Case C-196/04

Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd

v

Commissioners of Inland Revenue

(Reference for a preliminary ruling from the

Special Commissioners of Income Tax, London)

(Freedom of establishment – Law on controlled foreign companies – Inclusion of the profits of controlled foreign companies in the tax base of the parent company)

Summary of the Judgment

1. *Freedom of movement for persons – Freedom of establishment*

(Arts 43 EC and 48 EC)

2. *Freedom of movement for persons – Freedom of establishment – Tax legislation*

(Arts 43 EC and 48 EC)

1. The mere fact that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty. On the other hand, a national measure restricting freedom of establishment may be justified on the ground of prevention of abusive practices where it specifically relates to wholly artificial arrangements, which do not reflect economic reality, aimed at circumventing the application of the legislation of the Member State concerned, in particular with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.

(see paras 50-51, 55)

2. Articles 43 EC and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a controlled foreign company in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure 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 that controlled company is actually established in the host Member State and carries on genuine economic activities there.

(see para. 75, operative part)

JUDGMENT OF THE COURT (Grand Chamber)

12 September 2006 (*)

(Freedom of establishment – Law on controlled foreign companies – Inclusion of the profits of controlled foreign companies in the tax base of the parent company)

In Case C-196/04,

REFERENCE for a preliminary ruling under Article 234 EC by the Special Commissioners of Income Tax, London (United Kingdom), made by decision of 29 April 2004, received at the Court on 3 May 2004, in the proceedings

Cadbury Schweppes plc,

Cadbury Schweppes Overseas Ltd

v

Commissioners of Inland Revenue,

THE COURT (Grand Chamber),

composed of V. Skouris, President, P. Jann and A. Rosas, Presidents of Chambers, J.N. Cunha Rodrigues, R. Silva de Lapuerta, K. Lenaerts (Rapporteur), E. Juhász, G. Arestis and A. Borg Barthet, Judges,

Advocate General: P. Léger,

Registrar: C. Strömholm, Administrator,

having regard to the written procedure and further to the hearing on 13 December 2005,

after considering the observations submitted on behalf of:

– Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd, by J. Ghosh, Barrister, and J. Henderson, adviser,

– the United Kingdom Government, by R. Caudwell, acting as Agent, and D. Anderson QC, M. Lester and D. Ewart, Barristers,

– the Belgian Government, by E. Dominkovits, acting as Agent,

– the Danish Government, by J. Molde, acting as Agent,

– the German Government, by A. Tiemann and U. Forsthoff, acting as Agents,

– the Spanish Government, by L. Fraguas Gadea and M. Muñoz Pérez, acting as Agents,

– the French Government, by G. de Bergues and C. Mercier, acting as Agents,

– Ireland, by D. O'Hagan, acting as Agent, and R.L. Nesbitt, A. Collins SC and P. McGarry BL,

– the Italian Government, by I.M. Braguglia, acting as Agent, assisted by A. Cingolo, avvocato dello Stato,

– the Cypriot Government, by A. Pantazi, acting as Agent,

– the Portuguese Government, by L. Fernandes and J. de Menezes Leitão, acting as Agents,

– the Finnish Government, by A. Guimaraes-Purokoski, acting as Agent,

– the Swedish Government, by A. Kruse and I. Willfors, acting as Agents,

– the Commission of the European Communities, by R. Lyal, acting as Agent,

after hearing the Opinion of the Advocate General at the sitting on 2 May 2006,

gives the following

Judgment

1 The reference for a preliminary ruling concerns the interpretation of Articles 43 EC, 49 EC and 56 EC.

2 The reference was made in proceedings between Cadbury Schweppes plc ('CS') and Cadbury Schweppes Overseas Ltd ('CSO') on the one hand and the Commissioners of Inland Revenue on the other hand concerning the taxation of CSO in respect of the profits made in 1996 by Cadbury Schweppes Treasury International ('CSTI'), a subsidiary of the Cadbury Schweppes group established in the International Financial Services Center in Dublin (Ireland) ('the IFSC').

National legislation

3 The tax legislation of the United Kingdom of Great Britain and Northern Ireland provides that a company resident in that Member State within the meaning of that legislation ('the resident company') is subject in that State to corporation tax on its worldwide profits. Those profits include the profits made by branches or agencies through which the resident company carries on its activities outside the United Kingdom.

4 On the other hand, the resident company is not generally taxed on the profits of its subsidiaries as they arise. Nor is it taxed on dividends distributed by a subsidiary established in the United Kingdom. Dividends distributed to a resident company by a subsidiary established abroad are taxed in the hands of that company. In order to prevent double taxation, the United Kingdom tax legislation provides, however, for the grant of a tax credit to the resident company up to the amount of the tax which was paid by the foreign subsidiary as the profits arose.

5 The United Kingdom legislation on controlled foreign companies ('CFCs') provides for an exception to the general rule that a resident company is not taxed on the profits of a subsidiary as they arise.

6 That legislation, which is contained in sections 747 to 756 and Schedules 24 to 26 of the Income and Corporation Taxes Act 1988, provides that the profits of a CFC – namely, under the version of that legislation applicable at the time of the facts in the main proceedings ('the legislation on CFCs'), a foreign company in which the resident company owns a holding of more than 50% – are attributed to the resident company and taxed in its hands, by means of a tax credit for the tax paid by the CFC in the State in which it is established. If those same profits are then distributed in the form of dividends to the resident company, the tax paid by the latter in the United Kingdom on the profits of the CFC is treated as additional tax paid by the latter abroad and gives rise to a tax credit payable in respect of the tax owed by the resident company on those dividends.

7 The legislation on CFCs is designed to apply when the CFC is subject, in the State in which it is established, to a 'lower level of taxation', which is the case, under that legislation, in respect of any accounting period in which the tax paid by the CFC is less than three quarters of the amount of tax which would have been paid in the United Kingdom on the taxable profits as they would have been calculated for the purposes of taxation in that Member State.

8 The taxation which is attributable to the application of the legislation on CFCs is accompanied by a number of exceptions. According to the version of that legislation in force at the time of the facts in the main proceedings, that taxation does not apply in any of the following cases:

– the CFC adopts an 'acceptable distribution policy', which means that a specified percentage (90% in 1996) of its profits are distributed within 18 months of their arising and taxed in the hands of a resident company;

– the CFC is engaged in 'exempt activities' within the meaning of that legislation, such as certain trading activities carried out from a business establishment;

– the CFC satisfies the 'public quotation condition', which means that 35% of the voting rights are held by the public, the subsidiary is quoted and its securities are dealt in on a recognised stock exchange, and

– the CFC's chargeable profits do not exceed an amount set at UK £50 000 (de minimis exception).

9 The taxation provided for by the legislation on CFCs is also excluded when 'the motive test' is satisfied. The latter involves two cumulative conditions.

10 First, where the transactions which gave rise to the profits of the CFC for the accounting period in question produce a reduction in United Kingdom tax compared to that which would have been paid in the absence of those transactions and where the amount of that reduction exceeds a certain threshold, the resident company must show that such a reduction was not the main purpose, or one of the main purposes, of those transactions.

11 Secondly, the resident company must show that it was not the main reason, or one of the main reasons, for the SEC's existence in the accounting period concerned to achieve a reduction in United Kingdom tax by means of the diversion of profits. According to that legislation, there is a diversion of profits if it is reasonable to suppose that, had the SEC or any related company established outside the United Kingdom not existed, the receipts would have been received by, and been taxable in the hands of, a United Kingdom resident.

12 The decision making the reference also states that in 1996 the United Kingdom tax authorities published a list of States within which, subject to specified conditions, a CFC could be established and carry on its activities and be regarded as meeting the requirements for exemption from the taxation provided for by the legislation on CFCs.

The facts in the main proceedings and the question referred for a preliminary ruling

13 CS, a resident company, is the parent company of the Cadbury Schweppes group which consists of companies established in the United Kingdom, in other Member States and in third States. That group includes, inter alia, two subsidiaries in Ireland, Cadbury Schweppes Treasury Services ('CSTS') and CSTI, which CS owns indirectly through a chain of subsidiaries at the head of which is CSO.

14 CSTS and CSTI, which are established in the IFSC, were subject to a tax rate of 10% at the time of the facts in the main proceedings.

15 The business of CSTS and CSTI is to raise finance and to provide that finance to subsidiaries in the Cadbury Schweppes group.

16 According to the decision making the reference, CSTS replaced a similar structure which included a company established in Jersey. It was established for three purposes: first, to remedy a tax problem encountered by Canadian taxpayers holding CS preference shares, secondly, to avoid the need to obtain consent from the United Kingdom authorities for overseas lending transactions and, thirdly, to reduce the withholding tax on dividends paid within the group under the scheme of Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ 1990 L 225, p. 6). According to that decision, those three objectives could have been achieved if CSTS had been incorporated in accordance with United Kingdom legislation and established in the United Kingdom.

17 CSTI is a subsidiary of CSTS. In the view of the national court, it was incorporated in Ireland in order not to fall within the application of certain United Kingdom tax provisions on exchange transactions.

18 According to the decision making the reference, it is common ground that CSTS and CSTI were established in Dublin solely in order that the profits related to the internal financing activities of the Cadbury Schweppes group could benefit from the tax regime of the IFSC.

19 Given the rate of tax applicable to companies established in the IFSC, the profits of CSTS and CSTI were subject to 'a lower level of taxation' within the meaning of the legislation on CFCs. The United Kingdom tax authorities took the view that, for the 1996 financial year, none of the conditions for exemption from taxation provided for by that legislation applied to those subsidiaries.

20 By decision of 18 August 2000, the Commissioners of Inland Revenue therefore claimed, under the CFC legislation, corporation tax from CSO in the sum of UK £8 638 633.54 on the profits made by CSTI in the financial year ending 28 December 1996. The tax notice related only to the profits made by CSTI because, in that financial year, CSTS made a loss.

21 On 21 August 2000, CS and CSO appealed against that tax notice to the Special Commissioners of Income Tax, London. Before that body, they maintained that the legislation on CFCs was contrary to Articles 43 EC, 49 EC and 56 EC.

22 The national court states that it is faced with a series of uncertainties as to the application of Community law to the case before it.

23 First, it asks whether, in establishing and capitalising companies in another Member State solely to take advantage of a tax regime more favourable than that applicable in the United Kingdom, CS is abusing the freedoms introduced by the EC Treaty.

24 Secondly it asks whether, if CS is merely exercising those freedoms in a genuine manner, the correct approach in the circumstances of this case is to consider whether the legislation on CFCs may be viewed as a restriction on the exercise of those freedoms, or discrimination.

25 Should that legislation be viewed as involving a restriction on the freedoms enshrined by the Treaty, the national court asks, thirdly, whether the fact that CS may pay no more tax than what CSTS and CSTI would have paid if they had been established in the United Kingdom means that there is no such restriction. It also asks whether it is relevant that on the one hand there are differences in some respects between the rules for calculating the tax liability in respect of the income of CSTS and CSTI and the ordinary rules applicable to United Kingdom subsidiaries of CS and on the other the fact that losses of a CFC cannot be deducted from the profits of another CFC or from the profits of CS and its United Kingdom subsidiaries, whereas such a deduction would have been available if CSTS and CSTI had been established in the United Kingdom.

26 Should the legislation on CFCs be viewed as involving discrimination, it asks, fourthly, whether a parallel should be drawn between the facts in the main proceedings and the incorporation by CS of subsidiaries in the United Kingdom or the establishment by CS of subsidiaries in a Member State which does not charge a lower rate of tax as provided for in that legislation.

27 Should the legislation on CFCs be viewed as involving discrimination or a restriction on the freedom of establishment, it asks, fifthly, whether that legislation can be justified on grounds of prevention of tax avoidance, given its objective to prevent the reduction or diversion of profits liable to United Kingdom tax; and, if so, whether the legislation may be considered to be proportionate having regard to its purpose and the exemptions which may be obtained by companies which, unlike CS, succeed in proving under the motive test that their purpose does not relate to tax avoidance.

28 In the light of those questions, the Special Commissioners of Income Tax, London, decided to stay the proceedings and refer the following question to the Court for a preliminary ruling:

'Do Articles 43 EC, 49 EC and 56 EC preclude national tax legislation such as that in issue in the main proceedings, which provides in specified circumstances for the imposition of a charge upon a company resident in that Member State in respect of the profits of a subsidiary company resident in another Member State and subject to a lower level of taxation?'

The question referred for a preliminary ruling

29 By that question, the national court asks, essentially, whether Articles 43 EC, 49 EC and 56 EC preclude national tax legislation such as that in issue in the main proceedings, which provides under certain conditions for the imposition of a charge upon the parent company on the profits made by a CFC.

30 That question must be understood as referring also to Article 48 EC, under which companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community are to be treated in the same way as natural persons who are nationals of Member States, referred to in Article 43 EC, for the purposes of the provisions of the Treaty on freedom of establishment.

31 In accordance with settled case-law, national provisions which apply to holdings by nationals of the Member State concerned in the capital of a company established in another Member State, giving them definite influence on the company's decisions and allowing them to determine its activities come within the substantive scope of the provisions of the Treaty on freedom of establishment (see, to that effect, Case C-251/98 *Baars* [2000] ECR I-2787, paragraph 22, and Case C-436/00 *X and Y* [2002] ECR I-10829, paragraph 37).

32 In this case, the legislation on CFCs concerns the taxation, under certain conditions, of the profits of subsidiaries established outside the United Kingdom in which a resident company has a controlling holding. It must therefore be examined in the light of Articles 43 EC and 48 EC.

33 If, as submitted by the applicants in the main proceedings and Ireland, that legislation has restrictive effects on the free movement of services and the free movement of capital, such effects are an unavoidable consequence of any restriction on freedom of establishment and do not justify, in any event, an independent examination of that legislation in the light of Articles 49 EC and 56 EC (see, to that effect, Case C-36/02 *Omega* [2004] ECR I-9609, paragraph 27).

34 Before examining the legislation on CFCs in the light of Articles 43 EC and 48 EC, it is important to answer the national court's initial question seeking to ascertain whether the fact that a company established in a Member State establishes and capitalises companies in another Member State solely because of the more favourable tax regime applicable in that Member State constitutes an abuse of freedom of establishment.

35 It is true that nationals of a Member State cannot attempt, under cover of the rights created by the Treaty, improperly to circumvent their national legislation. They must not improperly or fraudulently take advantage of provisions of Community law (Case 115/78 *Knoors* [1979] ECR 399, paragraph 25; Case C-61/89 *Bouchoucha* [1990] ECR I-3551, paragraph 14; and Case C-212/97 *Centros* [1999] ECR I-1459, paragraph 24).

36 However, the fact that a Community national, whether a natural or a legal person, sought to profit from tax advantages in force in a Member State other than his State of residence cannot in itself deprive him of the right to rely on the provisions of the Treaty (see, to that effect, Case C-364/01 *Barbier* [2003] ECR I-15013, paragraph 71).

37 As to freedom of establishment, the Court has already held that the fact that the company was established in a Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse of that freedom (see, to that effect, *Centros*, paragraph 27, and Case C-167/01 *Inspire Art* [2003] ECR I-10155, paragraph 96).

38 As noted by the applicants in the main proceedings and the Belgian Government, and by the Cypriot Government at the hearing, it follows that the fact that in this case CS decided to establish CSTS and CSTI in the IFSC for the avowed purpose of benefiting from the favourable tax regime which that establishment enjoys does not in itself constitute abuse. That fact does not therefore preclude reliance by CS on Articles 43 EC and 48 EC (see, to that effect, *Centros*, paragraph 18, and *Inspire Art*, paragraph 98).

39 It must therefore be examined whether Articles 43 EC and 48 EC preclude the application of legislation such as that on CFCs.

40 According to settled case-law, although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community law (Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, paragraph 19; Case C-319/02 *Manninen* [2004] ECR I-7477, paragraph 19; and Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, paragraph 29).

41 Freedom of establishment, which Article 43 EC grants to Community nationals and which includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, under the conditions laid down for its own nationals by the law of the Member State where such establishment is effected, entails, in accordance with Article 48 EC, for companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community, the right to exercise their activity in the Member State concerned through a subsidiary, a branch or an agency (see, in particular, Case C-307/97 *Saint Gobain ZN* [1999] ECR I-6161, paragraph 35; *Marks & Spencer*, paragraph 30; and Case C-471/04 *Keller Holding* [2006] ECR I-0000, paragraph 29).

42 Even though, according to their wording, the provisions of the Treaty concerning freedom of establishment are directed to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation (see, in particular, Case C-264/96 *ICI* [1998] ECR I-4695, paragraph 21, and *Marks & Spencer*, paragraph 31).

43 In this case, it is common ground that the legislation on CFCs involves a difference in the treatment of resident companies on the basis of the level of taxation imposed on the company in which they have a controlling holding.

44 Where the resident company has incorporated a CFC in a Member State in which it is subject to a lower level of taxation within the meaning of the legislation on CFCs, the profits made by such a controlled company are, pursuant to that legislation, attributed to the resident company, which is taxed on those profits. Where, on the other hand, the controlled company has been incorporated and taxed in the United Kingdom or in a State in which it is not subject to a lower level of taxation within the meaning of that legislation, the latter is not applicable and, under the United Kingdom legislation on corporation tax, the resident company is not, in such circumstances, taxed on the profits of the controlled company.

45 That difference in treatment creates a tax disadvantage for the resident company to which the legislation on CFCs is applicable. Even taking into account, as suggested by the United Kingdom, Danish, German, French, Portuguese, Finnish, and Swedish Governments, the fact referred to by the national court that such a resident company does not pay, on the profits of a CFC within the scope of application of that legislation, more tax than that which would have been payable on those profits if they had been made by a subsidiary established in the United Kingdom, the fact remains that under such legislation the resident company is taxed on profits of another legal person. That is not the case for a resident company with a subsidiary taxed in the United Kingdom or a subsidiary established outside that Member State which is not subject to a lower level of taxation.

46 As submitted by the applicants in the main proceedings and by Ireland and the Commission of the European Communities, the separate tax treatment under the legislation on CFCs and the resulting disadvantage for resident companies which have a subsidiary subject, in another Member State, to a lower level of taxation are such as to hinder the exercise of freedom of establishment by such companies, dissuading them from establishing, acquiring or maintaining a subsidiary in a Member State in which the latter is subject to such a level of taxation. They therefore constitute a restriction on freedom of establishment within the meaning of Articles 43 EC and 48 EC.

47 Such a restriction is permissible only if it is justified by overriding reasons of public interest. It is further necessary, in such a case, that its application be appropriate to ensuring the attainment of the objective thus pursued and not go beyond what is necessary to attain it (Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471, paragraph 26; Case C-9/02 *De Lasteyrie du Saillant* [2004] ECR I-2409, paragraph 49; and *Marks & Spencer*, paragraph 35).

48 The United Kingdom Government, supported by the Danish, German, French, Portuguese, Finnish and Swedish Governments, submits that the legislation on CFCs is intended to counter a specific type of tax avoidance involving the artificial transfer by a resident company of profits from the Member State in which they were made to a low-tax State by means of the establishment of a subsidiary in that State and the effecting of transactions intended primarily to make such a transfer to that subsidiary.

49 In that respect, it is settled case-law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company (see, to that effect, Case 270/83 *Commission* v *France* [1986] ECR 273, paragraph 21; see also, by analogy, Case C-294/97 *Eurowings Luftverkehr* [1999] ECR I-7447, paragraph 44, and Case C-422/01 *Skandia and Ramstedt* [2003] ECR I-6817, paragraph 52). The need to prevent the reduction of tax revenue is not one of the grounds listed in Article 46(1) EC or a matter of overriding general interest which would justify a restriction on a freedom introduced by the Treaty (see, to that effect, Case C-136/00 *Danner* [2002] ECR I-8147, paragraph 56, and *Skandia and Ramstedt*, paragraph 53).

50 It is also apparent from case-law that the mere fact that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty (see, to that effect, *ICI*, paragraph 26; Case C-478/98 *Commission* v *Belgium* [2000] ECR I-7587, paragraph 45; *X and Y*, paragraph 62; and Case C-334/02 *Commission* v *France* [2004] ECR I-2229, paragraph 27).

51 On the other hand, a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned (see to that effect *ICI*, paragraph 26; Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779, paragraph 37; *De Lasteyrie du Saillant*, paragraph 50; and *Marks & Spencer*, paragraph 57).

52 It is necessary, in assessing the conduct of the taxable person, to take particular account of the objective pursued by the freedom of establishment (see, to that effect, *Centros,* paragraph 25, and *X and Y*, paragraph 42).

53 That objective is to allow a national of a Member State to set up a secondary establishment in another Member State to carry on his activities there and thus assist economic and social interpenetration within the Community in the sphere of activities as self-employed persons (see Case 2/74 *Reyners* [1974] ECR 631, paragraph 21). To that end, freedom of establishment is intended to allow a Community national to participate, on a stable and continuing basis, in the economic life of a Member State other than his State of origin and to profit therefrom (Case C-55/94 *Gebhard* [1995] ECR I-4165, paragraph 25).

54 Having regard to that objective of integration in the host Member State, 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 (see Case C-221/89 *Factortame and Others* [1991] ECR I-3905, paragraph 20, and Case C-246/89 *Commission* v *United Kingdom* [1991] ECR I-4585, paragraph 21). Consequently, it presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there.

55 It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.

56 Like the practices referred to in paragraph 49 of *Marks & Spencer*, which involve arranging transfers of losses, within a group of companies, to companies established in the Member States which apply the highest rates of taxation and in which the tax value of those losses is therefore the highest, the type of conduct described in the preceding paragraph is such as to undermine the right of the Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardise a balanced allocation between Member States of the power to impose taxes (see *Marks & Spencer*, paragraph 46).

57 In the light of those considerations, it must be determined whether the restriction on freedom of establishment arising from the legislation on CFCs may be justified on the ground of prevention of wholly artificial arrangements and, if so, whether it is proportionate in relation to that objective.

58 That legislation covers situations in which a resident company has created a CFC which is subject, in the Member State in which it is established, to a level of taxation which is less than three quarters of the amount of tax which would have been paid in the United Kingdom if the profits of that CFC had been taxed in that Member State.

59 By providing for the inclusion of the profits of a CFC subject to very favourable tax regime in the tax base of the resident company, the legislation on CFCs makes it possible to thwart practices which have no purpose other than to escape the tax normally due on the profits generated by activities carried on in national territory. As the French, Finnish and Swedish Governments stated, such legislation is therefore suitable to achieve the objective for which it was adopted.

60 It must further be determined whether that legislation goes beyond what is necessary to achieve that purpose.

61 The legislation on CFCs contains a number of exceptions where taxation of the resident company on the profits of CFCs does not apply. Some of those exceptions exempt the resident company in situations in which the existence of a wholly artificial arrangement solely for tax purposes appears to be excluded. Thus, the distribution by a CFC of almost the whole of its profits to a resident company reflects the absence of an intention by the latter to escape United Kingdom income tax. The performance by the CFC of trading activities excludes, for its part, the existence of an artificial arrangement which has no real economic link with the host Member State.

62 If none of those exceptions applies, the taxation provided for by the CFC legislation may not apply if the establishment and the activities of the CFC satisfy the motive test. That requires, essentially, that the resident company show, first, that the considerable reduction in United Kingdom tax resulting from the transactions routed between that company and the CFC was not the main purpose or one of the main purposes of those transactions and, secondly, that the achievement of a reduction in that tax by a diversion of profits within the meaning of that legislation was not the main reason, or one of the main reasons, for incorporating the CFC.

63 As stated by the applicants in the main proceedings and by the Belgian Government and the Commission, the fact that none of the exceptions provided for by the legislation on CFCs applies and that the intention to obtain tax relief prompted the incorporation of the CFC and the conclusion of the transactions between the latter and the resident company does not suffice to conclude that there is a wholly artificial arrangement intended solely to escape that tax.

64 In order to find that there is such an arrangement there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment, as set out in paragraphs 54 and 55 of this judgment, has not been achieved (see, to that effect, Case C-110/99 *Emsland-Stärke* [2000] ECR I-11569, paragraphs 52 and 53, and Case C-255/02 *Halifax and Others* [2006] ECR I-0000, paragraphs 74 and 75).

65 In those circumstances, in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.

66 That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State, as is apparent from the case-law recalled in paragraphs 52 to 54 of this judgment.

67 As suggested by the United Kingdom Government and the Commission at the hearing, that finding must be 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.

68 If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a 'letterbox' or 'front' subsidiary (see Case C-341/04 *Eurofood IFSC* [2006] ECR I-0000, paragraphs 34 and 35).

69 On the other hand, as pointed out by the Advocate General in point 103 of his Opinion, the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established does not warrant the conclusion that there is a wholly artificial arrangement.

70 The resident company, which is best placed for that purpose, must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine.

71 In the light of the evidence furnished by the resident company, the competent national authorities have the opportunity, for the purposes of obtaining the necessary information on the CFC's real situation, of resorting to the procedures for collaboration and exchange of information between national tax administrations introduced by legal instruments such as those referred to by Ireland in its written observations, namely Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (OJ 1977 L 336, p. 15) and, in this case, the Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains of 2 June 1976.

72 In this case, it is for the national court to determine whether, as maintained by the United Kingdom Government, the motive test, as defined by the legislation on CFCs, lends itself to an interpretation which enables the taxation provided for by that legislation to be restricted to wholly artificial arrangements or whether, on the contrary, the criteria on which that test is based mean that, where none of the exceptions laid down by that legislation applies and the intention to obtain a reduction in United Kingdom tax is central to the reasons for incorporating the CFC, the resident parent company comes within the scope of application of that legislation, despite the absence of objective evidence such as to indicate the existence of an arrangement of that nature.

73 In the first case, the legislation on CFCs should be regarded as being compatible with Articles 43 EC and 48 EC.

74 In the second case, on the other hand, the view should be taken, as submitted by the applicants in the main proceedings, the Commission and, at the hearing, the Cypriot Government, that that legislation is contrary to Articles 43 EC and 48 EC.

75 In the light of the preceding considerations, the answer to the question referred must be that Articles 43 EC and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a CFC in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure 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 that CFC is actually established in the host Member State and carries on genuine economic activities there.

Costs

76 Since these proceedings are, for the parties to the main proceedings, a step in the action pending before the national court, the decision on costs is a matter for that court. Costs incurred in submitting observations to the Court, other than the costs of those parties, are not recoverable.

On those grounds, the Court (Grand Chamber) hereby rules:

Articles 43 EC and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a controlled foreign company in another

Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure 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 that controlled company is actually established in the host Member State and carries on genuine economic activities there.

[Signatures]

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* Language of the case: English.