The ATAD CFC – All Roads Lead to Cadbury Schweppes

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It may well be said that George and Ira Gershwin's simple and unforgettable line, "Let's call the whole thing off!", sums up the European Commission's ("**Commission**") view that the "wholly artificial arrangement" limitation in *Cadbury Schweppes* (C-196/04) does not apply to the CFC rule in Art 7(2)(b) of the Anti-Tax Avoidance Directive ("**ATAD**").
It is indeed a tempting conclusion, on the basis that:

- Art 7(2)(b) ATAD is centred on a Significant People Functions (**"SPF"**) test;
- the SPF test only attributes to the controlling parent the income that the CFC is unable to earn (because it does not have the necessary SPFs for it); and
- the arm's length principle, on which the SPF test is based, does not restrict the EU fundamental freedoms.

However, that reasoning is deceptive in that it flows from an incorrect interpretation of Art 7(2)(b), and fails to address the interaction between CFC and transfer pricing rules.

The fork in the road

ATAD gives Member States a choice between two approaches to the definition of CFC income. That choice is explained in the Commission's state aid decision concerning the UK's CFC Group Financing Exemption at [43].

"The actual CFC rule is laid down in Article 7 of the Anti Tax (sic) 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 the 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."

The two options provide alternative definitions of "CFC income" i.e., the income earned by the CFC that should be attributed to the shareholders or controlling parties of the CFC. The "standard rule" **(Option "A")** is centred on specific types of income that are deemed to raise BEPS concerns. The "alternative rule" **(Option "B")** is centred on the level of activity in the CFC tested by reference to the SPFs performed within the group.

Critically, Option "A" is subject to a substance carve out while Option "B" is not (albeit in appearance only). This is, according to the Commission, because Option B does not restrict the freedom of establishment and therefore does not engage the "wholly artificial arrangement" limitation in *Cadbury Schweppes.* Thus, it claims, the substance carve-out is unnecessary and has thus been omitted.

The policy reasons behind the fork in the road

The definition of "CFC income" is the third "building block" in the BEPS Action 3 report, and Options A and B largely reflect the two approaches set out in that report. For that reason, Options A and B are different means to tackling the same problem: the BEPS risk associated with CFCs.

Option A operates as a "catch and release" mechanism. It first "catches" certain categories of the CFC's non-distributed income, and then "releases" the income if the CFC is engaged in genuine economic activities. The "substance carve-out" deals with the "release" part of the process, and is set out in a separate paragraph following the list of income categories. It is therefore in plain sight, and its purpose is to ensure compliance with the "wholly artificial arrangement" limitation in *Cadbury Schweppes.*

Option B's way of complying with the "wholly artificial arrangement" limitation is not immediately obvious, and the reason for that is that the "escape clause" has to be read into Option B as a matter of interpretation Option B reads:

> 2. Where an entity or permanent establishment is treated as a controlled foreign company under paragraph 1, the Member State of the taxpayer shall include in the tax base:
>
> (b) the non-distributed income of the entity or permanent establishment arising from **non-genuine arrangements** which have been put into 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." [Emphasis added]

All roads lead to *Cadbury Schweppes*

Reduced to its essentials, there are five key ingredients to explain why the Commission has misread Option B.

First, the ordinary meaning of "which" is to "add extra information to a previous clause". This in turn means that there are two cumulative conditions in Option B: the arrangement (i) must be a "**non-genuine arrangement**"; and (ii) must have been put into place for the "**essential purpose of obtaining a tax advantage**".

Secondly, determining whether an arrangement is a "non-genuine arrangement" (first condition) is tested by reference to the SPF test. The test is a proportionate one. Only the income linked to SPFs performed by the controlling parent is to be attributed to the controlling parent. That is clear from Art 8 ATAD.

Thirdly, the term "obtaining a tax advantage" (second condition) is also used in the GAAR in Art 6 ATAD. It follows that the intention must be for the term to bear the same meaning in Articles 6 and 7 ATAD (as the opposite view would give different meanings to the same term used in different places within ATAD). The only variation between Articles 6 and 7, in respect of the obtaining a tax advantage test, lies on whether it is the "essential", or the "main" or "one of the main" purpose[s] of the arrangement. That difference is, however, a threshold issue, and does nothing to obscure the meaning of the term "obtaining a tax advantage". It only indicates that the threshold requirement in Art 7 (CFC rule) is higher than the threshold requirement in Art 6 (GAAR) -as the "main" or "one of the main" does not need to be the "essential" purpose-, and may also signal conformity with *Cadbury Schweppes*, as in practical terms "essential" operates as a synonymous of "central", which is the term used in the judgment at [72].

Fourthly, recourse to OECD materials is appropriate to interpreting the "obtaining a tax advantage" condition, as the ATAD GAAR draws from the BEPS Action 6 Final Report and the GAAR in Article 29(9) of the 2017 OECD Model Tax Convention. The argument for relying on OECD materials in this case is identical to the argument relied on by the ECJ in the so-called *Danish Beneficial Ownership* cases (particularly in C-115/16, C-118/16, C-119/16 and C-299/16 [at 90]) i.e., that the Interest Directive "draws upon" and "pursues the same objective, namely avoiding international double taxation" of its OECD counterpart. Similarly, the OECD GAAR and the ATAD GAAR draw upon the BEPS Action 6 report, and both the ATAD GAAR and the OECD GAAR pursue the objective of tackling treaty shopping and other forms of treaty abuse.

Fifthly, according to OECD materials, *bona fide* exchanges of goods, or movements of capital and persons (as opposed to arrangements whose "principal purpose" is to secure a more favourable tax treatment) are not captured by the GAAR. Whether or not the "obtainment" of the tax advantage is one of the principal purposes of the arrangement turns on an objective analysis of "relevant facts and circumstances" (OECD Commentaries at [178]). This is not far removed from the test laid down in *Cadbury Schweppes* at [67]: "based on **objective factors** which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of **premises**, **staff and equipment**". For CFC rules, premises, staff and equipment are, *inter alia*, the relevant facts and circumstances.

Back to square one, but why?

The common effect of Options A and B is that the EU(1)-resident parent will be taxed on some or all of the income earned by its EU(2)-resident subsidiary whilst, in a purely domestic transaction, the EU(1)-resident parent will not be taxed on the income earned by its EU(1)-resident subsidiary. Thus, the proposition that CFC rules are inherently restrictive of the fundamental EU freedoms (particularly establishment) remains true, regardless of how "CFC income" is defined. There remains a restriction on the fundamental EU freedoms, and that restriction is justified only if the national measure specifically targets wholly artificial arrangements.

CFC rules can capture income that is not captured by transfer pricing rules, and therefore the notion that Option B does not restrict the fundamental EU freedoms because it relies on transfer pricing methodology (the SPF analysis) is incorrect. As recognised in the BEPS Action 3 report [at 9], there is nothing preventing a country from subjecting the return allocated to a low-function cash box to a CFC charge if the low-function cash box is in a low tax territory. This, in other words, means that the "risk-free return" (see BEPS 8-10 report at [1.103]) which a funding company that neither performs, nor has control over the specific financial risks, would be able to retain, pursuant to current transfer pricing rules, could be subject to a CFC charge. The CFC charge would therefore arise after the operation of the arm's length principle, and would generate additional revenue for the country of the parent company.