The Law Society

EU Commission State Aid investigation

Representations by The Law Society of England and Wales

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PREFACE

The Law Society of England and Wales ("The Society") is the professional body for the solicitors' profession in England and Wales, representing over 170,000 registered legal practitioners.

We refer to the Commission's letter to the Foreign Secretary of the United Kingdom dated 26 October 2017, and published on 24 November 2017 (the **Decision**) informing the United Kingdom (the **UK**) of its decision to open the procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union in relation to aspects of the UK's tax rules for controlled foreign companies (**CFCs**).

As the representative body of the UK's legal profession, which is concerned with the proper functioning and interpretation of the UK's legal code, the Society wishes to submit comments on the Decision.

Unless otherwise defined, capitalised terms in this submission are used in the same way as they are in the Decision. References to "Chapters" are to Chapters of Part 9A of TIOPA.

In summary, we agree with the position that we understand to have been put forward by the UK government that, properly construed, Chapter 9 of Part 9A TIOPA constitutes a delineation of the scope of the CFC rules, rather than an exemption from those rules and therefore forms part of the reference system for the purposes of a state aid analysis. We disagree with the criticisms of that analysis that are put forward in the Decision, for the reasons set out in more detail below. Even if Chapter 9 were to constitute a derogation, we consider that derogation does not result in enterprises in comparable legal and factual situations in view of the objectives of the reference system being treated differently, and we therefore do not agree that any derogation results in selective treatment. In view of the need to have regard to the wider objectives of the UK's tax legislation in relation to non-UK source income, it is in our view appropriate to regard the reference system for the purposes of this case as the general UK tax legislation as it applies to company taxation.

In this submission, we focus first on the objectives of the CFC rules, and then go on to discuss the application of those objectives to the definition of artificial diversion of income of group finance companies, before addressing certain aspects of the analysis of the Decision. More particularly:

- in sections 1 and 2, we discuss the objectives of CFC rules generally, and the background to Part 9A of TIOPA, in order to demonstrate the objectives of Part 9A TIOPA;

- in section 3, we then comment on the proper approach to interpretation of UK legislation, and in particular the need to construe legislation as a whole;

- in section 4, we address the main point of the Decision, which is how Part 9A of TIOPA identifies diversion of income, and whether that diversion is artificial. We demonstrate that the "full exemption" and the "partial exemption" for group financing income are both logical ways of defining whether income has been diverted, and, if so, whether that diversion is artificial;

- in section 5, we address the arguments about selectivity; and

- in section 6, we comment on certain aspects of the analysis in the Decision, which we believe is based on some incorrect assumptions about the underlying purpose and objective of the UK's CFC rules. In our view, this has resulted in the Decision coming to an erroneous conclusion that there has been a selective derogation from the CFC rules in the case of group financing companies.

1. OBJECTIVES OF CFC RULES GENERALLY

1.1 As helpfully set out in the OECD's report on CFC rules, *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report* (the **OECD Report**), CFC rules will be designed differently depending on the policy objectives of the relevant jurisdiction.

1.2 In paragraph 7 of the OECD Report, it states "CFC rules are generally designed to act as a deterrent. In other words, CFC rules are not primarily designed to raise tax on the income of the CFC. Instead, they are designed to protect revenue by ensuring profits remain within the tax base of the parent or, <u>in the case of CFC regimes that also target the stripping of third countries' bases ("foreign-to-foreign stripping"),</u> other group companies, typically by preventing taxpayers from shifting income into CFCs." (our emphasis). In other words, CFC rules may legitimately not be addressed to counteracting the stripping of third countries' bases: where a jurisdiction operates a territorial approach to CFC rules, the focus will be on protecting the tax base of the parent and there will not be rules to target base erosion in other jurisdictions.

1.3 At paragraph 13, the OECD Report goes on to say "If a jurisdiction has a worldwide tax system, its CFC rules could apply broadly to any income that is not being currently taxed in the parent jurisdiction and still remain consistent with the parent jurisdiction's overall tax system. If, however, a jurisdiction has a territorial tax system, it may be more consistent for its CFC rules to apply narrowly and only subject income that <u>should have been taxed</u> in the parent jurisdiction to CFC taxation." (our emphasis). In the context of a territorial system, a key policy question for the jurisdiction will therefore be how to define income that "should have been taxed" there. The OECD Report states at paragraph 15, "jurisdictions with territorial systems are more likely to tax only income that was clearly diverted from the parent jurisdiction". Definitions of diversion will differ between jurisdictions depending on their priorities, which are clearly policy decisions to be taken by those jurisdictions.

2. CONTEXT OF UK CFC RULES

2.1 The current CFC rules were introduced against the backdrop of a wholesale change to the UK system for taxing foreign income of companies, required as a result of a number of decisions of the European Court of Justice[1]. These cases required the UK to amend its system of taxation of foreign dividends and subsequently, with the decision in the *Cadbury Schweppes* case, its CFC rules. As the ECJ stated in that case, permissible CFC rules within the European Union must "specifically target wholly artificial arrangements which do not reflect economic reality and whose only purpose would be to obtain a tax advantage".

2.2 Before these decisions, the UK had essentially operated a worldwide system of corporate taxation, taxing dividends received by UK entities from foreign subsidiaries subject to credit for foreign taxes, and operating CFC rules that were based on an assumption that, subject to specific exemptions, income generated in a CFC should have been generated in the UK.

2.3 Change to this position was essentially forced on the UK government by the decisions of the ECJ, and the decision was taken to move to a territorial system of taxation, which was more consistent with the ECJ case law and had the benefit of also improving the UK's competitiveness as a place to locate businesses[2].

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[1] including *Test Claimants in the FII Group Litigation v Inland Revenue Commissioners* (Case C-446/04); *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* (C-196/04); *Test Claimants in the CFC and Dividend Group Litigation v Revenue and Customs Comrs* (C-201/05)

[2] See for example, the Government's Consultation Paper issued in 2007 on the Taxation of the Foreign Profits of Companies: http://webarchive.nationalarchives.gov.uk/20131002170101tf_/http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_027592

2.4 The Government therefore consulted in 2007 about the broad shape of reform to the overall regime for taxation of foreign income. Key elements of the package included an exemption for the taxation of nearly all dividends, revised CFC rules and some restrictions on the deductibility of interest. Given the introduction of the UK's dividend exemption, CFC rules were necessary to prevent the uncontrolled erosion of the UK tax base. The Government had considered the introduction of wider limitations on the ability of UK companies to deduct interest, particularly for debt incurred to make investments in foreign subsidiaries. This was rejected in favour of narrower restrictions, and it is clear that the scope of the CFC rules was, from the outset, linked to the fact that significant interest limitations were not being introduced.[3] However, the design of the CFC rules was intended to be consistent with a territorial tax system: the UK would not seek to tax income that was genuinely earned offshore without having been the subject of artificial diversion from the UK. It was not sufficient that income could have arisen in the UK but for the activities of the CFC; that diversion of income had also to be artificial.

2.5 In our view, there were therefore three objectives to the reformed CFC rules: to comply with the requirements of ECJ jurisprudence, including the *Cadbury Schweppes* case, to move to a territorial tax system, and to protect the UK tax bases against erosion as a result of the introduction of the dividend exemption by preserving the integrity of the UK tax system. It was also a stated aim of Government at the time that the rules should be "more certain and straightforward in application".

3. INTERPRETATION OF UK LEGISLATION – DISCERNING ITS PURPOSE

3.1 To discern the purpose of UK legislation as a matter of UK law, one has to consider the legislation as a whole. It is only by considering the overall "scheme of the legislation" that the underlying purpose can be established.

3.2 This is particularly the case with more recently drafted tax legislation. The style of drafting of recent UK tax legislation (particularly but not exclusively in the avoidance area) has been to cast the net wide and then to narrow down the scope of the legislation through specific provisions that articulate what is considered to be acceptable.

3.3 An example of this outside the avoidance area is the exemption for taxation on dividends. It was clear that the intention of the government was to introduce a broad exemption for taxation of dividends from UK and foreign companies. However, it was drafted as a taxing provision for dividends subject to a large number of exclusions.

3.4 This is also the case with the CFC rules. The ambit of the rules is only clear when they are considered in their totality. For example, the requirement for the CFC to suffer tax at a rate of less than 75% of the UK rate is contained in an "exemption". However, no one would argue that this was not part of the definition of the scope of the CFC rules. In our view, Chapter 9 is in the same category – it is an essential part of the determination of whether diversion of profits to a CFC is artificial in the case of a group finance company.

3.5 We therefore consider the Decision's classification of Chapter 5 as containing a "general rule" by reference to which it is possible to determine the object of the CFC rules relating to non-trading finance income to be incorrect. It is necessary to consider Chapters 5 and 9 together to determine the scope of the CFC rules as they apply to non-trading finance income.

[3] See paragraph 4.6 of the Consultation Paper: "it is clear that a move to exemption will open up new risks for diversion of profits: so if the UK adopts a form of exemption, the CFC rules will necessarily assume a greater importance in terms of protecting the UK tax base. (This will be especially true if exemption is not accompanied by any wide-ranging restriction of interest relief.)" Also paragraph 5.1: The Government believes that by adopting a package of targeted exemption, more targeted controlled companies (CC) rules and limited, targeted interest rules, it is possible to provide the widest dividend exemption without the need for complex interest restriction rules, such as those based on apportionment."

4. THERE HAS TO BE DIVERSION AND IT ALSO HAS TO BE ARTIFICIAL

4.1 As discussed above, one of the essential functions of the CFC rules was to protect the UK tax base and the integrity of the UK tax system, given the move from a worldwide tax system to a territorial one.

4.2 In a territorial tax system, before determining whether there is a diversion of income, one first has to decide what income *ought* to arise in the UK. It is not consistent with a territorial system to say that any income that could have arisen in the UK but for the existence of the CFC should have done so. It is therefore necessary to seek a closer connection of the income with the UK.

4.3 The fact that the majority of the significant people functions may be in the UK, or that the activity is funded using UK resources may be indicators that income is being diverted from the UK but they are not necessarily determinative (and indeed CFC rules based on these factors alone would probably not be compliant with *Cadbury Schweppes*). So, for example, in Chapter 4, even if these factors are present, trading income of a CFC that complies with various other substance requirements will not be treated as artificially diverted from the UK.

4.4 One relevant factor is the extent to which a CFC transacts with UK resident group members. This is because such transactions may generate tax deductible expenses without the inclusion of taxable income, resulting in an erosion of the UK base. Such transactions clearly do divert income from the UK (in the form of the payments by the UK entity). Therefore, where a group finance company undertakes such transactions, they will be considered to be artificial unless the majority of the significant people functions are outside the UK and no UK capital has been used to fund the relevant transaction. This effectively requires the substance of the CFC's operations to be aligned with where the profits arise.

4.5 In the case of a group finance company that only transacts with non-UK group members, it is more difficult to identify a diversion of income from the UK.

(a) The significant people function test is unlikely to be a good indicator of diversion in the context of group treasury management, as groups will naturally centralise many of these activities for commercial reasons without reference to the economic substance of the group or where funding is required or can be provided. Group treasury management is in any event a capital intensive, rather than a people intensive business.

(b) Where no UK funds are used to finance the activities of a group finance CFC, it seems self-evident that there is no diversion of income from the UK.

(c) However, the use of UK derived funds is not in itself enough to lead to a presumption that income is being diverted; under a territorial system one cannot simply say that the funds could have been used by the UK to make the relevant investment, and therefore they should have been. This is confirmed by the OECD Report at paragraph 78 (also referred to in footnote 68 of the Decision), which identifies the potential problem as "<u>over</u>leveraging of the parent <u>and</u> <u>over</u>capitalisation of the CFC". (our emphasis)

(d) Under that approach, one can therefore also conclude that there is no artificial diversion where there is no net finance expense in the parent (as provided for in the matched interest rules), because there is no overleveraging.

4.6 On this basis, we consider that the "full exemption" for group non-trading finance income that is funded out of qualifying resources or to the extent that the matched interest rules apply is clearly designed to ensure that income that is not artificially diverted from the UK is not within the scope of the rules in Chapter 5. This is entirely consistent with the objectives of the CFC rules and the way that they fit into the UK corporation tax system as a whole.

4.7 Where a CFC is overcapitalised, it does not follow that *all* of its income has been diverted from the UK. Indeed, rules that were based on that principle would not be consistent with the requirements of *Cadbury Schweppes* (which, it must be recalled, concerned the treatment of group finance companies), which only permit the application of CFC rules to "wholly artificial arrangements which do not reflect economic reality". As the OECD Report highlights, the problem of overcapitalisation is inextricably linked to the problem of overleveraging in the parent. It is the overleveraging which is the real diversion of UK income, by creating tax deductible interest expense with no corresponding interest income. This approach to the assessment of diversion of income is consistent with a territorial system of taxation which seeks to protect the tax base of the parent, and with the reasoning of the OECD Report.[4]

4.8 Given the need for simplicity of administration by the government and the taxpayer, it is therefore logical to assess the amount of income that has been diverted by reference to a typical amount that a multinational group pays in interest compared with its operating profits. As noted in Table B.4 and paragraph 96 of the OECD's final report on Action 4, the typical interest to EBITDA ratio of publicly traded multinational groups is between 10% and 30%. A CFC charge that is based on 25% of the profits of the CFC is consistent with this principle.

4.9 We agree with the UK government that thin capitalisation safe harbour tests in other jurisdictions are not a relevant comparison. The UK does not operate such a safe harbour test, and pure debt/equity tests do not give direct information about a company's borrowing costs. It is notable that when the UK government used to publish a "rule of thumb" for thin capitalisation purposes, as well as a guideline debt:equity ratio of 1:1, it required an interest cover ratio of 3:1. This interest cover ratio is consistent with the principle adopted in the CFC rules.

4.10 We also do not think that a comparison with the alternative formulation for CFC rules contained in the ATAD (which operate on an entity basis so are not directly comparable) sheds much light on what an appropriate level of assumed diverted income might be. Ultimately, it is for the UK government to decide what income it considers to be artificially diverted on the basis of objective criteria. It seems to us that reference to the external interest:EBITDA ratios of the largest multinational groups is clearly objective, given that the diversion of income identified by the UK government is the overleveraging of the parent entity. We note that the UK government has recently introduced (and the ATAD requires other member states to introduce) restrictions on the deductibility of interest, including external interest, based on these ratios.

4.11 We do not consider this position to be undermined by the fact that the CFC rules do not require an investigation of the actual level of capitalisation of the group financing CFC. An important feature of the rules is that they have to be easy to administer, and group finance companies are nearly always fully equity funded. A group that wishes to minimise its exposure under the CFC rules can determine the level of equity funding of its group finance company accordingly.

[4] It is also consistent with the way that the overall shape of the reform package for foreign profits was designed in 2007 (see footnotes2 and 3 above).

4.12 On the basis of the above, we consider that the "partial exemption" for group finance companies reflects an objective and practical assessment of the level of income that has been artificially diverted from the UK where a group has a non-UK group finance company that does not lend to UK entities and does not qualify for the "full exemption".

4.13 Outside the context of group financing, the other obvious area of risk for diversion of UK income is the use of money-box CFCs. Without rules to prevent this, a wholly UK business (or indeed a UK individual acting through a UK company) could seek to avoid UK tax on investment income by incorporating a tax haven entity to make the investments, and distribute the return free of UK tax. In practice, this is not something that a multi-national group would often seek to achieve in the ordinary course of its business activities, and the exclusions for incidental non-trading finance profits would ordinarily cover the needs of a multi-national group to make external investments of its funds.

4.14 The major area of risk here relates to closely held companies, which can be essentially used as a vehicle for individuals to make offshore investments outside the scope of the UK's anti-avoidance rules in respect of income tax. The CFC rules are therefore an essential backstop to ensure the integrity of the UK tax system as a whole. We therefore agree with the UK government that on a risk-based approach it is reasonable to take the approach that third party non-trading finance income will be artificially diverted from the UK where it derives from UK funds or the exercise of significant people functions in the UK and is not incidental to the CFC's trading profits or property business profits.

4.15 We therefore conclude that the CFC rules have to be seen within the context of the UK tax system as a complete reference system, properly defining the scope of the types of income that fall within the scope of corporation tax having regard to the objectives of achieving a territorial tax system, complying with the *Cadbury Schweppes* requirements and preserving the UK tax base and the integrity of the UK tax system.

5. SELECTIVITY

5.1 Given our conclusion above, we do not consider there is a derogation from the rules which could be subject to an analysis of selectivity. However, if such an analysis were required, we do not consider that the purported "selectivity" identified in the Decision can be sustained.

5.2 We note that, as the CJEU has held[5], "the appropriate criterion for establishing the selectivity of the measure at issue consists in determining whether that measure introduces, between operators that are, in the light of the objective pursued by the general tax system concerned, in a comparable factual and legal situation, a distinction that is not justified by the nature and general structure of that system"

5.3 The selectivity proposed by the Decision relates solely to the position of UK headed groups with UK funded CFCs that either lend to UK group members, or invest funds with unrelated third parties to produce passive income (paragraph 87 of the Decision)

5.4 We do not consider that UK headed groups with UK funded CFCs lending to UK group members are in a comparable legal or factual situation to those with UK funded CFCs lending to non-UK group members, having regard to the objectives of the CFC rules, in particular that of protecting the UK tax base. The tax consequences of lending to the UK are that the debtor will obtain an interest deduction, and profits will be diverted from the UK as a result of the payment of UK interest to the CFC. This is not the case where the funds are lent to a jurisdiction outside the UK.

[5] *European Commission v World Duty Free SA and others*, paragraph 60

5.5 We also do not consider that UK headed groups with UK funded “money-box” CFCs are in a comparable legal or factual situation to UK headed groups with UK funded CFCs lending to non-UK group members, having regard to the objectives of the CFC rules, in particular that of policing a territorial system of taxation. There is a much higher risk in the case of the “money-box” CFC that the funds have been artificially diverted from the UK and that the income earned by the CFC ought to have been earned in the UK as described in paragraph 4.13 and 4.14 above.

5.6 One further difference between a “money-box” CFC and a CFC that participates in intra-group financing arrangements is that, in the former case, the group as a whole is generating passive income from the third-party investments. By contrast, payments under intra-group financing arrangements will ultimately be funded by the active business activities of the relevant group members. It is clear that, looked at from the perspective of the UK group parent, there is much more risk of diversion of profits from the UK where the group as a whole is earning passive income from the transactions than if it is earning active income. This principle is consistent with the approach to passive income taken in the rest of the CFC rules.

5.7 The relevance of the ultimate source of group income in these circumstances is recognised in paragraph 78 of the OECD Report where, in discussing whether a CFC earning dividend income poses a risk of diversion of profits, it says: “The general concern underlying the treatment of dividends is that dividends could be used to shift purely “passive” income (i.e. income that does not arise from any underlying activity) into a CFC. However, dividend income typically does not raise such concerns in at least three situations. First, if the dividends were paid out of active income of an affiliate, those dividends may not raise BEPS concerns…” The reference here to dividends paid out of active income of an affiliate is analogous to the position of intra-group interest payments. As discussed in more detail above, the mischief identified in the OECD report in relation to intra-group interest income is the combination of over-leveraging of the parent and over-capitalisation of the CFC, not simply the receipt of income by the CFC.

5.8 The position of “money-box” CFCs is discussed in paragraph 95 of the Decision, where it is stated that “the Commission recalls 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. That is a matter of fact rather than a matter of policy.” We do not consider that it is possible to make such a sweeping statement (which prejudges the question that it is purporting to analyse). “Money-box” structures are the archetype of the kind of avoidance that requires the introduction of CFC rules, especially in the context of a general exemption system for dividends. CFC rules have to protect against the position of a purely domestic business or individual establishing an offshore entity in order to roll up investment income tax free offshore. It may be the case that intra-group arrangements pose a large risk of arbitrage arrangements, but the UK rules are only concerned (and are legitimately only concerned) with the artificial diversion of profits from the UK.

6. SELECTED ADDITIONAL COMMENTS ON THE REASONING IN THE DECISION

6.1 We set out below some specific detailed comments on the reasoning in the Decision. They fall into two basic categories:

(a) in a number of places in the Decision, it is clear that the assumption has been made that Chapter 5 is an exhaustive description of what constitutes artificial diversion in the case of non-trading finance income. As a matter of correct construction and having regard to the overall objectives of the CFC rules, we do not consider that this is correct: artificial diversion is rather to be described by considering Chapter 5 together with Chapter 9 (and indeed other provisions of Part 9A such as the "tax exemption" in Chapter 14). The conclusion that follows from this assumption – that Chapter 9 is a derogation from a "general rule" set out in Chapter 5 – is therefore also not correct; and

(b) the Decision appears to be based on an assumption that any income that could have arisen in the UK but for the existence of the CFC should have arisen there, and so is diverted from the UK. This assumption may be suitable for a worldwide system of tax, but it is not relevant to a territorial system of tax. The Decision does not reflect the fact that the UK operates a territorial system of tax, as it is entitled to do as a policy matter. This misunderstanding pervades the whole of the analysis of when income is to be treated as artificially diverted from the UK. For example, insufficient weight is given to the analysis in the OECD Report that the risk of artificial diversion of profit to a group financing CFC arises because of the possibility of overleveraging of the parent combined with overcapitalisation of the CFC, and not because of the receipt of income by the CFC *per se*.

Detailed comments

6.2 Paragraphs 16, 17 and 20 of the Decision set out a hypothesis of the logic for applying a CFC charge, derived from the four tests set out in Chapter 5. By focusing only on the tests in Chapter 5, and not including the provisions of Chapter 9, the Decision formulates a hypothesis that does not reflect a full understanding of what constitutes *artificial* diversion of profits from the UK. Furthermore, at footnote 81, the Decision asserts that the tests concerning financial lease transactions and abusive circular transactions are simply "additional tests", "complementary to the general rule". We do not consider this to have foundation as a matter of interpretation of the relevant provisions. They are inherent parts of the rules, and demonstrate that the intended target of the CFC rules is artificial diversion of profits which can in appropriate cases be identified and quantified by the fact that the transactions generate UK tax deductions.

6.3 In paragraph 31, the Decision states "Both the partial and the full exemption are in principle only available if the foreign group interest qualifies as artificially diverted non-trading finance profits subject to Chapter 5". This demonstrates an assumption that underlies the whole of the reasoning in the Decision that Chapter 5 is an exhaustive description of what amounts to artificial diversion. We do not consider this assumption to be correct. The CFC rules, in their entirety, are intended to delineate the scope of artificial diversion. It is not permissible as a matter of construction to take one part of the rules in isolation and purport to use this to define artificial diversion.

6.4 In a number of places in the Decision, it refers to the "general rule" about artificial diversion being set out in Chapter 5, which is used to support the conclusion that the rules in Part 9 are a derogation from that rule. As explained above, we do not consider this is correct as a matter of principle, nor having regard to the need to construe UK tax legislation as a whole, but we also do not consider it is supported by the words of the legislation itself. Section 371EA refers to a "basic rule" applying a CFC charge where the profits of the CFC fall within one of sections 371EB to 371EE. This terminology is used across all of Chapters 4 to 14, all of which contain a "basic rule" which is then amplified or further defined. In our assessment, this reference to a "basic rule" is a drafting technique to help signpost the legislation (such signposting is a common feature of modern UK tax legislation following the re-writing of the tax code in order to make it more accessible). It is intended to indicate that it is a rule that is subject to refinement in accordance with the rest of Part 9A. It does not indicate that Chapters 4 to 8 contain an exhaustive definition of artificial diversion that is then subject to exception or derogation in Chapters 9 to 14.

6.5 Paragraph 74 states that “intercompany interest from foreign group companies earned by a qualifying CFC and meeting one of the four tests of Chapter 5 seems to meet the test for being regarded as artificially diverted profits by the UK’s own standards”. We do not agree. As set out above, the question of whether profits have been artificially diverted can only be assessed by considering the rules as a whole, and not simply a part of the rules.

6.6 In paragraphs 75 to 79, the Decision criticises the UK government’s argument that there is not necessarily artificial diversion in capitalising a CFC as the UK parent could have capitalised the ultimate debtor. The criticism asserts that the UK’s argument is “intrinsically inconsistent” as it would otherwise have resulted in a full exemption as applicable for dividends. This criticism reflects a misunderstanding of the nature of the artificial diversion in the case of overcapitalisation of a CFC, namely the corresponding overleveraging of the parent. It is this overleveraging that results in the diversion of profits from the UK, and a partial exemption is therefore consistent with the argument of the UK government.

6.7 In paragraph 83, it is stated “Thus, not applying an anti-abuse rule to a certain type [sic] of transactions or enterprises that meet the objective and general criteria for being classified as abusive, favours certain economic operators compared to others who, in the light of the objective pursued by the anti-abuse rules, are in a comparable legal and factual situation”. For the reasons given above, we do not agree that group financing income does meet “objective and general criteria for being classified as abusive”. In the context of a territorial tax system, group financing income may or may not be abusive depending on the wider circumstances. The provisions of Part 9 are an inherent part of an assessment of the extent to which it results in artificial diversion of profits.

6.8 Similarly, the statement in paragraph 84 that “the effect of the Group Financing Exemption is that certain non-trading finance profits with a high risk of diversion, as objectively defined under the general rules of Chapter 5 are excluded from the normal application of the anti-abuse rule” ignores the fact that the rules are concerned with *artificial* diversion, and not just diversion, and in our view begs the question as to how artificial diversion is to be defined.

6.9 In paragraph 94, it is asserted that “artificial diversion arises where a UK company diverts financing profits (interest) to a CFC, which income would have accrued directly to and be taxed in the UK absent the CFC structure”. In our view this reflects an assumption that pervades the Decision (see for example also paragraph 114) that the UK intends to operate a worldwide system of taxation, under which income that does not accrue in a CFC should automatically be attributed to the parent. This assumption is incorrect. The UK deliberately changed from a worldwide to a territorial system of taxation, and the reformed CFC rules were an integral part of this transition. Under this territorial system of taxation, the source of the profits of the CFC is indeed relevant (contrary to the further statements in paragraph 94), as is the question of whether those profits result in erosion of the UK tax base. A “differentiated treatment of finance income depending on the nature and residence of the debtor” is not only justified by the logic of the CFC rules but is an integral part of their design.

6.10 In relation to paragraph 95, the substance of the Commission’s complaint here appears to be that the UK CFC rules do not operate to prevent the artificial diversion of non-UK profits. However, this is a policy choice that the UK is free to make, and indeed is a feature of adoption of a territorial tax system (as operated by a number of other EU member states). The objectives of such a system include being neutral as regards what a UK headed group may do in respect of the tax base of non-UK group entities where that does not result in a reduction of the UK tax base. It is for those other jurisdictions to police the diversion of profits from their tax base using their own domestic rules. The reference to the *P Oy* case is therefore not relevant here.

7. CONCLUSION

7.1 For the reasons given above, we therefore disagree with the reasoning of the Commission in the Decision. We agree with the position of the UK government that the provisions of Chapter 9 of Part 9A TIOPA are an intrinsic part of the delineation of the scope of the UK's CFC rules within the wider corporation tax rules, and that they are consistent with (and indicative of) the objectives of those rules. There is therefore no derogation from the CFC rules that could constitute state aid. Even if there were, however, we do not consider that the selectivity identified by the Commission can be supported, as the types of enterprise identified by the Commission are not in legally and factually comparable situations.