# Substance requirements in anti-tax-avoidance legislation – The end of tax planning with holding companies?

**The international focus on taxpayers' methods of minimizing taxes is stronger than ever. Parallel to the development of new tax-planning possibilities, concerned states are eagerly trying to protect their tax base by developing anti-tax-avoidance legislation – often in ways that disregard the character of the activity conducted. This article focuses on so-called Controlled Foreign Company (CFC) legislation. Whereas the development of these rules, especially within the European Union, has justifiably aimed at differentiating commercially justified businesses from artificial ones, it may at the same time also negatively affect tax planning for holding companies.**

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Generally, tax planning carefully aims to avoid the application of CFC rules. However, in many states these rules are extremely wide in application and make no difference between, e.g., the types of activity that the foreign entity conducts. In Europe, however, recent case law both from national courts and the European Court of Justice (ECJ) has contributed to several countries modifying their CFC legislation in order to make it compatible with EC law. Especially the ECJ "landmark decision" in the Cadbury Schweppes case has moved the "substance" requirement in foreign legal entities into focus (Case C-196/04; Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue, delivered in 2006).

**Compatibility of national CFC rules with EC law**

Even if direct taxation falls within the sovereign competence of each member state of the EU, the states are required to legislate in accordance with EC law. Thus, when the states apply national anti-abuse legislation, they need to ensure compatibility with Community law and especially the freedom of establishment, which is one of the fundamental freedoms of EC law. The ECJ has repeatedly confirmed that counteraction of tax avoidance is an overriding reason in the public interest which can justify restrictions on the freedoms, as long as they are proportionate to the aim to be achieved. Application of CFC legislation is generally based only on the jurisdiction where the foreign entity is established or on the effective tax rate applied to the foreign legal entity's profits. Consequently, the main question is: Can CFC legislation be considered compatible and proportionate with the EC freedoms?

**Substance requirements for application of CFC rules**

The Cadbury Schweppes case examined whether British CFC legislation violated the principle of freedom of establishment. The case involved a British company's Irish subsidiary which served for group financing operations. The ECJ stated in its judgment that the application of British CFC was too general and therefore contrary to EC law when applied to actual establishments that had genuine economic activity in the host state. It furthermore stated that CFC legislation is only acceptable if it aims specifically at wholly artificial arrangements. The Cadbury Schweppes decision has thus clarified that for CFC rules to be compatible with EC law, they must exclude companies with a genuine economic activity. However, what are the requirements to prove such an activity? According to the ECJ, there is economic activity if the entity has its own staff and equipment. Thus, it seems like the legal entity has to be physically present in the host state.

ECJ has in subsequent case law, in the CFC GLO case, confirmed that national CFC rules could be justified only if they specifically target "wholly artificial arrangements designed to circumvent the legislation of the member state concerned" (Case C-201/05, Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue, delivered in April 2008). It concluded that the application of CFC legislation is justified, if the establishment does not reflect an economic reality and is created "with a view to escaping the tax normally due on the profits generated by activities carried out on national territory". The court also reaffirmed that CFC legislation must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that, despite the existence of tax motives, the company is actually established in the host member state and carries on genuine economic activities there.

**Impact of ECJ case law on national legislation**

The Cadbury Schweppes judgment has prompted several EU member states to change their CFC legislation, since the rules in most cases risked to be considered both incompatible and disproportionate. A brief summary:

*United Kingdom:* England, which was directly concerned by the Cadbury Schweppes case, has inserted a new "effectively managed" condition. The intention of the change is to make CFC rules applicable only when the controlled foreign company lacks economic activity. Amendment was also made in regard to the "exempt activities" test: A CFC in an EU member state will

only be considered to be "effectively managed" in that state, if there are adequate individuals working for it. The suitability of employees is determined by their proficiency and power to carry on the business, i.e. they must be more than mere nominees or administrators.

## What is CFC legislation?

The term CFC legislation refers to national anti-abuse legislations that aim to encourage local investment and therefore prevent company establishment in foreign low tax jurisdictions as an alternative to local establishment if certain conditions apply. For the concerned companies, the application of CFC rules is harsh since it implies an immediate taxation of the company's net profits at the level of the shareholder, even without any profits being distributed.

*Sweden:* Sweden changed its legislation as from 1 January 2008. The main change was that CFC rules shall not apply on a CFC within the EES states if the Swedish resident shareholder can prove that the CFC represents a real establishment engaged in genuine business operations. All relevant circumstances are to be taken into account, although some circumstances per se are considered indicative of such a "true" or "real" economic nature and are stated directly in the legislation. Thus, the rules prescribe that the CFC shall have its own premises in order to distinguish it from so-called letterbox companies, and that it has requisite equipment for carrying out its responsibilities. As further evidence of the existence of a "real" establishment, the presence of sufficient and suitably competent personnel of the foreign corporation is required. Last but not least, the day-to-day operations shall be carried out independently by the said personnel without the influence or involvement of staff from the CFC's parent company or any other company within the business group.

*Germany:* According to the German rules, the arrangement is not wholly artificial as long as the foreign entity has "business substance", which implies, a.o., that the business activities in the country of the subsidiary's residence are carried out on regular basis; that there is sufficient managerial and support staff, who is appropriately skilled and able to perform the company's tasks independently and on its own responsibility; that the subsidiary's income should be earned through activities carried out by the company itself; and, when the revenue stems predominantly from related-party transactions, that the services are value-generating for the related person and the capital funding of the subsidiary is appropriate to the value being added.

*France:* The French CFC legislation was already adapted in 2005 as a result of a national court ruling, and only small changes were made in October 2006 after the Cadbury Schweppes case. The French parent company must show that it is physically established in another state in terms of premises, equipment and staff and that it performs economic activity.

*Spain:* Spain opted for the easy way out: Its CFC rules have been changed so that they only apply to foreign entities established outside the EU.

**Substance requirements in other anti-tax-avoidance legislation**

Substance requirements are also found in other anti-abuse rules, such as national anti-treaty-shopping rules. One example is *Switzerland,* where there is no actual CFC legislation but instead a relatively strict application of anti-treaty-shopping rules and practice in order to obtain tax-treaty benefits. Before allowing treaty benefits, the Federal tax authority will inquire on, a.o., the economic motivations on the establishment of the foreign legal entity, on the number of people working directly for that company, on the existence of offices or premises etc. For a foreign holding company, it will generally also require participations in more than one subsidiary.

**Tax planning for holding companies**

What about the future of foreign holding companies? A holding company owns shares in other companies. This activity requires little physical presence in the form of staff and equipment. Still, it is a real economic activity which generates income. Since the main purpose of a holding company is to own shares in other companies, it would seem that, based on these CFC requirements, the very nature of the activity would imply that the company must be considered wholly artificial. But should CFC rules really be applicable here? Should the genuine economic activity of the holding company be questioned, when substance in the form of local staff and premises is not even needed to conduct the business activity?

**Conclusion**

The ruling of the ECJ in the Cadbury Schweppes case has had an important impact on CFC legislation in many EC member states. In its decision the Court clearly stated that states can only invoke CFC provisions where activities are carried out in other member states through wholly artificial arrangements intended to escape national tax. As long as it can be proven that there is a genuine economic activity, CFC rules cannot be applied. However, considering the new requirements in several member states' CFC legislation, it seems to become much more difficult for taxpayers to set up foreign companies, unless an active business activity is performed by a legal entity employing its own personnel and having its own offices.

Thus, for pure holding companies or other companies with more passive business activities, such as portfolio investments, which usually do not require this kind of substance, establishment in the most tax-favorable jurisdictions may prove to be complicated and expensive. If a holding company must hire staff and rent office space, the cost for creating the necessary substance may become more important than the potential tax savings. In view of this, careful consideration is needed and expert advice should be sought early on in the planning process in order to get a full understanding of the implications of a foreign establishment.

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