

## **Summary of the Thesis by Alexander Rust (EATTA Prizewinner 2007)**

full text: 267 pages (in German)

# **Necessity of a reform of the German CFC legislation**

## **I. Introduction**

After the Cadbury Schweppes decision of the European Court of Justice CFC legislations seem to be reduced to a very limited scope. However, CFC legislations are still necessary in order to prevent tax flight to low tax jurisdictions. Without a CFC legislation a taxpayer can easily reduce his tax burden by setting up a company in a low tax country and transferring his mobile assets to this company. As long as he does not repatriate his income the income remains untaxed leading to an enormous loss of tax revenues in his home country. As a result, the home country either has to raise its tax rates on non-mobile income or reduce its government spending. This thesis analyzes the different types of CFC legislations and tries to draft a CFC legislation for Germany which complies with the requirements of both tax treaty law and EC law.

## **II. Description of different CFC legislations**

CFC legislations can work in two different ways. They either attribute the income earned by the controlled foreign company to the shareholder, regarding the company as a transparent entity (piercing the veil approach), or deem a distribution of the profits earned by the foreign company to the shareholders (deemed distribution approach). As a first step the thesis describes several legislative measures which try to reduce tax flight to low tax jurisdictions and examines their effects. The impact of these legislative measures also depends on the tax treatment of dividends in the home state. In a computation system tax advantages gained by transferring income abroad are only transitional. In contrast, a dividend exemption system offers a permanent tax advantage allowing a tax free repatriation of income. An effective CFC legislation has to be coordinated with the tax treatment of dividends. Realistically, a reform of the CFC legislation is only feasible if it interferes the least possible with the general tax system. The draft presented in the thesis tries to avoid changes in other areas of tax law.

### **III. Requirements by tax treaty law**

The future CFC legislation has to be in compliance with the requirements of tax treaty law. The thesis analyses for each type of CFC legislation the relevant tax treaty provisions which might limit the scope of the respective CFC legislation. In its tax treaties Germany generally exempts business income earned through a foreign branch and applies the credit method for all sorts of passive income earned abroad. In contrast to the OECD-Model Convention, it also exempts dividends received by a German corporation if certain participation requirements are met. This intercompany dividend exemption makes a CFC legislation which follows the deemed distribution approach ineffective. A deemed distribution is covered by the dividend article of the respective tax treaty and, therefore, benefits from the intercompany dividend exemption as well.

It is, however, possible to construe a CFC legislation following the piercing the veil approach without violating tax treaty law. If the country of the shareholder treats the foreign corporation as a transparent entity whereas the country of the corporation treats the corporation as an intransparent entity the situation very much resembles the situation described in example 16 of the partnership report of the OECD. The solutions given by the report can be transferred to the CFC context. That means that the home state of the shareholder is not bound by the attribution decision of the country of the corporation. The home state of the shareholder is allowed to tax the income earned by the foreign corporation but has to avoid the double taxation in accordance with Art. 23 of the OECD-MC. Consequently, Germany has to exempt the foreign income if the foreign corporation earns business income and can be regarded as a permanent establishment of the “shareholder”. Concerning all types of passive income earned by the foreign corporation, Germany has to grant a credit for the taxes paid by the foreign corporation. This solution has the charm of treating foreign branches and foreign legal entities in exactly the same way. As a result, it is possible to draft an effective CFC legislation without violation of tax treaty law.

### **IV. Requirements of EC law**

#### **a. CFC legislation in relation to other Member States**

As a next step the requirements of EC law have to be analyzed. According to the ECJ in the Cadbury Schweppes case, CFC legislations which limit their scope to foreign controlled companies are only justified to “prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality”. In order to be effective, however, CFC legislations must go beyond what is allowed as a mere fight against wholly artificial arrangements.

The destiny of an effective CFC legislation within the European Union depends on whether or not such legislation can be justified by the need to preserve the cohesion of a tax system. The meaning of the coherence/cohesion argument is one of the central focuses of this thesis. The thesis scrutinizes all major decisions of the ECJ involving “cohesion” in the original language and shows the development of the cohesion argument over time. The etymology of the word “cohesion” and especially the synonymous use of the word “sammenhæng” for “direct link” as well as “cohesion” in the original Danish language version of the Vestergaard judgment clarify the meaning of the justification requirement. Advantage and disadvantage must be linked together so that they exactly correspond to each other and form a part of a consistent tax system.

Concerning an imputation system, the ECJ even allowed an interpersonal compensation of advantages and disadvantages in the Manninen decision. The ECJ described a computation system as justified by the need to preserve the fiscal cohesion of a tax system if the residence state of the shareholder allows an indirect credit for the corporate taxes paid by the distributing company against the tax liability of the shareholder irrespective of whether the corporate taxes are paid at home or abroad. Although a foreign corporation may be subject to a lower tax rate than a domestic corporation resulting in a lower credit entitlement of foreign dividends compared to domestic dividends this disadvantageous treatment of foreign dividends does not violate the EC treaty. Such computation system is even justified by the need to preserve the cohesion of the tax system if domestic dividends remain completely untaxed because the tax credit exactly matches the tax liability and only foreign dividends suffer from a residual tax because the tax credit is lower than the tax liability on the dividends.

These conclusions of the ECJ represent the sheet anchor for the future of an effective CFC legislation. A CFC legislation can be designed to work in the same way as a computation system and should be equally justifiable. If the CFC legislation follows the piercing the veil approach the taxes paid on the level of the CFC can be credited against the tax liability of the shareholder on his attributed income. Extending such CFC legislation to purely domestic situations does not complicate domestic tax law. Attributing the income earned by domestic corporations to the shareholder in the same way as attributing the income earned by foreign corporations leads to a tax neutral result if the taxpayer is taxed on the attributed income at a rate similar to the corporate tax rate. In this case income tax on the attributed income is matched by the credit and no income tax is due. In case of a foreign investment the attributed income may be subject to a residual tax depending on the tax rate in the country of the foreign

corporation. This new CFC legislation raises the tax burden on foreign investment to the level of a domestic investment and destroys the advantages of investing in a low tax country. The overall tax burden of a foreign and a domestic investment will be the same due to the new CFC legislation. The new CFC legislation still treats domestic and foreign investment differently as it only allows a credit at the amount of the taxes paid by the CFC<sup>1</sup>. This different treatment is, however, justified by the need to preserve the cohesion of the tax system.

#### **b. CFC legislation in relation to Non-Member States**

The free movement of capital is the only fundamental freedom which protects investments in non-member states. CFC legislations which restrict investments in countries outside the European Union have to be in compliance with Art. 56 of the EC treaty. The scope of the free movement of capital in relation to non-member states is another central point of the thesis. Although Art. 56 EC treaty uses the same wording to prohibit restrictions on the free movement in relation to other member states and to non-member states the purpose of establishing a single market within the European Union requires a stricter scrutiny for measures which limit the free movement of capital to other member states. The thesis comes to the conclusion that tax restrictions vis-à-vis third countries can be justified more easily. Even the need to protect its tax revenue against erosion qualifies as a valid justification for a CFC legislation applicable to third countries. Consequently, in relation to third countries, there is no need to abolish the current CFC legislations.

### **V. Conclusions**

As a final step the requirements of tax treaty law and EC law have to be put together. A future CFC legislation only meets both requirements if it follows the piercing the veil approach. Tax treaty law limits the scope of the CFC legislation to non-business income, EC-law as well as tax treaty law require a tax credit for the taxes paid on the level of the controlled company. Pursuant to EC law, the CFC legislation has to be extended to purely domestic situation. The thesis suggests a draft bill which raises the tax rates on passive income earned by the controlled foreign company to the level of the home country of the shareholder and does not complicate purely domestic investments. The thesis wishes to help governments to protect their tax revenues. It enables them to fight tax flight in an effective way and to abstain from raising tax rates on non-mobile income or spending cuts.

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<sup>1</sup> If the CFC legislation is extended to domestic companies the term *Controlled Foreign Company* legislation is no longer correct. This summary nevertheless continues to use the term.