

CFC CODE REMOVED FROM STATUTE BOOK BY JUDGE¹

by Laurent Sykes

It is by now uncontroversial that domestic law which enters into conflict with directly enforceable Community law rights must be disapplied so as to give effect to those rights. This flows from s2 European Communities Act 1972 and the principle of direct effect.² What happens, however, where a provision is capable of entering into conflict with directly enforceable Community law rights on *some* occasions but *also* applies in situations which have nothing to do with the exercise of directly enforceable Community law rights? There is, in the writer's view, no basis for a disapplication of UK domestic law where there are no directly effective Community law rights to protect. So in the latter case the provision of domestic law stands. As a result a statutory provision may, so to speak, be "switched" on and off according to whether it enters into conflict with Community law. The uncertainty which results for users of the legislation is for the Member State to sort out. This point (although, in part at least, a question of UK domestic law) has been addressed by the ECJ in *ICI v Colmer*³:

"Accordingly, when deciding an issue concerning a situation which lies outside the scope of Community law, the national court is not required, under Community law, either to interpret its legislation in a way conforming with Community law or to disapply that legislation. Where a particular provision must be disapplied in a situation covered by Community law, but that same provision could remain applicable to a situation not so covered, it is for the competent body of the State concerned to remove that legal uncertainty in so far as it might affect rights deriving from Community rules.

Consequently, in circumstances such as those in point in the main proceedings, Article 5 of the Treaty does not require the national court to interpret its legislation in conformity with Community law or to disapply the legislation in a situation falling outside the scope of Community law."

This very issue fell for consideration in *Vodafone 2*.⁴

Vodafone 2 concerns the controlled foreign companies ("CFC") regime⁵, the corporate tax cousin of s720 ITA 2007 (transfer of assets) and s13 TCGA 1992 (attribution of gains to members of non-resident companies). The CFC regime imposes a charge on UK resident companies with interests in UK controlled subsidiaries which are resident in low tax jurisdictions (subject to a limited number of exemptions).

An example of the CFC code entering into conflict with directly effective Community law rights (in that case rights under Article 43 of the EC Treaty (freedom of establishment)) is a CFC charge imposed on a UK company carrying on genuine economic activities in the EU through its local subsidiary (even if the activities are being carried on outside the UK purely to save tax). The ECJ said so in *Cadbury Schweppes*⁶. An example of the CFC code *not* entering into conflict with directly effective Community law rights is the imposition of a CFC charge on a UK company carrying on genuine economic activities in a country which is not in the EU through

its local subsidiary⁷. Yet another case of the CFC code *not* entering into conflict with directly effective Community law rights is the imposition of a CFC charge on a UK parent company in respect of an EU subsidiary in circumstances where there is no genuine establishment through the subsidiary, e.g. where it is merely a “brass plate operation”. That is because (as the ECJ put it in *Cadbury Schweppes*):

“the concept of establishment within the meaning of the Treaty provisions on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period. Consequently it presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there.”⁸

The requirement for an “actual establishment” before the freedom of establishment in Article 43 can be engaged was expanded upon by Advocate General Léger in his Opinion in *Cadbury Schweppes*. He referred to the need to examine “whether the subsidiary has the premises, staff and equipment necessary to carry out the services provided to the parent company which have resulted in the reduction of the tax due in the State of origin”. This approach was followed by the ECJ, which referred to “the extent to which the CFC physically exists in terms of premises, staff and equipment”.

The judge’s decision

The *Vodafone 2* case concerned the legitimacy of HMRC’s enquiry into the accounting period of Vodafone 2 for the year ended 31 March 2001. The enquiry was stated to be for the purposes of establishing whether Vodafone 2 was liable to a charge under the UK’s CFC legislation in respect of the profits of its wholly owned Luxembourg subsidiary. HMRC argued that, even if the CFC regime was incompatible with Article 43 of the EC Treaty, Vodafone 2 should still be required to demonstrate that it was genuinely established in Luxembourg through its subsidiary before the CFC regime could be disapplied in relation to it. As a result the enquiry should continue. The judge rejected this submission. He decided that the CFC code was to be disapplied, irrespective of whether Vodafone 2 was genuinely established in Luxembourg (an issue which could have been determined by being remitted back to the Special Commissioners, as well as, possibly, a continuation of the enquiry process). In effect, the CFC code was, on the judge’s analysis, removed from the statute book irrespective of whether Community law-protected rights were being exercised. He said:

“The CFC legislation and the motive test are of potentially wide application throughout the UK business world. To adapt the speech of Lord Hope in [the *Fleming*⁹] case, the nature of the defect [in the UK CFC legislation] is such that a single solution is required that can reasonably be applied to all taxpayers. That can only be done by Parliament, or possibly by appropriate executive steps as was suggested by the House of Lords in the *Fleming* case....

In my judgment the CFC legislation, which depends on Section 747 and Section 748 for its effectiveness, must be disapplied so that, pending such amending legislation or executive action, no charge can be imposed on a company such as Vodafone under the CFC legislation. It follows that

HMRC's enquiry into Vodafone's tax return for the Accounting Period has no legitimate purpose and should be closed."

It is not clear whether the disapplication of the CFC code was considered by the judge to extend to companies in respect all overseas subsidiaries (that would be a "single solution") or in respect of EU subsidiaries only (that would apply to companies "such as" Vodafone 2, but would not, in all senses at least, be a "single solution"). That is of course a point of fundamental importance in practice. In the former case this would allow companies with CFCs in non-EU jurisdictions to "piggy back" from the disapplication of the CFC code to give effect to directly enforceable Community law rights even in cases when no such rights were being exercised. In the writer's view however, the judge's decision is flawed on either basis. The proper relationship between Community law and domestic law requires directly effective Community law rights to be exercised before a provision of domestic law which conflicts with those rights can be disapplied.

The relationship between Community law and national law

The *ICI* case dealt with the point at issue. The ECJ judgment in that case (see above) makes it clear that the disapplication of a provision of national law is required only to the extent necessary to permit directly enforceable Community law rights to be exercised unhindered. Moreover, domestic case law suggests that, in giving effect to Community law rights, the relevant provisions of national law take effect "as if enacted as being without prejudice to" the directly enforceable Community rights in question.¹⁰ A process of "moulding" or "adapting" consequential provisions may be appropriate¹¹ as a result. That was not the rather more heavy-handed approach adopted by the judge in *Vodafone 2*. He considered the CFC code to be disapplied in a manner which made the question of enforceable Community rights irrelevant. The basis for the disapplication of the CFC regime given by the judge was the uncertainty for taxpayers which would result were the CFC regime to be effective on some occasions and on others not. Confusion would result. In the writer's view however the "switching" on and off a provision according to whether it is conflict with Community law is of course unwelcome, but it is an issue for Parliament, not the judiciary.

The case of *Fleming*, cited by the judge in *Vodafone 2*, does not provide support for the judge's reasoning on this point. The case concerned the absence of transitional provisions in changes to the VAT time limit rules which, as Lord Walker put it, resulted in an "infringement of directly enforceable Community rights"¹². Transitional provisions which were Community law compliant could not be read into the domestic legislation, since that would have amounted to the invention of transitional rules by the courts. This would have resulted in uncertainty for taxpayers, who would never have been in a position to know from the face of the legislation what those Community law compliant transitional measures might have been. The avoidance of uncertainty therefore required the offending measures to be disapplied completely, until Community law-compliant transitional rules were introduced by the legislature.

The *Fleming* case involved directly enforceable Community rights only, however, since it concerned claims for repayment of VAT under the VAT Directive.

Fleming was therefore, it is submitted, an imperfect analogy for the judge to draw on in *Vodafone 2* since the case did not address the disapplication of domestic law in cases where it did not enter into conflict with directly effective Community law rights.¹³ At some point *Vodafone 2* should therefore, in the writer's view, have been required to demonstrate that it was exercising a right of establishment protected by the EC Treaty before the CFC legislation was disappplied in relation to it, whether this was through an enquiry on the basis of "remoulded" CFC legislation which exempts cases where a genuine right of establishment in the EU is being exercised¹⁴ or, more probably, a further Special Commissioners' hearing.

The other point

Little has been said above in relation to the point which occupied most of the judgment, namely the question of whether a specific exemption in the CFC code (the motive test, contained in s748(3) ICTA 1988) could be construed so as to allow the CFC code to be compatible with Article 43. The judge found, reversing the Special Commissioners, that it could not be. In the writer's view the impact of this issue on the facts of the *Vodafone 2* case should have been procedural only. On any analysis *Vodafone 2* should have been required to demonstrate that it was actually established in Luxembourg.

Had the judge found that the motive test *could* be read as compatible with Article 43, then this would have resulted in the disapplication of the CFC regime in relation to *Vodafone 2* only if it could show that it was indeed exercising its right of establishment in the EU through the Luxembourg subsidiary: i.e. if, through the subsidiary, *Vodafone 2* was actually established in Luxembourg and carrying on genuine economic activities there. However, if the motive test could *not* be construed as compatible with Article 43, the CFC regime should also have been disappplied in relation to *Vodafone 2*, this time as a consequence, not of the motive test, but of the direct effect and supremacy of Community law, as a result of which measures of domestic law which offend directly effective provisions of Community law are disappplied to give effect to Community law. However, this would have required *Vodafone 2* to qualify for the protection of Article 43 in the first place. This too would, once again, have required it to be shown that, through the subsidiary, *Vodafone 2* was actually established in Luxembourg and carrying on genuine economic activities there.

In both cases therefore one would have expected that the company would have been required to demonstrate that it was actually established in Luxembourg and carrying on genuine economic activities there.¹⁵ The judge's conclusion, however, was that finding the CFC code to be incapable of being read as compatible with directly effective Community law rights was the end of the matter. Whether that is indeed the position was, in the writer's view, a more fundamental issue on the facts than the construction of the motive test and should have been addressed at the outset, rather in the last few paragraphs of the judgment.

Where does this leave us?

The discussion above should not be taken to suggest that a taxpayer who does not exercise directly enforceable Community law rights, as a result of provisions of domestic law which are in breach of the EC Treaty, has no Community law rights –

e.g. an action for damages. However that issue is distinct from the disapplication of the offending measure of domestic law.

The *Vodafone 2* decision is, it is understood, being appealed. The writer's expectation is that the relationship between Community law and domestic law set out in *ICI* will be re-established and that it will therefore at some point be necessary to determine whether *Vodafone 2* was, in 2001, exercising its freedom of establishment in the EU through its Luxembourg subsidiary, in order for the CFC regime to be disappplied in relation to it.

¹ The subject of this article is also addressed in an article by the writer for the British Tax Review to be published later this year ([2008] 5 BTR).

² *R v Secretary of State for Transport, ex p Factortame Ltd (No 2)* [1991] 1 AC 603 and Case 106/77, *Amministrazione delle Finanze dello Stato v Simmenthal SpA*. [1978] ECR 629, [1978] 3 CMLR 263, ECJ: "Any national court must, in a case within its jurisdiction, apply Community law in its entirety and protect rights which the latter confers on individuals and must accordingly set aside any provision of national law which may conflict with it, whether prior to or subsequent to the Community rule."

³ Case C-264/96 *Imperial Chemicals Industries plc (ICI) v Colmer (Inspector of Taxes)* [1998] STC 874 at [34] and [35].

⁴ *Vodafone 2 v HMRC* [2008] EWHC 1569 (Ch), [2008] STC 2391

⁵ Contained in Chapter IV Part XVII ICTA 1988

⁶ Case C-196/04 *Cadbury Schweppes plc v IRC* [2006] STC 190.

⁷ And also outside the non-EU EEA, since similar considerations apply to the EEA as apply to the non-EU EEA. As to the possible application of Article 56, case C-201/05 *The Test Claimants in the CFC and Dividend Group Litigation v HMRC* [2008] STC 1513 suggests that this would not be of assistance to the UK parent of a non-EU subsidiary. However the ECJ did not deal fully with the possibility that a CFC charge can be imposed even where the UK company on which the charge is imposed is not the UK resident controlling the CFC.

⁸ Case C-196/04 *Cadbury Schweppes plc v IRC* [2006] STC 190 at [54].

⁹ *Fleming (trading as Bodycraft) v HMRC; Condé Nast Publications Ltd v HMRC* [2008] UKHL 2, [2008] STC 324.

¹⁰ Per Lord Nolan in *ICI v Colmer (Inspector of Taxes)* [1998] STC 874 at [23] and Lord Bridge in *R v Secretary of State for Transport, ex p Factortame Ltd* [1990] 2 AC 85 at 140.

¹¹ Per Lord Nicholls in *Re Claimants under Loss Relief Group Litigation Order* (sub nom *Autologic Holdings plc v IRC*) [2005] UKHL 54 [2005] STC 1357 at [17].

¹² At [26].

¹³ The point is well made by P. Davison, Freshfields Bruckhaus Deringer, in a *Letter to the Editor*, Tax Journal, Issue 946, 3.

¹⁴ It is not clear whether that was how HMRC were genuinely proposing to approach things, although it might have been, given that HMRC considered the motive test to be *Cadbury Schweppes*-compliant. Account must however be taken of HMRC's controversial views as to what establishment protected by Article 43 requires in practice, as one can glean from new ICTA 1988 section 751A, intended to make the CFC regime *Cadbury Schweppes*-compliant, and HMRC statements in relation to that provision. This would not have made the CFC legislation compliant with the EC Treaty (see Case C-33/03 *EC Commission v United Kingdom* [2005] STC 582 at [25]), but one would have nevertheless expected it to make the procedural imposition on *Vodafone* more likely to have been palatable to the court.

¹⁵ The difference may though have been relevant in determining the procedure for demonstrating this i.e. whether through a continuation of the enquiry process or a Special Commissioners' hearing to have the enquiry closed.