arrangements exploiting arbitrage between debt and equity, is generally

considered to be in intercompany relations. They maintain that the Group Financing Exemption reflects the UK policy choice not to address the artificial diversion of foreign profits. The differential treatment identified by the Commission would therefore be inherent in the objective of the UK CFC rules. The UK authorities recall that the CFC regime is only concerned with the artificial diversion of profit from the UK, not with the artificial diversion of foreign group interest where it is not the UK being disadvantaged.

4.2.3. *Justification by the basic and guiding principles of the reference system*

(70) The UK authorities argue that if the Group Financing Exemption constitutes a derogation, it is justified by the basic and guiding principles of the corporate tax system and the CFC regime, i.e. the prevention of artificial diversion of profit from the UK through a system that is robust, administrable and compatible with Union law.

(71) The UK authorities highlight that Chapter 9 is based on a mechanical test which strikes the appropriate balance between adequately dealing with only the high risk cases across diverse taxpayers, whilst also ensuring there is no over inclusion of profits that would be incompatible with Union jurisprudence on fundamental freedoms. The UK authorities argue that according to the case law of the European Court of Justice on freedom of establishment, most notably the *Cadbury Schweppes* case⁽⁶⁴⁾, no CFC charge can be levied in relation to foreign subsidiaries with genuine commercial activities. The UK authorities state that the mechanical tests and fixed percentages have been set at levels that ensure there is no over-inclusion of profits. The UK authorities believe this balance is clearly in line with internationally accepted practice, and in particular BEPS Action 3 Report.

(72) The UK authorities argue that Chapters 5 and 9 reflect this approach by using specific criteria to differentiate between the risk and impact of different arrangements on the UK tax base and by using a mechanical approach to deal with avoidance risks across diverse taxpayers. The use of this approach delivers reasonable approximations of artificially diverted profit for arrangements where this is difficult to establish, or which necessitate subjective judgements on the appropriate counterfactual; in the UK authorities' view, the 75 % exemption / 25 % inclusion rate in the Group Financing Exemption provides this appropriate balance.

5. **COMMENTS FROM INTERESTED PARTIES**

(73) Comments were submitted by eight interested parties. The Law Society of England and Wales submitted comments on 19 December 2017. Joseph Hage Aaronson LLP submitted comments on 21 December 2017. Four interested parties, which requested their identity to be withheld, submitted comments on 22 December 2017. On the same day, comments were received from Ernst & Young LLP. Finally, on 2 January 2018, Vodafone Group plc submitted its comments on the Opening Decision. The interested parties are either

enterprises that have applied the Group Financing Exemption over the past years or tax consultancy firms advising UK clients on international tax issues, including the application of the contested measure, or in one case a national UK organisation representing UK law practitioners.

- (74) In substance, most of the comments from the interested parties reflect the arguments raised by the UK authorities. Where the interested parties raise new arguments to those of the UK authorities they are summarised in this Section.

5.1. **Comments on the choice of the reference system**

- (75) Several interested parties share the UK's view that the reference system is the UK corporate tax system as a whole, since the CFC rules are an integral and necessary part of the UK corporation tax provisions, which apply to all corporate groups with overseas subsidiaries.

- (76) Joseph Hage Aaronson LLP argues that the UK CFC rules are the correct reference system, but maintains that it comprises several intertwined objectives — preventing tax avoidance, limiting its scope to non-genuine activities abroad and providing a workable regime. Chapter 5 and Chapter 9 work together by balancing each other for the achievement of these intertwined objectives. Some interested parties argue that, if the CFC regime were the correct reference system, the benchmark or normal rule identifying artificially diverted profits would be Chapter 4. The contested measure would not then qualify as a derogation to that system, since the partial exemption is more onerous than the general rules of Chapter 4 as it gives rise to UK tax in several situations where a CFC's trading business profits would not be subject to a CFC charge under Chapter 4, namely, when no SPF are located in the UK or when the percentage of SPF located in the UK is less than 50 % of the total relevant SPF.

- (77) One interested party notes that the Court ruled that the regulatory technique cannot affect the assessment of selectivity⁽⁶⁵⁾. The mere fact that the legislative technique of the UK entails casting the net wide and then narrowing down the scope of the legislation through specific provisions that articulate what is considered to be acceptable, does not indicate that the broad rule is the common or normal regime.

- (78) Several interested parties mention that the Group Financing Exemption does not derogate from the objectives of the CFC regime, but it rather assures compliance with the Court case law on freedom of establishment, namely the *Cadbury Schweppes* case. To comply with *Cadbury Schweppes*, the CFC regime may only levy a CFC charge in the case of wholly artificial arrangements aimed at circumventing UK tax legislation and not in the case of arrangements aimed at circumventing foreign tax legislation. The interested parties hold the view that the Group Financing Exemption aims to achieve this.

5.2. Comments on derogation

- (79) In the view of several interested parties, only UK companies with CFCs earning the same category of NTFP are in the same legal and factual situation. The two situations not covered by the Group Financing Exemption, lending to UK related-parties or lending to third parties, are clearly different from situations involving qualifying loan relationships. On the one hand, loans by a CFC to a UK-resident group company are a clear example of UK base erosion; on the other hand, passive loans to or deposits with a third party do not fund genuine commercial operations.
- (80) On the contrary, in the situation that can potentially be covered by the Group Financing Exemption, in which the CFCs of UK companies receive NTFP from a qualifying loan relationship, the CFC may have local substance and a clearer commercial justification, for example funding genuine activities of foreign group companies. The tests in the Group Financing Exemption aim to identify and exclude a situation that should be free from a CFC charge according to *Cadbury Schweppes*.
- (81) Lastly, interested parties argue that lending to third parties generates surplus profit for the group as a whole, which will be artificially diverted most of the time, while lending to foreign related-parties is a matter of allocating resources within the group to fund the operating companies' genuine overseas activities.

5.3. Comments on the justification

- (82) Interested parties also suggest that the need for administrable rules may justify the Group Financing Exemption. Some of them provide arguments on the proportionality of the 1:3 debt/equity ratio which underpins the level of the partial exemption (75 %), claiming that it cannot be compared to what would be a reasonable thin capitalisation ratio. Others define the 25 % inclusion / 75 % exemption as a pragmatic solution in circumstances where it is not feasible to require companies to identify or track accurately the source of each and every amount of capital. This would amount to a significant compliance burden.
- (83) An interested party signals that some taxpayers may have employed the administratively simpler rules of Chapter 9 without checking whether they are more beneficial than the application of the rules in Chapter 5, so that, in reality, those taxpayers may have obtained little or no benefit from applying Chapter 9.

6. STATE AID ASSESSMENT

6.1. Existence of aid

- (84) Article 107(1) of the Treaty provides that any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the provision of

certain goods is incompatible with the internal market, in so far as it affects trade between Member States.

- (85) According to settled case-law, for a measure to qualify as aid within the meaning of Article 107(1) of the Treaty, all the conditions set out in that provision must be fulfilled⁽⁶⁶⁾. It is thus well-established that, for a measure to qualify as State aid, first, there must be an intervention through State resources and that intervention must be imputable to the State, second, the intervention must be liable to affect trade between Member States, third, the intervention must confer a selective advantage on an undertaking and, fourth, it must distort or threaten to distort competition⁽⁶⁷⁾.
- (86) As regards the first condition for a finding of State aid, the Group Financing Exemption finds its basis in Chapter 9 of Part 9A of TIOPA, a legislative act that necessarily emanates from the State. The Group Financing Exemption is therefore imputable to the UK.
- (87) As regards the measure's financing through State resources, the Court has consistently held that a measure by which the public authorities grant to certain undertakings a tax exemption which, although not involving a positive transfer of State resources, places those undertakings in a more favourable financial situation than other taxpayers constitutes State aid⁽⁶⁸⁾. As explained in Section 2.2 and hereafter in Section 6.3, the Group Financing Exemption results in a lowering of the UK corporate tax liability of undertakings that have applied the contested measure by reducing the CFC charge that would otherwise apply based on the ordinary application of the UK CFC rules. Consequently, the Group Financing Exemption gives rise to a loss of State resources, since any reduction of UK corporate tax for the undertakings benefiting from the contested measure results in a loss of tax revenue that would otherwise have been available to the UK.
- (88) As regards the second condition for a finding of State aid, the undertakings benefiting from the contested measure are UK resident companies that are part of a multinational group operating in several jurisdictions, which could include other Member States, so that any advantage in favour of those companies is liable to affect intra-Union trade. Moreover, the contested measure offers greater advantages to UK tax payers that are part of UK-headed multinational groups compared with UK tax payers that are part of multinational groups headquartered in other Member States. That is because the Group Financing Exemption is only available on interest derived from a foreign group company if that foreign group company is controlled by the same UK resident companies that control the CFC. It is not available if the interest is derived from a foreign group company controlled by companies resident in another Member State. To put it differently, the negative effect of the Group Financing Exemption on intra-Union trade is twofold. First, UK-headed multinational groups may relocate group finance functions (to a large extent encompassing the SPF) from abroad to the UK to benefit from the

reduced tax rate offered by the Group Financing Exemption. And second, foreign multinational groups with group finance activities in the UK may be induced to restructure themselves into a UK-headed multinational group by relocating their central holding company to the UK in order to increase the advantage of the Group Financing Exemption. Accordingly, the contested measure is liable to influence the choices made by multinational groups as to the location of both their group finance functions and their head office within the Union and thus to affect intra-Union trade.

- (89) Similarly, a measure granted by the State is considered to distort or threaten to distort competition when it is liable to improve the competitive position of the recipients as compared with that of other undertakings with which the recipients compete⁽⁶⁹⁾. To the extent that the contested measure relieves the undertakings benefiting from it of a burden that they would otherwise be obliged to bear by reducing the corporate tax liability that they would otherwise have to bear under the ordinary system of taxation of corporate profits in the UK, it distorts or threatens to distort competition in that it strengthens the financial position of those undertakings. Therefore, the fourth condition for a finding of State aid is also met in this case.

6.2. **Existence of a scheme**

- (90) The Commission considers that the contested measure constitutes an aid scheme within the meaning of Article 1(d) of Regulation (EU) 2015/1589. That provision defines an aid scheme as ‘any act on the basis of which, without further implementing measures being required, individual aid awards may be made to undertakings defined within the act in a general and abstract manner [...]’.
- (91) That definition sets out three criteria for a measure to constitute an aid scheme: (i) it must be an act on the basis of which individual aid awards can be awarded; (ii) it must not require any further implementing measures in order for such awards to be made; and (iii) it must define the potential beneficiaries of the awards in a general and abstract manner.
- (92) As for the first criterion, the Group Financing Exemption is granted on the basis of TIOPA which is a general law of which the Group Financing Exemption is an integral part.
- (93) As for the second criterion, since application of the Group Financing Exemption is available to all multinationals meeting the conditions, by simply electing for its application, and since application does not involve any further approval or other action from the UK authorities, the Commission concludes that the Group Financing Exemption does not require any further implementing measures⁽⁷⁰⁾.
- (94) As for the third criterion, the act on the basis of which the Group Financing Exemption is granted defines the potential beneficiaries in a general and

abstract manner. Chapter 9, which forms the legal basis to benefit from the exemption, applies in a general and abstract manner to NTFP derived from loans to non-UK group companies under UK control.

- (95) In conclusion, the Group Financing Exemption meets the criteria laid down in Article 1(d) of Regulation (EU) 2015/1589 for classification as an aid scheme. According to the case-law of the Court, in the case of an aid scheme the Commission may confine itself to examining the general characteristics of the scheme in question without being required to examine each particular case in which it has been applied⁽⁷¹⁾.

6.3. **Advantage**

- (96) Whenever a measure adopted by the State improves the net financial position of an undertaking, an advantage is present for the purposes of Article 107(1) of the Treaty⁽⁷²⁾. In establishing the existence of an advantage, reference is to be made to the effect of the measure itself⁽⁷³⁾. As regards fiscal measures, an advantage may be granted through different ways of reducing an undertaking's tax burden and, in particular, through a reduction of the taxable base or of the amount of tax due⁽⁷⁴⁾.
- (97) The contested measure allows a UK resident company that is subject to a CFC charge under Chapter 5 to claim that the CFC charge is set at 25 % of the CFC's NTFP (the partial 75 % exemption) or at an even lower percentage, down to 0 % (the full exemption), to the extent that the NTFP are funded from 'qualifying resources' or that the 'matched interest' rule applies. The Group Financing Exemption can only be claimed in relation to a certain category of NTFP, namely profits derived from a qualifying loan relationship.
- (98) Consequently, the contested measure will always provide an advantage if more than 25 % of a CFC's NTFP earned from qualifying loan relationships would be subject to a CFC charge under Chapter 5 and may provide an advantage if less than 25 % of those NTFP would be subject to a CFC charge under Chapter 5, depending on whether a full exemption is available under the 'qualifying resources' rule or the 'matched interest' rule.
- (99) The fact that the application of the contested measure instead of applying the provisions under Chapter 5 provides an advantage is also acknowledged by the HMRC Guidance, when explaining whether or not to make a claim to apply the contested measure: 'If the loan is a Qualifying loan relationship, Chapter 9 will give a more favourable result for a company than a CFC charge under Chapter 5 unless the application of TIOPA10 S371EB leaves at least 75 % of the profit in respect of the loan outside the CFC charge. (...) For large structural loans our expectation is that most if not all of the SPF will be located in the UK'⁽⁷⁵⁾.
- (100) Furthermore, the fact that making the claim under Chapter 9 is optional, means that it is at the full discretion of the chargeable entity whether it applies the

rules establishing a CFC charge under Chapter 5, or whether it makes a claim resulting in the partial (75 %) or full exemption. The UK resident companies will only make a claim under Chapter 9, if this option is more favourable than the mere application of Chapter 5. Although it cannot be fully excluded that reasons of administrative simplification are taken into account by these undertakings, in general UK resident companies will make a claim under Chapter 9 if that reduces the CFC charge otherwise due under Chapter 5.

- (101) In general, beneficiaries of the contested measure will therefore have received an advantage compared to the situation without applying the measure.

6.4. **Selectivity**

- (102) In order to classify a tax measure as conferring a selective advantage, it is first necessary to identify the ‘normal’ or common tax regime applicable in the Member State concerned, known as the (tax) reference system, and then to examine the operation of that regime with reference to its objective⁽⁷⁶⁾. Second, it is necessary to assess whether the measure derogates from the reference system by differentiating between economic operators who, in the light of the objective pursued by the reference system, are in a comparable legal and factual situation. If such a derogation exists, the measure will be deemed to be *prima facie* selective. Third, if a measure is considered to be a derogation from the reference system, it may nonetheless be justified by the nature and overall structure of the reference system. In that respect it is up to the Member State concerned to demonstrate that the contested measure results directly from the basic or guiding principles of the reference system, resulting from inherent mechanisms necessary for the functioning and effectiveness of the system. If the derogation from the reference system is justified on these grounds, the measure is not deemed to be selective.

6.4.1. *Reference System*

- (103) In the Opening Decision, the Commission had considered the UK CFC regime to be the appropriate reference system. The objective of the UK CFC regime was described as being to ensure the taxation of profits which are artificially diverted from the UK into UK controlled non-resident associated entities⁽⁷⁷⁾. On that basis, the Commission concluded on a preliminary basis that a derogation leading to *prima facie* selective treatment would exist if certain UK resident companies were exempt when artificially diverting (non-trading finance) profits to a CFC they controlled, whereas the general rule holds that UK resident companies would be taxed on artificially diverted (non-trading finance) profits to a CFC they control, while both are in a comparable legal and factual situation in the light of the objective of the reference system (i.e. ensuring taxation of UK profits artificially diverted to a UK controlled non-resident entity).
- (104) The UK authorities, as well as some interested parties, identified the general UK corporate tax regime as the appropriate reference system, arguing that the

purpose and design of the CFC regime can only be properly understood in the context of the overall UK approach to taxing corporate profit. Whilst the Commission agrees with these arguments, and recognises the relevance of the objective of the UK corporate tax system in the context of the objective of the UK CFC rules, it retains the view that the reference system for the State aid analysis of the contested measure is the UK CFC rules.

- (105) The UK claims to have ‘a largely territorial corporate tax regime, which is designed to tax the profits attributable to UK activities and assets’⁽⁷⁸⁾. Its objective is accordingly to tax UK resident taxpayers or non-UK resident taxpayers with a UK permanent establishment on profits arising from UK activities and assets. Taxing profits of non-UK resident taxpayers without a UK permanent establishment in principle falls beyond the objective of the general UK corporate tax system. But that may not necessarily apply to foreign profits that have been *artificially diverted* from the UK while being attributable to UK activities and assets. In fact, rules achieving the latter could be said to be the necessary corollary of a largely territorial tax system such as the UK corporate tax system and the UK CFC regime is precisely that type of rule. As the UK authorities correctly state, the UK CFC regime, together with a series of other anti-abuse rules, protects the UK corporate tax system. The objective of the UK CFC rules is to protect the UK corporate tax base thereby ensuring that the UK corporate tax system achieves its objective. It achieves this objective by bringing into charge profits from UK activities and assets which are considered to have been *artificially diverted* from the UK to non-resident associated entities. Indeed, the objective of the UK CFC rules is derived from and can be held to form a logical and necessary extension of the objective of the general UK corporate tax system.
- (106) The UK authorities have justifiably raised these factors, but that does not mean that the reference system for the assessment of the contested measure — which concerns an exemption from the CFC charge — must be widened to the entire UK corporate tax system. The Commission considers that the CFC rules form a specific set of rules. They are part of the general UK corporate tax system, but they have their own objective. That objective finds its origin and purpose in the objective of the general UK corporate tax system, but it is sufficiently distinct to form a reference system in its own right.
- (107) The reference system in the context of tax measures or charges consists of the set of rules that together form the normal or ordinary rules for taxation or for those charges in the Member State concerned, covering all undertakings potentially subject to the tax or charge. It is the CFC rules which, taken together, determine the subject matter or chargeable basis for the CFC charge and it is therefore within those rules that an examination of comparability must be carried out⁽⁷⁹⁾.
- (108) As regards other arguments put forward by the UK and interested parties, compliance with any applicable Union laws cannot in principle be said to

be the objective of a tax system. It is simply a condition that applies to all legislation of all Member States. In the Commission's view the need for the CFC rules to be administrable is not so much an objective of the reference system, but could explain an inherent mechanism necessary for the functioning and effectiveness of the reference system.

6.4.1.1. *The general rule under the reference system; establishing the CFC charge*

(109) As a preliminary remark, the Commission acknowledges that it is primarily up to the UK legislature to establish the need for and scope of anti-abuse rules protecting the UK tax base⁽⁸⁰⁾. At the same time, however, once the UK has chosen to introduce an anti-abuse rule, the UK should apply that rule equally to all economic operators. With respect to State aid law, this means that two situations that are legally and factually comparable in the light of the objective of the anti-abuse rule should not be treated differently⁽⁸¹⁾.

6.4.1.2. *Regulatory technique, as such, does not determine derogation*

(110) The UK and several interested parties have mentioned that Chapter 9 and Chapter 5 must be read together to define what the UK considers to be artificially diverted NTFP. They emphasise that the fact that Chapter 9 is separate from Chapter 5 and is referred to as an 'exemption' does not *per se* mean that, for State aid purposes, Chapter 9 constitutes a derogation to the 'normal treatment' laid down in Chapter 5. The Commission partially shares this view. However, the finding of a derogation in this case is based on a substantive comparability analysis as to whether situations that are legally and factually similar in the light of the objective of the reference system are treated differently. As underlined by the Court in the *A-Brauerei* judgment⁽⁸²⁾, 'while the regulatory technique used is not decisive in order to establish that a tax measure is selective, so that it is not always necessary for that technique to derogate from a common tax system, the fact that it is, like the measure at issue in the main proceedings, a derogation is relevant for those purposes where the effect of that technique is that two categories of operators — those who fall within the scope of the derogating measure and those who continue to fall within the scope of the ordinary tax system — are distinguished and are subject, a priori, to different treatment, even though those two categories are in a comparable situation in the light of the objective pursued by that system (judgments of 21 December 2016, *Commission v World Duty Free Group and Others*, C-20/15 P and C-21/15 P, ECLI:EU:C:2016:981, paragraph 77, and of 28 June 2018, *Andres (insolvency of Heitkamp BauHolding) v Commission*, C-203/16 P, ECLI:EU:C:2018:505, paragraph 93)'.

(111) In this case, this means assessing whether the contested measure excludes certain operators from being subject to a CFC charge on profits that would otherwise be caught by the charge under the general criteria for artificial diversion laid down in the UK CFC rules, thereby treating differently

companies that are in a comparable factual and legal situation in the light of the objective of the CFC rules.

- (112) It is therefore necessary to examine the general criteria according to which it is assessed when profits of a CFC under the UK CFC rules are considered to be artificially diverted, taking into account the type and level of risks tackled by these rules, the structure and the logic of these rules and the tools used so as to tackle these risks⁽⁸³⁾.

6.4.1.3. *Methodology and logic of the UK CFC rules*

- (113) The UK CFC rules include different tests, either generally applying to all types of profit or targeting specific types of profits earned by the CFC, in order to identify and quantify the CFC's assumed total profits that pass through the CFC charge gateway, thus becoming chargeable profits. According to the UK, these tests and conditions differentiate on the basis of the type of activity underlying the profit so as to reflect the risk for tax revenues being lost to the UK treasury in the case of different profit-generating arrangements. They aim to ensure the administrative manageability of applying an anti-abuse test to a wide range of different arrangements for a large number of different taxpayers, thereby safeguarding the effectiveness and efficiency of the CFC rules.
- (114) The Commission accepts that the scope of a rule that has as its objective the protection of the corporate tax system against a loss of tax revenues resulting from artificial diversion of profits may be targeted at situations objectively posing the highest risk of such a loss of tax revenues, in order to ensure the efficiency, manageability and effectiveness of that rule.
- (115) Indeed, that logic is reflected in the design of the UK CFC rules. They firstly apply a very wide net — all profits of foreign subsidiaries controlled from the UK — and subsequently exclude various situations where the UK legislator considers the risk of a loss of tax revenues to be objectively low. The HMRC Guidance to the UK's CFC rules in that regard states that: 'if one of the CFC exemptions applies to a CFC it is not necessary to consider whether or not it has any chargeable profits' and that in practice: 'groups will easily be able to establish that almost all of their foreign subsidiaries will be outside the scope of the new CFC regime or exempt from it'. This approach is reflected in the general entry level exemptions in Chapter 3 as well as the entity level exemptions in Chapters 10 to 14. Only if none of these exemptions is applicable is it necessary to identify and quantify a CFC's chargeable profits.
- (116) Chapter 3 forms the initial part of the CFC charging provisions. It contains tests that UK resident companies apply to a CFC they control in order to determine whether any of the more detailed charging provisions in Chapters 4 to 8 need to be applied. Concerning NTFP, for example, Chapter 3 determines that UK resident companies can disregard the rules of Chapter 5 (and thus also of Chapter 9) if the NTFP earned by a CFC are incidental to its other operations and fall within a 5 % safe harbour⁽⁸⁴⁾.

- (117) Similarly, Chapters 10 to 14 contain entity level exemptions (see recitals 19 and 20), such as the excluded territories exemption, the low profit exemption and the low profit margin exemption that exclude a CFC's profits from the scope of the UK CFC rules if it is reasonable to assume that there is a low risk that the profits of such a CFC have been artificially diverted or if there is more generally a low risk for loss of tax revenue for the UK treasury. This indeed seems reasonable to assume in relation to CFCs that earn little profits, that realise a low profit margin or that are subject to a relatively high effective tax rate.
- (118) In summary, the UK's CFC rules with their entry level and entity level exemptions aim to ensure that application of the rules is limited to situations posing a high risk to the UK Treasury and that have a high potential for artificial diversion.

6.4.1.4. *The tools used: the charging provisions*

- (119) If none of the entity exemptions in Chapters 10 to 14 apply and none of the entry exemptions in Chapter 3 apply, then the charging chapters beginning with Chapter 4 (Profits attributable to UK activities) need to be applied. As mentioned before, Chapter 4 applies to all profits except where a CFC exclusively earns NTFP or property business profits⁽⁸⁵⁾. The general approach for the identification and quantification of artificially diverted profits in Chapter 4 is based on the concept of SPF. This is an attribution exercise that is based on the same logic and principles as those applied under the Authorised OECD Approach ('AOA') to establish the attribution of profits to a permanent establishment. It identifies the relevant SPF that are located in the UK and those that are located in the location of the CFC or elsewhere outside the UK. After that, it is necessary to establish the extent to which the relevant profits of the CFC are attributable to the SPF located in the UK⁽⁸⁶⁾. This analysis, in different variations, is also required in other charging chapters. The HMRC Guidance accompanying the legislation emphasises the important role of the SPF test, describing it as 'central to the analysis' of whether profits are attributable to the UK⁽⁸⁷⁾.
- (120) The UK CFC rules contain subsequent charging provisions in Chapters 5 to 8 that may apply in addition to Chapter 4. These provisions exclusively apply to certain types of profits, for which a parallel application of the general Chapter 4 and a specific charging Chapter is possible. For example, it is possible that only part of a CFC's profits are chargeable under Chapter 4, but that does not exclude that the remainder may be chargeable under Chapter 6⁽⁸⁸⁾. It is also possible that whilst no CFC charge may arise under Chapter 4, a CFC charge may nonetheless apply under Chapters 5 to 8. Therefore, the CFC charge may be higher following the application of the subsequent charging chapters, but it cannot be lower than the charge that would apply under Chapter 4⁽⁸⁹⁾.

- (121) One of the specific charging provisions is Chapter 5, which concerns NTFP. Like Chapter 4, Chapter 5 also uses an SPF analysis to assess whether a CFC charge should apply; it identifies NTFP from assets that are owned by the CFC and profits from risks allocated to the CFC in situations where relevant SPF are carried out in the UK. However, the SPF analysis differs from Chapter 4 in two crucial points.
- (122) First, the SPF test prescribed by Chapter 5 is ‘lighter’ than that prescribed by Chapter 4 in the sense that it is more easily met, so that the application of the SPF analysis in Chapter 5 may lead to a CFC charge while no such charge would be due under the SPF analysis under Chapter 4 in the same set of circumstances. That is so because Chapter 5 directly refers back to Chapter 4 for the SPF analysis to identify and quantify artificially diverted profits, but with less steps⁽⁹⁰⁾.
- (123) Furthermore, Chapter 5 includes a second test on the basis of which a CFC charge can be established, even without SPF located in the UK, which is unique to NTFP. The second test that can trigger a CFC charge looks at how the loans that generate the CFC’s NTFP were funded and imposes a CFC charge on a CFC’s NTFP to the extent that those loans arise from UK connected capital. The UK authorities have explained that the reason why Chapter 5 contains that second test is that NTFP may not always require the presence of substantial SPF so relying exclusively on the SPF test would not sufficiently protect the UK corporate tax base against artificial diversion in the case of NTFP.

6.4.2. *The Group Financing Exemption is a derogation*

- (124) According to settled case-law, a measure is *prima facie* selective if it leads to a difference in treatment between undertakings that are in a comparable legal and factual situation, in view of the objective of the reference system⁽⁹¹⁾. In the present case, the question is whether the Group Financing Exemption exempts some companies from the CFC charge that would be due upon other companies under the normal system of CFC rules, while both situations are legally and factually comparable in the light of the objective of the reference system, i.e. the UK CFC rules.
- (125) The Group Financing Exemption provides an exemption from the CFC charge for a specific category of NTFP⁽⁹²⁾. Under the UK CFC rules, the criteria to determine whether and to what extent a CFC charge is due if a CFC earns such profits are included in Chapters 5 and 9. Chapter 5 contains rules and criteria applicable to all NTFP, whether received from a related debtor (group loan) or from an unrelated debtor (e.g. a bank) and regardless of whether received from a UK debtor or from a foreign debtor. Then Chapter 9 contains specific rules (the Group Financing Exemption) for NTFP received from loans to foreign group companies, the ‘qualifying loan relationships’⁽⁹³⁾ and (partially) exempts those profits from the CFC charge that would otherwise be due

under Chapter 5. In the Opening Decision, the Commission has provisionally considered that the Group Financing Exemption granted certain companies with a CFC earning NTFP from a qualifying loan relationship a *prima facie* selective advantage over companies with a CFC earning other forms of NTFP, while both were in a comparable factual and legal situation in view of the reference system.

- (126) The UK authorities have raised two arguments as to why a situation with a chargeable entity controlling a CFC earning NTFP from a qualifying loan relationship would not be comparable to a chargeable entity controlling a CFC earning other NTFP⁽⁹⁴⁾. The first argument of the UK authorities is that a CFC's NTFP, other than NTFP from a qualifying loan relationship, are *per-se* artificially diverted while that could not be said for NTFP from a qualifying loan relationship⁽⁹⁵⁾. The second argument is that the obligation to respect Treaty freedoms has different implications for both categories⁽⁹⁶⁾.

6.4.2.1. *The comparability of an exempted CFC according to Chapter 9 of the CFC rules with CFC earning other NTFP*

- (127) Concerning the first argument, the UK argues that CFCs granting loans to UK resident related parties — referred to as *upstream loans* — pose a direct and evident threat to the UK tax base if such profits are earned through a CFC. This threat would be less obvious for CFCs with qualifying loan relationships (holding loans to foreign group companies). The UK argues that upstream loans essentially are circular transactions. A UK company puts equity funds in a CFC which returns the funds as a loan to a related UK company. The UK also argues that in these situations interest has been deducted from the UK tax base at the level of the UK resident group companies, thus directly eroding the UK tax base. Conversely, NTFP from loans to foreign related parties concern truly outbound UK funding, so they cannot be seen as a circular arrangement. Moreover, a potential interest deduction at the level of the group company receiving the loan from the CFC does not erode the UK tax base.
- (128) The UK equally argues that CFCs earning NTFP from qualifying loan relationships and CFCs lending to an unrelated party constitute fundamentally different situations posing different risks to the UK corporate tax base. According to the UK, the risk to the UK Treasury is more clearly evident for arrangements involving a CFC lending to an unrelated party which the UK authorities refer to as *moneyboxes* and which merits having a single, strict rule for those situations since such an arrangement has no commercial rationale, and can have no other purpose than avoiding UK taxes⁽⁹⁷⁾. Conversely, in case of qualifying loan relationships the NTFP are related to supplying genuine funding to overseas business operations of the group. The UK maintains that in such an arrangement the risk of artificial diversion is less immediately apparent and may give rise to no, or to partial or to full artificial diversion⁽⁹⁸⁾. The difference in risk for artificial diversion, in the UK authorities' view,

means that both arrangements are not in a legally and factually comparable situation in the light of the objective of the CFC rules.

- (129) The Commission cannot accept the points put forward by the UK in support of its first argument.
- (130) As set out in recital 111, the question to be addressed is whether NTFP from loans to foreign group companies are factually and legally comparable to NTFP from third party loans or from loans to UK group companies in the light of the objective of the CFC rules.
- (131) Having said that, the Commission recalls that the UK CFC rules achieve their objective to protect the UK corporate tax base by bringing into charge profits from UK activities and assets which have been *artificially diverted* from the UK to non-resident associated entities. The tests to identify and quantify artificially diverted profits for the specific category of NTFP have been included in Chapter 5. Given the fact that the UK CFC rules seek to protect the UK corporate tax base, it is no surprise that the tests to identify artificial diversion are directly related to the factors on which the UK corporate tax base is founded, i.e. *UK activities* (reflected by UK SPF) or *UK assets* (reflected by UK connected capital). The criteria to establish artificial diversion for NTFP under the UK CFC rules are therefore inherently and logically linked to the UK corporate tax base which the UK CFC rules seek to protect. The Commission fails to see why in the light of that objective, those criteria would be suitable to establish artificial diversion for all NTFP except those from qualifying loan relationships.
- (132) With respect to the UK's arguments that the types of NTFP excluded from the contested measure clearly lack commercial justification and create an obvious indication of artificial diversion — which would be less obvious in the case of NTFP earned from qualifying loan relationships so that they are not legally and factually comparable in the light of the objective of the UK CFC rules the Commission will first address comparability between NTFP from qualifying loan relationships with NTFP from loans to UK resident group companies, and then address comparability with NTFP from loan relationships with third parties.
- (133) As regards comparability with NTFP from loans to UK related parties, firstly, the Commission understands that such arrangements may cause concerns for the UK legislator, notably tax base erosion through interest deductions caused by excess debt financing of UK activities. It is indeed true that these concerns are not apparent in the case of NTFP earned from a qualifying loan relationship, because a potential base erosion concern — if at all — would be present abroad but not in the UK. As a preliminary remark, the Commission notes in that regard that the UK are not fully consistent in addressing that concern. Under the current rules, a situation may arise whereby a loan to a UK group company may be considered a qualifying loan relationship under

Chapter 9, provided the ultimate debtor under that loan arrangement is a foreign group company (the funding is channelled through a UK ‘conduit’ company). Also in that situation, the UK conduit will claim an interest deduction on the interest paid to the CFC, while the interest will nevertheless be (partially) exempt under the contested measure⁽⁹⁹⁾.

- (134) In any case, however, any consistent differentiation based on the presence of a UK deduction would only mean that both arrangements are in a different legal and factual situation if we were assessing a national measure that has as its objective protecting the tax base *through base erosion from interest deductions*. The UK corporate tax law has several anti-avoidance measures with such objective. However, protection against tax base erosion from excessive interest deductions in the UK is not the objective of the UK CFC rules. They seek to protect the UK from artificial diversion of *profits* from financing and other operations by levying a CFC charge on such profits⁽¹⁰⁰⁾. The difference raised by the UK authorities therefore does not mean that both situations are in a different legal and factual situation in the light of the objective pursued by the contested measure, i.e. protecting the UK tax base against the artificial diversion of profits including those earned through financing activities.
- (135) Secondly, the Commission notes that NTFP from loans to UK related parties may also arise for valid commercial reasons and are not necessarily ‘circular transactions’ in all instances, i.e. UK funds moved to a CFC and then moved back to the UK. If NTFP are derived from a loan to a UK related party whereby the SPF are in the UK, a CFC charge should arise in keeping with the charging criteria within Chapter 5, even if the loan is not funded from UK connected capital (i.e. regardless of ‘circularity’).
- (136) Thirdly, the Commission does not share the UK's view that there would be an apparent valid commercial reason for structuring financing from a UK resident company to a foreign group company through a CFC (instead of lending the money directly), whilst that would not be the case for structuring financing from a UK resident company to a UK resident group company through a CFC (instead of lending the money directly). The intermediate finance function and role of the CFC in both arrangements is fully comparable. The Commission does not agree that valid commercial reasons can be assumed present in one situation and assumed absent in the other, which would mean that both situations are not legally and factually comparable in the light of the objective of the CFC rules. Valid commercial reasons for the presence and use of a CFC earning NTFP for both arrangements is determined on the basis of facts and circumstances concerning the nature and quality of the CFC's functions and risks, not on the basis of the source of the NTFP.
- (137) For the reasons set out in recitals 133 to 136, the argument of the UK authorities that NTFP from qualifying loan arrangements and NTFP from loans to UK group companies are not comparable must be rejected.

- (138) As regards comparability with NTFP derived from external loans, which the UK authorities refer to as *moneyboxes*, the Commission notes that the UK considers a moneybox an arrangement using a low-tax CFC as a conduit to deposit funds with a bank so that the resulting NTFP are earned by the CFC rather than the UK, and it understands that the UK CFC rules were designed to prevent such arrangements. In that regard, the Commission recalls that loans to third parties may include, but are not limited to bank deposits. They can also cover for example incidental loans to suppliers, to external service providers, to customers or to other non-related parties. Moreover, the Commission does not agree that these arrangements must be seen as *per se* abusive whilst that would not apply to arrangements using a low-tax CFC as a conduit to provide a loan to a foreign group company. Indeed also in this case the resulting NTFP are earned by the CFC rather than the UK.
- (139) An interested party argued that in the case of a qualifying loan arrangement, the funds provided will be used by the foreign group company to fund genuine commercial operations. In that regard, the Commission first recalls — as set out in recital 136 — that the nature or quality of the party receiving a loan from a CFC does not affect (the risk for) artificial diversion concerning NTFP earned by the CFC. Second, the Commission does not agree that it can be assumed that funds granted under a qualifying loan relationship will be used by the debtor to fund genuine commercial operations, while funds granted under a loan to a third party will not be used by that third party to fund genuine commercial operations. Provided the debtor is engaged in commercial operations itself, in both cases he will use the funds to finance its business operations, be it new investments, acquisitions or any other commercial purpose. Moreover, given the fungibility of money, the ultimate use of the funds by the debtor may change over time in both cases and may be very difficult to trace, just like the source of the funding as pointed out by the UK authorities in a different context (see recital 155).
- (140) Concluding, for the reasons set out in recitals 138 and 139, even if it could be assumed that qualifying loan relationships fund genuine commercial operations whilst loans to third parties do not — which the Commission contests — such difference in the ultimate destination and purpose of the funds provided as a loan by a CFC does not affect the comparability of these loans in the light of the objective of the UK CFC rules⁽¹⁰¹⁾.
- (141) More in general in relation to the UK's first argument, the Commission notes that NTFP from qualifying loan relationships is the profit category that is the most susceptible to artificial diversion. First, because non-trading activities are more mobile than trading activities, since they generally require less functions and/or human intervention and are therefore easier to relocate (finance profits are primarily capital intensive and capital is much more mobile than, for example, labour and can therefore easily be moved). And second, because groups are to a significant extent free to determine their

internal finance operations using a mix of capital and debt that provides the most favourable result from a tax perspective. This also explains why NTFP is internationally typically targeted by CFC rules⁽¹⁰²⁾. For example, Article 7(2) (a) of the Anti Tax Avoidance Directive lists several categories of CFC income that are to be taxed under CFC rules, starting with interest. Article 7(3) of that Directive further stipulates that Member States can choose not to apply the CFC rule if one third or less of the CFC income is comprised of interest and one third or less of the interest income is comprised of interest from group companies (see recital 44). This implies that interest income received from group companies is considered by the Anti Tax Avoidance Directive as the most important income category to be covered by CFC rules.

- (142) Concluding, the Commission rejects the UK's first argument that a CFC's NTFP other than NTFP from a qualifying loan relationship are *per-se* artificially diverted while that could not be said for NTFP from a qualifying loan relationship, which means that this argument does not provide a basis to accept that they would concern situations that are not legally and factually comparable in the light of the objective of the UK CFC rules. Furthermore, the Commission does not see any contradiction of this conclusion with its past decision practice on the Dutch Groepsrentebox scheme and on the Hungarian group interest tax regime. The Commission observes that neither decision confirms, as the UK seems to argue, that the reference system in case of a measure concerning companies dealing with related parties must necessarily be limited to rules concerning those types of transactions.

6.4.2.2. *The obligation to respect Treaty freedoms for exempted and non-exempted categories of CFC*

- (143) With its second argument, the UK authorities seem to imply that chargeable entities with a CFC earning NTFP from qualifying loan relationships require a more lenient approach than chargeable entities with a CFC earning other NTFP in order to ensure compliance with the Treaty freedoms. In other terms, there would be a risk of violation of the Treaty freedoms as a result of the taxation of profits from qualifying loan arrangements, if the exemption foreseen by Chapter 9 did not exist. This risk would not exist for the taxation of other NTFP. Therefore, the two situations would not be comparable. In that regard, the UK authorities recall that the CFC reform by which the contested measure was introduced was, to a significant extent, motivated by the Court's findings in *Cadbury Schweppes*. The UK underlines, in particular, the difficulties of trying to comply with the *Cadbury Schweppes* decision in the absence of any case law or clear guidance on how the concept of 'wholly artificial arrangements' should be applied and interpreted in different situations⁽¹⁰³⁾. In this scenario, in order to devise an administrable set of rules that is also compatible with Union law, Chapter 9 contains mechanical tests and fixed percentages set at levels that were considered to ensure that the profits brought within the scope of the charge were identified in a way that

is consistent with that jurisprudence. According to the UK, the new rules are designed to minimise the risk of over-inclusion because that could lead to a Union law challenge to the CFC rules⁽¹⁰⁴⁾.

- (144) The Commission also does not accept the second argument brought forward by the UK since it is based on incorrect and inconsistent conclusions drawn from the Court's jurisprudence.
- (145) As it will be demonstrated in the next section (6.4.3) of the present decision, the removal of the exemption set out by Chapter 9 for NTFP from QLR, when the SPF is located in the UK, does not entail a risk of violation of the Treaty freedoms. But, in the current section of the reasoning, the Commission will focus on the argument according to which the risk of violation of the Treaty freedoms would be different for taxation of the different types of NTFP.
- (146) The Commission does not agree that a (potential risk for) infringement of the freedoms in the Treaty would be assessed differently for a CFC earning NTFP from a qualifying loan relationship than for a CFC earning other NTFP, which would mean that both are not in a comparable legal and factual situation in the light of the objective of the CFC rules.
- (147) The *Cadbury Schweppes* judgment⁽¹⁰⁵⁾ recalls previous case law of the Court where it has been clarified that the objective pursued by the freedom of establishment is to allow a national of a Member State to set up a secondary establishment in another Member State to carry on his activities there and thus assist economic and social interpenetration within the Community. In order for CFC legislation to comply with Community law, the Court has stated that its application must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality⁽¹⁰⁶⁾. This means that the CFC's incorporation must correspond to an actual establishment intended to carry on genuine economic activities in the host Member State⁽¹⁰⁷⁾.
- (148) The Commission does not read anything in the *Cadbury Schweppes* judgment which would support the view that the obligations of the Treaty freedoms would have a different impact on chargeable entities with CFCs earning NTFP depending on the quality and nature of the CFC's debtor. What matters is whether the CFC itself reflects economic reality and that cannot be assumed present or absent solely based on the nationality of or the relation with the debtor paying the passive interest.
- (149) To the extent that the UK authorities argue, as certain interested parties seem to do, that the application of the contested exemption is subject to the condition that the CFC meets a business premises test which would be relevant for Treaty freedoms purposes, the Commission notes that such condition can in any case not affect the comparability analysis. That analysis requires an evaluation whether NTFP from loans to foreign group companies are factually and legally comparable to NTFP from third party loans or from loans to UK group companies in the light of the objective of the CFC rules and under

otherwise equal conditions. The latter is an obvious requirement in every comparability analysis, since adding aspects in one of the situations and not in the other will inevitably affect the comparability of the two situations thus rendering the evaluation ineffective. Put differently, that condition could be included in the comparability analysis but only when applied to both parties, i.e. a comparison between a CFC meeting the business premises test earning NTFP from qualifying loan relationships and another CFC meeting the business premises test earning other NTFP. In that case the former would still be treated better under the contested measure, despite being in a comparable legal and factual situation in the light of the objective of the CFC rules.

- (150) The Commission therefore concludes that the charging provisions in the UK CFC rules specifically dealing with NTFP differentiate between, on the one hand, chargeable entities with a CFC earning NTFP from qualifying loan relationships, who are eligible to make a claim under Chapter 9, and, on the other hand, chargeable entities with a CFC earning NTFP from other passive loans. In fact, both situations are legally and factually comparable considering the objective pursued by UK CFC rules, which is to protect the UK corporate tax base by bringing into charge profits from UK activities and assets which have been artificially diverted from the UK to non-resident associated entities.
- (151) For these reasons, the contested measure constitutes a derogation from the general rule under the UK CFC regime. It relieves those chargeable entities with a CFC earning NTFP from a qualifying loan relationship who made a claim under Chapter 9 from being subject to the CFC charge normally borne by chargeable entities with a CFC earning NTFP. This means that all chargeable entities who have made a claim under Chapter 9 have obtained a *prima facie* selective advantage.

6.4.3. *Justification by the nature and overall structure of the tax system*

- (152) A measure which derogates from the reference system may still be justified by the nature or overall structure of that system. This is the case if the Member State concerned can show that the measure derives directly from the basic or guiding principles of the reference system or where it is the result of inherent mechanisms necessary for the functioning and effectiveness of the system⁽¹⁰⁸⁾.
- (153) It should be recalled that the UK authorities bear the burden of proof of such a justification. The Commission will therefore hereafter check whether the UK authorities have demonstrated the existence of such a justification in the present case. The interested parties have not put forward other justifications than the UK.
- (154) In that regard, the UK authorities essentially put forward two grounds to justify the *a priori* selective nature of the contested measure. First, they argue that the measure aims to ensure that the system is manageable and administrable for both HMRC and taxpayers and, secondly, they argue that

the measure ensures compliance with the case law of the Court on the Union fundamental freedoms.

6.4.3.1. *As to the alleged justification by the complexity of historically tracing the origin of the funds*

- (155) Concerning the first argument, the UK authorities argue that the default 75 % exemption aims to address the inherent difficulty and complexity of historically tracing the origin of the funds used to finance the loans granted by a CFC. This is particularly problematic for multinational groups where finance arrangements typically involve complex funding patterns. The UK authorities explained in that regard that group financing companies are often established as part of a complex reorganisation or acquisition, that their loans have often been and continue to be refinanced, consolidated, exchanged and re-assigned and that they are often shareholders in overseas group operations, thus receiving distributions of profit from which loans can be funded or re-financed. This complexity in tracing the funding of loans according to the UK authorities is typical for group finance companies of multinationals.
- (156) All these features, according to the UK authorities, make the UK connected capital test under Chapter 5 complex and burdensome to apply for UK taxpayers under the self-assessment regime, but it also makes the test difficult to enforce for HMRC.
- (157) The UK authorities have explained that the UK legislator for that reason introduced a different rule to identify and quantify artificially diverted profits in case of passive interest derived from a qualifying loan relationship, which is easier to apply and enforce while ensuring sufficient protection of the UK corporate tax base in line with the objective of the UK CFC rules. That different rule according to the UK authorities considers that, instead of linking the CFC charge to funding from UK connected capital actually tracing the original source of the funding, the CFC charge is levied on a fixed proportion of a CFC's NTFP from a qualifying loan relationship.
- (158) The proportion chosen in that respect is meant to reflect that absent tax motives such group financing CFC's would have been financed by a mix of debt and equity, whereby debt funding of the CFC would have generated interest income for the UK parent company. The UK in its comments further explained that the approach with a 25 % charge (75 % exemption) was adopted following consultation and consideration of the wide range of funding ratios observed from market data which pointed at an assumed debt: equity ratio of 1:3 for wholly equity funded CFCs. In line with the approach chosen and in order to prevent over-inclusion, the contested measure allows increasing the 75 % exemption (reducing the 25 % inclusion) in appropriate circumstances, for example to the extent that the CFC can demonstrate, based on actual facts and circumstances, that its loans are for more than 75 % supported by funds that have a non-UK origin.

- (159) The Commission notes that the HMRC Guidance in the introductory comments to Chapter 9 confirms this explanation, stating:

The exemptions for NTFPs provided within Chapter 9 have been introduced to address the difficult issues which arise as a result of the fungibility of money within a multinational group. The rules represent to a large extent a proxy for establishing the exact source and history (tracing) of a group's financing arrangements and the extent these are borne by the UK⁽¹⁰⁹⁾

- (160) In that regard and with respect to anti-avoidance rules, the Commission in general can accept that an *a priori* selective measure that is applied for specific cases to ensure that the rules to counter the tax avoidance in those cases are both sufficiently robust and at the same time manageable and administrable, can indeed be said to follow from an inherent mechanism necessary for the functioning and effectiveness of the CFC rules, provided it complies with the principle of proportionality⁽¹¹⁰⁾. The *a priori* selective measure in that case would be justified and would therefore not fulfil the condition relating to the selectivity of the advantage concerned, as required by Article 107(1) of the Treaty.
- (161) As stated before in Section 2.1.2, it is consistent with these principles that the CFC rules apply risk-based exclusions to limit the scope of the CFC charging provisions to situations with either a high risk to the UK treasury for loss of tax revenues or with a high potential for artificiality. Equally, the Commission notes that using general percentages and mechanical rules based on standard ratios instead of assessing each and every case individually may be acceptable under certain circumstances, provided it is established that the assessment of each and every case individually would entail complex, costly and burdensome formalities and provided the percentages and ratios used comply with the principle of proportionality. In this respect, the Commission was unable to conclusively rebut that the ratio chosen by the UK to approximate the portion of UK sourced CFC capital was proportionate, nor could it successfully identify a different, more appropriate ratio.
- (162) Given these considerations and taking into account the arguments and explanation provided by the UK authorities during the formal investigation, the Commission, to the extent related to the test based on 'UK connected capital' *and only to that extent*, accepts that the contested measure can be said to ensure that specifically for CFCs earning NTFP from a qualifying loan relationship, the CFC rules can be applied in an administrable way, without requiring businesses and UK tax authorities to undertake disproportionately burdensome tracing exercises, while ensuring a CFC charge on profits from UK assets that can reasonably be said to be artificially diverted from the UK. For these reasons, the Commission considers the *a priori* selective character of the contested measure justified and therefore not selective, to the extent that the identification and quantification of the CFC charge under Chapter 5 would

be exclusively based on the UK connected capital test under Section 371EC of Chapter 5 of TIOPA, which would require a disproportionately burdensome tracing exercise.

- (163) However, the Commission notes that the test based on ‘UK connected capital’ to establish the CFC charge for NTFP is only one of two general tests included in Chapter 5, next to the test based on the approach generally applied in the UK CFC rules, notably the SPF test. The Commission recalls that that additional test was included in Chapter 5 next to the general SPF test to ensure that an appropriate CFC charge would still be due in situations where NTFP arise with limited SPF or where the relevant SPF are difficult to establish.
- (164) In situations where the CFC charge is based on the application of the SPF test and the SPF related to the assets and risks giving rise to the NTFP from qualifying loan relationships are located in the UK, applying the *a priori* selective mechanical rule laid down in the contested measure is not justified. In those situations, there are no inherent mechanisms making the application of a mechanical rule necessary for the functioning and effectiveness of the CFC rules.
- (165) The HMRC Guidance to the CFC rules discusses the location of SPF in case of NTFP and shows that such a mechanical rule is not necessary:

The active decision-making about the roll-over of large intra-group loans may be planned and decided by an overseas group treasury company, but the original planning and decision to structure the investment by way of an intra-group loan will remain an important factor. For significant structural loans in a UK headed multinational group related to an acquisition for example we would usually expect the main SPF to be in the UK even where treasury/group finance functions are located elsewhere. The availability and form of the funding will be an important part of the investment appraisal process that would require the involvement of the centre of operations, even where regional centres and divisions have considerable autonomy devolved to them⁽¹¹¹⁾

- (166) The general assumption that the SPF related NTFP from qualifying loan relationships, will generally rest with the group's finance function, where it concerns larger, medium to long term intercompany loans, follows also from another part of the HMRC Guidance, which discusses whether such tax payers should or should not make a claim to apply the contested measure:

Our expectation is that for larger, medium to long term loans funded by equity, the SPF relating to the creation of the loan and, in most cases, the ongoing management of the loan will rest with a group's finance function (meaning the function encompassing the accounting, tax, treasury, corporate finance and mergers and acquisitions teams or a similar central operation) rather than the group treasury team in isolation. Experience has shown that this type of loan is planned and managed from “the centre”. The actual lender may be seen as having taken the decision to

lend, but will in most cases not have initiated or carried out the planning for intra-group finance structures.

Assertions that the relevant SPF are undertaken by the lender or other bodies outside of the group finance function in such situations should therefore be subject to careful scrutiny. For large structural loans our expectation is that most if not all of the SPF will be located in the UK⁽¹¹²⁾

- (167) Thus, the intercompany financing operations, financing of specific overseas projects and other types of structured loans will normally require operational decision-making and monitoring functions. And it is furthermore reasonable to assume that the SPF relevant to these types of qualifying loan relationships will be closely linked to the location of the finance function within a multinational group.
- (168) It should also be underlined that neither the UK authorities nor the interested parties alleged that it would be difficult to trace the significant people function for NTFP and that the exemptions laid down by Chapter 9 would be justified by the necessity to avoid a burdensome tracing exercise concerning the localisation of the SPF.
- (169) In summary, the Commission accepts the justification brought forward by the UK authorities that the contested measure avoids disproportionately burdensome tracing exercises which may be said to follow from an inherent mechanism necessary for the functioning and effectiveness of the CFC rules. However, that justification would only apply if a CFC charge under Chapter 5 were based solely on the 'UK connected capital' test. The Commission rejects that justification where a CFC charge under Chapter 5 could be applied and established without any disproportionate burden applying the normal attribution rules under the SPF test.

6.4.3.2. *As to the alleged justification by the necessity to comply with the Treaty freedoms*

- (170) Since the Commission considers the contested measure to be partly justified and therefore, for that part, not selective, as summarised in the previous recital, it only needs to assess if the second argument brought forward by the UK authorities — compliance with the Treaty freedoms — may provide a justification for the *a priori* selective nature of the contested measure that is not justified under the first argument. The question to be answered, therefore, is whether for chargeable entities with a CFC earning NTFP from a qualifying loan relationship, the obligation under Union law for the UK not to apply measures restricting the freedom of establishment of its resident undertakings can justify applying the contested measure to establish the CFC charge, instead of applying the general tests under Chapter 5, if it concerns a situation where the SPF related to the NTFP from a qualifying loan relationship are located in the UK. The Commission does not consider that the case.

- (171) Levying a tax on profits of foreign subsidiaries only to the extent attributable to domestic assets and activities does not pose a restriction to the freedom of establishment because it follows the same principles as those underlying the AOA concerning the attribution of profits of a foreign entity to a domestic permanent establishment. That approach is based on the arm's length principle. This is indeed how the SPF analysis in the UK CFC rules works. It ensures a CFC charge on the profits of a CFC but limited to those profits that have been artificially diverted away from the UK, whereby the identification and quantification of such artificially diverted profits is based on a test that first identifies which SPF relevant for generating the CFC's profits are located in the UK, and subsequently subjects only that part of the CFC's profits to a CFC charge that is proportionate to the relevant SPF being located in the UK. Given this effect of an SPF test, a CFC charge based on such test should in principle be compliant with the provisions in Union law concerning the freedom of establishment following the definition and explanations given to the concept of abuse by the Court.
- (172) As a matter of fact, the conclusion drawn in the previous recital is consistent with the design of Article 7 of the Anti-Tax Avoidance Directive, which obliges Member States to introduce a CFC rule in their domestic legislation. As explained in recital 43, that Directive gives Member States two options for the design of their CFC rule. The first option concerns a rule that targets specific types of profit which — if subject to low tax — should be taxed under the CFC rule. That rule is combined with an 'escape clause' in Article 7(2) (a) of the Anti Tax Avoidance Directive: 'This point shall not apply where the controlled foreign company carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances'. The purpose of that clause is ensuring compliance with the Union freedoms following the definition and explanations given to the concept of abuse by the Court. The second option concerns a rule that is based on the SPF test, stating that a CFC's profits derived from SPF carried out in the controlling Member State shall be subject to a CFC charge, just as the UK CFC rules. It is not a mistake that Article 7(2)(a) of the Anti-Tax Avoidance Directive (the escape clause), does not apply to this second option. The reason is that the EU legislature concluded that there was no need for such an escape clause to ensure compliance with the Union freedoms for an SPF based CFC rule for the exact same reasons explained in the former recital⁽¹¹³⁾.
- (173) Since levying a CFC charge based on the general SPF test under Chapter 5 does not pose a restriction to the Union freedom of establishment, the second UK argument that the contested measure would be needed to ensure compliance with the Treaty freedoms is misplaced and cannot justify the *a priori* selective treatment in those situations.
- (174) The Commission concludes that the contested measure provides an *a priori* selective advantage to UK corporate taxpayers controlling a CFC earning

NTPF from qualifying loan relationships in situations where SPF relevant to the NTFP are located in the UK and that *a priori* selective advantage cannot be justified by the need to have administrable and manageable anti-avoidance rules, nor by the need to comply with the Treaty freedoms. Since the UK authorities and interested parties have not brought forward any other grounds to justify the *a priori* selective advantage and the Commission, during its formal investigation, has found no other grounds for justification, the Commission concludes that the contested measure — to the extent described in this recital — cannot be said to derive directly from the intrinsic basic or guiding principles of the UK CFC rules nor to be the result of inherent mechanisms necessary for the functioning and effectiveness of that system. To that extent, the contested measure therefore cannot be justified by the nature and overall structure of the reference system.

6.4.4. *Conclusion on the existence of a selective advantage*

- (175) For the reasons set out in this Section, the Commission concludes that the contested measure confers a selective advantage on UK corporate taxpayers artificially diverting NTFP earned from a qualifying loan relationship to a CFC to the extent that the SPF relevant to the NTFP can be identified and are located in the UK, by relieving them of the CFC charge which those taxpayers would otherwise have been obliged to pay under the ordinary system for levying a CFC charge under the UK CFC rules.

6.4.5. *Beneficiaries of the contested scheme*

- (176) The beneficiaries of the contested scheme are UK entities that control a CFC earning NTFP from qualifying loan relationships in as far as it applies to non-trading finance profits from qualifying loan relationships, which profits fall within Section 371EB (UK activities) TIOPA. The Commission notes that all those entities form part of a multinational group since both the CFC and the foreign group company or companies being financed through the qualifying loan relationship must be under common UK control.

6.5. **Conclusion on the existence of aid**

- (177) In light of the analysis in Sections 6.1 to 6.4, the Commission concludes that the contested measure grants a selective advantage to the beneficiaries of the scheme described at recital 176 as well as to the multinational groups to which they belong. The selective advantage is imputable to the UK and financed through State resources, distorts or threatens to distort competition and is liable to affect intra-Union trade. The contested scheme therefore constitutes State aid within the meaning of Article 107(1) of the Treaty.

- (178) Since the contested measure gives rise to a reduction of charges that should normally be borne by the beneficiaries in the course of their annual business operations, it should be considered as granting operating aid to the beneficiaries and the multinational groups to which they belong.

(179) The Commission further observes that the changes occurred to the scheme during the formal investigation procedure, mentioned in Section 2.3, ensure that, as of 1 January 2019, a claim for the application of the contested measure cannot be made with regard to NTFP from qualifying loan relationships that are derived from assets and risks in relation to which relevant SPF are carried out in the UK. Since these amendments make it compliant with State aid rules, the Commission has no objection on the amended regime in place since 1 January 2019.

6.6. **Unlawfulness of the aid**

(180) Under Article 108(3) of the Treaty, Member States are obliged to inform the Commission of any plan to grant aid (notification obligation) and they may not put into effect any proposed aid measures until the Commission has taken a final position decision on the aid in question (standstill obligation).

(181) The contested measure was put into effect per 1 January 2013, well after the entry into force of the Treaty in the UK, and does not meet any of the other grounds for being classified as existing aid under Article 1(b) of Procedural Regulation (EU) 2015/1589. It therefore constitutes a new aid scheme.

(182) The Commission notes that the UK did not notify the Commission of any plan to grant aid through the contested measure, nor did it respect the standstill obligation laid down in Article 108(3) of the Treaty. Therefore, the contested measure constitutes unlawful aid within the meaning of Article 1(f) of Regulation (EU) 2015/1589.

6.7. **Compatibility of the aid**

(183) State aid is deemed compatible with the internal market if it falls within any of the categories listed in Article 107(2) of the Treaty and it may be deemed compatible with the internal market if it is found by the Commission to fall within any of the categories listed in Article 107(3) of the Treaty. However, it is the Member State granting the aid which bears the burden of proving that State aid granted by it is compatible with the internal market pursuant to Article 107(2) or (3) or Article 106(2) of the Treaty.

(184) Neither the UK nor any interested party has invoked any of the grounds for a finding of compatibility of the contested measure.

(185) In the present case, the Commission does not find any ground for compatibility of the contested measure. Moreover, as explained in recital 178, the contested scheme should be considered as granting operating aid. As a general rule, such aid can normally not be considered compatible with the internal market under Article 107(3) of the Treaty in that it does not facilitate the development of certain activities or of certain economic areas. Furthermore, the advantages granted under the contested measure are not limited in time, digressive or proportionate to what is necessary to remedy

a specific economic market failure or to fulfil any objective of general interest in the areas concerned.

- (186) Consequently, the contested scheme, to the extent that it constitutes State aid, is incompatible with the internal market.

7. RECOVERY OF STATE AID

- (187) In accordance with the Treaty and the established case-law of the Court, once the Commission qualifies a measure as unlawful and incompatible State aid, it is competent to request the Member State to re-establish the situation previously existing in the market. This is done by means of recovery of the State aid⁽¹¹⁴⁾ and by abolishing the aid measure⁽¹¹⁵⁾.

- (188) Accordingly, Article 16(1) of Regulation (EU) 2015/1589 places an obligation on the Commission to order recovery of unlawful and incompatible aid. That provision also provides that the Member State concerned shall take all necessary measures to recover unlawful aid that is found to be incompatible with the internal market. Article 16(2) of Regulation (EU) 2015/1589 establishes that the aid is to be recovered, including interest from the date on which the unlawful aid was at the disposal of the beneficiary until the date of its effective recovery. Commission Regulation (EC) No 794/2004 elaborates the methods to be used for the calculation of recovery interest⁽¹¹⁶⁾. Finally, Article 16(3) of Regulation (EU) 2015/1589 states, that ‘recovery shall be effected without delay and in accordance with the procedures under the national law of the Member State concerned, provided that they allow for the immediate and effective execution of the Commission decision’.

- (189) Furthermore, the Commission notes that the contested measure is no longer in place since 1 January 2019.

7.1. No legitimate expectations

- (190) Article 16(1) of Regulation (EU) 2015/1589 also provides that the Commission shall not require recovery of the aid if this would be contrary to a general principle of EU law.

- (191) Even though neither the UK authorities nor any interested parties have brought forward any explicit arguments that recovery should be prevented by the principle of legitimate expectations, the Commission will nevertheless assess its eventual application. In this regard, the Commission notes that the UK authorities have been in contact with the Commission services in 2009 and 2010 on the revision of CFC rules⁽¹¹⁷⁾. This concerned an exchange of formal letters related to the question whether amendments made by the UK to the old (pre-2013) UK CFC rules were properly addressing the obligation rested on the UK to comply with the judgment of the Court in the *Cadbury Schweppes* case, as was referred to by one of the interested parties.

- (192) The principle of the protection of legitimate expectations concerns any person who can entertain expectations which are justified and well founded, having received precise, unconditional and consistent assurances from the competent Union institutions. Those assurances must be given in accordance with the applicable rules⁽¹¹⁸⁾.
- (193) In the case at stake, the Exchange of Letters between the Commission services and the UK authorities in the context mentioned in recital 191 cannot be considered as providing precise and unconditional assurance on compliance of the Group Financing Exemption with the Union State aid provisions. The exchange did not take place in the context of discussing EU State aid rules and certainly not in the context of a formal procedure pursuant to Article 108(2) of the Treaty. The discussions on the CFC related to the *Cadbury Schweppes* case concerning a potential breach of the CFC of the freedom of establishment. Consequently, no assurance whatsoever could have been provided to the UK or to the scheme beneficiaries in the context of these letters on the absence of State aid as regards the CFC rules introduced in 2013 or — more specifically — the contested measure.

7.2. **No infringement of other fundamental principles of EU law**

- (194) As regards the concerns raised by some interested parties that recovery might lead to an infringement of the Treaty freedoms, the Commission recalls that its obligation to enforce compliance of a tax measure with the State aid rules of the Treaty can never produce a result which would be contrary to other specific provisions of the Treaty⁽¹¹⁹⁾. The Commission's obligation to ensure an application of the EU State aid provisions that is consistent with other provisions of the Treaty is all the more necessary where those other provisions also pursue the objective of undistorted competition in the internal market, such as Article 49 of the Treaty does in seeking to preserve the freedom of establishment and free competition between the economic operators of one Member State established in another Member State and the economic operators of the latter Member State⁽¹²⁰⁾.
- (195) However, as set out in recitals 170 to 174, the illegal aid granted to the beneficiaries by means of establishing an exemption from a CFC charge is not justified by considerations based on the freedom of establishment, because the levying of such a charge itself does not infringe on that freedom. Consequently, since the levying of the charge does not infringe the referred internal market freedom, requesting the recovery of the correct CFC charge from the companies benefiting from the contested measure cannot be considered as an infringement of that freedom. Recovery of the foregone CFC charge from those companies applying the Group Financing Exemption is needed to restore the level playing field in the internal market. Since the qualification of the Group Financing Exemption as an aid to be recovered is fully consistent with the Treaty provisions seeking to preserve

the fundamental freedoms, the Commission does not consider recovery of the aid to be prevented by a fundamental principle of EU law⁽¹²¹⁾.

(196) No other general principle has been invoked by the UK authorities or by the interested parties and there is no indication of such a violation in the case at hand.

(197) In conclusion, there are no reasons or arguments that could prevent or limit recovery of the aid granted through the application of the contested scheme.

7.3. **Methodology for establishing the recovery aid amount**

(198) The purpose of recovery is to restore the situation which existed in the internal market before the aid was at the disposal of the beneficiary⁽¹²²⁾. In this context, the Court has stated that that objective is attained once the recipient has repaid the amounts granted by way of unlawful aid, thus forfeiting the advantage which it had enjoyed over its competitors on the market, and the situation prior to the payment of the aid is restored⁽¹²³⁾.

(199) No provision of Union law requires the Commission, when ordering the recovery of aid declared incompatible with the internal market, to quantify the exact amount of the aid to be recovered. Rather, it is sufficient for the Commission's decision to include information enabling the addressee of the decision to work out that amount itself without overmuch difficulty⁽¹²⁴⁾.

(200) In relation to unlawful State aid in the form of tax measures or other levies, the amount to be recovered should be calculated on the basis of a comparison between the amount of tax actually paid and the amount which should have been paid if the generally applicable rule had been applied. In order to arrive at an amount of tax which would have been paid if the beneficiaries referred to in recital 176 had not applied the contested measure, the UK authorities should reassess the tax liability of the entities benefiting from the contested measure for each tax year that they benefited from that measure. The entities in question are UK resident entities controlling a CFC that earns NTFP from a qualifying loan relationship to the extent that the SPF relevant to the assets and risks giving rise to NTFP are located in the UK, insofar as those entities have made a claim as described in Section 371IJ of Chapter 9.

(201) The amounts of aid to be recovered from each beneficiary should take into account:

- the amount of tax saved as a consequence of making a claim as described in Section 371IJ of Chapter 9, and
- the compound interest on that amount calculated as from the date at which the aid was put at the disposal of the beneficiaries. For each tax year, the aid is deemed at the disposal of the beneficiary from the day that the unpaid tax would have been due in the absence of the claim.

(202) The amount of tax saved in a specific tax year should be calculated as:

- the CFC charge on NTFP from qualifying loan relationships, which would have been included in the company tax return if the claim described in Section 371IJ of Chapter 9 had not been made, *minus*
 - the CFC charge actually levied on those same profits.
- (203) The CFC charge that would have applied to a beneficiary, if the beneficiary had not made the claim described in Section 371IJ of Chapter 9, should be calculated on the basis of the general UK corporate tax system including the UK CFC rules applicable in the UK at the time the aid is deemed to be granted and in respect of the actual factual and legal situation of the beneficiary. Hypothetical alternative situations based on different operational and legal circumstances that a beneficiary might have chosen if the beneficiary had not been allowed to make the claim described in Section 371IJ of Chapter 9 should not be taken into account⁽¹²⁵⁾.
- (204) The obligation to recover the unlawful and incompatible aid covers the fiscal years 2013 to the last fiscal year in which each beneficiary made use of the aid measure. The Commission considers that the scheme was in force until 31 December 2018. As from the date of notification of this decision, the UK authorities in assessing the tax returns of chargeable entities shall reject any claim made under Section 371IJ of Chapter 9 for a full or partial exemption to the extent that the SPF related to the assets and risks giving rise to NTFP are located in the UK.

8. CONCLUSION

- (205) In conclusion, the Commission finds that the United Kingdom has unlawfully implemented the contested measure to the benefit of certain UK resident companies in breach of Article 108(3) of the Treaty. The Commission also finds that the Group Financing Exemption constitutes State aid that is incompatible with the internal market within the meaning of Article 107(1) of the Treaty, in as far as it applies to non-trading finance profits from qualifying loan relationships, which profits fall within Section 371EB (UK activities) of TIOPA. By virtue of Article 16 of Regulation (EU) 2015/1589 the United Kingdom is required to recover all aid granted to the beneficiaries of the Group Financing Exemption,

HAS ADOPTED THIS DECISION:

Article 1

The group financing exemption scheme, included in the Taxes Acts as Chapter 9 of Part 9A of Taxation (International and Other Provisions) Act 2010, constitutes aid within the meaning of Article 107(1) of the Treaty, in as far as it applies to non-trading finance profits from qualifying loan relationships, which profits fall within Section 371EB (UK activities) of Part 9A of TIOPA. It does not constitute aid when applied to non-trading finance profits from qualifying loan relationships that fall within Section 371EC (capital investments from the UK) of Part 9A of TIOPA and that do not fall within Section 371EB (UK activities) of Part 9A of TIOPA. To the extent that the group financing exemption

scheme constitutes aid, it forms an ‘aid scheme’ within the meaning of Article 1(d) of Regulation (EU) 2015/1589. The aid granted under the aid scheme is incompatible with the internal market and was unlawfully put into effect by the United Kingdom in breach of Article 108(3) of the Treaty.

Article 2

1 The United Kingdom shall recover all incompatible aid granted under the aid scheme from the beneficiaries of that aid.

2 The sums to be recovered shall bear interest from the date on which they were put at the disposal of the beneficiary in question until their actual recovery. For the purposes of this Article, aid is deemed to be put at a beneficiary's disposal, with respect to each year, on the day that the tax foregone for that tax year as a result of the aid scheme would have fallen due in the absence of the aid scheme.

3 The interest on the sums to be recovered shall be calculated on a compound basis in accordance with Chapter V of Regulation (EC) No 794/2004.

4 The United Kingdom shall cancel all outstanding payments of aid granted under the aid scheme, and shall cease granting the benefit of the aid scheme with effect from the date of notification of this Decision.

5 Article 1 shall not apply to aid granted on the basis of the contested measure if, at the time the aid was granted, it fulfilled the conditions laid down in the Commission Regulation (EU) No 1407/2013⁽¹²⁶⁾.

Article 3

1 Recovery of the aid in accordance with Article 2 shall be immediate and effective.

2 The United Kingdom shall ensure that this Decision is fully implemented within four months following the date of notification of this Decision.

Article 4

1 Within two months following notification of this Decision, the United Kingdom shall submit the following information to the Commission:

- a a list of the beneficiaries that have received aid under the aid scheme;
- b a list of the tax payers that have applied the group financing exemption to non-trading finance profits from qualifying loan relationships falling within Section 371EC (capital investments from the UK) of Part 9A of TIOPA and not falling within Section 371EB (UK activities) of Part 9A of TIOPA;
- c for each beneficiary, the CFC charge actually charged in determining the beneficiary's liability under the corporate income tax return, for each tax year that he has applied the group financing exemption, as well as the relevant corporate income tax return forms⁽¹²⁷⁾;
- d for each beneficiary, the CFC charge that would have been charged if he had not applied the group financing exemption, including underlying calculations, for each tax year that the beneficiary has applied the group financing exemption;
- e the total aid amount and its detailed calculation (principal aid amount and recovery interest) to be recovered from each beneficiary;
- f documents demonstrating that the beneficiaries have been ordered to repay the aid.

2 For each beneficiary, the United Kingdom shall supply the Commission with supporting evidence demonstrating how the extent to which non-trading finance profits from

qualifying loan relationships fall within Section 371EB of Part 9A of TIOPA has been calculated.

3 For each tax payer, referred to in paragraph (1)(b) of this Article, the United Kingdom shall supply the Commission with supporting evidence demonstrating that the non-trading finance profits from qualifying loan relationships fall within Section 371EC of Part 9A of TIOPA and do not fall within Section 371EB of Part 9A of TIOPA.

4 The United Kingdom shall keep the Commission informed of the progress of the national measures taken to implement this Decision until recovery of the aid in accordance with Article 2 has been completed. On request by the Commission, it shall immediately submit information on the national measures already taken and on those planned to be taken, in order to comply with this Decision, including detailed information on the amounts of aid and recovery interest already recovered from the beneficiaries.

Article 5

This Decision is addressed to the United Kingdom of Great Britain and Northern Ireland.

Done at Brussels, 2 April 2019.

For the Commission

Margrethe VESTAGER

Member of the Commission

- (1) OJ C 400, 24.11.2017, p. 10.
- (2) Additional requests for information were sent by letter of 11 March 2014, 4 June 2015 and 19 December 2016.
- (3) Distribution exemption rules were introduced in the Finance Act 2009 and the foreign branch profits exemption was introduced in the Finance Act 2011.
- (4) See <https://www.gov.uk/government/publications/the-corporation-tax-road-map>
- (5) Under the UK CFC regime, any company resident in a country other than the UK and controlled by one or more UK persons is a CFC. Control by UK residents is generally exercised by companies, but also interests of individuals or trustees may be taken into account to establish if a foreign subsidiary is a CFC. Control can be legal, economic or accounting control. It can be direct or indirect; if a UK resident company controls non-UK resident company A, which in turn controls non-UK resident company B, then both A and B are CFCs. Section 371RG of TIOPA broadened the definition of control so that the interests of non-resident associates are taken into account when considering whether a foreign company is a CFC.
- (6) HM Treasury, *Consultation on Controlled Foreign Companies (CFC) reform*, June 2011, recital 1.12.
- (7) *Ibidem*, recital 2.4.
- (8) Discussions for the current CFC rules arose in the context of many multinational enterprises moving their headquarters away from the UK: the 2010 Corporate Tax Roadmap stated that 'It is time to reverse this trend' by re-establishing the UK tax system as an asset. The UK Government identified the CFC reform in particular as a 'priority of our multinational business and a key step in the Government's plans to rebuild competitiveness'.
- (9) The UK already had CFC rules before 2013 which were based on an entirely different concept. The old CFC provisions did not contain an exemption for international group financing.
- (10) HMRC Internal Manual, International Manual, INTM190000, <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm190000>
- (11) The term 'assumed taxable total profits' is a defined term essentially referring to what the total taxable UK profits had been under the UK corporate tax rules, if the CFC had been a resident of the UK.
- (12) In the case of businesses in the financial sector the identification of key entrepreneurial risk-taking ('KERT') functions is central to this analysis.
- (13) Section 371DA(3)(f) of TIOPA.
- (14) See HM Treasury, *Consultation on Controlled Foreign Companies (CFC) reform*, June 2011.
- (15) House of Commons, Public Bill Committee, Finance Bill debate, 19 June 2012, PBC (Bill 001) 2012-2013, p. 466 (statement of the Exchequer Secretary to the Treasury).
- (16) Chapter 9 of TIOPA provides an optional alternative rule for certain profits normally covered under the CFC charge gateway rules of Chapter 5, but is not formally part of the CFC charge gateway.
- (17) Its purpose is to exclude CFCs that despite not meeting any of the entity level exemptions are unlikely to earn (significant) artificially diverted profits in a relatively simple way in order to keep the cost of administration of the CFC regime as low as possible. The conditions are relatively straightforward following a risk-based approach to facilitate self-assessment without any special requirements for documentation. The underlying principle of artificial diversion arising when there has been a separation of assets and risks from the underlying activity that supports the group's holding of those assets is evident here. For example, as regards trading profits, the CFC does not need to identify the presence of chargeable profits if it does not have assets and bears no risks that are managed or controlled from UK activities. Similarly, as regards non-trading finance profits, for example, if 5 % or less of a CFC's profits belong to that category (5 % safe harbour), they are considered incidental to business profits and are excluded from Chapter 5 under Chapter 3 of Part 9A of TIOPA.
- (18) Section 371CA (1) to (11) of TIOPA. Property business profits are completely excluded from the scope of the CFC charge gateway and from the definition of accounting profits for the purposes of the entity level exemptions in Chapters 10 to 14, see HMRC Internal Manual, International Manual, INTM248550.

- (19) Chapter 7 of Part 9A of TIOPA deals with CFCs earning profits carrying on captive insurance business. Chapter 8 of Part 9A of TIOPA, finally, deals with CFCs earning profits accrued by certain subsidiaries of regulated financial companies. Chapters 15 to 22 of Part 9A of TIOPA contain various operating and administrative rules, such as rules to prevent double taxation, rules about control, definitions and various other rules relevant to the proper application of the CFC rules by the UK tax authorities.
- (20) HMRC, *CFC reform: response to consultation*, December 2011, Executive Summary, key points.
- (21) Section 371DA of TIOPA, see also the HMRC Internal Manual, International Manual, INTM200100 ‘Chapter 4 provides a mechanism for determining the extent to which any of a CFC’s assumed total profits [...] pass through the CFC charge gateway (“Chapter 4 profits”) and are thus potentially subject to the CFC charge because of specific UK activities that have allowed the CFC to make those profits’.
- (22) HMRC Internal Manual, International Manual, INTM200100 as well INTM197200: ‘Chapter 4 will apply to and bring overseas trading profits within the scope of the CFC charge [...] where the CFC is diverting profits from the UK by means of a separation of assets and risks from the underlying activity that supports the group’s holding of those assets, or that necessarily goes with its bearing of that risk’.
- (23) Section 371DA (3)(f) of TIOPA. See also HMRC Internal Manual, International Manual, INTM200300.
- (24) HMRC Internal Manual, International Manual, INTM203310, states that ‘Like Chapter 4, Chapter 5 identifies NTFP from assets that are owned by the CFC and profits from risks allocated to the CFC in situations where relevant significant people functions (SPF) are carried out in the UK’ and on this basis chapter 5 imports many of the step tests from Chapter 4.
- (25) For example, application of the Chapter 4 test to certain trading finance profits of a CFC may lead to the conclusion that no profits pass through the CFC charge gateway on the basis of Chapter 4. But that conclusion does not exclude the possibility that some or all of those trading finance profits may pass through the CFC charge gateway — and thus become chargeable profits — on the basis of Chapter 6.
- (26) A foreign subsidiary involved in one or more incidental intercompany finance transactions will need to apply the Chapter 5 tests to assess whether a CFC charge applies whereas a subsidiary engaged in active group treasury activities will need to apply either the general Chapter 4 or Chapter 6 specifically dealing with trading finance profits.
- (27) A CFC that earns both NTFP and other types of profit may also need to apply other charging chapters, but a CFC earning solely NTFP is exclusively dealt with under Chapters 5 and 9.
- (28) This test is indeed very similar to the test applied under Chapter 4 to assess artificial diversion of ‘other profits’ of a CFC, essentially normal business profits. In particular, the test whether NTFP from assets owned by the CFC and from risks allocated to the CFC are related to relevant SPF which are carried out in the UK, refers to the principles from the authorised OECD approach, as set out in the 2010 Report on the Attribution of Profits to Permanent Establishments. It therefore also comprises the term KERT functions, which is used for businesses in the financial enterprise sector.
- (29) Consequently, if a CFC earns interest income from loans, whereby the relevant decision making and supervisory functions related to granting and managing the loan and interest payments are carried out from the UK, the interest income will be captured by the CFC rules and taxed in the UK.
- (30) UK connected capital is defined as any direct or indirect, formal or informal contribution of capital by a UK connected company into the CFC as well as any amount of CFC profits that were identified as ‘artificially diverted profits’ for any earlier accounting period and are now used to fund subsequent loans of the CFC.
- (31) These two additional specific tests look at whether the NTFP arises from arrangements in lieu of dividends to UK resident companies or an arrangement regarding UK finance leases.
- (32) According to the specific Chapter 6 test, trading finance profits of a CFC pass through the CFC charge gateway to the extent they are funded with excess equity from UK connected capital contributions. While the Chapter 5 gateway for NTFP uses the broader criterion of any UK connected capital funding for its alternative test, the specific test in Chapter 6 for trading finance profits is based on ‘excess free capital’ of the CFC, i.e. capital over that which it would be reasonably expected to have it was not a 51 % subsidiary of another company (Section 371FA of

- TIOPA). Only in circumstance of excess equity funding from UK connected capital will assumed profits pass through this gateway and become subject to a CFC charge.
- (33) Such a company will effectively be operating in a manner similar to a retail bank: a high volume of transactions, a large number of incomings and outgoings, hedging activity. Structural lending activity will largely be funded from group deposits and, overall, it will realise a profit based on margins between lending activities and deposit taking.
 - (34) To determine whether a CFC is a 'group treasury company', Section 316(5) to (11) of TIOPA applies.
 - (35) Section 371CE(2) of TIOPA.
 - (36) See recital 36.
 - (37) Qualifying resources are those loans of the CFC that are not directly or indirectly linked to wider group funds and include profits of the CFC deriving from the making of loans to relevant members of the CFC group which are used solely for the purposes of the business of the CFC group in the relevant territory, or funds or other assets received by the CFC in relation to shares held by the CFC in, or issued by the CFC to, members of the CFC group (see Section 371IB of TIOPA).
 - (38) Section 371IE of TIOPA. Under the matched interest rule, any CFC charge remaining after the application of the partial or full exemption, is capped at the level of net UK interest expense within the UK group. The cap prevents a CFC charge when the UK members of the group, in aggregate, have net financing income which is equal to or greater than their net financing deductions (HMRC Internal Manual, International Manual, INTM216100).
 - (39) The department of the UK Government responsible for the collection of taxes is known as *Her Majesty's Revenue and Customs* ('HMRC').
 - (40) HMRC Internal Manual, International Manual, INTM216100.
 - (41) UK letter dated 15 January 2018, paragraph 58.
 - (42) Point 6 of the Minutes of the CFC Monetary Assets working group meeting of 4 February 2011.
 - (43) Section 371IG of TIOPA outlines tracing rules to identify when a loan provided by a CFC is a qualifying loan relationship, addressing situations where the party initially receiving the loan uses the funds to provide a loan itself (the 'ultimate debtor' rule). See also HMRC Internal Manual, International Manual, INTM217100.
 - (44) See HMRC Internal Manual, International Manual, INTM216100. In addition, it was also stated that the inclusion of this exemption aims to have a fixed low tax-rate applicable on intra-group financing which would in most situations 'give rise to an effective UK corporation tax rate on profits overseas intra-group financing of 5,75 % by the year 2014'. HMRC Consultation on CFC reform, June 2011 at 1.10.
 - (45) Section 371DG of TIOPA. HMRC have published additional guidance on the operation of the test in the specific context of Chapter 9 and NTFP (HMRC Internal Manual, International Manual, INTM216650).
 - (46) Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, [OJ L 193, 19.7.2016, p. 1](#)).
 - (47) http://www.legislation.gov.uk/ukpga/2019/1/pdfs/ukpga_20190001_en.pdf
 - (48) This concerns for example the definition of control, low tax and shifted profits but also administrative provisions on the computation of the CFC profits and the prevention of double taxation.
 - (49) OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. <http://dx.doi.org/10.1787/9789264202719-en>
 - (50) OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241152-en>
 - (51) OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, paragraph 85, footnote 12. The report does not make any reference to special exemptions in CFC rules for group financing income.

- (52) Directive (EU) 2016/1164. According to Article 11 of the Directive, Member States shall have implemented and apply the provisions of the Directive from 1 January 2019.
- (53) Article 8 of the Anti Tax Avoidance Directive further illustrates the way to compute CFC profits.
- (54) With effect from 14 October 2015, Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union (OJ L 248, 24.9.2015, p. 9), repealed and replaced Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty (OJ L 83, 27.3.1999, p. 1). Any reference to Regulation (EC) No 659/1999 may be construed as a reference to Regulation (EU) 2015/1589 and should be read in accordance with the correlation table in Annex II to the latter regulation.
- (55) The UK authorities nevertheless note that also in case of a narrower reference system, i.e. the UK CFC regime, the outcome of the State aid assessment will be the same if the objectives are correctly defined.
- (56) Case T-287/11, *Heitkamp BauHolding GmbH v European Commission*, ECLI:EU:T:2016:60 and Case T-620/11, *GFKL Financial Services AG v European Commission*, ECLI:EU:T:2016:59.
- (57) The UK authorities outline the alternative approaches that were considered at the time of implementing reform of the CFC rules, to the current CFC rules enacted in 2013. The UK authorities further explain why none of these alternative options were chosen (UK letter dated 22 March 2018, Section 4).
- (58) UK letter dated 15 January 2018 in response to the European Commission Opening Decision at recital 106.
- (59) In the case of upstream lending, the UK resident group company can deduct the interest expense on this loan from its profits while the interest income on the investment is not taxed (or subject to low tax) at the level of the CFC. In this situation, the UK considers that the combination of the non-taxation of the NTFP at the level of the CFC, and the interest deduction in the UK poses a threat to the UK treasury. The UK considers that there is no valid commercial reason for structuring finance from a UK resident company through a CFC instead of lending the money directly to the other UK company. Therefore, both the purpose and the effect of the finance arrangement would be to artificially divert interest income from the UK and thereby obtain a UK tax advantage. Similarly, in the case of money boxes the likelihood of profits actually being artificially diverted and the impact on the UK's tax base is substantial, according to the UK authorities.
- (60) UK letter dated 3 July 2018, Annex point 3.
- (61) Commission Decision 2009/809/EC of 8 July 2009 on the groepsrentebox scheme which the Netherlands is planning to implement (C 4/07 (ex N 465/06)) (OJ L 288, 4.11.2009, p. 26).
- (62) Commission Decision 2010/95/EC of 28 October 2009 on State aid C 10/07 (ex NN 13/07) implemented by Hungary for tax deductions for intra-group interest decisions (OJ L 42, 17.2.2010, p. 3).
- (63) UK letter dated 15 January 2018, recital 119.
- (64) Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, ECLI:EU:C:2006:544.
- (65) Joined Cases C-106/09 P and C-107/09 P, *Commission v Government of Gibraltar and United Kingdom*, ECLI:EU:C:2011:732.
- (66) See Case C-399/08 P, *Commission v Deutsche Post*, ECLI:EU:C:2010:481, paragraph 38 and the case-law cited therein.
- (67) See Case C-399/08 P, *Commission v Deutsche Post*, ECLI:EU:C:2010:481, paragraph 39 and the case-law cited therein.
- (68) See Joined Cases C-106/09 P and C-107/09 P, *Commission v. Government of Gibraltar and United Kingdom*, ECLI:EU:C:2011:732, paragraph 72 and the case-law cited therein.
- (69) See Case 730/79, *Phillip Morris*, ECLI:EU:C:1980:209, paragraph 11 and Joined Cases T-298/97, T-312/97 etc., *Alzetta* ECLI:EU:T:2000:151, paragraph 80.
- (70) Clearances can be obtained under a non-statutory clearance procedure whereby the HMRC may provide certainty to a UK resident company as to the application of the CFC rules to their particular set of facts, resolving areas of doubt prior to the completion of the self-assessment tax return by

the UK resident company (see also recital 46). Requesting such clearance is voluntary. It is not a condition for the application of the measure and does not constitute an implementing measure within the meaning of Article 1(d) of Regulation (EU) 2015/1589.

- (71) See Joined Cases C-182/03 and C-217/03, *Belgium and Forum 187 ASBL v Commission*, ECLI:EU:C:2006:416, paragraph 82; Case 248/84, *Germany v Commission*, ECLI:EU:C:1987:437, paragraph 18; and Case C-75/97, *Belgium v Commission*, ECLI:EU:C:1999:311, paragraph 48.
- (72) Case C-143/99, *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke*, ECLI:EU:C:2001:598, paragraph 41.
- (73) Case 173/73, *Italy v Commission*, ECLI:EU:C:1974:71, paragraph 13.
- (74) See Case C-66/02, *Italy v Commission*, ECLI:EU:C:2005:768, paragraph 78; Case C-222/04, *Cassa di Risparmio di Firenze and Others*, ECLI:EU:C:2006:8, paragraph 132; Case C-522/13, *Ministerio de Defensa and Navantia*, ECLI:EU:C:2014:2262, paragraphs 21 to 31.
- (75) HMRC Internal Manual, International Manual, INTM203410. Section 371EB of TIOPA, to which the Guidance refers, is the provision within Chapter 5 that contains the SPF test, prescribing a CFC charge to the extent the CFC's NTFP are derived from relevant SPF located in the UK.
- (76) Case C-374/17, *Finanzamt B v A-Brauerei*, ECLI:EU:C:2018:1024, paragraphs 35 and 36.
- (77) See Opening Decision, recital 61. The Commission put forward an alternative narrower reference system made up of Chapters 3, 5 and 9 of TIOPA in footnote 52 of the Opening Decision. The Commission is not pursuing this narrower reference system.
- (78) UK letter dated 22 March 2018.
- (79) Case C-374/17, *Finanzamt B v A-Brauerei*, ECLI:EU:C:2018:1024, paragraph 37.
- (80) The UK does, however, need to respect the limits set by the CJEU where an anti-abuse rule may pose a limitation to the EU freedom of establishment.
- (81) The comparability test is not a test of its own. It must always be made in light of the objective of the reference system, which is actually the benchmark, and thus of primary importance, see case C-203/16 P, *Dirk Andres v European Commission*, ECLI:EU:C:2018:505, in particular paragraphs 86 and 89.
- (82) Case C-374/17, *Finanzamt B v A-Brauerei*, ECLI:EU:C:2018:1024, Paragraph 33.
- (83) See Opening Decision, recital 61.
- (84) See Section 371CC of TIOPA.
- (85) If a CFC exclusively earns NTFP, it is exclusively covered by Chapters 5 and 9 which also contains a SPF test, which is however slightly different. If a CFC exclusively earns property business profits, it is not covered by the CFC rules because such profits by their nature cannot be diverted from the UK.
- (86) See Section 371DB of TIOPA. CFC rules based on profit attribution to special people functions is well recognised both in International and in EU regulations concerning CFC provisions. The final OECD BEPS report OECD (2015) Final Report on Action 3 on the effective design of CFC rules for example highlights that many European jurisdictions rely, or partially rely, on a substance based test analysing if the CFC is engaged in substantial activities by using a variety of proxies, most notably whether the CFC's income was separated from the underlying substance, including the people premises assets and risks. The Report stresses that regardless of the tests used the fundamental question pertaining to substance is 'whether the CFC had the ability to earn the income itself' — in line with the objective of the SPF test. In discussing the best practice for the design of a substance analysis the Report advocates for a test that would examine all the 'significant functions performed by entities within the group' to determine whether the CFC is the entity most likely to own particular assets, or undertake particular risks if the entities were unrelated. The Report identifies the UK CFC rules as an exemplification of this SPF test stating that the UK CFC rules have 'used the concepts and guidance developed by the OECD for Article 7 to identify the group's significant people functions associated with each asset, so that it can be determined whether the CFC undertakes those functions'. At a European level, the preamble to Directive (EU) 2016/1164 recalls that it is a 'proportionate response to BEPS concern' to 'limit their CFC rules to income which has been artificially diverted to the subsidiary precisely target situations where most of the decision-making functions which generated diverted income at the level of the controlled subsidiary are carried out in the Member State of the taxpayer'.

- (87) HMRC Internal Manual, International Manual, INTM200200.
- (88) See for example HMRC Internal Manual, International Manual, INTM210200.
- (89) While it is true that Chapter 4 does not apply to a CFC that *exclusively* earns NTFP, in which case only Chapter 5 applies, this does not affect this conclusion, since Chapter 5 to a large extent replicates the SPF test of Chapter 4 as explained in recitals 121 and 122.
- (90) The application of the SPF test under Chapter 4 is done through an 8-step method (Section 371DB(1) of TIOPA). Chapter 5 refers back to Chapter 4 and requires some of the steps in Chapter 4 to be taken; specifically steps 1 to 5 and 7 to determine the extent to which NTFP fall within Chapter 5. Steps 6 and 8 are not taken because the UK legislator considered that those steps were not relevant for NTFP.
- (91) Judgment of the Court of Justice of 15 November 2011, *Commission and Spain v Government of Gibraltar and United Kingdom*, C-106/09 P and C-107/09 P, ECLI:EU:2011:732, paragraph 75. See also Judgment of the Court (Grand Chamber) of 21 December 2016, *European Commission v World Duty Free Group SA and other*, C-20/15 P and C-21/15 P, ECLI:EU:C:2016:981, paragraph 54.
- (92) NTFP means interest income that has not been earned from a finance trade or business; it includes interest income from passive portfolio investments, interest earned on a bank deposit or interest earned on incidental loans to related or unrelated parties.
- (93) Section 371IG(1) of TIOPA.
- (94) Other NTFP in this regard can be either derived from loans to UK Group companies, or from loans to third parties.
- (95) See recital 66.
- (96) See recital 71.
- (97) UK letter dated 15 January 2018 in response to the Opening Decision at recital 116.
- (98) UK letter dated 15 January 2018 in response to the Opening Decision at recital 117.
- (99) In this respect, see HMRC, International Manual, INTM217190: ‘If a CFC makes a long-term loan to the UK resident treasury company, which in turn uses the funds to make a series of short term loans to other group members, then the NTFPs of the CFC will most likely fall within Chapter 5 and, if a claim under Chapter 9 is made, the ultimate debtor rules will need to be considered.’
- (100) Base erosion can be distinguished from artificial diversion of profits (or profit shifting) in that the former deals with erosion of the *payer’s* tax base by excessive deductions, whereas the latter deals with the *recipient* of income who reduces his tax base by artificially diverting that income abroad. The former is generally dealt with by interest limitation rules (see for example Article 4 of the Anti Tax Avoidance Directive), whereas CFC rules address the latter.
- (101) The provisions defining the ‘ultimate debtor’ (see footnote 43) do not affect that conclusion, since they do not contain any conditions for the (commercial) use of the funds by the debtor under the loan arrangement, apart from provisions concerning on-lending.
- (102) The G20/OECD BEPS Report on Action 3 states in paragraph 78: ‘The general concern underlying the treatment of interest and financing income is that this income is easy to shift and therefore could have been shifted by the parent into the CFC, possibly leading to overleveraging of the parent and overcapitalisation of the CFC. Interest and financing income is more likely to raise this concern *when it has been earned from related parties, when the CFC is overcapitalised*, when the activities contributing to the interest were located outside the CFC jurisdiction, or *when the income was not earned from an active financing business.*’ These situations objectively causing most concern for income shifting according to the OECD are precisely the circumstances to which the UK applies the contested measure.
- (103) UK letter in response to the Opening Decision dated 15 January 2018, point 155.
- (104) *Ibidem*, point 26.
- (105) Judgment of the Court of Justice of 12 September 2006, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, C-196/04, ECLI:EU:C:2006:544.
- (106) *Ibidem*, paragraph 65.
- (107) *Ibidem*, paragraph 66.

- (108) Joined Cases C-78/08 to C-80/08 of the Court of Justice of 8 September 2011, *Paint Graphos and others*, ECLI:EU:C:2011:550, paragraph 69.
- (109) HMRC Internal Manual, International Manual, INTM216100.
- (110) See, for example, Joined Cases C-78/08 to C-80/08, *Paint Graphos*, ECLI:EU:C:2011:550, paragraph 69 and 73 to 75 and Case T-287/11, *Heitkamp BauHolding GmbH v European Commission*, ECLI:EU:T:2016:60, paragraph 160.
- (111) HMRC Internal Manual, International Manual, INTM203380.
- (112) HMRC Internal Manual, International Manual, INTM203410.
- (113) Directive (EU) 2016/1164.
- (114) Case C-278/92, *Spain v. Commission*, ECLI:EU:C:1994:325, paragraph 75.
- (115) Case C-275/10, *Residex Capital IV CV*, ECLI:EU:C:2011:814, paragraphs 45-47.
- (116) Commission Regulation (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty (OJ L 140, 30.4.2004, p. 1).
- (117) *Letter of formal notice* of 22 March 2010, C(2010) 1521; *Reasoned Opinion* of 20 May 2011, C(2011) 3275 final.
- (118) Judgment of the Court of Justice of 24 March 2011, *ISD Polska and Others v Commission*, C-369/09 P, ECLI:EU:C:2011:175, paragraph 123; Judgment of the Court of Justice of 16 December 2010, *Kahla Thüringen Porzellan v Commission*, C-537/08 P, ECLI:EU:C:2010:769, paragraph 63; Judgment of the Court of Justice of 16 December 2008, *Masdar (UK) v Commission*, C-47/07 P, ECLI:EU:C:2008:726, paragraphs 34 and 81.
- (119) Case 73/79 of 21 May 1980, *Commission v Italy*, ECR, ECLI:EU:C:1980:129, paragraph 11; Case C-156/98 of 19 September 2000, *Germany v Commission*, ECR, ECLI:EU:C:2000:467, paragraph 78; and Cases T-197/97 and T-198/9731 of 31 January 2001, *Weyl Beef Products and Others v Commission*, ECR, ECLI:EU:T:2001:28, paragraph 75.
- (120) Case T-511/09 of 13 May 2015, *Niki Luftfahrt v Commission*, ECLI:EU:T:2015:284, paragraph 215.
- (121) Case T-308/00 *renv*, *Salzgitter v Commission*, ECLI:EU:T:2013:30.
- (122) See Judgment of the Court of Justice of 11 December 2012, *Commission v Spain ('Magefesa II')*, C-610/10, ECLI:EU:C:2012:530, paragraph 105.
- (123) Judgment of the Court of Justice of 4 April 1995, *Commission v Italy ('ALFA Romeo')*, C-348/93, ECLI:EU:C:1995:95, paragraph 27.
- (124) Case C-441/06, *Commission v France*, ECLI:EU:C:2007:616, paragraph 29 and the case-law cited.
- (125) Case C-148/04 of 15 December 2005, *Unicredito Italiano*, ECLI:EU:C:2005:774.
- (126) Commission Regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid (OJ L 352, 24.12.2013, p. 1).
- (127) Including preparatory material and relevant supplementary pages to the company tax return (e.g. form CT600B).