CFC legislation and EC law

A. Introduction
After the Cadbury Schweppes decision\(^1\) of the European Court of Justice the scope of a CFC legislation seems to be limited. The ECJ declared that the transfer of income sources to low-tax countries does not constitute abuse and that Member States must refrain from hindering its citizens to use the lower tax level in other Member States.
This paper explains why a CFC legislation is still necessary and illustrates how a CFC legislation can be drafted in line with EC law. The imperatives of tax treaty law will only be addressed shortly.

B. The Need for a CFC legislation
Due to the system of worldwide taxation residents are taxed on all their income in the same way irrespective of whether the income is earned at home or abroad. Certain types of active income earned abroad might be exempt by a tax treaty. There is no tax advantage in transferring sources of passive income abroad as the credit method is applied to passive income and industrialized countries do not conclude tax treaties with tax havens.
However, without a CFC legislation the 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 the income earned by the foreign company the income remains untaxed in the residence country of the shareholder and the income is only taxed at a low level in the country of residence of the interposed company. This tax advantage does not depend on the conclusion of a tax treaty.
The After Tax Profit of an investment can be expressed in the following way:

\[
\text{After Tax Profit} = \text{Capital} \times [1 + \text{Return} \times (1 - \text{Tax Rate})^n] - \text{Capital}
\]

This equation explains that the after tax profit depends on the tax rate. The lower the tax rate the higher the after tax profit. The result is exponential. The longer the ultimate taxpayer reinvests the income in the interposed company the higher the return. Some examples will illustrate the attractiveness of an investment in a foreign low-tax country:

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<th>Germany 25% TR</th>
<th>Cyprus 10% TR</th>
<th>Tax Haven 0% TR</th>
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\(^1\) ECJ, September 12th, 2006, C-196/05 (Cadbury/Schweppes), ECR 2006, I-7995.
With a return of 10% the proceeds of the invested capital in the home country of the taxpayer Germany will amount within 20 years to 325% of the invested capital whereas an investment in Cyprus will amount – under the same conditions – to 460% of the capital invested and in a tax haven without taxation even to 573% of the invested capital.

In order to increase the after tax return most taxpayers will use this easy way and set up a company in a low-tax country and transfer sources of income to the foreign company.

Without a CFC legislation high tax country will lose tax revenue. As a result of the tax flight to low-tax countries, high-tax countries are obliged to either raise its tax rates on non-mobile income or reduce its government spending.

In my opinion CFC legislations are necessary to prevent the erosion of the tax base in high-tax countries and ensure an equal taxation of all taxpayers in high tax countries. I believe that a CFC legislation can be drafted in a way that it does not violate neither tax treaty law nor EC-law. In the following I will focus mainly on the EC-aspects.

### C. 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 foreign company to the shareholders (deemed dividend approach).

### D. Imperatives of Tax Treaty Law

In Germany, a deemed dividend approach CFC legislation cannot be drafted in line with the imperatives of tax treaties. Germany has concluded in many of its tax treaties an Inter Company Dividend Exemption. Dividends distributed by a corporation in a tax treaty country and received by a domestic corporation are exempt from tax by Double Taxation Conventions. Deemed dividends in the form of anticipated dividends also fall within the ambit of the dividend definition of tax treaties and, therefore, have to be tax exempt as well. Drafting a CFC legislation in line with a deemed dividend approach will not be effective in Germany. As a result, a German CFC legislation in order to be in accordance with tax treaty law has to follow the piercing the veil approach.

Tax treaties also impose restrictions on a CFC legislation drafted in accordance with the piercing the veil approach. The piercing the veil approach lifts the corporate veil of a legal entity and attributes the income earned by the company to the shareholder. In a piercing the veil approach it is the shareholder who earns the income via the premises of the (no longer existing) corporation. Whenever the premises of the corporation constitute a permanent establishment the shareholder is regarded as earning the income through a permanent

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establishment abroad. If the residence country of the shareholder has concluded a tax treaty with the country of the corporation in which business income attributable to a permanent establishment of the taxpayer is exempt in the residence country this exemption obligation has to be respected when applying a piercing the veil approach CFC legislation as well. As a result, the CFC legislation should not apply whenever the income would have been tax exempt had it been attributed directly to the shareholder.

E. Imperatives of EC Law

This paper only deals with the question whether a piercing the veil approach CFC legislation can be drafted in accordance with EC law. As a deemed dividend approach CFC legislation clearly violates tax treaty law and the proposal wants to be in line with both tax treaty and EC law an examination of the compatibility of a deemed dividend approach CFC legislation with EC is no longer necessary.

A CFC legislation drafted in accordance with the piercing the veil approach disregards the legal entity of foreign companies and treats them as transparent entities. Foreign corporations will be classified as permanent establishments of the German shareholders. According to the jurisprudence of the ECJ the legal entity status of a foreign corporation of one Member State has to be recognized in the other Member States. A look-through approach vis-à-vis foreign corporations constitutes a restriction of the EC-treaty. The investment through a foreign corporation is treated worse than a comparable investment through a domestic corporation as the income of a foreign corporation is taxed directly on the level of the shareholder whereas the income of a domestic corporation is taxed on the level of the shareholder only when distributed. This different treatment of foreign and domestic investment constitutes a restriction of the EC-treaty and is only admissible if justified.

I. Prevention of abuse

The prevention of abuse cannot justify this different treatment. 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”. Foreign corporations can be disregarded if they are letterbox companies and do not even dispose of premises, staff and a telephone extension. In most situations, however, foreign corporations have enough economic substance. For a CFC legislation to be effective it is not enough to fight mere letterbox companies. Large tax benefits are also achieved by interposing companies which have economic substance. In my opinion CFC legislations should go beyond what is allowed as a mere fight against wholly artificial arrangements.

II. Need to preserve the cohesion of a tax system

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. Cohesion as a ground for justification was introduced by the ECJ for the first time in the Bachmann judgment. In this decision the ECJ allowed a Member State to make the deductibility of insurance premiums dependent on the later taxation of the sums paid by the insurers. You only get the benefit of the deduction if you also suffer the disadvantage of the

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5 ECJ, September 12th, 2006, C-196/05 (Cadbury/Schweppes), ECR 2006, I-7995 marg. note 55.
6 ECJ of January 28th, 1992, C-204/90 (Bachmann), ECR 1992, I-249.
later taxation. Advantage and disadvantage must be linked together so that they exactly correspond to each other and form a part of a consistent tax system.

It is not quite clear whether the ECJ allows an interpersonal compensation of advantages and disadvantages. In some decisions\(^7\) the ECJ rejected the existence of a direct link between advantage and disadvantage when two different taxpayers were involved. Consequently, the Court stated that when “one is dealing with different taxes or the tax treatment of different taxpayers” a tax system cannot be regarded as coherent.

A CFC legislation compensates the lower taxation on the level of the foreign company with a higher taxation on the level of the domestic shareholder. The link is made between two different taxes: corporate tax on the level of the controlled company and income tax on the level of the shareholder.\(^8\) Additionally, two different taxpayers are involved: the controlled company and the shareholder. In case an interpersonal compensation of advantages and disadvantages automatically excludes cohesion as a ground for justification it is not possible to draft an effective CFC legislation.

However, in the Manninen decision\(^9\) the ECJ allowed an interpersonal compensation of advantages and disadvantages. The ECJ regarded 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.

The facts of the Manninen decision were as follows: A resident in Finland received dividends from a Swedish company. Had he received the dividends from a Finnish company he would have been entitled to credit the taxes paid by the Finnish company against his taxes on his dividend income. But as he received the dividends from a foreign company, he was not entitled to an indirect credit at all. The ECJ declared that the denial of an indirect tax credit violated the EC-treaty. The Finnish system was not proportionate as it went beyond what was necessary to achieve the goal of the cohesion of the tax system. The court itself proposed a modification of the Finnish imputation system which would be in accordance with the EC-treaty. This system requires the residence state of the shareholder to grant a tax credit also for the taxes paid by foreign corporations. According to the ECJ, it is however, not necessary to grant the same amount of credits as in a domestic situation. It is sufficient to grant a tax credit for the taxes actually paid. In case of the Finnish system it was enough to grant a tax credit of 28% as the Swedish companies only had to pay corporation tax of 28%. The indirect credit received in case of an investment in Sweden was less than the indirect credit received in case of an investment in Finland as dividends from a Finnish corporation gave right to an indirect credit of 29%. Finnish companies had paid corporation taxes of 29%.

On the level of the shareholder an investment in Sweden was less attractive than an investment in Finland as Swedish dividends transported an indirect credit of only 28% in comparison to the 29% Finnish dividends transported. This worse treatment constitutes a violation of the EC treaty except that the worse treatment can be justified. The ECJ saw this justification in the cohesion of the tax system. As the distributing company had only paid 28% corporation tax it could not give right to an indirect credit of more than 28%. The worse treatment on the level of the shareholder (28% indirect credit instead of 29%) was compensated by a better treatment on the level of the distributing corporation (28% corporation tax instead of 29%).

The reasoning of the court concerning an imputation system can be transferred to a CFC legislation. It requires, however, the extension of the piercing the veil approach to domestic

\(^7\) ECJ, September 18th, 2003, C-168/01 (Bosal), ECR 2003, I-9409 marg. note 30; ECJ, December 12, 2002, C-324/00 (Lankhorst Hohorst), ECR 2002, I-11780 marg. note 42.

\(^8\) If the shareholder is a corporation both the controlled company and the shareholder are subject to corporate taxation.

\(^9\) ECJ, September 7th, 2003, C-319/02 (Manninen), ECR 2004, I-7477.
situations. The ECJ judgments in re Centros\textsuperscript{10}, Überseering\textsuperscript{11} and Inspire Art\textsuperscript{12} demand that companies incorporated in other Member States are treated in the same way as similar domestic companies. If the corporate veil is lifted for domestic corporations as well there is no longer an unequal treatment concerning the attribution of income. The only unequal treatment in a piercing the veil approach consists in a different credit entitlement and this difference is allowed according to the Manninen judgment.

My proposal is the following: As a first step the corporate veil of foreign as well as of domestic corporations is lifted. In other words, all corporations are treated as transparent entities and the income earned by corporations is attributed to the ultimate shareholder who is an individual. This first step should not constitute a violation of the EC-treaty as investments through foreign and domestic corporations are treated in exactly the same way.

As a second step, a tax credit for all corporate taxes paid by the controlled companies is granted to the ultimate shareholder who is taxed on all the income earned by the corporations. This way capital export neutrality is achieved. The ultimate shareholder is taxed in the same way irrespective of whether he invests through a company in his home country or a company abroad. The credit entitlement depends on the amount of taxes paid by the controlled companies. This differential treatment is justified by the need to preserve the cohesion of the tax system.

III. Consequences for domestic investments

Unfortunately, this proposal dramatically increases the tax complexities in a mere domestic setting. The tax liability of the ultimate shareholder only rarely matches the tax credit entitlement. Depending on the personal tax rate of the ultimate shareholder he receives a tax refund (if the personal tax rate is lower than the corporate tax rate) or he suffers from an additional tax liability (if the personal tax rate is higher than the corporate tax rate).

The CFC system can be simplified if a special tax for CFC income is introduced. The attributed income has to be taxed at a rate equal to the domestic corporate tax rate. As a result, there is never an additional tax in a domestic setting. In each occasion the tax liability on the attributed income is offset against the credit entitlement which amounts to exactly the same sum. The CFC legislation will only be relevant in cross border situations. If the corporate tax rate abroad is higher than or the same as the domestic tax rate the CFC legislation does not have any effect either. Only in cases where the corporate tax rate abroad is lower than the domestic corporate tax rate (and where is a need for a CFC legislation) the CFC legislation “pushes up” the tax burden borne by the ultimate shareholder to the level prevailing in his residence state.

My proposal for a new CFC legislation does not lead to any consequences in a domestic setting whereas it makes investments in other Member States more difficult. At first glance this seems to result in a hidden discrimination. Formally, there is no distinction between foreign and domestic investments but materially, there seems to be a burden on foreign investments only. But at the end of the day the foreign investment is not treated worse than the domestic investment. The application of the CFC legislation puts the same tax on foreign investment as on domestic investment. It aggravates foreign investment but not beyond the burden on domestic investment. As long as foreign investment is not treated worse than domestic investment the EC treaty is not violated.\textsuperscript{13}

Concerning an imputation system, the ECJ confirmed in the Franked Investment Income judgment\textsuperscript{14} that an exemption system for domestic dividends and an indirect credit system for

\textsuperscript{10} ECJ, March 9th, 1999, C-212/97 (Centros), ECR 1999, I-1459.

\textsuperscript{11} ECJ, November 5th, 2002, C-208/00 (Überseering), ECR 2002, I-9919.

\textsuperscript{12} ECJ, September 30th, 2003, C-167/01 (Inspire Art), ECR 2003, I-10155.

\textsuperscript{13} See ECJ, December 6th, 2007, C-298/05 (Columbus Container), ECR not yet reported, IStR 2008, 63.

\textsuperscript{14} ECJ, December 12th, 2006, C-446/04 (Test Claimants in the FII Group Litigation), ECR 2006, I-11753 marg.
foreign dividends does not violate the EC treaty. If in a domestic situation the indirect credit annuls the tax burden on the dividend income the exemption and the indirect credit come to the same result. The ECJ only required the Member States to ensure that “foreign-sourced dividends are not subject in [the Member State of the shareholder] to a higher rate of tax than the rate which applies to nationally-sourced dividends”.\textsuperscript{15} Member States are obliged to “[offset] the amount of tax paid by the non-resident company making the distribution against the amount of tax for which the recipient company is liable…”\textsuperscript{16} An imputation system is comparable to a piercing the veil approach CFC legislation. The proposal for a new CFC legislations secures that the income attributed from foreign companies is not subject to a higher tax rate than the rate applied to income attributed from domestic companies. And it secures that in domestic and in cross-border situations the respective corporate tax liability is credited against the tax liability of the individual shareholder.

The CFC legislation is drafted in a way that is does not affect the application of the income and the corporate income tax code. The CFC tax is designed as an additional special tax which does not influence other taxes. For income and corporate income tax purposes the income attribution is not altered. For the application of the income and the corporate income tax the corporate veil is not lifted and the income is still attributed to foreign and domestic companies which earn the income. Dividend distributions by the companies to the shareholders remain taxable.\textsuperscript{17}

The CFC legislation ensures that dividends – before being taxed as dividends – have all been burdened by an equal pre-tax. My proposal for a CFC legislation fulfils the task of achieving an effective economic double taxation on dividends.

\textbf{F. Wording of the Proposal}

\textbf{CFC legislation}

\textbf{§ 1 Tax Liability of Domestic Shareholders.} Where an individual subject to unlimited tax liability has an interest of more than 1\% in a company which is not a tax exempt entity in the sense of Sec. 3 (1) of the Corporate Income Tax Code (company) the passive low-taxed income earned by the company is attributed to this individual in proportion of his interest.

\textbf{§ 2 Lower-Tier Intermediate Companies.} Where a company has an interest of more than 1\% in another company (lower-tier intermediate company) then the passive low-taxed income earned by the lower-tier company is attributed to the individual in the sense of § 1. This paragraph is applied accordingly if the lower-tier intermediate company owns in turn other lower-tier intermediate companies.

\textbf{§ 3 Passive Income.} Passive income in the sense of this law is income of all types which would not have been tax exempt by a tax treaty concluded by Germany if attributed directly to the individual.

\footnote{a series of charges to tax on dividends received by a resident company by applying rules which exempt those dividends from tax when they are paid by a resident company, while preventing, through an imputation system, those dividends from being liable to a series of charges to tax when they are paid by a non-resident company.”

\textsuperscript{15} ECJ, December 12th, 2006, C-446/04 (Test Claimants in the FII Group Litigation), ECR 2006, I-11753 marg. note 49.

\textsuperscript{16} ECJ, December 12th, 2006, C-446/04 (Test Claimants in the FII Group Litigation), ECR 2006, I-11753 marg. note 50.

\textsuperscript{17} In Germany dividends received by a corporation are completely tax exempt, dividends received by an individual are 50\% tax exempt. See Sec. 8b (1) Corporate Income Tax Code and Sec. 3 N° 40 Income Tax Code.

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§ 4 Low-Taxed Income. Income constitutes low-taxed income if it is taxed at a rate lower than 25%.\textsuperscript{18}

§ 5 CFC Tax. The passive income is calculated in accordance with the provisions of the German Income Tax Code. Expenses are only deductible if economically linked with the passive income. The attributed income is taxed at a rate of 25%. Taxes paid by companies and lower-tier intermediate companies and levied on the passive income are creditable in accordance with Sec. 34c Income Tax Code.

§ 6 Attribution of income for Income Tax Code and Corporate Income Tax Code purposes. The income attribution according to this law does not change the income attribution for purposes of other laws. The Income Tax Code and the Corporate Income Tax Code are applicable irrespective of the application of this law.

G. Evaluation of the proposal

The proposal of a new CFC legislation

- Eliminates tax advantages by setting up a company in a low-tax country and transferring sources of passive income to the company.
- Does not tax the cross-border investment more burdensome than the domestic investment. It achieves capital export neutrality.
- Taxes cross border investments through a company in the same way as cross border investment without interposing a company. It achieves neutrality of the legal form of the investment.
- Does not increase the complexity of a domestic investment.
- Is in line with tax treaty and EC law.
- Faces a trade off between efficiency and feasibility. The proposal would be more effective without a minimum holding requirement. The minimum holding requirement ensures that the shareholder has a certain influence on the controlled company and has a chance of getting the necessary information for the calculation of the passive income earned by the company. A shareholder interest of 1% is probably not enough for the collection of information.

\textsuperscript{18} The corporate tax rate in Germany.