CFC Rules: A comparison between the German and the UK system

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<tr>
<td>art.</td>
<td>article</td>
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<tr>
<td>BCL</td>
<td>Basic Constitutional Law</td>
</tr>
<tr>
<td>BeckRS</td>
<td>Beck-Rechtsprechung</td>
</tr>
<tr>
<td>BGBl.</td>
<td>Bundesgesetzblatt</td>
</tr>
<tr>
<td>BMF</td>
<td>Federal Ministry of Finance</td>
</tr>
<tr>
<td>BSTBl.</td>
<td>Bundessteuerblatt</td>
</tr>
<tr>
<td>BT-Drs.</td>
<td>Bundestag Durcksachen</td>
</tr>
<tr>
<td>BWNotZ</td>
<td>Zeitschrift für das Notariat in Baden-Württemberg</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>CFC</td>
<td>controlled foreign company</td>
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<tr>
<td>CITA</td>
<td>Corporate Income Tax Act</td>
</tr>
<tr>
<td>CS</td>
<td>Cadbury Schweppes</td>
</tr>
<tr>
<td>CSO</td>
<td>Cadbury Schweppes Overseas</td>
</tr>
<tr>
<td>CSTI</td>
<td>Cadbury Schweppes Treasury International</td>
</tr>
<tr>
<td>CSTS</td>
<td>Cadbury Schweppes Treasury Services</td>
</tr>
<tr>
<td>DBA</td>
<td>Double tax treaty</td>
</tr>
<tr>
<td>DStR</td>
<td>Deutsches Steuerrecht</td>
</tr>
<tr>
<td>DStRE</td>
<td>Deutsches Steuerrecht Entscheidungsdienst</td>
</tr>
<tr>
<td>e. g.</td>
<td>Latin: exempli gratia; for example</td>
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<tr>
<td>EC</td>
<td>European Community</td>
</tr>
<tr>
<td>ECJ</td>
<td>European Court of Justice</td>
</tr>
<tr>
<td>et al.</td>
<td>Latin: et alii / aliae / alia; and others</td>
</tr>
<tr>
<td>et seq.</td>
<td>Latin: et sequens; and the following ones</td>
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<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>EuZW</td>
<td>Europäische Zeitschrift für Wirtschaftsrecht</td>
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<tr>
<td>EuR</td>
<td>Europarecht</td>
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<tr>
<td>FA</td>
<td>Finance Act</td>
</tr>
<tr>
<td>FCJ</td>
<td>Federal Court of Justice</td>
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<tr>
<td>FFC</td>
<td>Federal Finance Court</td>
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<td>fn.</td>
<td>footnote</td>
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<tr>
<td>FTA</td>
<td>Foreign Tax Act</td>
</tr>
<tr>
<td>GTC</td>
<td>General Tax Code</td>
</tr>
<tr>
<td>HMRC</td>
<td>Her Majesty’s Revenue and Customs</td>
</tr>
<tr>
<td>i. e.</td>
<td>it est; that is</td>
</tr>
<tr>
<td>ICTA</td>
<td>Income and Corporations Taxes Act 1988</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>--------------</td>
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<tr>
<td>IFSC</td>
<td>International Financial Services Centre</td>
</tr>
<tr>
<td>IncTA</td>
<td>Income Tax Act 2007</td>
</tr>
<tr>
<td>ISIR</td>
<td>Internationales Steuerrecht</td>
</tr>
<tr>
<td>ITA</td>
<td>Income Tax Act</td>
</tr>
<tr>
<td>Ltd</td>
<td>private company limited by shares</td>
</tr>
<tr>
<td>m</td>
<td>million</td>
</tr>
<tr>
<td>n. a.</td>
<td>not available</td>
</tr>
<tr>
<td>no.</td>
<td>number</td>
</tr>
<tr>
<td>nwb</td>
<td>Verlag Neue Wirtschafts-Briefe</td>
</tr>
<tr>
<td>p.</td>
<td>page</td>
</tr>
<tr>
<td>para.</td>
<td>paragraph</td>
</tr>
<tr>
<td>plc</td>
<td>public limited company</td>
</tr>
<tr>
<td>REIT</td>
<td>Real Estate Investment Trust</td>
</tr>
<tr>
<td>sec.</td>
<td>section</td>
</tr>
<tr>
<td>SSA</td>
<td>Solidarity Surcharge Act</td>
</tr>
<tr>
<td>TTC</td>
<td>Trade Tax Code</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
</tr>
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Introduction

The thesis at hand deals with the function and consequences of controlled foreign company (CFC) rules using the CFC rules from Germany and the United Kingdom (UK) as exemplary regimes.

CFC rules represent a major part of unilateral tax regulation\(^1\) by which most countries\(^2\) try to keep tax revenues within the country and to make the shift of volatile income less attractive. As the thesis will point out, the CFC rules are embedded in an area of different clashing interests. Besides European Community (EC) law that influenced the content of the CFC rules in the past, the legitimate interest of the taxpayer to reduce the overall tax burden by effective international tax planning stands vis-à-vis the state’s interest to curb the loss of tax revenues.

The intention of chapter A is to demonstrate first the benefits a taxpayer can obtain by efficient international tax planning. This requires pointing out some general applicable principles of taxation. Then, I will focus on the CFC rules as one legal instrument a state commonly applies to curb the extent of international tax planning. The particularities of the CFC regimes in Germany and the regime of the UK will be explained in detail in chapter B. Furthermore, in chapter C, I will give an overview of the influence by the European Court of Justice (ECJ) that affected the development of both systems. Finally, some more general important dogmatic differences of those two CFC regimes will be pointed out by applying the rules on selected scenarios in chapter D. A conclusion that first discusses whether one of the systems is preferable and then outlines the main points of criticism of the German CFC rules will finally be drawn in chapter E.

\(^1\) For several unilateral and bilateral mechanisms please refer to Birle, Doppelbesteuerung, characters B and C.

\(^2\) Information about the CFC regime of the single countries is available under http://ip-online.ibfd.org/gth/. 
A. Background – Why do countries have CFC rules?

This first chapter starts with giving the background information that is necessary for dealing with CFC rules. In section I some general principles of taxation are explained to demonstrate the effect of international tax planning that caused the implementation of CFC rules in many countries. Section II then continues with an example that shall clarify the aforesaid, whereas section III refers to a further statutory provision that has to be mentioned in relation with CFC rules for reasons of comprehensiveness. This chapter refers to the German CFC rules in order to apply the abstract rules with a concrete example and thus to make them more understandable.

Basically, German CFC taxation means to impose domestic tax on the income of a foreign controlled company. The foreign income is taxed on the level of the domestic taxpayer irrespective of whether or not profits are actually distributed to a domestic taxpayer.

As individuals as well as companies are entitled to transfer income abroad, they can benefit from more favourable tax rates and optimise their overall tax burden. But even though income that is transferred abroad is no longer subject to domestic taxation and basically out of reach of the fiscal authorities – as it is shielded by the foreign company – the German legislator implemented the CFC rules to limit the consequences of international tax planning to a certain extent. In 2007 the German state lost an amount of 100 billion Euro of tax revenues due to the shift of income to more attractive countries with regard to taxation.

Besides other rules which are preventive and regulating / restrictive, the German CFC regime exclusively addresses the generation of passive income by foreign companies that

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3 A list of the countries which have implemented CFC rules until the year 2002 can be found in Arnold / McIntyre, p. 89.
4 The German CFC rules are explained in detail in chapter B section I.
5 Djanani / Brähler, p. 1.
6 The shielding effect of a company is explained in section I of this chapter.
8 Those mechanisms are e. g. rules covering transfer prices or the alignment of domestic tax rates with the international average, for the latter one please refer to http://www.bundesregierung.de/Content/DE/Magazine/emags/economy/045/sp-2-unternehmensteuerreform-wichtig-fuer-den-investitionsstandort-deutschland.html.
are controlled by domestic taxpayers. The particularity of the CFC rules represents the fact that the state is given the jurisdiction to tax with regard to certain income, even though – under the common basic principles of jurisdiction to tax – he would generally not be entitled to submit that income to domestic taxation. The following section explains the common principles of taxation and thus to which extent CFC taxation overrides them. Even though the principles apply in Germany and in the UK, again, the German tax rules are exemplarily referred to. The chapter ends with a brief description of general anti tax avoidance rules in Germany and the UK which are addressed for supplementary purposes.

I. General principles of taxation

As a first common principle of taxation, a state may only levy taxes if there is a substantial link between the state and the individual or legal entity\(^9\) that shall be subject to tax. This principle shall prevent that taxes are levied randomly.\(^10\)

Most jurisdictions follow the jurisdiction to tax based on residency with unlimited tax liability and the jurisdiction to tax based on the source with limited tax liability.\(^11\) The first has a substantial link to the taxable entity and addresses either an individual or a legal entity, whereas the latter one has a substantial link to the tax object, the source of income. Those two principles are applied side by side and differ in the base – as stated above – and the scope of tax liability.

1. **Residence jurisdiction with unlimited tax liability**

First of all, a state is entitled to levy taxes from those persons who are resident within its territory. With regard to individuals, residence jurisdiction arises as far as the individual has its residence or habitual abode within the boundaries of Germany, whereas both terms are defined by sec. 8 and 9 of the General Tax Code (GTC). The same principle applies for the scope of liability of legal entities. The genuine link that triggers the right to tax a corporation’s income based on residence jurisdiction is the domestic incorporation or place of management pursuant to

\(^9\) If individuals as well as legal entities are addressed, they are referred to as “persons”.

\(^10\) Djanani / Brähler, p. 3.

\(^11\) Wilke, para. 20.
sec. 1 of the Corporate Income Tax Act (CITA) in connection with sec. 10 and 11 GTC. Tax jurisdiction based on residency entitles the state to submit the worldwide income to taxation and thus the income that was generated domestic as well as the income that was generated abroad.12

2. **Source jurisdiction with limited tax liability**

Source jurisdiction does not entitle the tax authorities to levy taxes based on the worldwide income but rather on the income that was generated – sourced – within its territory and thus applies if the state cannot grasp the person by residence jurisdiction (source jurisdiction).13

3. **Taxable persons**

A further common principle that is applied concerns the treatment of potential tax subjects for tax purposes. Individuals as well as corporations are subject to income tax or corporate income tax, respectively. Partnerships are not covered by those rules, as they are no separate legal entity and thus no taxable object.14 Because of this tax transparency, the income that is generated by a partnership is attributed to the partner of the company. On the partner’s level, the income then forms part of its income which is subject to income tax irrespective of whether the profits were actually distributed or not.15

In contrast to this, a corporation is a separate taxable subject as it is a separate legal entity.16 The corporation is taxed separately from its shareholders. Thus, the profits of a corporation are taxed on the level of the corporation with corporate income taxes on a yearly basis independent from whether the profits were distributed to the shareholders. This leads to a further taxation of the profits with income tax on the level of the shareholder when they are actually distributed.17

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12 Sec. 1 Income Tax Act (ITA) and sec. 1 CITA.
13 Wilke, para. 18; Djanani / Brähler, p. 12.
14 Arnold / McIntyre, p. 87.
15 For Germany please refer to sec. 15 para. 1 no. 2 ITA.
16 Mössner et al., para. E 141.
17 Lüdicke / Sistermann, sec. 2, para. 1; for Germany please refer to sec. 1 CITA and sec. 2 ITA in connection with sec. 20 ITA.
II. The possibility of international tax planning due to different tax levels

The separate taxation of corporations from its shareholders as explained above does not matter as long as the corporation and its shareholders are subject to the same jurisdiction of a country. But if e. g. the company\(^\text{18}\) is established in a foreign country, the profits of the company are only taxed in the foreign country and no domestic taxation occurs. This is due to the shielding effect of the foreign company that results out of the strict separate taxation of the company and its shareholders. The profits of the company are only subject to domestic taxation if they are distributed to the shareholders. Thus, domestic taxation can be deferred. Such a deferral is beneficial if the foreign country offers more favourable tax rates and the income of the company is subject to a lower taxation compared to the domestic rate.\(^\text{19}\)

For instance, to a group of companies it is advisable to transfer the income to a subsidiary that is resident in a country with a lower corporate income tax rate. The profit is then shielded from domestic taxation until it is distributed to the shareholder and the overall tax burden can be reduced.

Due to the heavily varying tax rates,\(^\text{20}\) persons are encouraged to transfer the income to the country offering the most favourable tax regime.\(^\text{21}\) In this context, predominantly streams of passive income are transferred to countries that offer a lower taxation, because e. g. cash can be generally shifted abroad more easily since its generation is not tied to any movables or assets like e. g. a factory.\(^\text{22}\) The following example demonstrates the effect by taking the different tax levels within the European Union (EU) into consideration.

Example 1:

A German Corporation is involved in financial services and generates high interest income (1.5 m Euro). As in Germany the interest payments are taxed with 15 % corporate income

\(^{18}\) In the course of the thesis the term company refers to corporations.

\(^{19}\) Brezing et al., preface sec. 7-14 FTA, para. 1 et seq.

\(^{20}\) With regard to the EU please refer to Table 1.

\(^{21}\) Arnold / McIntyre, p. 81.

\(^{22}\) Arnold / McIntyre, p. 87.
tax plus 14 % trade tax,\textsuperscript{23} the CEO considers to source this function out to one of the subsidiaries that carry on business from several European countries in order to reduce the overall tax rate. With reference to Table 1 that lists the different tax rates that are currently applicable in the European countries, he has identified the subsidiary that is resident in the country that offers the lowest corporate income tax rate, which is Bulgaria. He calculates the different amount of corporate income tax he would have to pay in Germany and the effect from diverting the interest income to Bulgaria.

<table>
<thead>
<tr>
<th>Member state of the EU\textsuperscript{24}</th>
<th>Corporate income tax rate\textsuperscript{25}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>33%</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>10 %</td>
</tr>
<tr>
<td>Denmark</td>
<td>25 %</td>
</tr>
<tr>
<td>Germany</td>
<td>15 % plus 14 % trade tax</td>
</tr>
<tr>
<td>Estonia</td>
<td>21 %</td>
</tr>
<tr>
<td>Finland</td>
<td>26 %</td>
</tr>
<tr>
<td>France</td>
<td>33.33 %</td>
</tr>
<tr>
<td>Greece</td>
<td>25 %</td>
</tr>
<tr>
<td>Hungary</td>
<td>16 %</td>
</tr>
<tr>
<td>Ireland</td>
<td>12.5% for trading income</td>
</tr>
<tr>
<td></td>
<td>25% for non-trading income</td>
</tr>
<tr>
<td>Italy</td>
<td>27.5 %</td>
</tr>
<tr>
<td>Latvia</td>
<td>15 %</td>
</tr>
<tr>
<td>Lithuania</td>
<td>20 %</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>21 %</td>
</tr>
<tr>
<td>Malta</td>
<td>35 %</td>
</tr>
<tr>
<td>Netherlands</td>
<td>25.5 %</td>
</tr>
<tr>
<td>Poland</td>
<td>19 %</td>
</tr>
<tr>
<td>Portugal</td>
<td>25 %</td>
</tr>
<tr>
<td>Romania</td>
<td>16 %</td>
</tr>
<tr>
<td>Slovakia</td>
<td>19 %</td>
</tr>
<tr>
<td>Slovenia</td>
<td>21 %</td>
</tr>
<tr>
<td>Spain</td>
<td>24 %</td>
</tr>
</tbody>
</table>

\textsuperscript{23} For the total tax burden please refer to fn. 71.
\textsuperscript{24} http://europa.eu/abc/european_countries/index_en.htm.
\textsuperscript{25} The table lists the general rates; surcharges are not considered; http://ip-online.ibfd.org/gth/index.jsp?where=/collections/wht/wht_al.html.
<table>
<thead>
<tr>
<th>Member state of the EU</th>
<th>Corporate income tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>26.3 %</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>28 %</td>
</tr>
</tbody>
</table>

Table 1: The differing tax levels within the EU. Source: self-generated

Alternative 1: Paying corporate income tax in Germany

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income</td>
<td>1.5 m Euro</td>
</tr>
<tr>
<td>Domestic tax(^{26})</td>
<td>1.5 m Euro * 29.825 %</td>
</tr>
<tr>
<td><strong>Total tax burden</strong></td>
<td><strong>447,375 Euro</strong></td>
</tr>
</tbody>
</table>

Alternative 2: Paying corporate income tax in Bulgaria

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income</td>
<td>1.5 m Euro</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>1.5 m Euro * 10 %</td>
</tr>
<tr>
<td><strong>Total tax burden</strong></td>
<td><strong>150,000 Euro</strong></td>
</tr>
</tbody>
</table>

This basic example shows that by planning taxes carefully, great monetary benefits can be obtained, while the structuring of a transaction in a smart manner in order to optimise the overall tax burden represents a legitimate interest of the domestic taxpayer. That tax planning has to be strictly distinguished from tax evasion is in compliance with case law. In numerous decisions the Federal Finance Court (FFC) confirmed that a taxpayer is not obliged to pay higher taxes but that he rather has the right to set up structures in a way that allows a maximal reduction of the tax burden.\(^{27}\) In contrast to tax avoidance, tax evasion is illegal and generally connected with fraud or the non-disclosure of tax relevant information towards the tax authorities. Tax evasion as an offence is incorporated in sec. 370 GTC.

\(^{26}\) For the tax burden of a German resident company please refer to fn. 71.

III. General anti-abuse rules in Germany

If one takes a closer look on the German CFC regime, one has to address sec. 42 GTC, too. As the CFC rules represent a further development of sec. 42 GTC, this section is important to understand the underlying rationale of the CFC rules.

The following subsections first contain a description of the application of sec. 42 GTC. After this, the limited scope of that section that encouraged the implementation of the CFC rules will be outlined and finally, the hierarchy of both rules will be explained.

1. Sec. 42 GTC

The general anti-abuse rule in sec. 42 GTC has a broader scope. It aims to avoid that a taxpayer circumvents the German tax laws by applying abusive legal construction opportunities. A legal construction opportunity is abusive, if the taxpayer has chosen an inappropriate structure to meet its economic targets that resulted in a tax advantage that was not intended by law.\(^{28}\) If a situation is covered by sec. 42 GTC and if no other tax law provision is applicable, the taxpayer is treated as if he did not apply the inappropriate legal construction.

German case law defined some exemplary cases that fall within the scope of sec. 42 GTC.\(^{29}\) Besides others, the use of a base company – a “Domizil- und Briefkastengesellschaft”\(^{30}\) – to shield income from domestic taxation represents an abuse of legal structure opportunities under certain circumstances.

If adjudication classifies an intermediate company as a base company that was implemented only to divert income to a foreign country offering lower taxation, the shareholder is taxed as if the abusive construction has not been established. The income is then attributed to the shareholder of the base company directly and taxed with the domestic income tax rate as part of that shareholder’s income irrespective of whether the profit of the base company was distributed to the shareholder or not. As a particularity of this provision, the attribution of income to

\(^{28}\) Klein, sec. 42, para. 1 et seq.

\(^{29}\) An overview gives Kraft, sec. 42, table of contents.

\(^{30}\) The definition of a base company is given in subsection 2.
the taxpayer does not require the denial of the legal existence of the base company itself. Rather, the structure chosen in order to gain a tax advantage is ignored for tax purposes.\(^{31}\) Thus, if the criteria of sec. 42 GTC are fulfilled, the company is looked through.

2. **Limitations of sec. 42 GTC**

The application of sec. 42 GTC is limited by strict criteria.\(^{32}\) Jurisdiction settled the principle that establishing a base company has to be assumed being a misuse of legal construction opportunities only as long as no economic or other substantial reasons can justify the establishment and if the base company is a mere letterbox having no corporate infrastructure like organs or offices.\(^{33}\) By assessing the economic function of the base company, objective criteria like the existence of offices and sufficient personnel have be taken into consideration as they are strong indications.\(^{34}\) Nevertheless, all facts of a case have to be taken into consideration carefully.\(^{35}\)

This limit was confirmed by an important decision of the FFC on 19.01.2000.\(^{36}\) The dispute occurred in connection with shares held by a German company in an Irish one. Being located in the Dublin-Docks, the Irish company benefited from tax privileges. As an International Financial Services Centre (IFSC), the income of the company was subject to 10 % corporate income tax rate, a state aid granted by the European Commission.\(^{37}\) The Irish company's task was to administer the capital contributed by the German company.

The fiscal authorities claimed that the German company only involved the Irish company for exercising financial services to divert income to a tax regime offering more favourable tax rates and thus assumed the requirements of sec. 42 GTC

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\(^{31}\) Christoffel et al., para. 8666.


\(^{33}\) Klein, sec. 42, para. 38; for further details to the term letterbox please refer to FFC case VIII B 61-62/74, BeckRS 1975, 22003050; FFC case I R 42/02, DSIR 2004, p. 1284.

\(^{34}\) FFC, case I R 117/97, ISIR 2000, 186.

\(^{35}\) Kraft, sec. 7, para. 62.

\(^{36}\) FFC, case I R 117/97, ISIR 2000, 182-186.

\(^{37}\) FFC, case I R 117/97, ISIR 2000, 182.
being fulfilled. This opinion was denied by the court as economic and substantial reasons were apparent. Because the Irish company had a Board of Directors that managed the investment activities, the Irish company was not a sole letterbox. In addition to this, the state aid granted by the Irish government was legitimated by the European Commission and the German government missed its chance to raise objections in the respective authorisation procedure.\textsuperscript{38} In a following decision\textsuperscript{39} the FFC even affirmed that a state aid granted by the European Commission cannot be abusive in the terms of sec. 42 GTC at all.

Finally, the fact that the company generated passive income excluded the application of sec. 42 GTC. By regulating those situations as apparent in the case expressly with CFC rules, the legislative body excluded such cases from the scope of sec. 42 GTC.\textsuperscript{40} Otherwise, if such an submission to CFC rules was not intended by the legislative body, CFC rules would not have been implemented at all. In addition to this, because of the incorporation in the statute, the abusive character of the structure chosen that is required by sec. 42 GTC can no longer be affirmed.

With regard to the diversion of income abroad, the scope of application of sec. 42 GTC is strictly limited. Thus, the German legislator implemented the CFC rules as a supplemental instrument that does not address base companies that are implemented without having economic or other substantial reasons but rather controlled foreign companies generating passive income.\textsuperscript{41}

\textbf{IV. General anti-abuse rules in the UK}

The legal system of the UK does not contain a comparable rule to the German sec. 42 GTC that addresses tax avoidance in general. Instead of providing a general rule, each UK tax avoidance rule addresses a rather specific situation, e.g. with regard to transaction in securities.\textsuperscript{42}

\textsuperscript{38} FFC, case I R 117/97, IStR 2000, 185.
\textsuperscript{39} FFC, case I R 42/02, IStR 2004, 529.
\textsuperscript{40} FFC, case I R 117/97, IStR 2000, 186.
\textsuperscript{41} The CFC rules from Germany and the UK are explained in detail in the following chapter B.
\textsuperscript{42} Sec. 682 et seq. Income Tax Act 2007 (IncTA).
The tax avoidance rules can be found in part 17 of the Income and Corporations Taxes Act from 1988 (ICTA) and in part 13 IncTA. The first does only contain rules for companies and the latter is only applied for individuals. While the CFC rules applicable for companies can be found in sec. 747 et seq. ICTA, the corresponding rules addressing individuals are set out in sec. 714 et seq. Income Tax Act 2007.

B. CFC rules in Germany and the UK

The German and the UK legislator have – besides other states – implemented CFC legislation in order to prevent resident taxpayers from implementing intermediate companies in countries with lower tax rates for the purpose of diverting income. As outlined above, first of all the German legislator’s intention to implement CFC rules was to establish rules that cover those cases in which the involved foreign company cannot be qualified as a base company and thus sec. 42 GTC is not applicable. The main conceptual difference between the two CFC regimes is the different approach towards the extent of income of the controlled foreign company that has to be attributed to the domestic shareholder. While the German CFC regime follows the so-called transaction approach, the UK CFC regime applies the so-called entity approach.

The transaction approach does only attribute certain foreign income that is generated by the foreign company to the domestic shareholder, whereas the CFC rules predetermine which income is concerned. In contrast to this, if a UK resident taxpayer is subject to CFC taxation, the whole amount of the income generated by the foreign income has to be attributed to the domestic shareholder and builds the base of CFC taxation. Of course, in both approaches, the amount that is attributed to the domestic shareholder income corresponds to its ratio of the shareholding in the foreign company.

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43 Both acts were last amended by the Finance Act 2008 (FA 2008).
44 The rules will be explained in detail in chapter B section II.
45 Kraft, sec. 7, para. 1.
46 The consequences of the two approaches will be demonstrated in chapter D section II.
47 Arnold / McIntyre, p. 94; both approaches will be clarified in the scenarios in chapter D.
In the following two sections, the concepts of the German and the UK CFC rules will be outlined, whereas the single requirements will be explained in more detail.

I. The German CFC rules

The German CFC rules apply in general if a German resident taxpayer holds more than 50% of the share capital of a foreign company (controlled foreign company). As a consequence, the income for which the company is the intermediate company (Zwischengesellschaft) is attributed in proportion to the German taxpayer’s holding the shares in the controlled foreign company. To a controlling German resident taxpayer such an attribution takes place irrespective of whether the intermediate company actually makes a profit distribution or not. The amount to add, the so called inclusion amount (Hinzurechnungsbetrag), is subject to income tax, corporate income tax and trade tax.48

If the controlled foreign company generates so called income with investment capital character (Zwischeneinkünfte mit Kapitalanlagecharakter), even a lower shareholding quota leads to the applicability of the CFC rules. In such a case, the CFC rules do already apply to a shareholding in the foreign company of at least 1%.49 Even stricter requirements apply, if the controlled foreign company generates almost exclusively income with capital investment character. Then CFC taxation applies, if the shareholding is less than 1% unless the shares are traded constantly on a stock exchange.50

The following description of the German CFC rules focuses on the most important aspects; the newly implemented sec. 8 para. 2 Foreign Tax Act (FTA) is excluded. Thus, this section describes the legal situation before the European Court of Justice decided the case “Cadbury Schweppes” which heavily influenced the development of the German CFC rules in the past. As this influence of EC case law is very important, a separate chapter will analyse the happenings in more detail in chapter C section III.

48 Blümich, sec. 7 FTA, para. 47.
49 For further information please refer to subsection 9 of this section; in accordance with sec. 7 para. 6 FTA; Blümich, sec. 7 FTA, para. 51 et seq.
50 Sec. 7 para. 6 sentence 3 FTA.
1. **The foreign company**

The definition of a foreign company is incorporated in sec. 7 para. 1 FTA. In accordance with this section the foreign company must be a company in the terms of sec. 1 CITA. Whether the foreign company fulfils this requirement is assessed by analysing if the company established under foreign law resembles a German corporation or another legal person within the meaning of sec. 1 para. 1 CITA.\(^{51}\) Accordingly, a foreign company shall be classified as a corporation if it is similar to a German corporation or another legal person in legal and economic terms. In addition to this, the company in consideration may neither have its place of management nor its registered offices within Germany and may not be exempt from corporate tax liability under sec. 3 para. 1 CITA which lists those companies that are exempt from corporate income tax.

2. **The addressees**

The rule addresses individuals and corporations that are resident taxpayers in Germany in the terms of sec. 1 para. 1 a ITA and sec. 1 CITA.\(^{52}\) and engaged in outbound investments.\(^{53}\)

3. **Exercising control**

As the description below shows, the rules about the definition of exercising control are very comprehensive and cover a broad range of constellations.

In general, a shareholder exercises control over a foreign company in the terms of the Foreign Tax Act if it holds more than 50% of the shares of the foreign company or of the voting rights.\(^{54}\) In compliance with the prevailing opinion of literature, only those holdings that are known by corporate law constitute a holding in the terms of the FTA.\(^{55}\) Thus, the holding of a share in the foreign company first of all requires

\(^{51}\) Blümich, sec. 7 FTA para. 14; the so-called “Typenvergleich” was established by the Federal Court of Justice (FCJ), case IX R 182/87, BeckRS 1992, 22010354; Blümich, sec. 1 CTA, para. 140 et seq.

\(^{52}\) Blümich, sec. 7 ITA, para. 13.

\(^{53}\) Christoffel et al., para. 9010.

\(^{54}\) Sec. 7 para. 1 FTA.

\(^{55}\) This principle e.g. does not cover profit-sharing rights and does even apply if any right entitles to income that is treated as dividends. Kraft, sec. 7, para. 192; Flick / Wassermeyer / Baumhoff, sec. 7, para. 12; Blümich, sec. 7 FTA, para. 21 et seq.
holding the share in the nominal capital. As an alternative, the foreign company is controlled if the German resident taxpayers hold more than 50% of the voting rights.\textsuperscript{56} If the foreign company neither has nominal capital nor voting rights, the ration of the holding in the company’s assets is crucial.

The general principle of holding 50% in the foreign company is modified besides others in sec. 7 para. 2 FTA. In accordance with this section, the shareholding quota must be held at the end of the company’s financial year. Furthermore, a resident taxpayer can hold the majority share either alone or together with other resident taxpayers. The majority share can even be held together with an individual that relocated its residency to a country with low taxation in accordance with sec. 2 FTA.

Even shares and voting rights that are held indirectly through another foreign company have to be attributed proportionally to the shareholders.\textsuperscript{57}

If a German resident taxpayer holds the shares in the foreign company through one or more partnerships or even if a third party which is bound to directives of the resident taxpayer holds those shares, \textsuperscript{58} the same rules apply according to sec. 7 para. 3 FTA.

4. \textit{Income of intermediate companies / passive income}

The income of a controlled foreign company is only subject to CFC rules for which the controlled foreign company is the intermediate company. The definition of the income for which the foreign company is the intermediate company (CFC income) can be found in sec. 8 FTA.

Instead of defining CFC income itself, the legislator incorporated an exhaustive catalogue in sec. 8 para. 1 FTA which lists all sources of income that do not constitute CFC income. In accordance with common principles, foreign income is excluded from CFC taxation provided that it is generated by exercising genuine

\textsuperscript{56} Sec. 7 para. 2 sentence 2 FTA.
\textsuperscript{57} Sec. 7 para. 2 sentence 2 FTA.
\textsuperscript{58} Sec. 7 para. 4 FTA.
economic activity.\textsuperscript{59} Thus, the catalogue lists active income and leaves passive income in the scope of CFC taxation only.\textsuperscript{60}

To qualify the income that the controlled foreign company generates into active or passive income, a functional view must be applied.\textsuperscript{61} This reflects the fact that the income of a controlled foreign company is rarely either solely active or passive. Applying a functional view means that not every single income source has to be considered separately but that activities that are economically connected with each other may be allocated to one income category only. Thus, side activities have to be allocated to the major business.\textsuperscript{62}

The following table gives an overview over the main content of the negative list, i.e. the categories of active income.\textsuperscript{63} The list differentiates between active and passive income, because under certain circumstances a basically passive income might be re-qualified in active income. This might be the case – as mentioned above – if the passive income is economically connected with an activity that generates active income. The same re-qualification can apply to income that is generally classified as active income if facts occur that invert this status. For instance, such a harmful aspect has to be affirmed if the controlled foreign company exercises business mainly with in Germany resident taxpayers that hold shares in it, because such a constellation strengthens the assumption that income is intentionally diverted abroad only in order to safe domestic taxes.

\begin{itemize}
\item \textsuperscript{59} Blümich, FTA preface, para. 25.
\item \textsuperscript{60} Kraft, sec. 8, para. 2.
\item \textsuperscript{61} Blümich, sec. 8 FTA, para 9; Kraft, sec. 8, para. 30 et seq.
\item \textsuperscript{62} Kraft, sec. 8, para. 33.
\item \textsuperscript{63} In accordance with Christoffel, para. 9015.
\end{itemize}
<table>
<thead>
<tr>
<th>Qualification as active income</th>
<th>Qualification as passive income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture and forestry</td>
<td>• N. a.</td>
</tr>
<tr>
<td>The manufacture, processing, preparation or assembly of tangible objects, the production of</td>
<td>• N. a.</td>
</tr>
<tr>
<td>energy as well as exploration for and extraction of minerals</td>
<td></td>
</tr>
<tr>
<td>The operation of banking institutions or insurance companies</td>
<td>• If the foreign company does</td>
</tr>
<tr>
<td></td>
<td>not maintain commercially</td>
</tr>
<tr>
<td></td>
<td>equipped offices in the</td>
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<td></td>
<td>country it is resident to</td>
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<td></td>
<td>exercise their business</td>
</tr>
<tr>
<td></td>
<td>operations or</td>
</tr>
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<td></td>
<td>• If the foreign company</td>
</tr>
<tr>
<td></td>
<td>carries on business</td>
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<tr>
<td></td>
<td>predominantly with German</td>
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<td></td>
<td>resident taxpayers or with</td>
</tr>
<tr>
<td></td>
<td>closely related parties</td>
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<td></td>
<td>thereto. Closely related</td>
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<td></td>
<td>parties in the terms of the</td>
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<td></td>
<td>CFC rules are persons that</td>
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<tr>
<td></td>
<td>hold a substantial share (at</td>
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<td></td>
<td>least 25 %) in the German</td>
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<tr>
<td></td>
<td>resident taxpayer and even</td>
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<td></td>
<td>third parties that can</td>
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<tr>
<td></td>
<td>influence the German resident</td>
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<tr>
<td></td>
<td>taxpayer.64</td>
</tr>
<tr>
<td>Trading</td>
<td>• If the German resident</td>
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<tr>
<td></td>
<td>taxpayer or a party that is</td>
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<tr>
<td></td>
<td>closely related to party</td>
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<tr>
<td></td>
<td>thereto has provided the</td>
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<td></td>
<td>foreign company with the</td>
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<tr>
<td></td>
<td>authority to dispose the</td>
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<tr>
<td></td>
<td>goods and merchandise traded.</td>
</tr>
<tr>
<td></td>
<td>• If a foreign company has</td>
</tr>
<tr>
<td></td>
<td>provided the German resident</td>
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<tr>
<td></td>
<td>taxpayer or a closely related</td>
</tr>
<tr>
<td></td>
<td>party thereto with the</td>
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<tr>
<td></td>
<td>authority to dispose the</td>
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<tr>
<td></td>
<td>goods and merchandise traded.</td>
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<tr>
<td></td>
<td>A re-qualification because</td>
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<tr>
<td></td>
<td>of the reasons as mentioned</td>
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<tr>
<td></td>
<td>above does not apply if the</td>
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<td></td>
<td>taxpayer can demonstrate</td>
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<td></td>
<td>that the foreign company</td>
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<td></td>
<td>maintains commercially</td>
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<td></td>
<td>equipped offices for such</td>
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<td></td>
<td>trading activities, takes</td>
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<td></td>
<td>part in general commerce and</td>
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<td></td>
<td>conducts work on preparing,</td>
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<tr>
<td></td>
<td>concluding and implementing</td>
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<tr>
<td></td>
<td>such business without the</td>
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<tr>
<td></td>
<td>participation of a German</td>
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<tr>
<td></td>
<td>resident taxpayer or a</td>
</tr>
<tr>
<td></td>
<td>closely related party thereto.</td>
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<tr>
<td>Services</td>
<td>• If the foreign company</td>
</tr>
<tr>
<td></td>
<td>makes use of the service of</td>
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<tr>
<td></td>
<td>a German resident taxpayer</td>
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<tr>
<td></td>
<td>or a closely related party</td>
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<td></td>
<td>thereto. A re-qualification</td>
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<tr>
<td></td>
<td>does not apply if the German</td>
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<td></td>
<td>resident taxpayer can</td>
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<td></td>
<td>demonstrate that the foreign</td>
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<td></td>
<td>company maintains commercially</td>
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<td></td>
<td>equipped offices for</td>
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<td></td>
<td>performing such services,</td>
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<td></td>
<td>participates in general</td>
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<td></td>
<td>commerce and performs the</td>
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<td></td>
<td>work included in its services</td>
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<td></td>
<td>without the participation of</td>
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<tr>
<td></td>
<td>a German resident taxpayer</td>
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<tr>
<td></td>
<td>or a closely related party</td>
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<tr>
<td></td>
<td>thereto.</td>
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<tr>
<td>Renting and leasing</td>
<td>• If the foreign company</td>
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<tr>
<td></td>
<td>grants the authorised use</td>
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<tr>
<td></td>
<td>of rights, plans, designs,</td>
</tr>
<tr>
<td></td>
<td>processes, knowhow and skills</td>
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<tr>
<td></td>
<td>unless the German resident</td>
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<tr>
<td></td>
<td>taxpayer can demonstrate</td>
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<td></td>
<td>that the foreign company</td>
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<td></td>
<td>commercialises the results</td>
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<td></td>
<td>of its own research and</td>
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<td></td>
<td>development work that it</td>
</tr>
<tr>
<td></td>
<td>undertook without the</td>
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<tr>
<td></td>
<td>participation of German</td>
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<tr>
<td></td>
<td>resident taxpayer or a closed</td>
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<tr>
<td></td>
<td>related party thereto.</td>
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<td></td>
<td>• If the foreign company</td>
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<tr>
<td></td>
<td>rents and leases real estate</td>
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<td></td>
<td>unless the German resident</td>
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<tr>
<td></td>
<td>taxpayer can demonstrate</td>
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<td></td>
<td>that the income would be</td>
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<tr>
<td></td>
<td>exempt from taxation under a</td>
</tr>
<tr>
<td></td>
<td>double taxation convention</td>
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<tr>
<td></td>
<td>if it was derived directly by</td>
</tr>
</tbody>
</table>

64 For further details please refer to sec. 1 para. 2 FTA.
<table>
<thead>
<tr>
<th>Qualification as active income</th>
<th>Qualification as passive income</th>
</tr>
</thead>
<tbody>
<tr>
<td>taxpayer.</td>
<td>If the foreign company rents and leases movables unless the German resident taxpayer can demonstrate that the foreign company maintains a business operation of commercial renting or leasing, participates in general commerce and performs all work associated with such commercial renting and leasing without the participation of the German resident taxpayer or a closely related party thereto.</td>
</tr>
</tbody>
</table>

The borrowing and lending of capital

- If the German taxpayer cannot demonstrate that the capital has been borrowed exclusively on foreign capital markets. Furthermore, the capital must not be supplied to businesses or permanent establishments within the scope of jurisdiction of the FTA. In addition to this, the capital must not be supplied to a business or permanent establishment that is outside the scope of jurisdiction of the FTA, too, but only if it does not earn gross revenues exclusively from those activities generating active income as listed in no. 1-6.

Dividends from other corporations

- N. a.

Gains realised by sale of shares in other companies / increases or decreases in capital

- If the gains are realised by the sale of assets that were used to generate income with capital investment character.66

Table 2: The qualification of income in accordance with sec. 8 para. 1 FTA. Source: self-generated

5. Low taxation

CFC taxation is not triggered automatically as far as the controlled foreign company generates passive income. As a cumulative requirement sec. 8 para. 1 FTA requires that the passive income of the controlled foreign company must be subject to low taxation, too. Section 8 para. 3 FTA ascertains a low taxation starting at less than 25 %.

With the implementation of the FTA in 1972, low taxation was fixed at a rate of 30 %67. In 2001 this rate was adjusted to the corporate income tax rate that was

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65 In compliance with the prevailing opinion in the literature, not only ordinary profit distributions of a corporation fall within this active income category. The qualification of dividends as active income and thus the factual exclusion of CFC taxation represents a necessary adjustment. This is due to the fact that certain capital gains that are received by German resident companies are exempt from corporate income tax in accordance with sec. 8 b CITA. The scope of this tax exemption of the CITA has to be transferred to the extent of this active income category as otherwise foreign income would be discriminated compared to the domestic receipt. Thus, all capital gains sec. 8 b CITA refers to – which are incorporated in sec. 20 para. 1 no. 1, 2 and 9 – are addressed by this active income category, too. Therefore e. g. profit-sharing rights have to be classified as active income, too.

66 For further details please refer to sec. 8 para. 1 no. 9 FTA.

67 Sec. 8 FTA in the version of art. 1 Foreign Tax Reform Act 1972.
applicable at that time and thus reduced to 25 %. But in the course of the reduction of the corporate tax rate to 15 % in 2008, the rate of low taxation was not adjusted as the legislative body did not see any necessity. The legislator justified the rate of low taxation by the fact that an average tax burden of a German resident company – which consists of corporate income tax plus solidarity surcharge and trade taxes – is about 29.825 % and thus the rate of low taxation is still lower. This statement is subject to criticism, as the calculated tax burden of 29.825 % only occurs in case a municipal rate of 400 % applies. Thus, even a German resident company might generate income that is subject to low taxation in the terms of the FTA.

6. **The amount to apportion**

The amount of income that is attributable to the respective shareholding of a foreign company has to be determined in accordance with sec. 7 para. 1 FTA. As the two previous sections explained, only passive income subject to low taxation of the foreign company will be attributed to a resident taxpayer.

Technically, the CFC income is generally attributed to a single shareholder in proportion to his shareholding in the foreign company’s nominal capital. If the foreign company has no nominal capital or if the same is not the base for the distribution of profits, the distribution of profits has to be taken as the basis for attribution as an alternative.

7. **Inclusion amount**

The inclusion amount is calculated on the basis of the income of the controlled foreign company. The CFC income in turn has to be calculated under application of

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68 Sec. 8 FTA in the version of art. 5 no. 3 Corporate Tax Reform Act 2001.
69 Sec. 25 CITA in the version of art. 10 Corporate Tax Reform Act 2008.
70 BT-Drs. 16/6290, art. 24, general aspects.
71 15 % corporate income tax * 5.5 % solidarity surcharge + 14 % trade tax = 29.825 %. This is in accordance with sec. 23 CITA in connection with sec. 4 of the Solidarity Surcharge Act (SSA) and sec. 16 of the Trade Tax Code (TTC).
72 Blümich, sec. 8 FTA, para. 181 et seq.
73 If a municipality applies the minimum rate of 200 % in accordance with sec. 16 para. 4 TTC, the total tax burden of the company is 22.825 % including the solidarity surcharge of 5.5 % in accordance with sec. 4 SSA.
74 Sec. 7 para. 5 FTA.
the German income tax rules; i. e. the income is treated as if it was generated in
Germany.

Section 10 FTA gives guidance on how to calculate the inclusion amount that is
finally added to the resident taxpayer’s income. Simplified, the CFC income has to
be reduced by the taxes levied at the expense of the foreign company on that
income and on the assets on which such income is based. Since sec. 10
para. 2 FTA simulates a yearly distribution of the profits, taxes may only be
deducted to the extent that they actually have been paid at the time when income
is deemed to have been received. If taxes have not been charged at the time the
income is imputed, they may only reduce the CFC income in the year they have
been paid. Of course, no inclusion amount can be added on the resident taxpayer’s
income if the resulting inclusion amount is negative. If the inclusion amount is not
negative, it forms part of the capital income pursuant to sec. 20 para. 1 no. 1 ITA
and is deemed to be received by the German resident taxpayer immediately at the
end of the financial year of the controlled foreign company irrespective of any
actual profit distribution.\(^{75}\) Section 10 para. 2 sentence 3 FTA furthermore
determines that the inclusion amount that is added on the taxpayer’s income is not
subject to any tax privileges.\(^{76}\)

The inclusion amount is modified by further amounts, if certain requirements are
met. For example, the gains realised by particular sales transactions are not to be
considered by the calculation of the inclusion amount. The gains, a controlled
foreign company realises by the sale of shares in another foreign company or a
company in the terms of sec. 16 of the REIT-codification as well as the gains
realised by dissolution or by a capital increase or decrease of the same have to be
excluded from the inclusion amount in accordance with sec. 11 FTA, too. This
exclusion does only apply if the income of the other company (or of a further

\(^{75}\) Sec. 10 para. 2 FTA.

\(^{76}\) In case the inclusion amount is added to the income of an individual, the partial income procedure as set out in sec. 3
no. 40 ITA does not apply. In also case the amount is added to the income of a company, the tax relief of capital gains
granted in sec. 8 b CITA does not apply. In addition to this, for both taxpayers the final withholding tax rate of 25 % that
is incorporated in sec. 32 d ITA and that generally applies on capital gains does not apply.
downstream company) is income with capital investment character (sec. 7 para. 6 a FTA) and – as inclusion amount – was subject to income tax or corporate income tax for the recent calendar year, the recent business year or in each case in one of the seven previous years. Additionally, the profits may not have been distributed and the taxpayer must be able to demonstrate this fact.

The following example will bring the aforementioned aspects together.

Example 2:

A German company (GerCo) holds 65 % in the shares of a subsidiary that is established in Romania (RoCo). Besides active income the subsidiary generates passive income with capital investment character that is taxed with 16 % corporate income tax. Thus, the foreign income is subject to German CFC taxation in accordance with sec. 7 FTA.  

The subsidiary makes a loss of 5,000 Euro in year 1 which has to be allocated to the capital investment business entirely. In year 2 a total profit of 1 m Euro is generated from which 850,000 Euro represent passive income. The Romanian company makes a profit again in year 3 and generates 500,000 Euro total income. 400,000 Euro from this amount again represent passive income. In this year, RoCo pays the corporate income taxes on the profit of year 2. The following table gives an overview over the financial situation of RoCo.

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A re-qualification in active income in accordance with sec. 8 para. 2 FTA is not possible as the income with capital investment character is not covered by the motive test. For detailed information about the motive test please refer to chapter C section III.
As RoCo generates no income in year 1, the attributable income to GerCo is nil and no CFC taxes are levied on the level of GerCo. But in year 2, the foreign subsidiary generates passive income that has to be modified first before it can be attributed to the domestic shareholder. As sec. 10 para. 3 sentence 5 FTA in connection with sec. 10 d ITA states, the loss of the previous year can be deducted from the income of year 2. Thus, corresponding to the ratio of shares GerCo holds in the foreign company, 549,250 Euro of the foreign income are attributed to GerCo in year 1 on which an amount of 163,814 Euro of domestic taxes is charged.

In the following year, the foreign income is reduced by the tax payment that RoCo has made. Even though RoCo has paid the taxes on the profits of the previous year, the tax payment first reduces the attributable income when the payment has been actually made. Again, under consideration of the ratio of shares GerCo holds in the foreign company, 41,600 Euro are added on GerCo’s income and 12,407 Euro domestic taxes are charged. The following table summarises the aforesaid.

<table>
<thead>
<tr>
<th>Year</th>
<th>Passive income of RoCo</th>
<th>Romanian corporate income tax on passive income</th>
<th>Actual tax payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>- 5,000 Euro</td>
<td>0 Euro</td>
<td>-</td>
</tr>
<tr>
<td>Year 2</td>
<td>850,000 Euro</td>
<td>850,000 Euro * 16%</td>
<td>136,000 Euro</td>
</tr>
<tr>
<td>Year 3</td>
<td>400,000 Euro</td>
<td>400,000 Euro * 16%</td>
<td>64,000 Euro</td>
</tr>
</tbody>
</table>

Financial situation of RoCo. Source: self-generated

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78 In accordance with sec. 10 para. 1 sentence 3 FTA.
79 For the tax burden of a German resident company please refer to fn. 71.
<table>
<thead>
<tr>
<th>Year</th>
<th>Attributable income</th>
<th>Modifications</th>
<th>Inclusion amount</th>
<th>Domestic corporate income tax and trade tax</th>
<th>CFC taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0 Euro</td>
<td></td>
<td>0 Euro</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2</td>
<td>850,000 Euro</td>
<td>- 5,000 Euro</td>
<td>549,250 Euro</td>
<td>549,250 Euro * 29,825 %</td>
<td>163,814 Euro</td>
</tr>
<tr>
<td>3</td>
<td>400,000 Euro</td>
<td>- 136,000 Euro* 65 %</td>
<td>41,600 Euro</td>
<td>41,600 Euro * 29,825 %</td>
<td>12,407 Euro</td>
</tr>
</tbody>
</table>

CFC tax liability of GerCo. Source: self-generated

8. **Mixed income**

Sec. 9 FTA contains a special rule for companies that generate both, active and passive income. If certain limits are not exceeded, the whole income of the controlled foreign company is exempt from CFC taxation. This rule was implemented to take out of the scope of CFC taxation those companies that generate only low passive income besides a major business from which active income results.\(^80\)

The exemption does only apply if all criteria are met cumulatively. The criteria address the controlled foreign company as well as the German taxpayer that holds a share in the controlled foreign company. First of all, the amount of passive income generated by the controlled foreign company may not exceed 80,000 Euro. In addition to this, the gross revenues of the amount of passive income may not amount to more than 10 % of the company’s overall gross revenues. Finally, the amount that would not be taken into account due to this rule on the German taxpayer’s level may not exceed 80,000 Euro.

If on the level of the controlled foreign company or the German taxpayer one limit is exceeded, sec. 9 FTA is no longer applicable. Then, the whole passive income of the controlled foreign company is again subject to CFC taxation.

\(^{80}\) Kraft, sec. 9, para. 1.
9. *Income with capital investment character*

Income with capital investment character is subject to special provisions, whereas the main difference to the general CFC rules is that CFC taxation already applies by a lower shareholding. Section 7 para. 6 FTA states that with regard to income with capital investment character the CFC income already has to be attributed to the German taxpayer if it holds at least 1 % of the controlled foreign company. A shareholding that is lower than 1 % can even trigger CFC taxation under certain circumstances if the controlled foreign company generates that specific kind of income almost exclusively unless the shares of the controlled foreign company are substantially and constantly traded on a stock exchange. If a controlled foreign company generates income with investment capital character, the further requirements set out in sec. 7 para. 1 FTA do not need to be fulfilled.

A controlled foreign company in particular generates passive income with capital investment character by e. g. holding and administering financial assets like debt claims, securities and shares as far as those activities are not economically connected with an active income source.\(^\text{81}\) In practice, this specific rule predominantly applies if the controlled foreign company receives interest payments.\(^\text{82}\)

Income with capital investment character shall not be subject to CFC taxation if the underlying gross amount of the income with capital investment character does not exceed 10 % of the gross amount of the total income and if the amount not taken into account accordingly for the intermediate company or the unlimited liable taxpayer does not exceed 80,000 Euro.\(^\text{83}\) CFC taxation is even excluded if the resident company can demonstrate that the income with capital investment character is economically connected with active income sources.\(^\text{84}\)

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\(^\text{81}\) Sec. 7 para. 6 a FTA in connection with sec. 8 no. 1-6 FTA.
\(^\text{82}\) Kraft, sec. 7, para. 270.
\(^\text{83}\) Sec. 7 para. 6 sentence 2 FTA.
\(^\text{84}\) Sec. 7 para. 6 a FTA.
The original purpose of implementing those stricter rules was to prevent tax avoidance by the use of foreign companies for exercising capital investment activities. By dispersing shares in foreign companies up to a certain level, the German taxpayer was able to take advantage of affiliation privileges granted by double tax treaties and thus avoided CFC taxation.85

10. The treatment of multi-tier companies

By implementing sec. 14 FTA, the legislator wanted to prevent that CFC taxation is avoided by implementing a further foreign company subsequent to the controlled foreign company in the terms of the CFC rules. If this subsequent foreign company in turn is controlled by the controlled foreign company and generates the passive income, no CFC taxation applies unless the subsequent company distributes the profits to the controlled foreign company.86 Therefore, sec. 14 FTA commands that the CFC rules do also apply for so called multi-tier companies to the extent to which its income was subject to low taxation.

The CFC provisions have to be applied on the income that is attributable to the foreign company in accordance with the ratio of its shares in the lower-tier company’s nominal capital. This attribution does not apply as far as it can be demonstrated that such income derived from active activities as listed in the catalogue set out in sec. 8 para. 1 FTA.

II. The British CFC rules

In the following sections the British CFC rules will be explained. They can be found in sec. 747-756 ICTA. Those statutory provisions are interpreted by Her Majesty’s Revenues and Customs (HMRC), a non-ministerial department of the British government that is mainly concerned with the collection of taxes. The HMRC publishes guiding manuals frequently on its homepage.87 Again, the amendment of law due to the ruling by the ECJ is excluded from the following description but picked up again in chapter C sec. II. Thus, the

85 Kraft, sec. 7, para. 273.
86 Kraft, sec. 14, para. 1.
legal situation before the decision of the Cadbury Schweppes case was rendered by the ECJ is explained.

UK CFC taxation applies if three major requirements are fulfilled. First, the foreign company may not be resident in the UK. Second, UK residents must exercise control over the intermediate company and third, the profits of the intermediate company must be subject to low taxation. If all those requirements have to be affirmed, sec. 747 para. 3 ICTA commands that the attributable profits are apportioned among the persons who had an interest in the intermediate company.

1. The foreign company

A foreign company can only be a company that is not resident in the UK. With regard to CFC taxation, the CFC rules do not provide for a separate definition of the term company. Thus, one has to take recourse to the definition given in sec. 823 ICTA which defines as a company any body corporate or unincorporated association.

2. The addressees

The CFC rules incorporated in the ICTA do only address companies that are resident in the UK, whereas part 13 of the Income Tax Act 2007 (IncTA) contains comprehensive anti-tax avoidance rules that are applicable on individuals.

Even though the thesis focuses on the tax avoidance rules that apply for corporations, the structure of the respective rules on individuals will be outlined. Before this, it will be explained briefly, why the CFC rules that are applicable on companies nevertheless refer to individuals at one important point, too.

(a) Considering individuals by determination of control

Even though the individuals and corporations are not covered by the same set of rules, for the purpose of examining whether the foreign company is

\[\text{Sec. 747 para. 1 ICTA.}\]
\[\text{Sec. 747 para. 1 ICTA.}\]
\[\text{INTM202010.}\]
\[\text{INTM201020.}\]
controlled by UK residents, the CFC rules set out in the ICTA address individuals as well as companies. The consideration of individuals by analysing the holding structure of a foreign company is very important, as an UK resident company can hold the controlling majority of the intermediate company either alone or together with one or more UK resident individual.92

(b) Tax avoidance rules applicable on individuals

The tax avoidance rules that are applicable on individuals consist of six chapters. Each chapter addresses a specific constellation by which a resident taxpayer can avoid domestic tax payments. Besides others, those rules e. g. focus on transactions in securities93 or the avoidance of domestic tax payments that involve trading losses.94

The rules addressing the transfer of assets abroad are fairly similar to the CFC rules covering corporations, as they prevent the avoidance of liability to income tax by individuals that are ordinarily UK resident.95 If the tax avoidance rules on a transfer of assets abroad apply, the foreign income then is treated as arising to the UK resident individual and taxed with income tax. But if the foreign income that would be attributed to the UK resident individual has already been attributed to an UK resident company under the CFC rules, the amount of income that is taxed on the basis of the UK resident individual is reduced in accordance with sec. 725 para. 2 IncTA. Even the same deductions and relieves are allowed as they would have been allowed if the UK resident individual had actually received the income in the UK.96

92 Please refer to subsection 3 of this section.
93 Sec. 682-713 IncTA.
94 Sec. 790-809 IncTA.
95 Sec. 720, 727 and 731 IncTA.
96 Sec. 746 IncTA.
The rules applicable on a transfer of assets abroad require that due to this transfer of assets the income has become income of a person abroad, too. Furthermore, the UK resident individual must – as a result of the transfer of assets – either have the power to enjoy the income of that person abroad or receive capital sums. An UK resident individual has the power to enjoy foreign income if the income was subject to income tax if it was received by the UK resident individual in the UK and if the capital is employed for the benefit of the UK resident individual, whereas a capital sum is deemed to be received, if it is connected with the transfer of assets.

Section 736 et seq. IncTA exempts the foreign income from the domestic tax liability, if the transfer of assets was not done to avoid domestic tax liability or if the transfer represents a genuine commercial transfer.

3. **Exercising control**

Furthermore, the foreign company has to be controlled by persons resident in the UK. In accordance with sec. 747 para. 1 ICTA, for the purpose of CFC taxation control means the power of a person to secure that business is conducted in accordance with his wishes. This power can be conveyed by a sufficient holding of shares, the possession of voting rights or even by virtue of conference by the articles of association. Furthermore, the position of control has to be affirmed if in a fictitious scenario the person would receive e. g. the greater part of the amount of a distribution of the whole income, or the greater amount of the disposal of the company’s share capital. The rules do even apply in the case where two or more persons taken together meet those requirements.

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97 Sec. 721 IncTA.
98 Sec. 728 IncTA.
99 The respective indications can be found in sec. 723 IncTA.
100 Sec. 729 IncTA.
101 Sec. 755D para. 1 a, b ICTA.
102 Sec. 755D 1A ICTA.
103 Sec. 755D 2 ICTA.
Section 747 para. 1A ICTA extends the term control by the so called 40 %-test that reduces the minimum shareholding quota. In accordance with this section, a foreign company is also controlled if two persons (an UK resident and a non UK resident) share the position of taking control and if both satisfy the 40 %-test set out in sec. 755D para. 3 and 4 ICTA. With regard to the UK resident, the 40 %-test is satisfied if he holds at least 40 % of the holdings, rights and powers. Regarding the non UK resident, the 40 %-test is satisfied if he holds at least 40 % of the holdings, rights and powers but not more than 55 %. By doing this calculation, e. g. rights and powers of persons that are connected with the UK resident as well as rights and powers held by third UK residents on which the person can exercise influence have to be taken into account as well.104

4. **Low taxation**

Sec. 750 ICTA ascertains a low level of taxation if the controlled foreign company is subject to a local tax rate which is less than 75 % of the corresponding UK tax rate. As the main corporate income tax rate currently is 28 %, low taxation has to be affirmed in the case the foreign tax rate is below 21 %.105

Besides this rule, the UK legislator prevents the use of designer tax rates in sec. 750A ICTA. This section was implemented to counteract foreign regimes that provide potential controlled foreign companies with tax rates that do only almost trigger CFC taxation but that in fact are still advantageous for the UK resident taxpayer.106 In accordance with this section, the foreign company that is subject to a designer rate shall be deemed to be subject to low taxation and thus the UK resident company cannot escape CFC taxation.

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104 Sec. 755D 6 b in connection with para. 7 and 6 c ICTA.
105 [http://www.hmrc.gov.uk/stats/corporate_tax/rates-of-tax.pdf](http://www.hmrc.gov.uk/stats/corporate_tax/rates-of-tax.pdf); besides this main rate, there is a relief for smaller companies that generate profits between 300,000 and 1,500,000 Pound in accordance with sec. 13 ICTA. INTM210010 states that for the purpose of the CFC rules the reduced corporate income tax rate is not an appropriate rate, as it does not represent a separate tax rate but rather a claim of reduction towards the fiscal authorities.
106 Cooklin / Bailey.
5. **The amount to apportion**

The total amount that has to be apportioned to the shareholders of the controlled foreign company is the amount of the chargeable profits\(^{107}\) of the controlled foreign company. The apportionment can address UK resident individuals or companies as well as non-UK residents. Nonetheless, due to the provision explained in subsection (a) of this section, tax liability arises only with regard to UK resident companies under these provisions.\(^{108}\)

The amount of taxes due on the CFC income is ascertained by way of self-assessment.\(^{109}\) A self-assessment must only be done in the case that the amount to be apportioned to the UK resident company plus the amount to be apportioned to any person that is connected or associated with the resident company is an amount greater than 25 % of the total profits of the controlled foreign company.\(^{110}\)

6. **Inclusion amount**

The inclusion amount is calculated on the case of the controlled foreign company’s profits. But in contrast to the German CFC rules, the whole income of the controlled foreign company and not only the passive income is taken into account. The chargeable profits have to be reduced by the capital gains the controlled foreign company has realised\(^{111}\) and thus, they do not have to be taken into account for the calculation of the inclusion amount.\(^{112}\) Capital gains with regard to business are those gains realised by the exchange or otherwise dispose of business assets. A business asset e. g. is land and buildings, shares or plant and machineries.\(^{113}\) The inclusion amount has to be added to the income of the UK resident company after it was modified.

\(^{107}\) The UK CFC rules refer to the profits which economically means the same as the term income. The chargeable profits are the modified profits on which the taxes are charged on. For further detail please refer to INTM209020.

\(^{108}\) INTM210010.

\(^{109}\) INTM201030.

\(^{110}\) Sec. 747 para. 5 ICTA; INTM201100.


\(^{112}\) INTM209020.

Section 747 para. 4 a ICTA states that the profits of the controlled foreign company have to be treated as if they were profits of the tax resident company. That includes the application of an appropriate tax rate – which in general is the corporation tax rate in force for the accounting period of the resident company for which the assessment is made\(^\text{114}\) – on the chargeable profits of the controlled foreign company, whereas taxes that have already been paid by the controlled foreign company on this amount are creditable.

The following example clarifies the aforesaid.

Example 3:

An UK company (UKCo) holds 65% in the shares of a subsidiary that is established in Romania (RoCo). The profits the subsidiary generates are subject to low taxation as they are taxed with 16% corporate income tax. Thus, the foreign income is subject to UK CFC taxation in accordance with sec. 747 ICTA. RoCo does not fulfil the requirements of any exemption method and thus UKCo cannot escape CFC taxation.\(^\text{115}\)

In year 1, RoCo generates income of 1 m Euro\(^\text{116}\) on which it pays corporate income taxes in the following year. From the total income, 200,000 Euro were generated by the sale of corporate assets and 500,000 Euro were generated by the investment business. The remaining income results out of trading business.

The Romanian company makes a profit again in year 2 and generates 750,000

\(^{114}\) INTM210010.

\(^{115}\) The exemption methods are explained in subsection 7.

\(^{116}\) To make the results generally comparable, all calculations are made in the same currency and rounded.
Euro by its investment business only. In this year, RoCo pays the corporate income taxes on the profit of year 2. The following table gives an overview over the financial situation of RoCo.

<table>
<thead>
<tr>
<th>Income of RoCo</th>
<th>Romanian corporate income tax</th>
<th>Actual tax payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1 1,000,000 Euro</td>
<td>1 m Euro * 16 %</td>
<td>160,000 Euro -</td>
</tr>
<tr>
<td>Year 2 750,000 Euro</td>
<td>750,000 Euro * 16 %</td>
<td>120,000 Euro 160,000 Euro</td>
</tr>
</tbody>
</table>

The financial situation of RoCo. Source: self-generated

UK CFC taxation does not differentiate between active and passive income but defines the whole chargeable profits reduced by capital gains as attributable income. Thus the attributable income is 800,000 Euro as the income that results out of the sale of corporate assets has to be deducted. Corresponding to the ratio in the shares of the foreign income UKCo holds, an amount of 520,000 Euro has to be attributed to its income and an amount of 145,600 Euro domestic corporate income taxes have to be paid on the CFC income. In the following year, again the whole chargeable profits have to be attributed to the domestic shareholder. As taxes have actually been paid in the second year, the inclusion amount has to be modified correspondingly. As a result, 107,380 Euro have to be paid by UKCo on the foreign income. The following table summarises the aforesaid.

<table>
<thead>
<tr>
<th>Attributable income</th>
<th>Modifications</th>
<th>Inclusion amount</th>
<th>Domestic corporate income tax</th>
<th>CFC taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1 800,000 Euro</td>
<td>-</td>
<td>520,000 Euro</td>
<td>520,000 Euro * 28 %</td>
<td>145,600 Euro</td>
</tr>
<tr>
<td>Year 2 750,000 Euro</td>
<td>750,000 Euro - 160,000 Euro * 65 %</td>
<td>383,500 Euro</td>
<td>383,500 Euro * 28 %</td>
<td>107,380 Euro</td>
</tr>
</tbody>
</table>

CFC tax liability of UKCo. Source: self-generated

7. **Exclusions of charge**

No apportionment is due if the UK resident company fits in one of the exemptions given by law. Those exemptions are listed in sec. 748 ICTA. According to sec. 748 ICTA an apportionment must not be done if the controlled foreign
company pursues an acceptable distribution policy, if it is engaged in exempt activities, if its chargeable profits do not exceed a certain amount or if the foreign company is resident in a CFC exempt territory. If the foreign company fulfils the criteria, its income is entirely out of the scope of CFC taxation.\footnote{INTM205010.} If no exemption is applicable, as a last resort the company can take the motive test set out in sec. 748 para. 3 ICTA.

(a) The acceptable distribution policy

As this exemption will be abolished in 2009 with effect from 1.07.2009 once the act found royal assent,\footnote{For the status of proceedings, please refer to http://services.parliament.uk/bills/2008-09/finance.html.} it will be explained briefly only.\footnote{Sec. 36 FA 2009 in connection with schedule 16, part 1, sec. 6 FA 2009.} An acceptable distribution policy has to be affirmed if at least 90 % of the controlled foreign company’s profits are distributed to UK residents within 18 months after the end of the accounting period.\footnote{Please refer to schedule 25 ICTA.} With regard to the purpose of CFC legislation, this exemption obviously is justified by the fact that the major portion of income is already subject to tax within the UK. The abolition of this exclusion of charge is even due to the fact that some companies were not able to comply with this rule, because their chargeable profits were much higher than the amount available for distribution.\footnote{Cooklin / Bailey.}

(b) The exempt activities test

CFC taxation is furthermore excluded if the foreign company is engaged in exempt activities in accordance with sec.748 para. 1 b ICTA in connection with schedule 25 part 2 ICTA. This exemption was incorporated to take out of the scope of CFC taxation those companies which have to be assumed not to be established for purposes of tax avoidance solely.\footnote{INTM205010.}
There are two alternatives to fulfil the test, but for both, the controlled foreign company can only be engaged in exempt activities, if, as a precondition, it has a business establishment in the territory in which it is resident. A business establishment requires that the foreign company possesses premises in the country in which it is resident which are actually occupied and used with a reasonable degree of permanence.\textsuperscript{123} As premises one can e. g. regard an office, a shop or a factory but as well a mine or building site.\textsuperscript{124} In addition to this, the foreign company must effectively manage its business from this business establishment which in turn requires a sufficient number of individuals who are working for the company in the territory in which it is resident. In addition to this, the personnel must be vested with sufficient power to undertake the company’s business.\textsuperscript{125}

The first exemption possibility that will be explained covers a wide range of trading activities and thus the majority of non-UK resident companies’ subsidiaries fall into its scope.\textsuperscript{126} If the requirements set out above are fulfilled, as a first alternative to pass the exempt activities the controlled foreign company’s main part of business must at no time be investment business or trading activities with local persons in the UK.\textsuperscript{127} Investment business in the terms of the CFC rules comprises e. g. the holding of or dealing with securities\textsuperscript{128} and thus basically prevents passive income from passing the exempt activities test. Trading activities with UK local persons were excluded to avoid that a company can escape CFC taxation just by invoicing goods but actually never taking physical delivery of the goods in its residence country. This first exemption addresses even companies, that

\textsuperscript{123} In accordance with schedule 25 part 2 sec. 7 para. 1 ICTA.
\textsuperscript{124} Schedule 25 part 2 sec. 7 para. 2 ICTA.
\textsuperscript{125} Schedule 25 part 2 sec. 8 para. 5 ICTA.
\textsuperscript{126} INTM205010.
\textsuperscript{127} Schedule 25 part 2 sec. 6 para. 2 ICTA.
\textsuperscript{128} Schedule 25 part 2 sec. 9 para. 1 ICTA.
are engaged in wholesale or distributive financial or service business and that do not earn more than 50% of the gross trading receipts directly or indirectly from business connected or associated persons.

As stated above, the criteria refer to the main business of the company. If the company pursues more than one business at the same time, it may be difficult to clearly determine. As criteria of general guidance, the main business is likely to be the one generating the highest turnover, having the highest profitability or requiring the major part of investments.

The second alternative is available for holding companies, whereas due to the FA 2009, the exemption rules for non-local holding companies and superior holding companies as they are still today will be abolished, too. Thus, only local holding companies can pass the exempt activities test in the future. As the amendment will have effect from 1.07.2009 once the act found royal assent, only the upcoming legal surrounding will be described. For companies that were classified as an exempt holding in the last accounting period that ended before 1.07.2009, the amendment does commence later, with effect from 1.07.2011.

A so called local holding company e.g. will pass the exempt activities test if it receives at least 90% of its gross income in the country where it is resident and if the income derives from companies which it controls. The controlled companies in turn must be resident in the same territory as the holding company. Furthermore, they must not be qualified as holding companies but be engaged in exempt activities or be qualified as an exempt trading company. An exempt trading company is in accordance with schedule 25 part 2 sec. 5A para a ICTA a trading company that is

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129 INTM205060.
130 For the status of proceedings, please refer to http://services.parliament.uk/bills/2008-09/finance.html.
131 Schedule 16 part 2 sec. 13 para. 1 FA 2009.
132 Schedule 25 part 2 sec. 3 ICTA.
either not resident in a country offering low taxation, resident in a country listed on the “white list” or that passes the motive test.\textsuperscript{134}

\textbf{(c)} The de-minimis rules

The de-minimis rule also leads to a relief of CFC taxation, too. Under application of the de-minimis rule in sec. 748 para. 1\textsuperscript{d} ICTA, no apportionment shall be done if the chargeable profits of the foreign company do not exceed 50,000 Pound.

\textbf{(d)} Exempt countries

Furthermore, the legislator drafted a “white list” of countries which are partly or wholly outside CFC taxation.\textsuperscript{135} The list can be found in the Controlled Foreign Countries Excluded Countries Regulations 1998 in schedule 2 part 1 and 2.\textsuperscript{136} The purpose of the list is to take out of CFC taxation those countries which are unlikely to be involved in UK tax avoidance.\textsuperscript{137}

To fall in the scope of the list, the income and gains requirement has to be fulfilled.\textsuperscript{138} In accordance with this provision, the non-local source income does not exceed 50,000 Pound or 10\% of the amount of profits before tax disregarding profits or losses.

\textbf{(e)} The motive test

As a final resort, the resident company can take the motive test provided for in sec. 748 para. 3 ICTA. According to this provision, no apportionment of profits shall be made if the transactions which are reflected in the controlled foreign company’s profits do only achieve a minimum reduction of UK tax income or if the reduction achieved in the UK tax by those transactions was

\textsuperscript{133} Please refer to subsection (d) of subsection 7 of this section.
\textsuperscript{134} Please refer to subsection (e) of subsection 7 of this section.
\textsuperscript{135} Cooklin / Bailey.
\textsuperscript{136} Statutory Instrument (SI) 1998/3081; the current list is set out in INTM203130.
\textsuperscript{137} INTM203020.
\textsuperscript{138} The income and gains requirement is set out in sec. 4 para. 1 and 2 SI 1998/3081 in connection with sec. 5 para. 1 SI 1998/3081.
not the main reason for the transaction. As an additional requirement the main reasons for the existence of the controlled foreign company must not be to achieve a reduction in the UK tax by a diversion of profits.

Schedule 25 part 4 specifies the terms referred to in this provision. A reduction in UK tax occurs if in the case the transaction had not been effected, a person in the UK would have been liable for income tax, corporation tax or capital gains tax for a greater amount. The same principle applies in relation to any relieve from or a repayment of a tax or if the relieve or repayment would have been smaller if the foreign transaction had not been exercised. If the foreign transaction entitles an UK resident to a tax relief or repayment within the UK, the UK revenues from taxes are reduced anyway.\(^{139}\)

To assess the motive of the transaction, the HMRC established two principles in order to make the provision practicable. Those principles focus on whether the business of the controlled foreign company could have been carried out in the UK and whether one of the main reasons for that the business was not carried out in the UK is that the tax that would have been payable in the UK would have been greater than the tax paid by the controlled foreign company in the territory in which it is resident. The motive test is not passed if one of the above mentioned has to be answered with yes and thus CFC taxation applies.\(^{140}\)

C. **Cadbury Schweppes: The facts of the case**

With regard to taxes, the EC Treaty\(^ {141}\) does only convey the right to harmonise indirect taxes to the European Commission.\(^ {142}\) Nevertheless, the ECJ constantly reviews single

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140 INTM208160.
142 Art. 90-93 EC; Tiedtke / Mohr, EuZW2008, p. 424.
provisions of the member states that regulate direct taxes,\textsuperscript{143} with the review focussing on whether the national rule of the member state is in harmony with the fundamental freedoms granted by the EU.\textsuperscript{144}

In the Cadbury Schweppes case, the ECJ reviewed the UK CFC rules. The facts of the case and the decision from 12.06.2006\textsuperscript{145} will be outlined briefly as they are of high importance. The decision did not only address the UK CFC rules directly but also influenced the German CFC regime. This is due to the fact that the rules of both regimes are similar to each other in the points addressed in the decision.\textsuperscript{146} Thus it was likely that they would be suspended, too, if they were subject to review by the ECJ.\textsuperscript{147}

The dispute arose between Cadbury Schweppes p.l.c. (CS) and Cadbury Schweppes Overseas Ltd. (CSO) on the one hand and the Commissioners of Inland Revenue of the UK on the other hand. The contentious issue concerned the taxation of the UK resident CSO in respect of the profits made by Cadbury Schweppes Treasury International (CSTI) in 1996, a subsidiary of the Cadbury Schweppes group established in the International Financial Services Centre (IFSC) in Dublin, Ireland, and thus benefiting from preferential tax treatment, as a tax rate of 10\% applied.\textsuperscript{148} As the main business purpose of the subsidiaries was to raise finance and to provide it to the subsidiaries, the UK fiscal authorities tried to impose taxes on the income of the subsidiaries on the level of CSO, because they concluded that the subsidiary was established in Dublin only in order to benefit from the advantageous tax regime. This conclusion was based on the argument that all benefits mentioned by the Cadbury Schweppes group to justify the establishment outside the UK could also have been realised by establishing the subsidiaries within its


\textsuperscript{144} The ECJ justifies this by the fact that it does not interpret the national law itself. Rather, the member states have the obligation to exercise their competence – which is to regulate direct taxes – in harmony with community law. Cloer / Lavrelashvili, p. 58; Vogt, DSIR 2005, p. 1347.

\textsuperscript{145} ECJ, case C-196/04, BeckRS 2006, 70669.

\textsuperscript{146} The similarities will be illustrated in section III.

\textsuperscript{147} Tiedtke / Mohr, EuZW2008, p. 425; Kraft / Bron, ISIR 2006, p. 620.

\textsuperscript{148} Fromm, ISIR 2000, p. 706.
boundaries. Thus, in 2000, the tax authorities claimed corporation tax from CSO on the profits made by CSTI based on CFC legislation. Thereupon, CSO and CS raised objections before court claiming that the application of CFC rules violated the European fundamental freedoms. As the UK court faced some uncertainties with regard to the compatibility of the CFC rules with the European fundamental rights, it approached the ECJ and asked for a preliminary ruling.

I. The findings of the ECJ

The UK court referred in his request for a preliminary ruling by the ECJ to the freedom of establishment in art. 43 EC, the freedom to provide services in art. 49 EC and the freedom of free movement of capital in art. 56 EC. But the ECJ analysed the compatibility of the CFC rules only with regard to art. 43 EC, as the two further fundamental rights would be constrained automatically as a consequence of a violation of the freedom of establishment.

To point out whether the CFC rules interfere in the freedom of establishment, the ECJ first specified the purpose of the freedom of establishment, which is to enable a national to participate on a stable and continuing basis in the market in a member state he chooses. Thus, foreign nationals and companies shall be treated in the host member state the same way as the nationals of that state. By applying CFC taxation, the UK government intentionally treats those resident companies that fall in the scope of CFC taxation in a different way, as only they are taxed on profits from another foreign legal person.

This differing treatment of resident taxpayers represents a kind of intentional discrimination which in turn restricts the freedom of establishment. Such a restriction of the fundamental freedoms can only be satisfied by overriding reasons of public interest. With regard to this, the ECJ stated clearly that reducing the domestic tax burden by diverting income abroad represents a legitimate interest – and therefore no overriding reason – of the

149 Thus the motive test as the one alternative for the exclusion of charge of CFC taxes was not passed. For further information about the motive test please refer to chapter B section II subsection 7(e).
150 In accordance with Art. 234 EC.
151 ECJ, case C-196/04, BeckRS 2006, 70669, para. 33.
152 ECJ, case C-196/04, BeckRS 2006, 70669, para. 45.
resident taxpayer as long as the diversion occurs in compliance with the principles of the freedom of establishment. This requires a stable and continuing economic participation in the other member state’s market. In accordance with this, the ECJ nevertheless admitted that a restriction of the freedom of establishment consequently is justified if it concerns a mere abusive practice which. Such an abusive practice has to be affirmed in the case the arrangement is wholly artificial and only established in order to circumvent national legislation. Then a taxpayer resident within the EU can no longer refer to his freedom of establishment as his activities are no longer in harmony with the purpose of this fundamental right but rather a means of escaping national taxation.

Reviewing the British CFC rules in this light, the ECJ came to the conclusion that the CFC rules are only compatible with EC law, if they base the application of CFC taxation on the requirement that the subsidiary is a wholly artificial arrangement. Thus, in order to apply CFC taxation in harmony with EC law, the intention to benefit from a more favourable tax regime may be nothing objectionable unless objective elements indicate strongly that the incorporation of the foreign company reflects no economic reality. This economic reality in turn has to be assessed by considering whether the extent of premises, staff and equipment allows carrying out genuine economic activities in the host member state. As the resident company is best positioned to do, it must be given the opportunity to produce respective evidence if strong indications are given before CFC taxation finally applies.

II. The reaction of the UK legislator

After the ECJ rendered his decision, the UK legislator implemented sec.751A ICTA and sec. 751B ICTA by the FA 2007. Even though the UK legislator assumed that the CFC regime had already been compatible with EC law, the new sections were implemented

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154 ECJ, case C-196/04, BeckRS 2006, 70669, para. 55.
156 ECJ, case C-196/04, BeckRS 2006, 70669, para. 64.
157 ECJ, case C-196/04, BeckRS 2006, 70669, para. 63-75.
158 INTM210510.
to transfer the ECJ’s clear demand that the resident company must be given the possibility to prove the economic reality of the controlled foreign company’s activities.\textsuperscript{159}

In accordance with sec. 751A ICTA the resident company now may apply for a reduction of the chargeable profits of a controlled foreign company that is established in a member state of the EEA.\textsuperscript{160} The reduction nevertheless is limited by the amount of foreign income that was generated by genuine economic activity, the so-called net economic value.\textsuperscript{161} The application requires thereby the UK resident company to produce sufficient evidence that proves the extent of the foreign company’s genuine economic activity.\textsuperscript{162} For the purpose of CFC taxation, the profits are excluded from the controlled foreign company’s chargeable profits. As a result, the inclusion amount that is added to the UK resident company’s income is reduced and thus the amount of domestic taxes that has to be paid on the foreign income.

The UK legislator limits the amount of reduction. The maximum amount that can be reduced is the amount equal to the economic value that the controlled foreign company generates. This limitation allows to separate the mere abusive arrangements from the economically motivated establishments more precisely. An abusive character of the implementation of a foreign company is more likely in the case a company does only hold assets and pursues no genuine economic activity. In contrast to profits that normally arise where the activities are located if they are actually created by work, the income of holding assets is mobile as it arises to the owner which is not tied to the location where the company is established. Thus, if the controlled foreign company has not sufficient personnel and offices located in the country where it is established to exercise a stable activity in the market,\textsuperscript{163} this are strong indications for an abusive diversion of income abroad. But if the controlled foreign company pursues a fully or partial stable and continuing business in the market of the country in which it is located and applies for a

\textsuperscript{159} ECJ, case C-151/94, para 70.
\textsuperscript{160} The scope of application is restricted to those taxpayers that can refer to the freedom of establishment. Besides the EU member states those of the EEA are included, because the EEA provides for similar fundamental freedoms.
\textsuperscript{161} In accordance with sec. 751A para. 4 ICTA.
\textsuperscript{162} INTM210520.
\textsuperscript{163} The requirement that individuals are working directly for the controlled foreign company in the country where it is established is set out in sec. 751A para. 6 and 7 ICTA.
reduction in accordance with sec. 751A ICTA, this economic value is excluded from CFC taxation. In contrast, if the UK resident company cannot bring sufficient evidence, the tax authorities can ensure that only passive income that was not generated by genuine economic activity is subject to CFC taxation.\footnote{INTM210530.}

In case the application is granted, the chargeable profits of the controlled foreign company are reduced by the specified amount as well as the amount of taxes that has actually been paid by the controlled foreign company on the specified amount.\footnote{Sec. 751A ICTA.}

### III. The reaction of the German legislator

The German legislator had to react on the decision of the ECJ, because it was likely that the ECJ would deny the conformity of the German CFC rules with the fundamental freedoms in the case they were subject to review.\footnote{Vogt, DSIR 2005, 1347; Kraft / Bron, ISiR 2006, p. 614; Köhler / Eicker, DSIR 2006, p. 1871.} This was due to the similarities of the German CFC system with the UK CFC rules. Thus, sec. 8 para. 2 FTA was implemented in the course of general changes of tax law on 20.12.2007 with effect from the beginning of 2008\footnote{http://www.bgblportal.de/BGBL/bgbl1f/bgbl107s3150.pdf, sec. 24; Vogt, DSIR 2005, p. 1347.} to avoid a possible suspension of the German CFC rules.

The German CFC rules had to be adjusted with the principles the ECJ established, because the German CFC rules assumed every German resident taxpayer – as a UK taxpayer under the UK CFC regime – to use artificial arrangements in order to avoid domestic taxation automatically, if the requirements of CFC taxation were fulfilled. At this time the CFC rules did not respect that benefiting from a more favourable tax regime first of all is a legitimate interest of the domestic taxpayer. Therefore the requirements on which the assumption of abusiveness of the implementation of a foreign company was based were not specific enough.\footnote{Kraft / Bron, ISiR 2006, p. 620.} In contrast to focussing on wholly artificial arrangements only, the CFC rules covered all situations in which certain passive income was generated.\footnote{Axer, ISiR 2007, p. 164.}

This represented an unjustifiable restriction of the freedom of establishment as assuming abusive intentions based on the generation of that certain kind of income was not
reasonable. In addition to this, the catalogue of active income set out in sec. 8 para. 1 FTA did not assess the existence and extent of genuine economic business – as the ECJ prescribed – and did not even provide for a possibility of the German resident taxpayer to proof the contrary in the case strong indications for an abusive avoidance of domestic taxation were given.

To reconcile the drawbacks of CFC legislation with EC law, sec. 8 para. 2 FTA implemented a motive test, the possibility for the German resident taxpayer to proof that the activities of the controlled foreign company are in harmony with his freedom of establishment. This requires that the German resident company proves the genuine economic activity of the controlled foreign company that is resident within the EU / EEA. If the German resident taxpayer produces sufficient evidence, the assumption of abusive tax avoidance is invalidated and the foreign income excluded from CFC taxation.

1. **The BMF circular**

In a first tentative step – as such a ministerial instruction is not sufficient to adjust national legislation with EC law but rather requires a statutory amendment – the Federal Ministry of Finance (BMF) published its instructions about how to handle the decision of the ECJ in its circular dated 8.01.2007. In this circular the BMF commands that even if the preconditions of sec. 7-14 FTA are present, CFC taxation may not be imposed on the resident taxpayer if it can demonstrate that the controlled foreign company pursues genuine economic activity in the other state. Besides emphasising the need of an individual consideration of the particularities of each case, the proof by the taxpayer especially has to point out that

- the economic activities are ongoing and sustainable,

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171 ECJ, case C-196/04, BeckRS 2006, 70669, para. 54 and 55.
173 Kraft, sec. 8, para. 794.
174 The applicability is restricted with regard to those controlled foreign companies, because only they can rely on the European fundamental freedoms. The member states of the EEA are included in the scope because the respective treaty constitutes similar fundamental rights. Rainer / Müller, ISIR 2007, p. 151.
176 Concerning the obligation of adherence to administrative instructions please refer to Klein, sec. 4, para. 9.
• sufficient management and further employees are on site,
• the employees are equipped with appropriate skills and qualifications,
• the income is generated due to the economic activities and
• in the case of operating business with closely related parties, there is as reasonable added value as well as an appropriate capital intensity employed.177

The BMF furthermore limits the applicability of the proof of the contrary as such a proof cannot apply with regard to income that is generated by a multi-tier company pursuant to sec. 14 FTA as well as income that is generated by branches located outside the EU / EEA which has to be attributed to the controlled foreign company. The same exclusion applies to income with capital investment character in the terms of sec. 7 para. 6 FTA.

2. The proof of the contrary

The content of the BMF circular was basically incorporated in sec. 8 para. 2 FTA. In accordance with this section, a German resident taxpayer can absolve itself from CFC tax liability by proving the contrary, i. e. by demonstrating that the controlled foreign company pursues genuine economic activity. If that proof succeeds, the foreign company is not classified as being an intermediate company for the income that was generated directly by the genuine economic activity of the controlled foreign company and thus CFC taxation is impeded.178

The legislator missed to incorporate a legal definition of what genuine economic activity is. Even the explanatory memorandum of the 2008 annual changes of law179 does only give some guidelines for interpretation. The given requirements are basically the same as those the BMF circular has already stated, whereas they are much more imprecise. With regard to the required sustainability of the

177 BMF, circular IV B 4 – 1351 1/07, BStBl. I, p. 99, no. 2.
178 Kraft, sec. 8, para. 741.
economic activity, the intermediate company must execute its core function by itself and some managing employees must be on-site. ¹⁸⁰

To make the rule practicable, some scholars recommend taking recourse to the more detailed statements made by the BMF.¹⁸¹ This recommendation by no means represents common consent, as the preconditions defined in the circular are deemed to go beyond the required standard set by the judgement of the ECJ and sec. 8 para. 2 FTA¹⁸² and therefore are stricter.

By taking a look at the wording of the provision itself, its explanatory memorandum and the judgement given by the ECJ, the following requirements can be summarised: The foreign company must exercise genuine economic activity which first of all requires a permanent establishment that can be verified objectively by offices, employees and equipment. The business thereby must express a minimum level of substance.¹⁸³ Again, the requirements that the foreign company itself operates its core function and that management tasks are executed on site, too, have to be fulfilled.

As in the BMF circular, the resident taxpayer can only bring the evidence for a foreign company that is resident within the EU / EEA. In addition to this, the exchange of relevant information between the German and the respective foreign fiscal authorities must be warranted.¹⁸⁴ Section 8 para. 2 s. 3 and para. 4 FTA also excludes the income that is generated by multi-tier companies pursuant to sec. 14 FTA and the income generated by non EU / EEA located branches from the scope of sec. 8 para. 2 FTA. Because the motive test refers to sec. 8 para. 1 FTA, which includes the catalogue of active income, income with capital investment character is excluded from the scope of applicability as on this kind of income not sec. 8 para. 1 FTA, but special rules apply.

¹⁸⁰ BR-Drs. 544/07, p. 123.
¹⁸¹ Kraft, sec. 8, para. 741.
¹⁸² The controversial discussion is displayed in Kraft, sec. 8, para. 750.
¹⁸³ Kraft, sec. 8, para. 749.
¹⁸⁴ Base of such a right of disclosure of information can either be the directive 77/799/EWG or comparable bi- and multilateral agreements, Kraft, sec. 8, para. 760.
D. Selected scenarios

This chapter deals with the case that a corporation is planning to establish a new subsidiary abroad whose income is in principle subject to CFC taxation. By focussing on some certain aspects, differences between the German and the UK CFC regime shall be clarified.

After the facts of the case have been introduced, section I will first briefly demonstrate that requirements of CFC taxation in Germany and respectively in the UK generally are fulfilled. Then, in section II the structural difference between the German and the UK system that has already been mentioned in the introduction of chapter B will be demonstrated in detail. In the course of this analysis, the exemption methods that are generally available in the two regimes will be outlined, too. Finally, section III will illustrate the different consequences of the exemption methods which the two regimes implemented after the ECJ decided the case Cadbury Schweppes with regard to controlled foreign companies that are located within the EU / EEA.

I. The base scenario

A German resident corporation (GerCo) / alternatively UK resident corporation (UKCo) carries out three businesses at the same time within Germany / alternatively within the UK; 60 % of its income is generated by trading and 30 % is generated from financial services, investment business respectively, which result in income with capital investment character. The financial services and renting and leasing activities are not exercised in order to serve the trading business and thus are not economically connected to the trading business. In addition to this, 10 % of the income is generated by renting and

185 Please note that in section II only the basic structural difference is focussed on. Any exemption methods as well as exemption limits are intentionally ignored.

186 Please note that in section III only the two exemption methods with regard to subsidiaries that are established within the EU / EEA will be considered. Further exemption methods and exemption limits are intentionally ignored.

187 In accordance with sec. 8 para. 1 no. 4 FTA.

188 In the terms of schedule 25 part 2 sec. 9 ICTA.

189 In accordance with sec. 7 para. 6 a FTA.
leasing of real properties. This general passive income source cannot be re-qualified as an active income source\textsuperscript{190}.

The CEO of the company wants to expand the business. In order to keep the additional costs as low as possible, he wants to establish a new subsidiary in a country that offers low operating expenditures. The new subsidiary will be involved in the streams of business in the same ratio as the parent company whereas the trading activities will be pursued only within the country the subsidiary will be established. It shall be incorporated in 2010 at the latest. The subsidiary will be equipped with a huge office in which 3,500 people pursue their work. The number of employees for each department corresponds with the ratio of income that is contributed to the total amount. In addition to this, each department is managed independent from the parent company. An income of 1 m Euro per year is expected and in order to guarantee that the business is carried out in the interest of the parent company, it will hold 100 \% of the shares of the subsidiary. The consultants identified Bulgaria (BulCo) as the most attractive option. But before the decision for one country can be made, different tax consequences shall be assessed.

Before the applicability of the CFC rules in Germany and in the UK alternatively will be demonstrated in the following section, the graph below will display the targeted holding structure and the table will give important information about the taxation of a company in the different countries.

\textsuperscript{190} No re-qualification in the terms of sec. 8 para. 1 no. 6b FTA is possible.
The targeted holding structure and income structure. Source: self-generated

<table>
<thead>
<tr>
<th>Country</th>
<th>Corporate Income Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>29.825 %\textsuperscript{191}</td>
</tr>
<tr>
<td>UK</td>
<td>28 %\textsuperscript{192}</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>10 %</td>
</tr>
</tbody>
</table>

The taxation of companies in the different countries. Source: self-generated

1. **CFC taxation of GerCo in Germany**

   The foreign passive income of the Bulgarian subsidiary is subject to CFC taxation and thus is taxed with domestic tax on the level of GerCo.

   GerCo controls the subsidiary as it holds 100 % of its shares. In addition to this, the subsidiary generates passive income in the terms of the FTA\textsuperscript{194} that results out of financial services and renting and leasing activities. A re-qualification of the passive income into an active income source is not possible, because the passive income sources are not economically connected with the trading business but represents

\textsuperscript{191} Tax rates taken out of http://ip-online.ibfd.org/gth/.
\textsuperscript{192} Please refer to fn. 71.
\textsuperscript{193} Please refer to fn. 105.
\textsuperscript{194} This is due to the fact that renting and leasing represent only an active income source if the requirements of sec. 8 para. 1 no. 6 a FTA are fulfilled; financial services generate income with capital investment character in the terms of sec. 7 para. 6 a FTA.
an independent stream of business. As it represents no side activity of the trading business it cannot be assigned to the active income source. Finally, the income of the subsidiary is subject to low taxation because the income of the subsidiary is taxed in Bulgaria with a tax rate below 25%.

2. CFC taxation of UKCo in the UK

The foreign income of a Bulgarian subsidiary is generally subject to UK CFC taxation, too.

Again, the UK resident company controls the foreign company, as it can exclusively coordinate the subsidiary’s business as its single shareholder. The characteristics of income that the subsidiary generates are not relevant for the application of CFC taxation since pursuant to sec. 747 para. 3 ICTA the whole chargeable profits have to be taken into account if the requirements for CFC taxation are fulfilled.

The UK CFC regime does not classify low taxation on the basis of a fixed tax rate. Low taxation in the sense of the UK CFC rules requires that the amount of taxes paid by the controlled foreign company must be less than 75% of the amount of taxes the subsidiary would pay if the income was generated in the UK, whereas an appropriate tax rate has to be applied on the foreign income.195 Finally, one has to check whether the tax rate of the foreign country is less than 75% of the UK corporate tax rate which is 28%. As in Bulgaria the subsidiary is taxed with a tax rate lower than 21%, the foreign income is subject to low taxation and CFC taxation applies.

II. The main structural differences

As mentioned briefly in the introduction of chapter B, the German and the UK CFC system take a different basis for the attribution of income into account. From the attributed income in turn the inclusion amount derives which is finally taxed with domestic taxes on the level of the resident taxpayer. Thus, the lower the amount for the attribution of income is, the lower is the final tax burden.

195 In accordance with sec. 750 ICTA; even though the company would be classified as a smaller company, the reduced tax rate does not apply. Please refer to fn. 105.
The examples below will show that the aforementioned difference can result in substantial consequences with regard to the tax burden of a resident taxpayer due to CFC taxation. Therefore, it is important to take the different exemption methods that the respective CFC regimes offer into consideration. Subsection 2 will give an overview about which exemptions are granted in the two systems.

1. **The different base for the attribution of income**

While the German transactional approach does only focus on certain kinds of income, the passive income, the UK’s entity approach attributes the whole chargeable profits of the foreign company to the resident taxpayer. In the following two subsections the inclusion amount that has to be attributed to the German company / alternatively the UK company of the example will be calculated. Furthermore, the example intentionally does not go beyond this first step of determination of the inclusion amount and disregards any exemption methods and exemption limits. Thus, in the following it is assumed that the German company / UK company alternatively can not be excluded from CFC taxation by any exemption methods or exemption limits that are provided for by law.

(a) **The income attributable to GerCo**

In compliance with the aforementioned principles only passive income that the subsidiary generates is attributed to GerCo which is all income that is not listed in the catalogue of active income that is set out in sec. 8 para. 1 FTA.

The subsidiary generates 30 % from financial services, 10 % from renting and leasing activities. The total income is 1 m Euro. Thus, as GerCo holds 100 % in the shares of the subsidiary, an amount of 400,000 Euro has to be attributed to GerCo. As no modifications have to be done, 119,300 Euro domestic taxes are charged on the foreign income.

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196 Sec. 7 para. 1 FTA in connection with sec. 8 para. 1 sentence 1 FTA.
197 Arnold / McIntyre, p. 94.
198 Those are e. g. available for small amounts of mixed income sec. 9 FTA.
The attributable income to UKCo

UK CFC taxation takes the whole chargeable profits of a controlled foreign company into account; i.e. the whole income is attributed to the shareholders. Reduced by capital gains such income builds the basis for calculation of the inclusion amount.

As the facts of the case do not mention any capital gains, the whole income is attributed to UKCo and taxed with 28% domestic corporate income tax. UKCo has to pay 280,000 Euro on the attributed foreign income.

As the examples above show, the CFC tax liability of GerCo and UKCo deviates heavily. GerCo only has to pay 43% of the amount of taxes UKCo pays.

Arnold / McIntyre, p. 94.
Sec. 747 para. 1 ICTA in connection with sec. 747 para. 3 and 4 a ICTA.
is charged. In this case, the German CFC system is clearly preferable. This is due to the fact that the German CFC system does only impose domestic taxes on passive income.

Finally, as the German and the UK domestic income tax rates do only differ marginally, the German CFC regime should be preferred in case a shareholder could choose between being tax resident in Germany or in the UK. Nevertheless the conclusion that the German CFC regime is generally preferable cannot be drawn. In fact, unless a company generates passive income only, the German CFC regime at first sight always seems to be preferable as active income is not subject to CFC taxation.

2. Comparison of the exemption methods of the two CFC regimes

The following table summarises the several exemptions and exemption limits granted by the two CFC regimes. It shows that the German CFC regime does only offer the exemption incorporated in sec. 8 para. 2 FTA for a limited scope of controlled foreign companies which are those established within the EU / EEA. In addition to this, CFC income does not have to be taken into account if it falls in certain exemption limits for mixed income and income with capital investment character.

In the UK CFC regime, the domestic taxation of the whole foreign income always represents a much stronger economic consequence as if only passive income is attributed to the domestic shareholder. But the UK legislator does not want to cover all cases in which a foreign subsidiary generates income. It rather aims to prevent resident taxpayers from reducing their domestic tax burden by shifting income abroad. Thus in order to apply the rules more specific, several exemptions from CFC taxation are incorporated in the ICTA. The exemption rules address those

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201 The detailed description can be found for the German CFC rules in chapter C section III subsection 1 and 2 and for the UK CFC rules in chapter B section II subsection 7.

202 The exemption limit of mixed income is incorporated in sec. 9 FTA, the exemption limit for income with capital investment character is incorporated in sec. 7 para. 6 FTA.

203 INTM201020.

204 Cooklin / Bailes; INTM201050.
cases in which the UK legislator assumes no intentional diversion of profits and effectively cover a great number of subsidiaries which are controlled by UK resident taxpayers.\textsuperscript{205} If a company falls within the scope of an exemption, the whole profits are excluded from CFC taxation, unless a reduction of the chargeable profits in accordance with sec. 751A ICTA is applied for.\textsuperscript{206}

\textsuperscript{205} E. g. with regard to the white list INTM203020 or the motive test INTM208000.

\textsuperscript{206} For the consequences of such an application please refer to chapter C section II.
<table>
<thead>
<tr>
<th>Exemption</th>
<th>German CFC rules</th>
<th>U. K. CFC rules</th>
<th>Evaluation</th>
</tr>
</thead>
</table>
| **Mixed income** | Generation of mixed income has not to be taken into account for CFC taxation purposes if:  
• Passive gross revenues do not amount to more than 10% of the gross revenues in total.  
And  
• On the company’s and on the taxpayer’s level the amount not to be taken into account does not exceed 80,000 Euro.  
Keeping the exemption limit leads to a full exemption of the controlled foreign company’s income. | • N. a. | • The UK CFC regime does not provide for a rule addressing mixed income as it does only differentiate between active and passive income in relation to the single exemption possibilities. |
| **Income with capital investment character** | • CFC taxation up from a holding of 1%.  
• No CFC taxation if the income with capital investment character does not exceed 10% of the gross amounts of the total income and if the amounts not taken into account accordingly for the intermediate company or the unlimited liable taxpayer do not exceed 80,000 Euro.  
Keeping the exemption limit leads to a full exemption of the controlled foreign company’s income. | • N. a. | • The UK regime does not apply stricter rules for income with capital investment character. Thus the basic CFC rules apply with the result that German CFC taxation is applies sooner with regard to the required shareholding quota. |
| **Exempt activities test** | • N.a. | • Full exemption of CFC taxation of the | • This exemption aims to exclude companies that are |

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207 The table merely summarises what has been explained in detail in chapter B section I subsections 8 and 9 and section II subsection 7 as well as in chapter C sections III and II.
controlled foreign company if it is engaged in exempt activities.

- The controlled foreign company must have a business establishment from which it has to be managed.

In addition to this the controlled foreign company furthermore

- may neither be involved in investment business nor in trading with the UK or related persons or
- must be a local holding company in the terms of the ICTA.

This exemption leads to a full exemption of CFC taxation.

De-minimis rule
Refer to the exemption limits granted for mixed income and income with capital investment character.

- The controlled foreign company is exempt from CFC taxation if the chargeable profits are less than 50,000 Pound.210
- Besides this, CFC income does only have to be taken into account if the amount to apportion is higher than 25 % of the total profits of the controlled foreign company.211

- The UK regime offers two exemptions in the case the domestic tax would be charged on a marginal income base only. The de-minimis rule is comparable to the exemption limits granted by the German CFC rules.
<table>
<thead>
<tr>
<th>Exemption</th>
<th>German CFC rules</th>
<th>U. K. CFC rules</th>
<th>Evaluation</th>
</tr>
</thead>
<tbody>
<tr>
<td>White list</td>
<td>• N. a.</td>
<td>• Controlled foreign companies resident in a country listed on the white list are excluded from CFC taxation. This exemption leads to a full exemption of CFC taxation.</td>
<td>• This simplifies the application of the UK CFC rules. • The list includes those countries which are not deemed to encourage intentional profit diversion. • There is nothing comparable in Germany.</td>
</tr>
<tr>
<td>Motive test</td>
<td>• N. a.</td>
<td>• No CFC taxation if reduction in UK tax revenues is marginal or if it was not the purpose of the transaction and the main reason for the existence of the controlled foreign company is not the reduction of UK tax by diversion of profits. This exemption leads to a full exemption of CFC taxation.</td>
<td>• The German CFC regime does not provide for the consideration of the motive behind transactions that lead to a reduction of German tax revenues.</td>
</tr>
<tr>
<td>Proof of the genuine economic activity of the controlled foreign company that is established within the EU / EEA.</td>
<td>Proof given by the domestic resident taxpayer that • Controlled foreign company pursues genuine economic activity. • Thus, even if the controlled foreign company’s income is passive income, the relief might be granted. • Exchange of information with the state in which the controlled foreign company is resident must be possible. • No application of downstream companies. This exemption leads to a full exemption of CFC taxation.</td>
<td>Application of reduction of chargeable profits possible if: • Business establishment in the country of residence of the controlled foreign company with staff on site. • Amount to be reduced is not higher than the net economic value that was generated. This exemption leads to a partial exemption of CFC taxation.</td>
<td>• While the German legislator grants a full exemption from CFC taxation if the proof succeeds, the UK legislator does only exempt active income from CFC taxation. Thus, the passive income still is subject to CFC taxation as only the base for assessing the inclusion amount is reduced.</td>
</tr>
</tbody>
</table>

The different exemption methods of the German CFC rules and the UK CFC rules. Source: self-generated
III. The EU / EEA exemption methods

In section I the CFC tax liability of GerCo and UKCo with regard to their Bulgarian subsidiaries’ income was affirmed. Now the consequences of an exemption for controlled foreign companies that are established in the EU / EEA are analysed with regard to the two regimes. It is not intended to further discuss alternative exemption methods or exemption limits.

1. CFC taxation of GerCo under sec. 8 para. 2 FTA

It is questionable whether GerCo has the right to proof the genuine economic activity of the Bulgarian subsidiary in accordance with sec. 8 para. 2 FTA and thus to avoid the application of CFC taxation.

As the Bulgarian subsidiary is located within the EU / EEA and under the assumption that the German and Bulgarian fiscal authorities have the agreement to exchange relevant information, GerCo must prove that the Bulgarian subsidiary exercises genuine economic activities in Bulgaria. In subsection 2 of section III of chapter C, the major criteria to proof genuine economic activity have been outlined. In accordance with this, prove foreign company must maintain a permanent establishment that can be verified objectively by offices, employees and equipment and thus express a minimum level of substance. The foreign company must in particular participate in the market of the country in which it is resident, must be managed from this establishment and must generate its income by the activities that are exercised there.²¹²

As the facts of the case state, the subsidiary possesses sufficient office space and employees to exercise stable and continuing genuine economic activity. Thus, as the profits obviously directly arise out of the work done by the subsidiary, generally the entire passive income has to be excluded from CFC taxation in accordance with sec. 8 para. 2 FTA.

²¹² Kraft, sec. 8, para. 741 et seq.
But even though all requirements are fulfilled and the proof of the contrary generally succeeds, not every kind of the passive income is excluded from German CFC taxation.

Passive income generated by renting and leasing represents income for which the controlled foreign company is an intermediate company in the terms of sec. 8 para. 1 FTA. As GerCo can successfully prove underlying genuine economic activity, this part of passive income is excluded from CFC taxation. But any passive income with capital investment character does not fall under the definition of the ordinary passive income of a controlled foreign company as it is regulated by a special provision. Since sec. 8 para. 2 FTA does not refer to the special rules regulating income with capital investment character, investment income with capital investment character does not fall in the scope of sec. 8 para. 2 FTA. As a result, only the passive income that is generated by the renting and leasing activities falls within the scope of sec. 8 para. 2 FTA and can be excluded from CFC taxation.

Taking the aforementioned into consideration, GerCo has to pay 89,475 Euro domestic taxes on the CFC income.

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213 Sec. 8 para. 2 sentence I FTA in connection with the catalogue of active income in sec. 8 para. 1 FTA.
214 Those specific rules can be found in sec. 7 para. 6 and 6 a FTA.
215 Blümich, sec. 8 FTA, para. 155.
Total income of the foreign company 1 m Euro

- Thereof passive income 400,000 Euro
- Thereof income with capital investment character 300,000 Euro
- Thereof passive income from renting and leasing estate 100,000 Euro

Amount to apportion 400,000 Euro

Income for which the controlled foreign company is not the intermediate company according to sec. 8 para. 2 FTA: 100,000 Euro

Inclusion amount (Amount to apportion - Income for which the controlled foreign company is not the intermediate company) (400,000 Euro - 100,000 Euro) 300,000 Euro

* shareholding * 100 %

Applicable tax rate on inclusion amount 300,000 Euro * 29.825 % 89,475 Euro

Amount of taxes to pay 89,475 Euro

CFC tax liability of GerCo. Source: self-generated

2. **CFC taxation of UKCo under sec.751A ICTA**

If a UK resident company wants to apply for a reduction of the chargeable amount to be apportioned by the tax authorities in accordance with sec. 751A ICTA, the subsidiary must generate economic value. This requires sufficient personnel and offices located in the country where the subsidiary is established that allows exercising a stable activity in the market. With reference to the reasoning above the Bulgarian subsidiary should be qualified as generating genuine economic activities and thus fulfils the requirement.

However, any amount that may be deducted from the chargeable profits is limited. The amount of reduction, which is called “specified amount”, may not be higher than the generated net economic value. As pointed out in chapter C section II, the net economic value is an amount comparable to what the German CFC regime characterises as active income. Thus, first of all the income that was generated by
the trading activities represents the net economic value because it was generated directly by the work of the employees on site.

In contrast to this, the income generated by investment business and renting and leasing activities predominantly occurred by the holding of the assets and thus does not reflect genuine economic value.\textsuperscript{216}

Thus, the rate of the specified amount is limited to a reduction of income that was generated by active income and only passive income remains subject to CFC taxation. After the reduction of the chargeable profits by the specified amount the reduced chargeable profits are attributed to the shareholder and the respective tax rate applies on the inclusion amount. Under application of this exemption, UKCo has to pay 112,000 Euro domestic taxes of the passive income of the Bulgarian subsidiary.

\begin{table}[h]
\centering
\begin{tabular}{|l|c|}
\hline
Total income of the foreign company / chargeable profits & 1 m Euro \\
\hline
\hspace{1cm} Thereof net economic value / specified amount & 600,000 Euro \\
\hspace{1cm} Thereof passive income & 400,000 Euro \\
\hline
Amount to apportion: Total chargeable profits & 1 m Euro \\
\hspace{1cm} - specified amount & 400,000 Euro \\
\hline
Inclusion amount: & \\
\hspace{1cm} Amount to apportion & 400,000 Euro \\
\hspace{4cm} * shareholding & 400,000 Euro \\
\hspace{1cm} Applicable tax rate on inclusion amount & 400,000 Euro * 28 \% \\
\hline
Amount of taxes to pay & 112,000 Euro \\
\hline
\end{tabular}
\caption{CFC tax liability of UKCo. Source: self-generated}
\end{table}

3. \textit{Evaluation of the results}

The main difference between the exemption method granted for controlled foreign companies established within the EU / EEA is the extent of the relief. Whereas in Germany a full exclusion is generally granted – unless income with investment

\textsuperscript{216} INTM210530; in some cases a marginal amount of the passive income might reflect economic value. For instance if the foreign company can borrow on better terms. But this is not assumed in this case.
character is concerned – the UK exemption results in a partial relief only. The UK resident company then is taxed on an inclusion amount a German resident taxpayer would be attributed to in the ordinary course of CFC taxation without applying an exemption method.

Compared to the further exemption methods granted by the UK CFC regime, the above demonstrated exemption method is not as beneficial as it does not result in a full relief of CFC taxation. Even the legislative body stipulated that a UK resident company can only apply for a reduction of the chargeable amount in accordance with sec. 751 A FTA, if no other exemption method is applicable as they are likely to lead to a full relief of CFC taxation.\textsuperscript{217}

E. Conclusion

After the structure and consequences of CFC rules have been illustrated with reference to the German CFC rules and the UK CFC rules, finally two questions seem to be of further interest. These are the questions of the preferability of one regime and whether the reaction on the ECJ decision of the Cadbury Schweppes case was appropriate. The latter question focuses on the German CFC regime only and is likely to influence the further development of the German CFC regime.

I. The preferability of one regime

The thesis demonstrated the structural approaches of the two regimes and the respective example\textsuperscript{218} illustrated the substantial monetary differences that might occur in the case the further conditions, like e. g. the domestic tax rate that is charged on the CFC income, are similar. It is questionable if this structural difference allows the general conclusion that the German CFC regime should be preferred in the case a shareholder can choose where to be tax resident.

\textsuperscript{217} INTM210520.
\textsuperscript{218} Chapter D section II subsection 1.
Such a general preferability cannot be affirmed because all facts and circumstances of a case have to be taken into consideration in order to assess the monetary consequences properly. It would be misleading to focus on the extent of the attributable income only. The table in chapter D section II subsection 2 summarises the exemption methods that are available in the two regimes. With regard to the UK CFC rules, this table displays a variety of exemption methods that lead to a full relief of CFC taxation. In contrast to this, the German CFC regime does only offer one exemption method besides some exemption limits. These exemption limits have no relevance with regard to multinational corporations as they refer to small amounts only.\textsuperscript{219}

Due to this manifold exemption methods available in the UK CFC regime, one has to carefully assess whether the subsidiary fulfils the requirement of one of the exemption methods. If the controlled foreign company is likely to fall in one of those UK exemption methods, it is the UK CFC regime that should be preferred as it grants a full relief of CFC taxation. Corresponding to this, it is advisable to be tax resident in Germany if no exemption method is available, because only passive income is subject to CFC taxation.

Finally, one has to state that no regime per se is more beneficial than the other. One rather has to analyse the conditions both regimes offer and compare those with the facts and the circumstances of the specific situation.

II. Criticism with regard to EC law and outlook

The ECJ’s judgement of the Cadbury Schweppes case disclosed the incompatibility of German CFC rules with EC law. The German legislator tried to remedy the drawbacks of German CFC rules by implementing sec. 8 para. 2 FTA and now grants the resident taxpayer to prove by objective criteria that the activities of the controlled foreign company are of genuine economic reality and thus in harmony with exercising the freedom of establishment.

From a state’s view, the exemption method granted in sec. 8 para. 2 FTA rather reduces tax revenues as passive income is taken out of the scope of CFC taxation if the proof

\textsuperscript{219} Sec. 9 FTA and sec. 7 para. 6 FTA.
succeeds. Therefore, the legislator obviously reduced the scope of application of this exemption from CFC taxation as comprehensive as possible and made only those concessions that were absolutely necessary.\footnote{Köhler / Eick, DStR 2006, p. 1873.} For instance, the German legislator had no incentive to enact sec. 8 para. 2 FTA with general applicability but limited the scope to controlled foreign companies that are established within the EU / EEA. Furthermore, income with capital investment character is excluded from the scope of sec. 8 para. 2 FTA. Whether this exclusion is in harmony with EC law is strongly doubted as the assumption of an abusive character of the shareholding is already made if the German resident taxpayer holds a much lower percentage of shares in the foreign company.\footnote{If the CFC rules are subject to review by the ECJ with regard to income with investment capital character, the ECJ would probably not assess the compatibility of the national rules with the freedom of establishment. This would be the case if the ECJ denied that even with such a low shareholding the business of the foreign company can be influenced and controlled. But then he would probably take recourse to the freedom of capital movement and review the national rules on this basis. Kraft / Bron, ISIR 2006, p. 619.}

It is even questionable, whether the German CFC rules in the current version allow assuming an abusive character of the arrangement if the requirements for their application are fulfilled. This depends on whether the rules are specific enough to justify strong indications for such abusiveness.

One indication for an abusive character is the diversion of income to a regime that offers low taxation. In Germany, low taxation is assumed if the foreign tax rate is lower than 25 \%. The domestic tax burden of a resident company is assumed being 29.825 \% on average. The monetary benefit from the diversion of income to a foreign country that offers e. g. 24 \% income tax rate, compared to e. g. Bulgaria that offers a tax rate of 10 \%, the monetary advantage is rather small. This “soft” requirement makes it difficult to distinguish between abusive structures and real economically motivated arrangements precisely.

A further substantial objection concerns the system of sec. 8 para. 2 FTA. This section represents a counter-exemption that reverses the qualification of income of the controlled foreign company as CFC income. The counter-exemption refers to sec. 8 para. 1 FTA that includes the catalogue of active income. Furthermore, if a resident taxpayer wants to make use of the counter-exemption by proving the genuine economic activity of the controlled

\footnote{Köhler / Eick, DStR 2006, p. 1873.}
foreign company, sec. 8 para. 2 FTA allocates the entire burden of proof to the German resident taxpayer.\footnote{ECJ, case C-196/04, BeckRS 2006, 70669, para. 63-75; Köhler / Eick, DStR 2006, p. 1873.}

The ECJ settled in the Cadbury Schweppes decision the need to assess the character of an arrangement by taking the substance of the controlled foreign company on site into consideration. But instead of taking such an approach for the classification of income, the German CFC rules still assess whether the arrangement the German taxpayer is involved in is of abusive character on the basis of the generation of passive income. The shift of the burden of proof to the German resident taxpayer first of all goes far beyond the general obligation of a German resident taxpayer to co-operate.\footnote{The general obligation to co-operate can be found in sec. 90 GTC.} Even though the ECJ deems the German resident taxpayer to be best positioned to prove the economic reality of the controlled foreign company, the overall burden of proof may only be shifted to the German resident taxpayer if the fiscal authorities have clear indications that allow assuming the abusive character of using a controlled foreign company. But generating passive income in accordance with sec. 8 para. 1 FTA does not represent a sufficient indication as it refers to certain kinds of income only and does not – as already mentioned – take the substance of the activities pursued by the controlled foreign company into consideration. Therefore, the shift of the burden of proof to the German resident taxpayer is not justifiable at all.

This paragraph pointed out that there are points of criticism with regard to the validity of the German motive test. The legislator did not yet implement an appropriate mechanism to transfer the findings of the ECJ into domestic legislation and to detect abusive behaviour precisely. To draft the counter-exemption in harmony with the findings of the ECJ, sec. 8 para. 1 FTA must be reviewed first.

Finally, a German resident taxpayer may be nevertheless subject to CFC taxation even though the controlled foreign company that is established within the EU / EEA pursues genuine economic activity. This might be the case if a subsidiary generates passive income in the terms of the FTA and the proof of the contrary is rejected by the fiscal authorities because of e. g. the fiscal authorities assume that the number of employees and premises
on site is not sufficient to participate in the market of the other state. In case of a review by the ECJ the German legislator probably has to review the income catalogue in a way that it discloses indications for an abusive structure more precisely. Until this adjustment is done, the shift of the burden of proof to the resident taxpayer is not justifiable. Thus, with regard to this it is advisable to challenge the German CFC rules in such a case.
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Online Sources


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**Codifications**


Grundgesetz für die Bundesrepublik Deutschland in der im Bundesgesetzblatt Teil III, Gliederungsnummer 100-1, veröffentlichten bereinigten Fassung, das zuletzt durch Artikel 1 des Gesetzes vom 19. März 2009 (BGBl. I S. 606) geändert worden ist.


**BMF Circulars and HMRC manuals**


INTM120040 - Company Residence, Company residence: the incorporation rule.

INTM120060 - Company Residence, Company residence: the case law rule - central management and control.

INTM201020 - Controlled Foreign Companies: legislation - introduction and outline.
Judgements


