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INTERNATIONAL TAX

# CASE SUMMARY

# CADBURY SCHWEPPES vs UK

SEPTEMBER 2006

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His transfer pricing experience includes extensive involvement with the identification, valuation, and movement of intangible property in a variety of industries.

His more than 28 years' experience includes all aspects of income tax planning, Revenue Service administrative proceedings, and tax litigation.

Dr Erasmus holds a PhD in tax and Constitutional law, is an international tax adjunct professor, and author of numerous tax textbooks.

At the Adademy of Tax Law Dr Erasmus's primary responsibility within the academic panel is to ensure that all courses are developed and delivered professionally and that all faculty members deliver the most up-to-date information to students.

He is also the lead supervisor across all the MSc programmes, sharing his +30-year experience with students.

# PART 1

# SUMMARY



# JUDGEMENT SUMMARY

## CASE OVERVIEW

**Court:** European Court of Justice (First Chamber)

**Case No:** C-196/04

**Applicant:** Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd

**Defendant:** Commissioners of Inland Revenue

**Judgment Date:** 12 September 2006

**Full Judgment:** https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:62004CJ0196

**View Online:** https://academyoftaxlaw.com/cadbury-schweppes-cfc-case/

# JUDGMENT SUMMARY

The Cadbury Schweppes case is a seminal ruling in the context of the European Union's freedom of establishment and the limitations on Member States' tax authorities to impose tax measures on Controlled Foreign Companies (CFCs). The key issue in this case was whether the UK's CFC legislation, which sought to include the profits of foreign subsidiaries (CFCs) in the tax base of their UK parent company, violated the freedom of establishment under the EU Treaty.

The Court ruled that Member States may apply CFC rules, but only where such subsidiaries are wholly artificial arrangements intended to circumvent domestic tax laws. If the subsidiaries are engaged in genuine economic activities, their profits cannot be included in the tax base of the parent company, even if they benefit from a lower tax rate in another EU Member State.

This decision significantly limited the scope of the UK's CFC rules and established that the mere fact of setting up a subsidiary in a low-tax jurisdiction does not, in itself, justify the imposition of domestic tax measures. The ruling clarified that tax avoidance measures must be targeted only at wholly artificial arrangements that lack economic substance.

# KEY POINTS

## OF THE JUDGMENT

## BACKGROUND

Cadbury Schweppes plc, a UK-based multinational, set up two subsidiaries, Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI), in Dublin, Ireland, in order to benefit from Ireland's International Financial Services Centre (IFSC) tax regime, which provided a low tax rate of 10%. The UK authorities invoked the Controlled Foreign Company (CFC) legislation, which allowed them to tax the profits of these Irish subsidiaries, arguing that they were subject to a lower level of taxation.

The CFC legislation in the UK allowed the tax authorities to tax a UK company on the profits of its foreign subsidiaries if the subsidiary was subject to a tax rate less than 75% of the tax that would have been payable in the UK. The legislation included several exemptions, including an "acceptable distribution policy" and "exempt activities," but none applied in this case. The core issue was whether the UK's application of this CFC legislation was compatible with EU law, particularly the right to freedom of establishment.

# KEY POINTS

## OF THE JUDGMENT

## CORE DISPUTE

The central dispute was whether the UK's CFC legislation, which taxed profits of foreign subsidiaries based in low-tax jurisdictions, violated the freedom of establishment guaranteed under EU law. Cadbury Schweppes argued that its subsidiaries in Ireland were legitimately established and carried out genuine economic activities, and thus the application of the CFC rules was an infringement of its right to establish and operate businesses across EU Member States.

On the other hand, the UK argued that the subsidiaries were set up primarily for tax avoidance purposes, allowing Cadbury Schweppes to benefit from the lower tax rate in Ireland and divert profits from the UK to Ireland. The UK authorities claimed that such arrangements justified the imposition of the CFC rules to prevent tax avoidance.


# KEY POINTS

## OF THE JUDGMENT


## COURT FINDINGS

The Court's findings emphasized the balance between the freedom of establishment and the prevention of tax avoidance:

- **Wholly Artificial Arrangements:** The Court stated that the mere fact that a company establishes subsidiaries in another Member State to benefit from lower tax rates does not automatically amount to tax evasion or avoidance. National tax measures that restrict the freedom of establishment must be justified by the need to prevent wholly artificial arrangements that are designed to circumvent domestic tax rules.
- **Genuine Economic Activity:** The Court clarified that if the foreign subsidiary is genuinely established in the host Member State and engages in actual economic activities, the application of CFC rules would violate the freedom of establishment. In this case, the subsidiaries were providing legitimate treasury services and were not mere "letterbox" companies without real substance.
- **Objective Factors:** The Court highlighted that the national authorities must assess the economic substance of the subsidiary based on objective factors, such as the presence of physical offices, employees, and the nature of the business activities. If it is proven that the subsidiary is engaged in genuine economic activities, the CFC rules should not apply.

# KEY POINTS

## OF THE JUDGMENT

### OUTCOME

The Court ruled in favor of Cadbury Schweppes, holding that the UK's CFC rules could only be applied to wholly artificial arrangements that are solely aimed at avoiding tax. The profits of CSTS and CSTI could not be included in the UK tax base as long as these companies were genuinely established in Ireland and engaged in real economic activities, even if their establishment in Ireland was motivated by tax considerations.

The ruling provided clarity on the application of anti-avoidance measures within the EU, limiting the scope of national tax authorities to impose CFC rules unless the subsidiaries are deemed to be wholly artificial.

# TP METHOD

## HIGHLIGHTED (IF ANY)

While the case does not focus directly on a specific transfer pricing method, it highlights key principles relevant to transfer pricing, particularly the Transactional Net Margin Method (TNMM), often used to determine arm's length pricing for intra-group transactions. In assessing whether a subsidiary is a "wholly artificial arrangement," authorities may examine whether the profits and pricing of intra-group transactions reflect genuine economic activity.

The case's emphasis on economic substance aligns with the key objectives of transfer pricing: ensuring that the profits of multinational companies reflect the value of the economic functions, assets, and risks present in each jurisdiction.

# PART 2

# SIGNIFICANCE

# MAJOR ISSUES

## AREAS OF CONTENTION

**Freedom of Establishment vs. Tax Avoidance**

The crux of the case was balancing the right to freedom of establishment within the EU with the legitimate interest of Member States in preventing tax avoidance. The Court had to determine whether the UK's CFC rules unjustifiably restricted this freedom by targeting companies established for legitimate tax planning purposes.

**Economic Substance**

The Court required evidence of genuine economic substance, including the physical presence of the subsidiary, employees, and actual business activities, to differentiate between legitimate establishments and wholly artificial arrangements.

**Anti-Avoidance Measures**

The case raised questions about the extent to which anti-avoidance measures like the CFC rules could be used by Member States to protect their tax base without violating the EU's fundamental freedoms.

# EXPECTED

## OR CONTROVERSIAL?

The decision was not entirely unexpected, given the Court's previous rulings in cases like Centros and Inspire Art, which affirmed the rights of companies to take advantage of more favorable regulatory environments within the EU. However, it was somewhat controversial as it significantly restricted the ability of Member States to apply broad anti-avoidance measures like CFC rules. The decision highlighted the tension between national tax sovereignty and the EU's commitment to the free movement of businesses and capital across Member States.

The ruling was seen as controversial by some national tax authorities because it limited their ability to tackle tax avoidance, particularly in cases where multinational companies set up subsidiaries in low-tax jurisdictions within the EU. Nonetheless, the decision reinforced the principle that anti-avoidance measures must be narrowly tailored to address only wholly

# SIGNIFICANCE

## FOR MULTINATIONALS

**Increased Flexibility in Tax Planning**

Multinational enterprises (MNEs) benefit from this ruling because it provides greater flexibility to engage in legitimate tax planning by establishing subsidiaries in EU Member States with more favorable tax regimes. As long as these subsidiaries are engaged in genuine economic activities, their profits cannot be subjected to tax in the parent company's jurisdiction under CFC rules.

**Transfer Pricing Compliance**

The decision underscores the importance of complying with transfer pricing rules, ensuring that profits are allocated according to the actual economic functions performed in each jurisdiction. MNEs need to ensure that their subsidiaries are not only legally established but also have sufficient substance to justify the allocation of profits.

**Tax Risk Management**

MNEs must ensure they have robust tax risk management processes in place to defend their structures against challenges from tax authorities. This includes providing evidence of the economic activities and substance of their subsidiaries to avoid being classified as wholly artificial arrangements.

# SIGNIFICANCE

## FOR REVENUE SERVICES

**Limitation on CFC Rules**

Tax authorities face limitations on the application of CFC rules, as these can only be applied to wholly artificial arrangements. The decision requires revenue services to carefully assess the substance of foreign subsidiaries and avoid applying broad anti-avoidance measures without sufficient evidence of tax evasion.

**Focus on Substance Over Form**

Revenue services must shift their focus from simply applying CFC rules based on tax rates to assessing the genuine economic substance of subsidiaries. This includes reviewing factors such as the physical presence of the subsidiary, the nature of its business activities, and the functions performed by its employees.

**Cross-Border Cooperation**

The decision encourages greater cooperation between national tax authorities, as they may need to exchange information to verify the substance of foreign subsidiaries and ensure compliance with international tax rules.

# SIMILAR CASES

## X BV VS NETHERLANDS ( C-337/08)

This case involved the consolidation of profits and losses within a group and whether a parent company could form a tax group with a subsidiary in another Member State. The CJEU ruled that restrictions on forming cross-border tax groups were justified by the need to maintain a balanced allocation of tax powers between Member States.

https://academyoftaxlaw.com/wholly-artificial-arrangement-tax-case/

## SWEDEN VS LEXEL (C-484/19)

In this case, the ECJ considered Swedish tax legislation that restricted interest deductions on intra-group loans. The Court ruled that even transactions conducted on arm's length terms could be restricted if part of a wholly artificial arrangement.

https://academyoftaxlaw.com/lexel-ab-v-sweden-interest-deductions/

# PART 3

# PREVENTION

## ENGAGING EXPERTS

Given the complexity and increased scrutiny surrounding cross-border transactions, it is crucial for MNEs to engage transfer pricing experts. These experts can help ensure that intra-group transactions are not only priced at arm's length but also supported by genuine economic substance, reducing the risk of tax disputes. Transfer pricing experts play a critical role in:

- Structuring transactions in a way that complies with both transfer pricing regulations and anti-abuse rules.
- Preparing robust documentation that demonstrates the commercial rationale behind cross-border transactions.
- Helping businesses navigate the complex web of national and international tax laws to avoid potential tax risks.

# PREVENTATIVE

## MEASURES TO AVOID SIMILAR CASES

## TAX RISK MANAGEMENT PROCESS

Implementing a comprehensive tax risk management process is essential to identify, assess, and mitigate tax risks associated with cross-border transactions. This process should involve:

- Regular reviews of intra-group transactions to ensure they have genuine economic substance.
- Proactive engagement with tax authorities to seek clarity on the application of anti-abuse rules.
- Thorough documentation of the business rationale for each transaction to support

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# PREVENTATIVE

## MEASURES TO AVOID SIMILAR CASES

## TAX STEERING COMMITTEE

Establishing a tax steering committee can help ensure that tax policies are aligned with the broader business strategy and that transactions are vetted for both commercial and tax implications. A tax steering committee can:

- Review all significant cross-border transactions before they are executed.
- Ensure that tax decisions are made in the context of overall business objectives, not solely for tax savings.
- Monitor changes in international tax laws to ensure ongoing compliance and avoid disputes like the X BV case.

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The eBook "Driving Tax Compliance: The Essential Role of a Tax Steering Committee" by Prof. Dr. Daniel N. Erasmus, Renier van Rensburg, and Gilbert Ferreira, emphasizes the critical importance of establishing a Tax Steering Committee (TSC) within multinational corporations to ensure tax compliance and manage tax-related risks effectively.

https://support.academyoftaxlaw.com/product/essential-role-of-the-tax-steering-committee/

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