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# Do the German CFC rules restrict the free movement of capital? The CJEU's decision in X GmbH (C-135/17)

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Do German CFC rules constrain the EU free movement of capital, which may also cover investments into third countries? This question has been hanging in the air for quite some time. In fact, currently the taxpayer cannot fend off German CFC taxation by applying to Sec. 8(2) of the German Foreign Tax Act (AStG), i.e. the Cadbury Schweppes test, by providing economic reasons for the establishment of a CFC located in a country outside the EU or EEA.

The CJEU has now set its course for German extended CFC taxation on foreign passive investment income (FPII) under Sec. 7(6) AStG in the eagerly awaited X GmbH-case (C-135/17). Regrettably, however, the court did not clarify the application of the standstill clause (Art. 64(1) TFEU), thus leaving the question open whether Sec. 8(2) AStG needs to be expanded to also cover CFCs located in third countries.

**The case**

X GmbH, which is resident in Germany, held a 30% share in Y AG, resident in Switzerland. Y AG entered into debt purchase and transfer agreements with Z GmbH. Y AG generated profits from this which were classified by the tax authorities as FPII, i.e. profits to be subjected to CFC rules at the level of X GmbH under Sec. 7(6) AStG. This provision extends CFC taxation to shareholdings of at least 1% provided the foreign company generated FPII. Following an unsuccessful administrative appeal and legal proceedings before the tax court, the Federal Tax Court of Germany referred case to the CJEU for examination as it doubted whether the rules in question were compatible with EU law (decision of October 12, 2016 I R 80/14). As a result, the CJEU had the opportunity to measure the (extended) CFC rules against the free movement of capital.

**Questions submitted by the Federal Tax Court**

In essence, the Federal Tax Court wanted to know whether the extended CFC rules are protected by the ‘standstill’ clause (Art. 64(1) TFEU). In a nutshell, the standstill clause protects local tax rules vis-à-vis third countries, provided these rules do exist unchanged since December 31, 1993.
The Federal Tax Court doubted whether the subsequent changes to the rules (in particular, the reduction of the required holding threshold from 10% to 1% in the year 2000) were far-reaching enough to essentially assume that in fact a new regulation had been introduced (after the cut-off date relevant for the standstill clause). What’s more, the Federal Tax Court asked whether the standstill clause would be annulled as a result of the CFC rules being amended by a law (StSenkG 2000), which had entered into force in practice, but never applied because it had already been repealed before its first application (UntStFG 2001).

But most importantly the Federal Tax Court asked whether an application of the CFC rules on FPII (Sec. 7(6) AStG) violates the EU free movement of capital.

## The CJEU's decision

As to the first question, the CJEU stated that the extended CFC rules are protected by the standstill clause despite the lowering of the required holding threshold from 10% to 1% in 2000. Of course, since then, it has also been possible to include portfolio holdings. But the rules could still be applied on a case-by-case basis as well to larger stakes and thus also to direct investments which are the focus of the standstill clause.

However, the CJEU concluded on the second questions that such standstill clause might not be applicable. In particular, the court affirms that even a law which was never applied in practice can interrupt or disrupt the validity of existing restrictions, required for the standstill guarantee. However, the decisive question here is whether this law was applicable at the time it entered into force. According to the CJEU, it is for the German Federal Finance Court to verify this.

In the opinion of the CJEU, the extended CFC rules can, however, restrict the free movement of capital. In line with the Cadbury Schweppes principles (C-196/04), the CJEU recognises, in particular, the need to prevent tax avoidance and tax evasion. According to the court, it must be examined on a case-by-case basis whether a foreign company is engaged in a real economic activity, the pursuit of which creates a purely tax-motivated structure. The criteria developed by the CJEU in Cadbury Schweppes can also be used as indicators with regard to the free movement of capital, while the focus must be an economic reasoning for the shareholding (rather than for the establishment of CFC as in Cadbury Schweppes).

But in terms of third countries, the CJEU ultimately addresses not only the requirement (as contained in Sec. 8(2) AStG) to give the taxpayer the opportunity in a motive test to explain the economic reasons for his choice of structure. Rather, here a two-stage analysis is necessary. The first thing to consider is whether bilateral agreements are in place for exchanging information with the third country concerned. These should enable the German tax authorities to verify the accuracy of information provided by the taxpayer on the company resident there, its activities and the motivation for the taxpayer's shareholding in that company. Where such an agreement exists, the taxpayer should be given the possibility of proving economic reasons for his shareholding. However, this opportunity should not be granted if there is no agreement on the exchange of information is in place and the German tax authorities would therefore be prevented from verifying the accuracy of the information provided by the taxpayer.

## Practical consequences

The application of the German CFC rules on FPII can constrain the EU free movement of capital. At first glance, the CJEU seems to want to impose more stringent requirements for the taxpayer in relation to third countries in terms of reviewing proportionality. At a closer look, however, Sec. 8(2) sentence 2 AStG also requires countries to exchange information on the basis of the EU Mutual Assistance Directive. Depending on the individual case, things may therefore not be much different from Sec. 8(2) AStG.

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And on the basis of the German-Switzerland DTT as well as the agreement concluded with Switzerland on May 27, 2015, on the automatic exchange of information, there should be good reasons for enabling the taxpayer to provide evidence. Whether the scope of application of this or of Sec. 8(2) AStG also has to be extended to third countries and the German legislature needs to act as a result will ultimately depend on the outcome of the German Federal Finance Court with regard to the validity of the standstill clause.

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