Commission finds UK finance company CFC exemption in part contrary to EU state aid rules

The European Commission has determined that the finance company exemption within the UK CFC rules was contrary to EU state aid rules to the extent that the exemption applied where there were UK activities in relation to the group funding.

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The European Commission has found that the group financing exemption within the UK CFC rules was, in part, illegal State Aid. The Commission's press release explains the Commission's view that, to the extent that the exemption applied whilst there was UK activities in relation to the group funding activities, then that gave rise to a selective advantage to certain multinational companies.

The UK is, in principle, now obliged to recover the illegal state aid from those companies that benefitted from the CFC exemption, but it is highly likely that the UK will appeal the decision.

The full version of the Commission decision dated 02 April 2019 has now been published.

Background

In 2013, the UK introduced a new and modernised CFC regime following extensive consultation. One aspect of this new regime was the inclusion of a "finance company exemption". This exemption enabled a UK headquartered group to use an foreign financing company (FFC) with the benefit of a 75% exemption from the CFC rules on intra-group financing activities outside the UK, notwithstanding that the income of that FFC might otherwise fall within the CFC rules. This might be the case because, for example, the funds used by the FFC for its financing activities derived from the UK or because activities related to the lending by the FFC took place in the UK.

The finance company exemption was an important part of the CFC rules and regarded as an attempt to provide a pragmatic solution. In particular, there was a desire to ensure that the rules did not include complex provisions on the tracing of funds back to the UK. The 75% exemption - and resulting 5% rate of tax at the time - was, therefore, very much a compromise.

The rules required that a FFC should be locally managed in its territory of residence, including an expectation that the management of monetary assets would include decision making relating to initiating and refinancing of intra-group loans. However, it was recognised that an FFC would not necessarily require significant substance in the form of employees

located in the company’s territory, depending on the level of activities being undertaken by the CFC.

Decision of the Commission

The decision of the Commission recognises that the financing company exemption can, in part, be justified by the UK. In particular, the Commission found that the restriction on the operation of the CFC rules in the context of determining the source of funds was justified. This was because “such an exemption avoids complex and disproportionately burdensome intra-group tracing exercises that would be required to assess the exact percentage of profits funded with UK assets. The Commission therefore acknowledges that, in line with UK arguments, the Group Financing Exemption in these cases provides for a clear proxy that is justified to ensure the proper functioning and effectiveness of the CFC rules”. On this issue, the Commission has accepted the UK’s arguments.

However, the Commission has not accepted that there was any need to extend the exemption to cases where there was significant UK involvement in the management of lending activities. Indeed, the press release states that “when financing income from a foreign group company, channelled through an offshore subsidiary, derives from UK activities, the Group Financing Exemption is not justified and constitutes State aid under EU rules”.

In these cases, the Commission rejected the argument that the exercise required to assess to what extent financing income derived from UK activities would be particularly complex or burdensome. Therefore, the use of a proxy rule in such cases was not justified and, according to the Commission, constitutes illegal state aid.

Recovery

EU state aid rules require that illegal state aid is recovered in order to remove the distortion of competition created by the aid. When State aid takes the form of tax measures or other levies, the amount to be recovered needs to be calculated based on a comparison between the amount of tax actually paid and the amount which should have been paid if the illegal exemption had not applied. Accordingly, the Commission points out that the UK should now reassess the tax liability of the UK companies that have illegally benefitted from the finance company exemption as it was applied to profits derived from UK activities.

Comment

The UK has already amended the finance company exemption within the CFC rules to ensure that it is compliant with the EU Anti-Tax Avoidance Directive (ATAD) which came into force with effect from 01 January 2019. In particular, the changes addressed the situation where “significant people functions” (SPFs) take place in the UK. The finance company exemption allowed a 75% exemption to apply to the finance profits of CFCs even where they derived from UK SPFs. The changes removed the exemption to the extent that finance profits derived from UK SPFs from 01 January 2019.

However, many international groups may be affected by the Commission’s ruling and will, unless the UK is successful in any appeal it brings, be required to account for any illegal benefit they received under the rules in place from 2013 to 2018. It would be down to HMRC to determine the exact amount that would need to be recovered on a case by case basis. However, given that the exemption was designed to ensure that multinational groups could rely on the simplified regime to avoid the need to provide detailed information on financing flows and people functions, it may be difficult in practice to accurately recreate the level of UK involvement in the management activities going back to 2012.

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