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Making Germany's CFC Rules Effective Again:
A Comparative Analysis to Spain's and UK's CFC
Rules to Find the Best ATAD Compliant Approaches
Provided in the OECD/G20's Report on Designing
Effective CFC Rules

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CONTENTS

1.	Introduction	13
1.1.	Structurings without CFC rules	13
1.1.1.	Tax deferral	14
1.1.2.	Tax avoidance	15
1.2.	Overview on German CFC rules.....	16
1.2.1.	Systematical classification.....	16
1.2.2.	Conditions and legal consequences.....	16
1.3.	Issues of the German CFC rules.....	17
1.3.1.	Issues.....	17
1.3.2.	Legal development of German CFC rules	17
1.4.	International developments.....	19
1.4.1.	BEPS	19
1.4.2.	ATAD.....	20
1.5.	Research goal	20
1.6.	Research method	21
2.	Conditions for a CFC taxation.....	23
2.1.	Rules for defining a CFC.....	23
2.1.1.	BEPS	23
2.1.2.	ATAD.....	26
2.1.3.	Germany	27
2.1.4.	Spain.....	47
2.1.5.	UK.....	55
2.1.6.	Recommendation.....	61
2.2.	CFC exemptions and threshold requirements	65

	8
2.2.1. BEPS	65
2.2.2. ATAD.....	69
2.2.3. Germany	71
2.2.4. Spain.....	84
2.2.5. UK.....	88
2.2.6. Recommendation.....	104
2.3. Definition of CFC income.....	109
2.3.1. BEPS	109
2.3.2. ATAD.....	114
2.3.3. Germany	115
2.3.4. Spain.....	153
2.3.5. UK.....	163
2.3.6. Recommendation.....	192
3. Consequences of a CFC taxation.....	199
3.1. Rules for computing income.....	199
3.1.1. BEPS	199
3.1.2. ATAD.....	199
3.1.3. Germany	200
3.1.4. Spain.....	203
3.1.5. UK.....	205
3.1.6. Recommendation.....	208
3.2. Rules for attributing income	208
3.2.1. BEPS	208
3.2.2. ATAD.....	209
3.2.3. Germany	210
3.2.4. Spain.....	214
3.2.5. UK.....	215

3.2.6.	Recommendation.....	225
4.	Rules to prevent or eliminate double taxation.....	227
4.1.	BEPS	227
4.2.	ATAD.....	227
4.3.	Germany	228
4.3.1.	Rules.....	228
4.3.2.	Issues.....	230
4.3.3.	ATAD compliance.....	232
4.4.	Spain.....	232
4.4.1.	Rules.....	232
4.4.2.	Issues.....	233
4.4.3.	ATAD compliance.....	233
4.5.	UK.....	234
4.5.1.	Rules.....	234
4.5.2.	Issues.....	236
4.5.3.	ATAD compliance.....	236
4.6.	Recommendation	236
5.	Conclusions, limitations and future lines of research.....	239
5.1.	Conclusions.....	239
5.1.1.	Rules for defining a CFC.....	240
5.1.2.	CFC exemptions and threshold requirements	242
5.1.3.	Definition of CFC income.....	244
5.1.4.	Rules for computing and attributing income/Double taxation	248
5.2.	Limitations	249
5.3.	Future lines of research	250

ABBREVIATIONS

AO	German General Tax Act
AStG	German Foreign Tax Act
ATAD	Anti-Tax Avoidance Directive
BB	Betriebs-Berater
BEPS	Base Erosion and Profit Shifting
BFH	Federal Tax Court
BGB	German Civil Code
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
BMF	Federal Ministry of Finance
BGBI	Bundesgesetzblatt
BStBl	Bundessteuerblatt
BVErfG	Federal Constitutional Court
CCo	Spanish Commercial Code
CFC	Controlled Foreign Company
CFC Report	OECD/G20's report on "Designing Effective CFC Rules" as of 5 October 2015
CTA	UK Corporation Tax Act 2009
DB	Der Betrieb
DStR	Deutsches Steuerrecht
DStZ	Deutsche Steuer-Zeitung
DTT	Double taxation treaty
EStG	German Income Tax Act
EU	European Union
EUAHiG	German EU Administrative Assistance Act
FR	FinanzRundschau
FRS	Financial Reporting Standard

G20	Group of 20
GewStG	German Trade Tax Act
GmbHStB	GmbH-Steuerberater
HMRC	Her Majesty's Revenue and Customs
IRPF	Spanish Income Tax Act
ISR	Internationale SteuerRundschau
IStR	Internationales Steuerrecht
INTM	International Manual
IWB	Internationales Steuer- und Wirtschaftsrecht
KSR	Kommentiertes Steuerrecht
KStG	German Corporate Tax Act
LIS	Spanish Corporate Tax Act
NWB	Steuer- und Wirtschaftsrecht
OECD	Organisation for Economic Co-operation and Development
P.	page
Pp.	pages
Para.	Paragraph
Paras.	Paragraphs
PE	Permanent Establishment
PRA	Prudential Regulation Authority
RCyT	Revista de Contabilidad y Tributación
REITG	German Real-Estate-Investment-Trust Act
RFH	Reich Fiscal Court
RIW	Recht der internationalen Wirtschaft
SEStEG	SE-Steuereinführungsgesetz
SolzG 1995	German Solidarity Surcharge Act
SPFs	Significant people functions and key entrepreneurial risk-taking functions
SteuerStud	Steuer und Studium

StÄndG	Steueränderungsgesetz
StSenkG	Steuersenkungsgesetz
StuB	Unternehmensteuern und Bilanzen
StVergAbG	Steuervergünstigungsabbaugesetz
TFEU	Treaty on the Functioning of the European Union
TIOPA	Taxation (International and Other Provisions) Act 2010
UK	United Kingdom
UmwStG	German Reorganization Tax Act
UntStFG	Unternehmenssteuerfortentwicklungsgesetz
WPg	Die Wirtschaftsprüfung

1. INTRODUCTION

Controlled Foreign Company (CFC) rules shall avoid that a CFC is interposed to defer or avoid tax (see “1.1 Structurings without CFC rules”). However, the German CFC rules (see “1.2 Overview on German CFC rules”) raise numerous issues. They are considered to be out of date (see “1.3 Issues of the German CFC rules”). In the course of its “Base Erosion and Profit Shifting” (BEPS) project the Organisation for Economic Co-operation and Development (OECD) and the Group of 20 (G20) published on 5 October 2015 a report titled “Designing Effective CFC Rules” (“CFC Report”; OECD, 2015). The CFC report contains various high level approaches to design effective CFC rules (see “1.4.1 BEPS”). However, in light of the Anti-Tax Avoidance Directive (ATAD) of the European Union (EU), the German legislator is not completely free to amend the German CFC rules. Certain minimum standards have to be observed (see “1.4.2 ATAD”). Furthermore, the German legislator has to ensure that neither the free movement of capital, nor the freedom of establishment are infringed.¹ Now, the research goal is to find the best ATAD compliant approaches provided in the OECD/G20’s CFC report to make Germany’s CFC rules effective again (see “1.5 Research goal”). Therefore, a comparative analysis to Spain’s and United Kingdom’s (UK) CFC rules is undertaken (see “1.6 Research method”).

1.1. STRUCTURINGS WITHOUT CFC RULES

CFC rules shall avoid that a foreign company is interposed to defer or avoid tax.²

¹ See Cortez and Schmidt (2017, pp. 1961-1963), Schön (2013, pp. 6-9), Schönfeld (2016, p. 417) and Weber (2017, pp. 1302, 1303) regarding the delimitation of both freedoms.

² See Gosch (2017, pp. 876-878) regarding the delimitation to the German general anti-avoidance rule.

1.1.1. Tax deferral

In national and international tax law corporate entities are themselves subject to tax. Basically, their shareholders are not subject to tax until they receive a profit distribution (Mössner, 2018, p. 889).³ Therefore, a resident taxpayer might interpose between itself and the source of income a foreign company, which is subject to a low level of taxation. Without CFC rules the resident taxpayer would not be subject to tax until it receives a profit distribution from the foreign company. The lower the level of taxation and the longer the deferral until profits are distributed, the higher the resulting interest effect. Consequently, tax can be deferred, but not avoided. However, there may be further beneficial effects, e.g. the shareholder's relevant tax rate or tax base may be lower (Strunk, Kaminski, & Köhler, 2018, Chapter Vor §§ 7-14, paras. 2, 3).

Example

Company A, resident in country A, has a taxable income of 100. The tax rate in country A is 30 percent tax, i.e. company A pays a tax of 30. For the following year company A expects to have the same taxable income, however, company A would like to lower the tax of 30. Thus, company A incorporates company B in country B, a low tax jurisdiction (0 percent) and provides it with equity of 1,000. Company B, in turn, provides these 1,000 under an interest bearing (5 percent) loan agreement to company A. Figure 1 illustrates the case at hand.

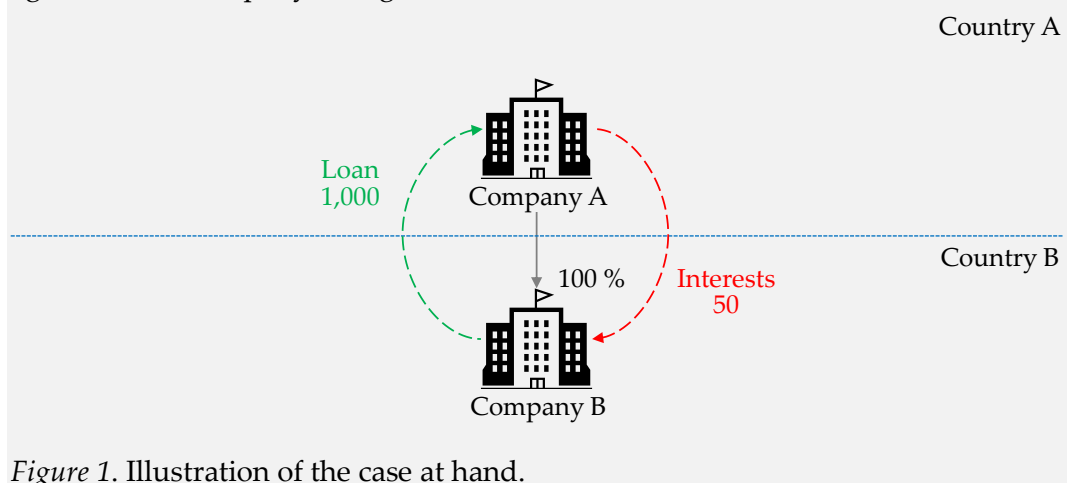


Figure 1. Illustration of the case at hand.

³ For Spain see (Aranzadi Insignis, n.db).

Without CFC rules company A's taxable income would be lowered due to the interest deduction of 50 from 100 to 50. The tax thereon would be 15 instead of 30. Company B would have interest income of 50. However, as country B's tax rate is 0 percent, company B would not pay tax thereon. Overall, the tax would be lowered from 30 to 15, i.e. by 50 percent. Only upon a profit distribution a taxation at the level of company A might occur.

1.1.2. Tax avoidance

Tax may be avoided, if profit distributions of a low taxed foreign company are not subject to tax at the shareholder's level, or if a reduced tax rate applies. For example Paragraph 8b(1) sentence 1 of the German Corporate Tax Act [Körperschaftsteuergesetz] ("KStG") provides that profit distributions are excluded when determining income for German corporate tax purpose, if the shareholder holds directly at the beginning of the calendar year at least 10 percent of the foreign company's stated or share capital, Paragraph 8b(4) sentence 1 of the KStG. Although 5 percent of the profit distributions are deemed to constitute expenses that may not be deducted as business expenses, Paragraph 8b(5) sentence 1 of the KStG, effectively 95 percent of the distributed profits are excluded when determining income for German corporate tax purpose. For trade tax purposes within the EU a minimum shareholding of 10 percent is required, outside the EU a minimum shareholding of 15 percent, Paragraphs 8 number 5 and 9 number 7 of the German Trade Tax Act [Gewerbsteuergesetz] ("GewStG"). Furthermore, the activity requirements of Paragraph 9 number 7 of the GewStG have to be met. Where a double taxation treaty (DTT) exempts dividends, such exemption should prevail over Paragraphs 8 number 5 and 9 number 7 of the GewStG. Consequently, a corporate entity, resident in Germany, may interpose between itself and the source of income a low taxed foreign company to avoid the higher domestic tax burden. The same holds true for natural persons residing in Germany where the partial income procedure is applicable (i.e. 40 percent of the income is tax free), Paragraph 3 number 40(d) of the German Income Tax Act [Einkommensteuergesetz] ("EStG"). In light of the worldwide tax differentials this offers significant tax structuring opportunities. CFC rules shall avoid such tax structurings (Strunk et al, 2018, Chapter Vor §§ 7-14, paras. 4-6).

1.2. OVERVIEW ON GERMAN CFC RULES

1.2.1. Systematical classification

As indicated above, for tax law purposes, a corporate entity is basically itself subject to tax, whereas its shareholder or shareholders are not subject to tax until they receive a profit distribution. Now, a legislator has the following possibilities to break through this shielding effect (Strunk et al, 2018, Chapter Vor §§ 7-14, para. 20):

- ▶ The unlimited tax liability might be extended to the foreign corporate entity;
- ▶ The legal personality of the foreign corporate entity might be ignored, i.e. the income would be attributed directly to its shareholder or shareholders;
- ▶ The foreign corporate entity might be treated as a transparent entity; or
- ▶ The foreign corporate entity might be deemed to distribute a dividend.

At a first glance the German legislator seems to have chosen the latter possibility (Schaumburg, 2017, p. 510), as the attributed income is basically income from capital assets, deemed to be received immediately after the close of the CFC's relevant fiscal year, Paragraph 10(2) sentence 1 of the German Foreign Tax Act [Außensteuergesetz] ("AStG"), the income is determined at the level of the CFC, and only a positive income is attributed, Paragraph 10(1) sentence 4 of the AStG. However, the CFC's income is computed applying the provisions of the German tax law, Paragraph 10(3) sentence 1 of the AStG, and is limited to low taxed passive income. So the German CFC rules ignore to some extent the legal personality of the CFC (Strunk et al, 2018, Chapter Vor §§ 7-14, para. 21).

1.2.2. Conditions and legal consequences

Broadly, the German CFC rules apply, where the following conditions are met:

- ▶ Resident taxpayers hold more than 50 percent of the ownership interests in a CFC (see "2.1.3.1 Rules");

- ▶ The CFC earns CFC income, also referred to as passive income (see “2.3.3.1 Rules”); and
- ▶ The passive income is subject to a low level of taxation, i.e. less than 25 percent (see “2.2.3.1 Rules”).

Are the foregoing conditions met, the CFC income is computed (see “3.1.3.1 Rules”). Generally, it is taxable for each of the resident taxpayers so far as it is attributable to its respective ownership interest in the CFC's nominal capital, Paragraph 7(1) of the AStG (see “3.2.3.1 Rules”). Last but not least there are rules to prevent or eliminate double taxation (see “4.3.1 Rules”).

1.3. ISSUES OF THE GERMAN CFC RULES

1.3.1. Issues

The German CFC rules raise numerous issues, as detailed under “2.1.3.2 Issues”, “2.2.3.2 Issues”, “2.3.3.2 Issues”, “3.1.3.2 Issues”, “3.2.3.2 Issues” and “4.3.2 Issues”. The key issues relate to control “2.1.3.2.2 Control”, the low level of taxation “2.2.3.2.2.1 Low level of taxation” and to the positive list “2.3.3.2.1 Positive list” (Jacobsen, 2018, p. 433). Generally, the German CFC rules are considered to be out of date (Benz, & Eilers, 2016, p. 9; Haarmann, 2011, p. 565; Kraft, 2010, p. 377), which does not surprise looking at their legal development.

1.3.2. Legal development of German CFC rules

Since the 1920s resident taxpayers interpose foreign companies between themselves and the source of income in order to avoid taxes. Such tax avoidance behavior rose continuously after the Second World War. The foregoing was first addressed in the report on tax havens ([Bundestag-Drucksache] IV/2412 as of 23 June 1964, p. 9). However, no legislative measures followed. The tax administration tried to combat such tax avoidance with its decree on tax havens as of 14 June 1965 (Niedersächsisches Finanzministerium, 1965) through a stricter application of Paragraph 42 of the German General Tax Act [Abgabenordnung] (“AO”; Haun, Kahle, Goebel, & Reiser, 2018, Chapter Vor §§ 7-14, para. 2). As the jurisprudence did not share the tax administrations point of view sufficiently, the legislator

enacted CFC rules as of 13 September 1972 with retroactive effect to 1 January 1972. These CFC rules were based on the US Subpart F legislation introduced in 1962 (Strunk et al, 2018, Chapter Vor §§ 7-14, para. 8; Kraft, & Trennheuser, 2013, p. 42). Afterwards the CFC rules were subject to some amendments. The following are mentionable:

- ▶ In 1992 a particular form of CFC taxation was introduced for passive investment income, which basically provided the non-application of the former Paragraph 10(5) of the AStG on such income. According to the latter paragraph CFC income was exempt from CFC taxation, if the CFC earned income, which would have been exempt under a DTT upon its distribution (Haun et al, 2018, Chapter Vor §§ 7-14, paras. 7, 10. In Paragraph 20(1) of the AStG was laid down that the AStG prevails in such cases over the DTT;⁴
- ▶ In 2000 a separate income category for the attributed income was introduced, which should have taken effect from 2001 onwards.⁵ However, in 2001 was decided with retroactive effect that the attributed income constitutes income from capital assets, or, if the shares in the CFC are held as business assets, income from commercial business activity.⁶ Therewith, the CFC taxation followed again the system of deemed profit distributions, however, the application of Paragraph 3 number 40(d) of the EStG and Paragraph 8b(1) of the KStG were expressis verbis excluded. Furthermore, the low level of taxation in terms of Paragraph 8(3) of the AStG was lowered from less than 30 percent (Quilitzsch, & Engelen, 2018) to less than 25 percent, to align it with the corporate tax rate of 25 percent. Last but not least, profit distributions, and to a large extend capital gains were included in the positive list and the level of control in CFCs with passive investment income was lowered from 10 to 1 percent (Haun et al, 2018, Chapter Vor §§ 7-14, paras. 8, 9);
- ▶ In 2003 inter alia the above mentioned Paragraph 10(5) of the AStG was repealed and Paragraph 20(2) of the AStG was modified to ensure in the

⁴ [StÄndG] as of 25 February 1992, BGBl 1992, I, p. 297.

⁵ [StSenkG] as of 23 October 2000, BGBl 2000, I, p. 1433.

⁶ [UntStFG] as of 20 December 2001, BGBl 2001, I, p. 3858.

corresponding permanent establishment (“PE”) cases a frequent switch over from the exemption to the credit method.⁷ Thereby, the DTT protection was removed completely (Strunk et al, 2018, Chapter Vor §§ 7-14, paras. 16, 17); and

- ▶ Since 2006,⁸ broadly, income from a foreign reorganization is active, if such reorganization, disregarding Paragraph 1(2) and (4) of the German Reorganization Tax Act [Umwandlungssteuergesetz] (“UmwStG”), could take place at book value, Paragraph 8(1) number 10 AStG (Schmidtman, 2007, pp. 229-231). Income from such reorganizations was passive before, if they took place at book value, as there was a low level of taxation (Strunk et al, 2018, Chapter Vor §§ 7-14, para. 17).

1.4. INTERNATIONAL DEVELOPMENTS

1.4.1. BEPS

On 12 February 2013 the OECD published a report titled “Addressing Base Erosion and Profit Shifting” (OECD, 2015a). Later in the year, in September, the OECD/G20 adopted a 15-point action plan to address BEPS. One of these actions aimed at strengthening CFC rules. After two years of work, on 5 October 2015, the CFC Report was published. The CFC Report sets out recommendations in the form of building blocks for the design of effective CFC rules. The building blocks are:

- ▶ Rules for defining a CFC;
- ▶ CFC exemptions and threshold requirements;
- ▶ Definition of CFC income;
- ▶ Rules for computing income;
- ▶ Rules for attributing income; and
- ▶ Rules to prevent or eliminate double taxation.

The recommendations are not minimum standards (OECD, 2015c; Radmanesh, 2015, pp. 896, 897).

⁷ [StVergAbG] as of 16 May 2003, BGBl 2003, I, p. 1209.

⁸ [SEStEG] as of 7 December 2006, BGBl 2006, I, p. 2782.

1.4.2. ATAD

The Commission proposed on 28 January 2016 an ATAD as part of the Anti-Tax Avoidance Package. 6 months later, on 12 July 2016, the Council adopted the ATAD (Kraft, 2019, Chapter Vor §§ 7-14, para. 125).⁹ One of the legally-binding anti-abuse measures contained in the ATAD, is a CFC taxation, Articles 7 and 8 of the ATAD. However, the ATAD only sets out a minimum standard. Member states are free to go beyond the minimum standard, Article 3 of the ATAD. The member states have to make their CFC rules, if necessary, until 31 December 2018 ATAD compliant and apply them from 1 January 2019 onwards, Article 11(1) of the ATAD.¹⁰

The minimum standard set out by the ATAD is presented below for each building block. The compliance of the German, Spanish and UK CFC rules with the foregoing minimum standard is also analyzed under each building block.

1.5. RESEARCH GOAL

As indicated above, the research goal is to find the best ATAD compliant approaches provided in the OECD/G20's CFC report to make Germany's CFC rules effective again. Although the CFC Report is titled "Designing Effective CFC Rules", the term effective is not defined throughout the CFC Report. However, in light of the shared policy considerations of the CFC Report, effective CFC rules must:

- ▶ balance preventing effectively avoidance with reducing administrative burdens and compliance costs (OECD, 2015c, para. 10); and
- ▶ balance preventing effectively avoidance with preventing or eliminating double taxation (OECD, 2015c, para. 11).

CFC rules that are relatively mechanical may not be preventing avoidance as effectively as rules that allow more flexibility. However, CFC rules that are relatively mechanical may create certainty (Reiners, 2018, p. 126), which may reduce administrative burdens and compliance costs. In contrast, CFC rules that

⁹ The political agreement was already reached on 21 June 2016, see López Ribas, (2016, p. 11).

¹⁰ The consequences of a retroactive implementation are discusses in Cloer and Niemeyer (2018, pp. 1017-1029).

allow more flexibility may create uncertainty, which may increase administrative burdens and compliance costs. Double taxation may occur under both, relatively mechanical and more flexible CFC rules. Effective CFC rules will have to strike a balance between preventing effectively avoidance, reducing administrative burdens, reducing compliance costs and preventing or eliminating double taxation.

1.6. RESEARCH METHOD

In order to find the best ATAD compliant approaches provided in the OECD/G20's CFC report to make Germany's CFC rules effective again, I proceed as follows:

- ▶ Under each building block elaborated by the OECD/G20 in its CFC Report (see "1.4.1 BEPS") I present first the outcome of the CFC Report. The CFC Report provides on 69 pages recommendations to design effective CFC rules. However, these recommendations often comprise numerous design alternatives without specifying how these alternatives shall work in detail (Calderón Carrero, & Martín Jiménez, 2017, p. 37) and together;
- ▶ Afterwards I address under each building block the minimum standard set out by the ATAD (see "1.4.2 ATAD");
- ▶ Now, to choose from the numerous and not very specific design alternatives provided by the OECD/G20 those which work in practice, I take a look at the Spanish and UK CFC rules and identify best practices (comparative approach). I chose the foregoing legislations, as the Spanish CFC rules have been amended lately considering the work of the OECD/G20 and also the UK rules are rather up-to-date and offer interesting approaches. For each set of rules, i.e. the German, Spanish and UK CFC rules I describe how they work, identify issues and indicate structurings;
- ▶ At the end of each building block I provide, based on the alternatives as they are contained in the OECD/G20's CFC Report, considering the minimum standard set out by ATAD, as well as the best practices identified in Germany, Spain and UK, a recommendation;
- ▶ The OECD/G20's building blocks are divided into conditions (see "2. Conditions for a CFC taxation"), consequences (see "3. Consequences

of a CFC taxation”) and double taxation (see “4. Rules to prevent or eliminate double taxation”).

2. CONDITIONS FOR A CFC TAXATION

2.1. RULES FOR DEFINING A CFC

2.1.1. BEPS

Defining a CFC requires to determine which entities fall under the term company and what kind of control is necessary.

2.1.1.1. *Entities*

Regarding entities the OECD/G20 recommend to include foreign corporate and transparent entities (trusts, partnerships) as well as foreign permanent establishments (“PE”) earning income that raises BEPS concerns, unless these concerns are not addressed differently (e.g. by taxing the transparent entities in the parent jurisdiction on a current basis; OECD, 2015, paras. 24, 26, 27).

Furthermore, a hybrid mismatch rule should be included. Such rule might consider intragroup payments if a payment is not included in the CFC income, but would have been included, if the entities and instruments had been classified as by the payer or payee jurisdiction. Otherwise, so far as the payment is deductible in the payer’s jurisdiction, foreign to foreign base erosion might occur, as the following example employed by the OECD and the G20 shows (OECD, 2015c, paras. 29-32):

Example

Company A, resident in country A, holds all ownership interests in company B, resident in country B, a low tax jurisdiction. The latter holds all ownership interests in company C, resident in country C, which is disregarded by country A for tax purposes. Company B provides an interest bearing loan to company C. According to the laws of company A the payment of interests from company C to company B is ignored and consequently not considered in the calculation of the CFC income. Figure 2 illustrates the case at hand.

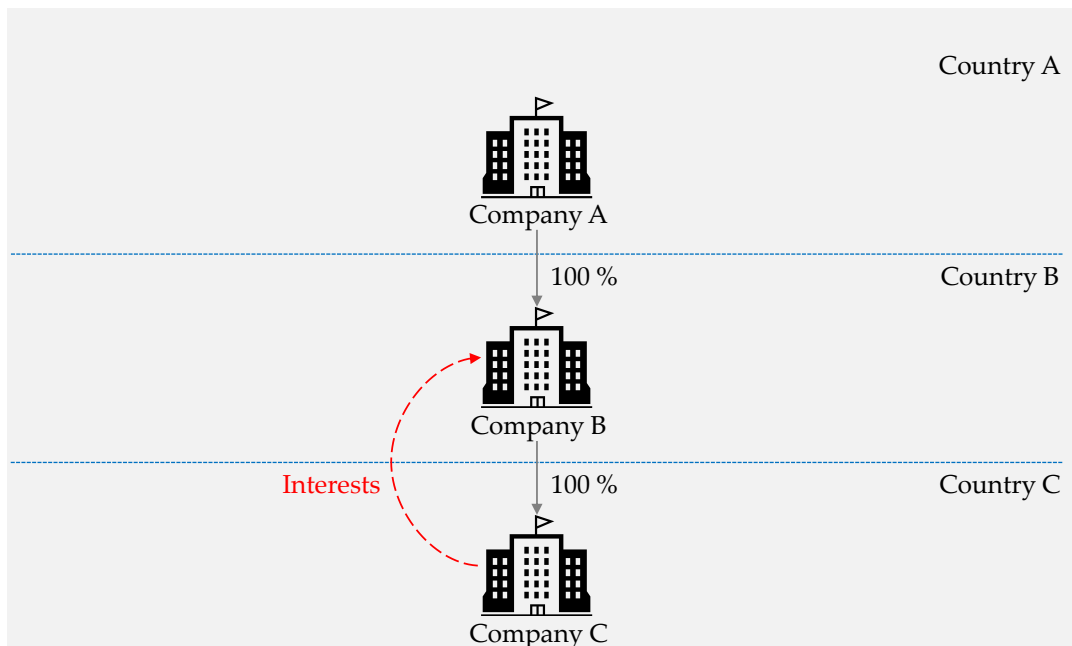


Figure 2. Illustration of the case at hand.

Under the hybrid mismatch rule, the payment of interests would be considered, as it is not included in the CFC income, but would have been included, had company C been classified as by the payer or payee jurisdiction.

2.1.1.2. Control

2.1.1.2.1 Type

Control should mean according to the OECD/G20 at least legal or economic control (OECD, 2015c, para. 25).

Legal control considers share capital held by a resident to determine the percentage of voting rights, which reflect the resident's power to instruct the foreign company. However, national corporate law often allows flexibility in designing the share structure (e.g. non-voting preferred shares), allowing to circumvent the control requirement (OECD, 2015c, para. 35).

Legal control is often combined with economic control, which looks at a resident's rights to a distribution of profits, the proceeds in the event of a disposal of the foreign entity's share capital and the latter's assets on a winding up. Again

circumvention is possible e.g. by interposing a new group holding company (OECD, 2015c, para. 35).

Countries may also include a de facto test, which could focus, for example, on who takes top-level decisions regarding the affairs of the foreign company or who can determine the foreign company's day-to-day business. As such test requires a facts and circumstances analysis and some subjective assessment, it leads to added costs, complexity and uncertainty for taxpayers, and, based on countries' experience, may relatively easy be circumvented (OECD, 2015c, paras. 25, 35).

A combination of legal and de facto control test could be to look at whether a foreign company is consolidated in the accounts of the parent company based on accounting principles, as they refer to criteria such as voting or other rights to exercise dominant influence over the foreign company (OECD, 2015c, para. 35).

2.1.1.2.2 Level

According to the OECD/G20 CFC rules should capture as a minimum situations where resident taxpayers have a legal or economic interest of more than 50 percent in the foreign company, as in these situations they may shift income to the latter. However, as also a lower legal or economic interest may allow to exert influence, jurisdictions may introduce lower thresholds (OECD, 2015c, para. 37).

The respective threshold does not necessarily have to be met by a single resident shareholder. The OECD/G20 recommend to aggregate the interests of minority shareholders that are acting together to exert influence. This may be proven either by (OECD, 2015c, paras. 38-43):

- ▶ an acting-in-concert test, i.e. only interests of resident shareholders are aggregated if the shareholders in fact act together to influence the foreign company;
- ▶ a related parties test, i.e. only interests of related resident shareholders are aggregated; or
- ▶ a concentrated ownership test, i.e. only interests of resident shareholders holding an interest higher than 10 percent are aggregated.

The OECD/G20 seem to prefer the rather mechanical related parties test, capturing most structures that raise BEPS concerns, as the acting-in-concert test leads to significant administrative and compliance burdens and the concentrated

ownership may not always accurately identify whether taxpayers are actually acting together (OECD, 2015c, paras. 39, 41, 43).

Besides interests of resident shareholders, the aforementioned three approaches might also consider interests of non-resident shareholders. However, as this would add complexity to these approaches, the OECD/G20 recommend to do not include interests of non-residents (OECD, 2015c, para. 45).

Control may be established through a direct shareholding or an indirect shareholding via a holding company. In case of an indirect shareholding there has to be more than 50 percent control at each level (OECD, 2015c, paras. 46, 47).

Whether the control requirement is fulfilled, might be checked at the end of the year or at any point throughout the year (OECD, 2015c, para. 49).

2.1.2. ATAD

2.1.2.1. Entities

According to Article 7(1) of the ATAD a CFC may be an entity, or a PE of which the profits are not subject to tax or are exempt from tax in the taxpayer's member state.

2.1.2.2. Control

2.1.2.2.1 Type

Article 7(1)(a) of the ATAD looks at the holding of voting rights, capital (legal control) or at the entitlement to receive profits (economic control).

2.1.2.2.2 Level

Regarding the level of control, Article 7(1)(a) of the ATAD provides that the control threshold is more than 50 percent.

This threshold has to be met either by the taxpayer itself or together with its associated enterprises. An associated enterprise is according to Article 2(4) of the ATAD:

- ▶ an entity in which the taxpayer holds directly or indirectly a participation of 25 percent or more (voting rights or capital ownership) or is entitled to receive 25 percent or more of its profits;
- ▶ an individual or entity which holds directly or indirectly a participation in a taxpayer of 25 percent or more (voting rights or capital ownership) or is entitled to receive 25 percent or more of its profits; and
- ▶ if an individual or entity holds directly or indirectly a participation of 25 percent or more in a taxpayer and one or more entities, all the entities concerned.

Whether the associated enterprises are domestic or foreign residents is not relevant. This may be problematic from a practical point of view, as the domestic corporation may not know in detail, the ownership structure of the foreign associated enterprises (e.g. of its parent company; Schnitger, Nitzschke, & Gebhardt, 2016, p. 963).

Furthermore, control is defined to include both, direct and indirect control.

2.1.3. Germany

2.1.3.1. Rules

2.1.3.1.1 Entities

Under Paragraph 7(1) of the AStG, broadly, CFC may only be a corporate entity, association, or independent property fund within the meaning of the KStG (Faber et al, 2018, Chapter Steuerpflicht, para. 9). To be a CFC, the foreign company has to be structurally comparable to such a corporate entity, association or independent property fund (Haase, 2017b, para. 514). This is determined in an entity classification test [Rechtstypenvergleich] (Jacobsen, 2019, para. 14), which was introduced by the Reich Fiscal Court [Reichsfinanzhof] (“RFH”) in its decision as of 12 February 1930 (VI A 899/27; Kessler, Kröner, & Köhler, 2018, Chapter 7, para. 6). Based on the jurisprudence the Federal Ministry of Finance [Bundesministerium der Finanzen] (“BMF”) has developed the classification

criteria shown in Table 1.¹¹ Although these criteria were developed to classify a US Limited Liability Company (“LLC”), they are also used to classify other entities (Endres, & Spengel, 2016, p. 396).

Table 1. Classification criteria.

	Corporation	Partnership
I.	Centralized management and representation: 1) Company is managed and represented at least by one non-member; 2) Company is managed and represented only by some members, as management and representation are limited by the articles of association (not legally) to a certain type of members; or 3) Company is managed and represented by at least one member, which is a corporation, and the latter one may be managed and represented at least by one non-member.	Decentralized management and representation: 1) All members manage and represent company; 2) Company is managed and represented only by some members, as management and representation is legally limited to a certain type of members (e.g. general partners); or 3) Company is managed and represented only by some members, as management and representation is not only legally limited to a certain type of members, but also further by the articles of association.
II.	None of the members is personally liable for claims of the company's creditors.	At least one member is personally liable for claims of the company's creditors.
III.	Interests may be transferred freely to third parties without consent of the other members.	Interests may only be transferred to third parties with the consent of at least one other member.

¹¹ See BMF (2004a) regarding the classification of a US LLC; However, according to Heuermann and Brandis (2018, Chapter § 1, para. 144) the test is also applicable to classify other foreign entities.

IV.	Distribution of profits is subject to a formal resolution of the members.	Distribution or retention of profits allocated to the members is at the members' discretion.
V.	Equity contributions are legally required.	Equity contributions are not legally required. Members may contribute services instead.
VI.	N/A	Limited life, i.e. the company is dissolved upon the occurrence of certain events without any further actions by its members.
VII.	Profit allocation is based on subscribed equity.	Formula for profit allocation is not only based on subscribed or contributed capital.
VIII.	Company is not incorporated by the mere agreement of the members. A registration has constitutive character.	Company is established by concluding a partnership agreement. A registration in a public register has only declarative character.

The entity classification is done on a case-by-case basis. An overall assessment of the described characteristics is necessary. No single criterion is decisive or dominant. If such judgment based on all facts and circumstances does not readily yield a conclusion, the entity is deemed a corporation, if a majority of the criteria I. - V. indicates a corporation.

Transparent entities and PEs are generally not subject to CFC taxation, as their income is basically taxed in Germany on a current basis. However, the income of transparent entities and PEs is usually exempt in Germany in accordance with a DTT (Strunk et al, 2018, Chapter § 7, para. 44). Paragraph 20(2) of the AStG therefore provides a switch over from the exemption to the credit method, where such income would be taxable as CFC income if this transparent entity or PE was a foreign company. The latter provision overrides any DTT, Paragraph 20(1) of the AStG. According to the decision of the Federal Constitutional Court [Bundesverfassungsgericht] ("BVerfG") as of 15 December 2015 (2 BvL 1/12) such treaty override by national statutory law is permissible under the constitution.

Consequently, from an economic point of view, the result is the same as it would be, if the CFC taxation was applicable to transparent entities and PEs.

2.1.3.1.2 Control

2.1.3.1.2.1 Type

Paragraph 7(2) sentence 1 of the AStG focuses on the shares and voting rights (legal control).

If neither shares nor voting rights exist, the ownership interests in the foreign company's property are decisive, Paragraph 7(2) sentence 3 of the AStG.

2.1.3.1.2.2 Level

Paragraph 7(1) of the AStG requires resident taxpayers to hold ownership interests of more than 50 percent in the foreign company.

Where a CFC earns passive investment income, the level of control is lowered to at least 1 percent, Paragraph 7(6) sentence 1 of the AStG. However, this special control level considers only the direct ownership interests of each single resident taxpayer, i.e. ownership interests of various resident taxpayers are not aggregated (Heuermann, & Brandis, 2018, Chapter § 7, para. 53). Passive investment income is defined in Paragraph 7(6a) of the AStG as income from the holding, management, value preservation, or value appreciation of cash and cash equivalents, receivables, securities, certain ownership interests, or similar assets (Wagemann, 2018, p. 453), unless the taxpayer proves that the income derives from active activities covered by Paragraph 8(1) numbers 1 to 6, excluding certain banking business. However, the level of control is not lowered if the gross revenue that underlies the passive investment income does not exceed 10 percent of the gross revenue underlying the CFC's entire passive income and the amounts to be disregarded by a CFC or by a taxpayer as a result hereof total to no more than 80,000 €. Where the foreign company earns exclusively or almost exclusively passive investment income, any level of control is sufficient, unless its shares are traded frequently and to a significant extent at a recognized stock exchange, Paragraph 7(6) sentence 3 of the AStG. Almost exclusively means at least 90 percent (Heuermann, & Brandis, 2018, Chapter § 7, para. 53).

According to Paragraph 7(2) sentence 1 of the AStG resident taxpayers hold ownership interests of more than 50 percent in the foreign company, if more than 50 percent of the shares or voting rights in the foreign company are attributable to them, either alone or together with any parties in terms of Paragraph 2 of the AStG. Parties in terms of the latter Paragraph are individuals who, having been liable as Germans to income tax on a resident basis for a total of at least five of the last ten years preceding the termination of their resident tax status under Paragraph 1(1) sentence 1 of the EStG, are residents in a foreign jurisdiction in which their income is subject only to a low rate of taxation (Flick, Wassermeyer, Baumhoff, & Schönfeld, 2018, Chapter § 7, para. 43). The resident taxpayers neither have to act in concert, nor have to be related. Also a concentrated ownership is not required. Although Paragraph 7(1) of the AStG requires resident taxpayers (plural) to hold ownership interests of more than 50 percent in the foreign company, a single resident taxpayer is also sufficient, as can be derived from Paragraph 18(1) of the AStG (Heuermann, & Brandis, 2018, Chapter § 7, para. 13).

Shares and voting rights held by a person who is obliged to follow or does follow the instructions of a resident taxpayer to such extent that the person retains no significant decision-making discretion of its own shall be attributed to this resident taxpayer for purposes of the CFC taxation, Paragraph 7(4) of the AStG. Although the wording of this Paragraph implies that any obliged person is considered, from a teleological interpretation follows that the obliged person has to be a non-resident. Otherwise the obliged person's ownership interest would be considered twice, under Paragraph 7(2) of the AStG at the level of the obliged person and under Paragraph 7(4) of the AStG at the level of the obliged person's shareholder (Strunk et al, 2018, Chapter § 7, para. 132). A person may be obliged to follow the instructions of a resident taxpayers e.g. as a result of a usufruct or transfer of voting rights (Heuermann, & Brandis, 2018, Chapter § 7, para. 33). However, the mere fact that the resident taxpayer holds an ownership interest in the person is not sufficient to meet this requirement (Strunk et al, 2018, Chapter § 7, para. 141).

The ownership interests are calculated alternatively considering the shares or voting rights, i.e. shares and voting rights are not added. This even holds true, where one resident taxpayer holds the shares and another one the voting rights in the same foreign company (Heuermann, & Brandis, 2018, Chapter § 7, para. 27a).

According to Paragraph 7(2) of the AStG shares and voting rights held through another foreign (Heuermann, & Brandis, 2018, Chapter § 7, para. 29) company are also counted, i.e. in such proportion as the shares or voting rights held in the other company bear to the total shares or voting rights in this company. Are ownership interests held via a partnership, the partners of the partnership (individuals, corporations or in case of partnerships their partners) are deemed to hold directly the ownership interests in the foreign company, Paragraph 7(3) of the AStG. Although the wording of the latter Paragraph is not clear, the ownership interest held by a partnership in a foreign company is only so far deemed to be held directly by a partner of this partnership as this partner holds an ownership interest in the partnership (Haase, 2016, Chapter § 7, para. 95).

Whether the control threshold is met, is determined at the end of the foreign company's fiscal year, Paragraph 7(2) sentence 1 of the AStG.

2.1.3.2. *Issues*

2.1.3.2.1 Entities

As mentioned above, transparent entities and PEs are generally not subject to CFC taxation, as their income is basically taxed in Germany on a current basis. Is their income exempt in Germany under a DTT, Paragraph 20(2) of the AStG has to be observed. The latter Paragraph provides a switch over from the exemption to the credit method, where such income would be taxable as CFC income if this transparent entity or PE was a foreign company. However, the extent of the fiction to treat a foreign partnership or PE as a corporation is unclear, as the following example (Haase 2014, p. 109; Haase, 2017c, pp. 164-166) shows:

Example

An individual has a PE in Romania, which generates passive income. Whereas the individual is subject to a Romanian income tax rate exceeding the threshold of less than 25 percent, stipulated in Paragraph 8(3) of the AStG, the Romanian corporate tax rate is only 16 percent. Figure 3 illustrates the case at hand.

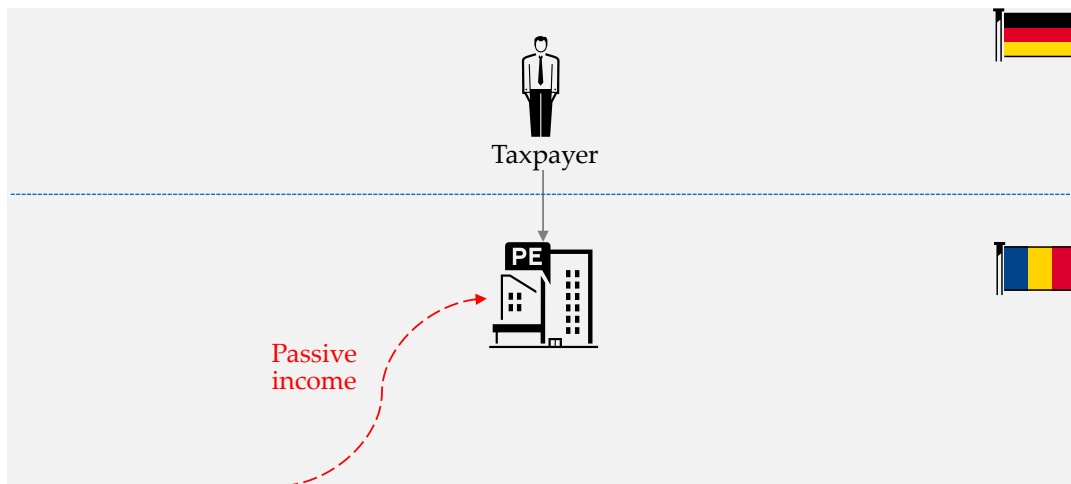


Figure 3. Illustration of the case at hand.

The mere wording of the fiction provided in Paragraph 20(2) of the AStG indicates that the corporate tax rate is relevant, i.e. the passive income would not fall under the tax rate exemption. However, this could lead to adverse results. Even if the individual was subject to an income tax rate of 45 percent, Paragraph 20(2) of the AStG would deny the application of the adequate tax rate exemption. Consequently, for individuals, Paragraph 20(2) of the AStG should be teleologically interpreted to rather look at the individual's actual income tax rate, than at the corporate tax rate of the CFC jurisdiction.

2.1.3.2.2 Control

2.1.3.2.2.1 Type

Usually the ownership interests are calculated based on shares or voting rights, Paragraph 7(2) sentence 1 of the AStG. Only if neither shares nor voting rights exist, the ownership interests in the foreign company's property is decisive, Paragraph 7(2) sentence 3 of the AStG. Now, ownership interests in the foreign company's property might refer to ownership interests in the foreign company's assets or profits (Heuermann, & Brandis, 2018, Chapter § 7, para. 54). Should they differ, it would not be clear how to calculate the relative ownership interests in the foreign company's property. However, in light of the wording of Paragraph 7(2) sentence 3 of the AStG (property [Vermögen]) it seems more reasonable to consider only the foreign company's assets (Strunk et al, 2018, Chapter § 7, para. 114).

2.1.3.2.2.2 Level

2.1.3.2.2.2.1 50 percent

According to Paragraph 7(1) of the AStG resident taxpayers have to hold ownership interests of more than 50 percent in the foreign company, which leads to the following issues:

- ▶ Each resident taxpayer holding an ownership interest in the foreign company has to find out whether the total ownership interests of resident taxpayers make up more than 50 percent. As no individual minimum ownership interest is required, it is often difficult for minority ownership interest holders to determine whether the control level is actually met (Haase, 2017a, p. I; Heuermann, & Brandis, 2018, Chapter § 7, para. 27); and
- ▶ The resident taxpayers do not have to be related, acting together, etc. Control is also presumed where resident taxpayers hold accidentally more than 50 percent of ownership interests in the foreign company. This even holds true where each resident taxpayer only holds a minimal ownership interest of for instance 0.01 percent (Wassermeyer, 2018, p. 744). Thus, the rules for defining control include also cases that clearly have no tax avoidance character (Strunk et al, 2018, Chapter Vor §§ 7-14, para. 31).

In determining whether resident taxpayers hold ownership interests of more than 50 percent in the foreign company, Paragraph 7(2) sentence 1 of the AStG also considers shares or voting rights attributable to parties in terms of Paragraph 2 of the AStG. Such parties are, as indicated above, individuals who, having been liable as Germans to income tax on a resident basis for a total of at least five of the last ten years preceding the termination of their resident tax status under Paragraph 1(1) sentence 1 of the EStG, are residents in a foreign jurisdiction in which their income is subject only to a low rate of taxation (Flick et al, 2018, Chapter § 7, para. 43). Considering parties in terms of Paragraph 2 of the AStG makes it even harder to determine whether resident taxpayers hold ownership interests of more than 50 percent in the foreign company (Heuermann, & Brandis, 2018, Chapter § 7, para. 27). Furthermore, a resident taxpayer will hardly be able to obtain the necessary

information to find out whether another ownership interest holder falls under Paragraph 2 of the AStG.

2.1.3.2.2.2.2 1 percent or less

For ownership interests in foreign companies with passive investment income the level of control is lowered to at least 1 percent or even to any level of control, where the CFC earns (almost) exclusively passive investment income, Paragraph 7(6) sentences 1 and 3 of the AStG. This clearly infringes the principle to apply the CFC taxation only where resident taxpayers may control and influence the CFC on a legally secured basis (Heuermann, & Brandis, 2018, Chapter § 7, para. 54). Paragraph 7(6) of the AStG was included by the [Steueränderungsgesetz 1992] as of 25 February 1992 and since then amended several times (Flick et al, 2018, Chapter § 7, para. 101). The Paragraph was included to cope with the following tax saving structure implemented by banks in the 1980s (Haun et al, 2018, Chapter § 7, para. 140):

Example

A company is established in a foreign country, which has concluded a DTT with Germany (DTT country). This DTT does not contain an activity clause. The foreign company's activity is limited to the holding and administration of assets. The foreign country has a preferential tax regime. The income of the foreign company is subject to low or no taxation in the DTT country. Profit distributions are tax exempt under the participation exemption provided in the DTT. Figure 4 illustrates the case at hand.

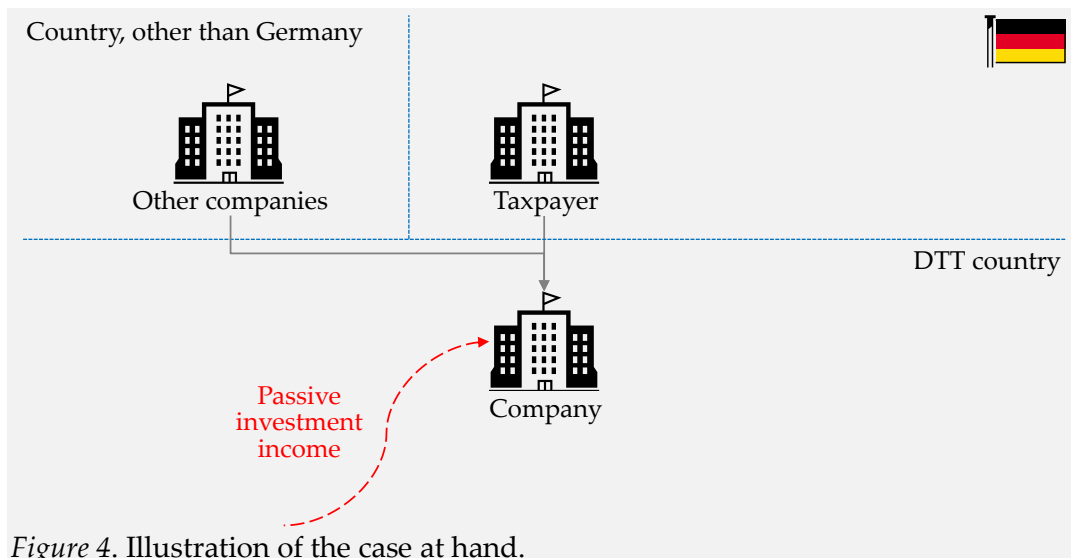


Figure 4. Illustration of the case at hand.

Now, in the 1980s, even where the minimum shareholding required under the DTT for the participation exemption to apply was not met, profit distributions could still be tax exempt due to the former Paragraph 8b(5) of the KStG. The latter Paragraph lowered the minimum shareholding requirement under a DTT unilaterally to 10 percent. Hence, without lowering the level of control in those day to at least 10 percent, a resident taxpayer holding an ownership interest of 10 to 50 percent in a foreign company would not have been subject to CFC taxation (unless the foreign company was controlled by resident taxpayers in terms of Paragraph 7(1) of the AStG).

Afterwards the level of control was lowered to at least 1 percent, especially because Paragraph 8b(1) of the KStG was amended by the [StSenkG] as of 23 October 2000 to exempt all intercompany profit distributions from taxation (Kraft, 2019, Chapter § 7, para. 273). However, according to Paragraph 8b(4) of the KStG profit distributions are only tax exempt since 1 March 2013, if the shareholder holds at least 10 percent in the foreign company (Binnewies, 2018, para. 92). Nevertheless, the level of control provided in Paragraph 7(6) sentence 1 of the AStG remained at 1 percent or more.

With the [UntStFG] as of 20 December 2001, Paragraph 7(6) sentence 3 of the AStG lowered the level of control to even any level of control, where the CFC earns (almost) exclusively passive investment income, to counter marketable collective structurings to invest capital in low tax jurisdictions (Kraft, 2019, Chapter § 7, para. 273). The reasoning behind Paragraph 7(6) sentence 3 of the AStG was to capture

ownership interests of less than 1 percent held by resident individuals, as the sale of such ownership interests was tax exempt after the 1 year speculation period provided in the former Paragraph 23(1) sentence 1 number 2 of the EStG (Grashoff, 2018, para. 288). The legislator wanted to avoid that collective structurings to invest capital are offered to resident individuals under which instead of profit distributions a tax exempt capital gain is realized after the end of this speculation period. Although such capital gains became taxable according to the [Unternehmensteuerreformgesetz] as of 14 August 2007, the level of control provided in Paragraph 7(6) sentence 3 of the AStG remained at any level of control (Strunk et al, 2018, Chapter § 7, para. 163).

Moreover, where a resident taxpayer is deemed to have control, because it holds an ownership interest of 1 percent or less in the foreign company, it is practically impossible for the resident taxpayer to obtain all necessary information to find out whether it is subject to tax and to file the tax return as required under Paragraph 18(3) sentence 1 of the AStG (Strunk et al, 2018, Chapter Vor §§ 7-14, para. 31; Wassermeyer, 2018, p. 745).

From a European law perspective, it is questionable, whether Paragraph 7(6) sentence 3 of the AStG is contrary to Community law, as the level of control provided thereunder, results in a stricter taxation of an ownership interest in a foreign investment company than in a domestic investment company (Flick et al, 2018, Chapter § 7, para. 103).

2.1.3.2.2.2.3 Indirect ownership interests

As indicated above, in the calculation of the ownership interests, shares and voting rights held through another foreign company are also considered, namely in such proportion as the shares or voting rights held in the other foreign company bear to the total shares or voting rights in this company, Paragraph 7(2) of the AStG. This may lead to adverse effects as the following example shows:

Example

A resident taxpayer holds 80 percent of the ownership interests in company A, resident in country A, which in turn holds 60 percent of the ownership interests in company B, resident in country B, a low tax jurisdiction. Figure 5 illustrates the case at hand.

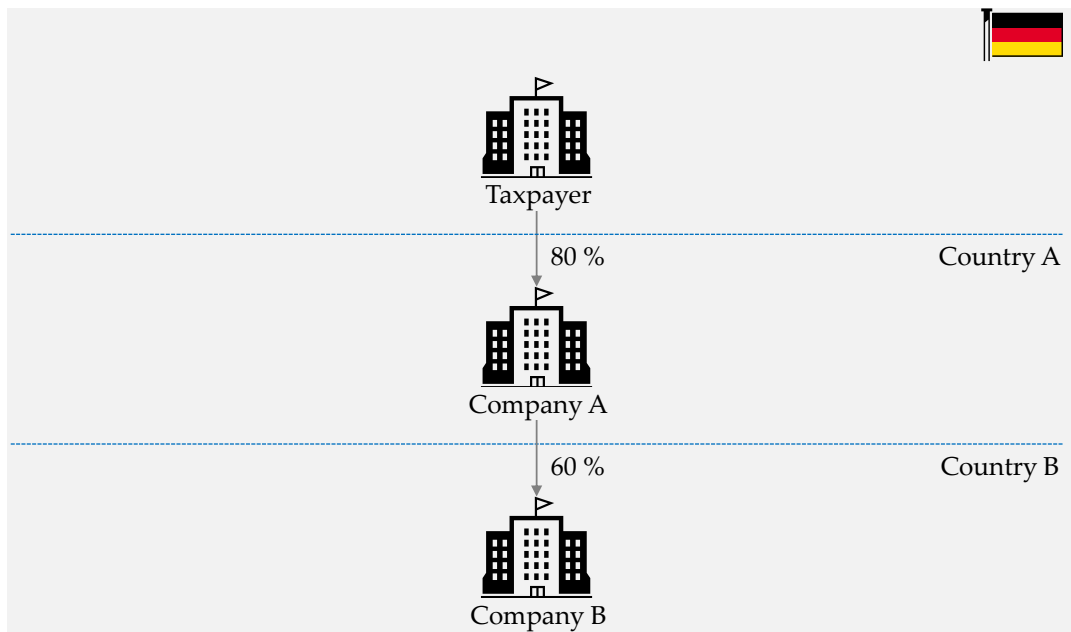


Figure 5. Illustration of the case at hand.

Although the resident taxpayer is able to control company A due to its 80 percent ownership interest and company A in turn is able to control the company B due to its 60 percent ownership interest, the resident taxpayer does not control company B in terms of Paragraph 7(2) sentence 2 of the AStG. The latter Paragraph provides that the direct ownership interest in company A (80 percent) has to be multiplied with company A's ownership interest in the company B (60 percent.). As the result of this multiplication (48 percent) does not meet the control threshold provided in Paragraph 7(2) sentence 1 of the AStG (more than 50 percent), the CFC rules are not applicable.

2.1.3.3. Structurings

2.1.3.3.1 Entities – Indirect PE

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a high tax jurisdiction without CFC rules (or without CFC rules considering PEs), which in turn has a PE in country B, a low tax jurisdiction. The PE earns passive income. Figure 6 illustrates the case at hand.

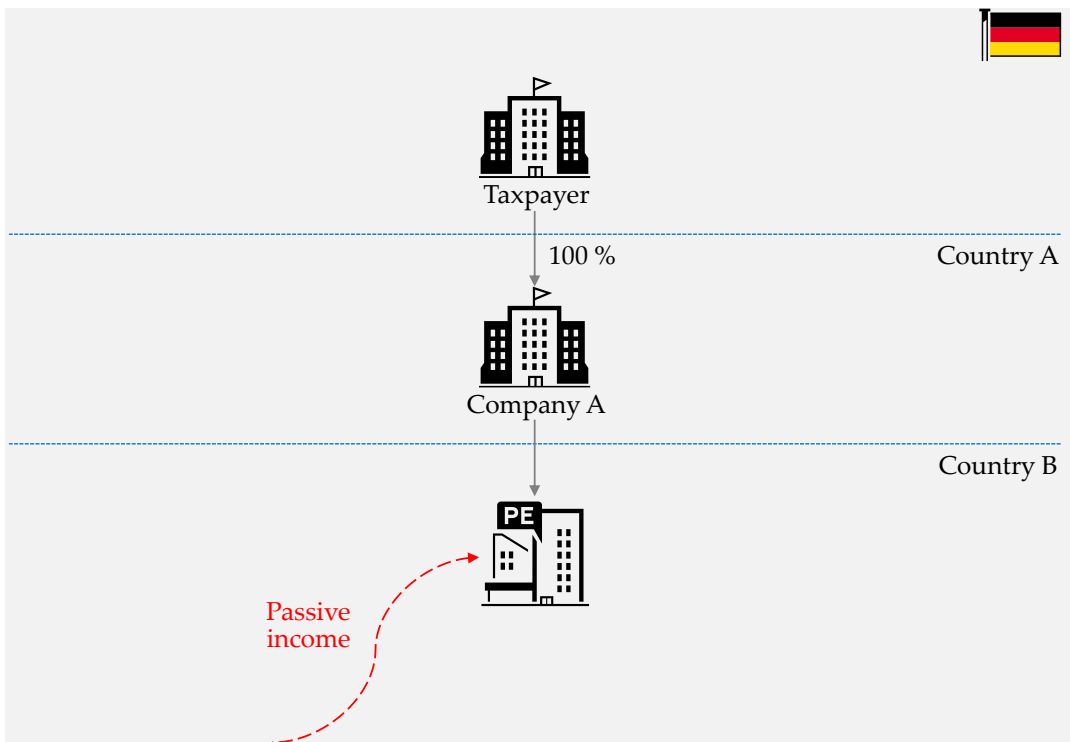


Figure 6. Illustration of the case at hand.

According to Paragraph 7(2) sentence 2 of the AStG shares and voting rights held through a foreign company are considered in calculating whether resident taxpayers hold ownership interests of more than 50 percent in a foreign company. However, company A neither holds shares nor voting rights in the PE. The PE forms part of Company A. Consequently, the PE may not be attributed to the resident taxpayer under Paragraph 7(2) sentence 2 of the AStG.

Paragraph 20(2) of the AStG provides a switch over from the exemption to the credit method, where PE income would be taxable as CFC income if this PE was a foreign company. However, Paragraph 20(2) of the AStG requires a foreign PE of the resident taxpayer. In this example the PE is a PE of the foreign company, which does not fall within the scope of Paragraph 20(2) of the AStG.

Company A is also unlikely to become itself a CFC due to its PE in country B. If the DTT between country A and B is in line with the OECD Model Tax Convention as of 21 November 2017 ("OECD MTC"), the profits that are attributable to the PE may be taxed in country B, Article 7(1) of the OECD MTC. The country of residence (country A) usually applies the exemption method

(Endres, & Spengel, 2016, p. 471). Consequently, the PE's passive income would not be included in Company A's tax base and thus not affect the level of taxation of Company A.

Should country A apply instead of the exemption method the credit method, e.g. because an activity clause established in the DTT with country B is applicable, the level of taxation of the PE's passive income would be raised to the high level of taxation in country A.

As a result the resident taxpayer can shift passive income into a PE, resident in a low tax jurisdiction, which the resident taxpayer holds indirectly through a foreign company, resident in a high tax jurisdiction, without triggering CFC taxation.

2.1.3.3.2 Control

2.1.3.3.2.1 Trust/profit participation right

Example

Trust A, resident in country A, holds all ownership interests in company B, resident in country B, a low tax jurisdiction. Company B earns passive income. A resident taxpayer finances company B. In consideration the resident taxpayer receives the entire profits of company B (profit participation right). However, the profit participation right does not confer any voting rights. Figure 7 illustrates the case at hand.

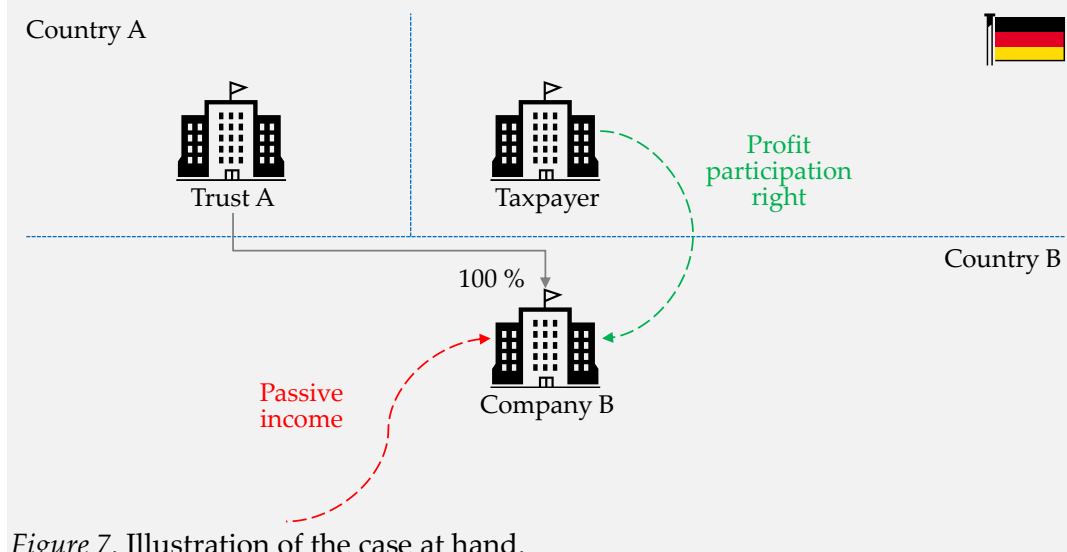


Figure 7. Illustration of the case at hand.

Paragraph 7(1) of the AStG requires resident taxpayers to hold ownership interests of more than 50 percent in the foreign company. According to Paragraph 7(2) sentence 1 of the AStG resident taxpayers hold ownership interests of more than 50 percent in the foreign company, if more than 50 percent of the shares or voting rights in the foreign company are attributable to them, either alone or together with any parties in terms of Paragraph 2 of the AStG. In contrast, a mere profit participation right under obligation law is not an ownership interest (Schnitger, & Bildstein, 2009, p. 636; Strunk, & Haase, 2007; Strunk et al, 2018, Chapter § 7, para. 51). Consequently, in this example, the resident taxpayer does not hold an ownership interest in company B. All shares and voting rights and therewith all ownership interests are held by trust A.

2.1.3.3.2.2 Disproportionate profit distribution

Example

Company A, resident in country A and a resident taxpayer hold 50 percent each of the ownership interests in company B, resident in country B, a low tax jurisdiction. Company B earns passive income. Company A and the resident taxpayer enter into a disproportionate profit distribution agreement. Under the latter the resident taxpayer shall receive (almost) all profits of company B. Figure 8 illustrates the case at hand.

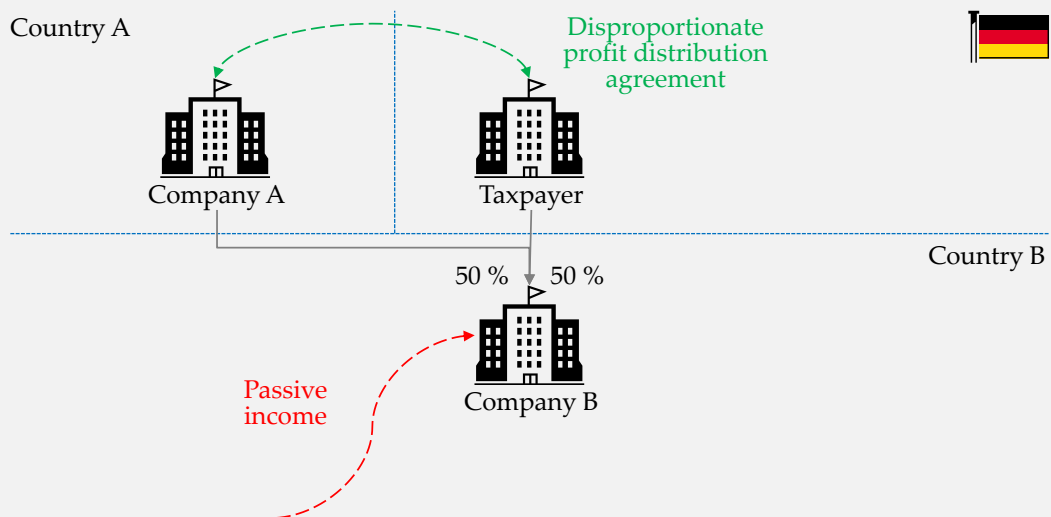


Figure 8. Illustration of the case at hand.

According to Paragraph 7(1) and (2) sentence 1 of the AStG control requires resident taxpayers to hold ownership interests, i.e. shares or voting rights, of more than 50 percent in the foreign company. Here, the resident taxpayer holds exactly 50 percent in company B. Control in terms of Paragraph 7(1) and (2) sentence 1 of the AStG is consequently not given. Nevertheless, the resident taxpayer receives (almost) all profits of company B.

The Federal Tax Court [Bundesfinanzhof] (“BFH”) held in its decision as of 19 August 1999 (I R 77/96) that disproportionate profit distribution agreements have to be recognized for tax law purposes and, generally, are not an abuse of legal structuring options in terms of Paragraph 42 of the AO, even if there are no obvious reasons, other than tax reasons, for the structuring. The BMF does not share completely the BFH’s view and indicates in its letter as of 17 December 2013 (BMF, 2013) that according to Paragraph 42(2) of the AO an abuse is given, where an inappropriate legal option is selected which, in comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer or a third party. For the BMF such abuse is not given, where considerable economic non-tax reasons are proven for the disproportionate profit distribution agreement.

2.1.3.3.2.3 Call option right

Example

Company A, resident in country A holds all ownership interests in company B, resident in country B, a low tax jurisdiction. Company B earns passive income. A resident taxpayer acquires 50 percent of the ownership interests in company B from company A. Regarding the other 50 percent of the ownership interests in company B the resident taxpayer acquires a call option right, allowing it to acquire these ownership interests later on from company A for a certain price. However, the call option right does not confer any voting rights. The resident taxpayer is interested rather in the hidden reserves of company B’s assets, than in its current profits and therefore chooses this restructuring. Figure 9 illustrates the case at hand.

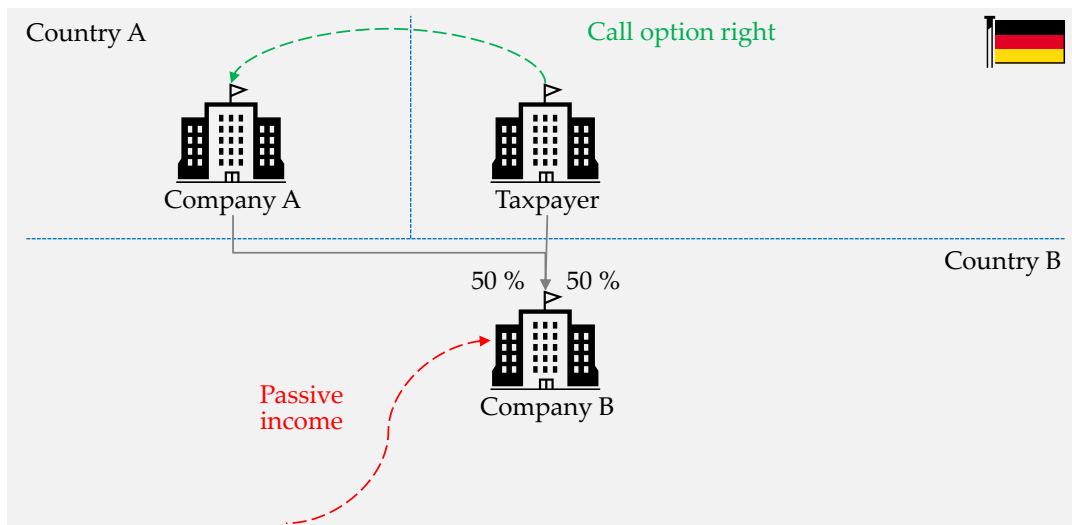


Figure 9. Illustration of the case at hand.

As mentioned above, control in terms of Paragraph 7(1) and (2) sentence 1 of the AStG requires resident taxpayers to hold ownership interests, i.e. shares or voting rights, of more than 50 percent in the foreign company. Generally, assets are attributable to its owners (legal ownership), Paragraph 39(1) of the AO. Here, both, the resident taxpayer and company A own exactly 50 percent each of the shares in company B. However, where a person other than the owner exercises effective control over an asset in such a way that it can, as a rule, economically exclude the owner from affecting the asset during the normal period of its useful life, the asset is attributable to this person (beneficial ownership), Paragraph 39(2) number 1 sentence 1 of the AStG. In light of the call option right, it is questionable, whether the acquisition of this right led to a transfer of the beneficial ownership in the underlying shares of company B from company A to the resident taxpayer. According to the decision of the BFH as of 4 July 2007 (VIII R 68/05) the acquisition of a call option right leads only to a change of the beneficial ownership, if the acquirer has obtained a legally protected position to acquire the right, which cannot be withdrawn against his will, and the essential rights connected to the shareholding, as well as the risk of a decreased value and the chance of an increased value have been transferred. Especially the last requirement is not met in this example. The resident taxpayer does not bear the risk of a decreased value.

2.1.3.3.2.4 Interposing a partnership**Example**

A resident taxpayer holds 50 percent of the ownership interests in partnership A, resident in country A, which in turn holds all ownership interests in company B, resident in country B, a low tax jurisdiction. Company B earns passive investment income. Figure 10 illustrates the case at hand.

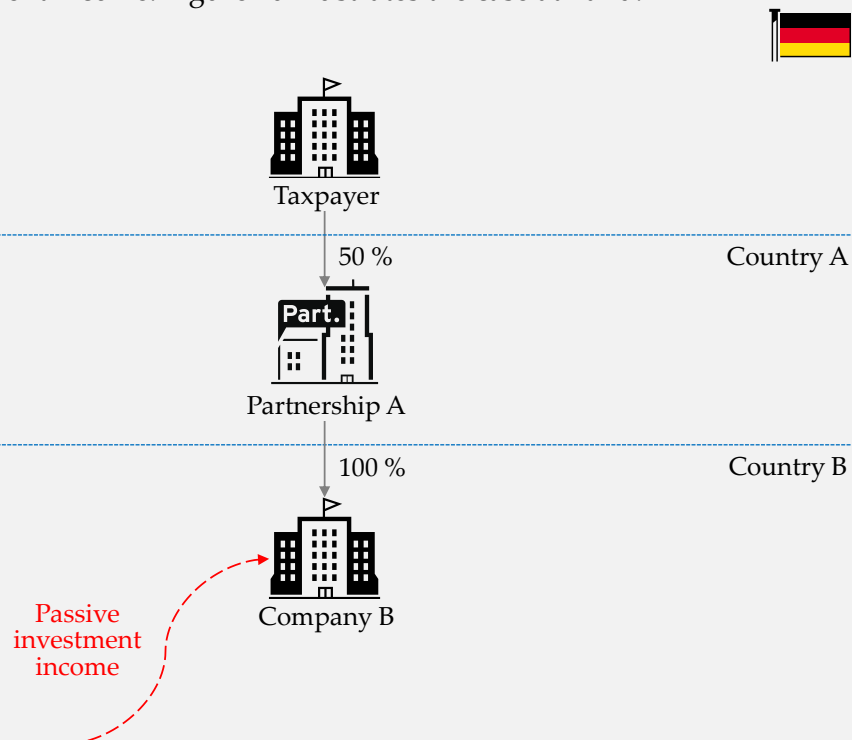


Figure 10. Illustration of the case at hand.

Are ownership interests held via a partnership, the partners of the partnership are deemed to hold directly the ownership interests in the foreign company, Paragraph 7(3) of the AStG, i.e. the resident taxpayer is deemed to hold an ownership interest of 50 percent in company B. This is not sufficient to meet the control threshold of more than 50 percent provided under Paragraph 7(1) of the AStG. Now, for ownership interests in foreign companies with passive investment income the level of control is lowered to at least 1 percent or even to any level of control, where the CFC earns (almost) exclusively passive investment income, Paragraph 7(6) sentences 1 and 3 of the AStG. However, in case of foreign companies with passive investment income, the BMF holds in its letter as of 14 May 2004 (BMF, 2004b, para. 7.2) that the control level is calculated exclusively

according to Paragraph 7(2) of the AStG. Consequently, Paragraph 7(3) of the AStG, which would deem the resident taxpayer to hold an ownership interest of 50 percent in company B, is not applicable. As the resident neither holds ownership interests in company B directly, nor via a foreign company, the control threshold of at least 1 percent or even any level of control is not met. In light of this structuring possibility, parts of the German tax literature propose to calculate the control level also in case of foreign companies with passive investment income according to Paragraph 7(2) to (4) of the AStG (Haase, 2017c, p. 96).

2.1.3.3.2.5 Joint venture

Example

Company A, resident in country A, and a resident taxpayer hold 50 percent each of the ownership interests in company B, resident in country B, a low tax jurisdiction. Company B earns passive income. Figure 11 illustrates the case at hand.

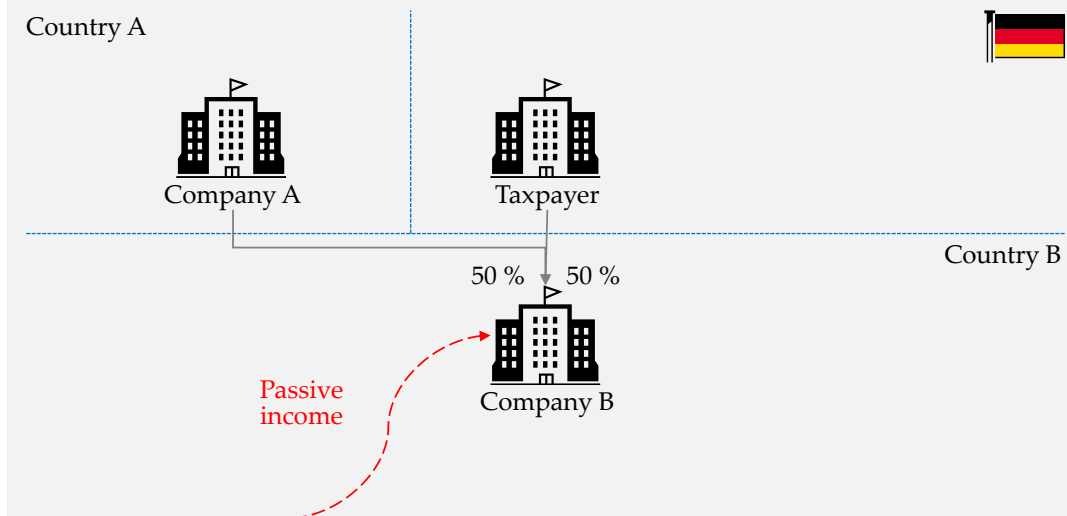


Figure 11. Illustration of the case at hand.

The control threshold established in Paragraph 7(1) and (2) sentence 1 of the AStG (more than 50 percent of the shares or voting rights) is not met, as the resident taxpayer holds exactly 50 percent in company B. Consequently, company A and the resident taxpayer may shift income to company B without triggering German CFC taxation.

2.1.3.3.2.6 Timing of the sale**Example**

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A earns passive income. Company A's current fiscal year ends on 31 December 2018. The resident taxpayer sells all ownership interests in company A on 30 December 2018. Figure 12 illustrates the case at hand.

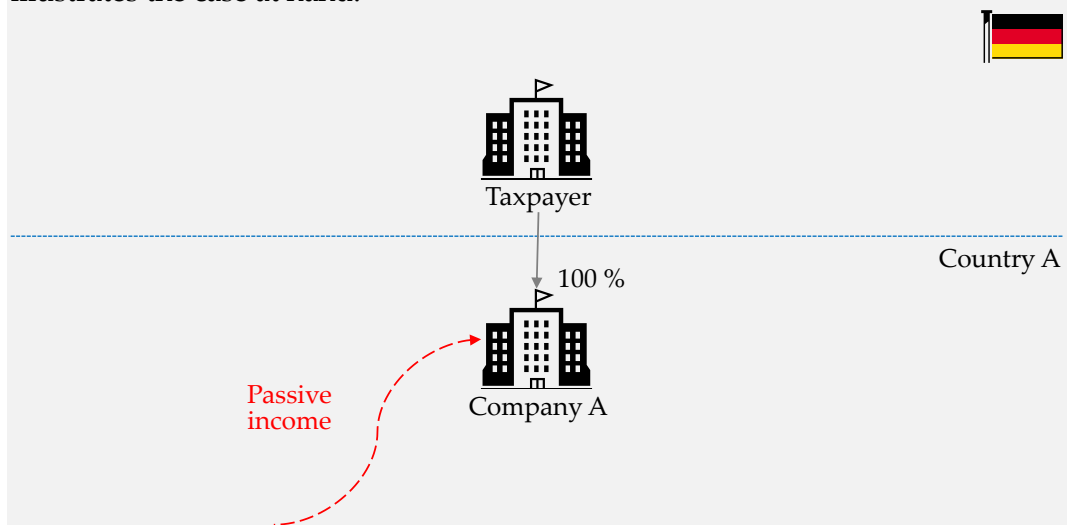


Figure 12. Illustration of the case at hand.

Although the resident taxpayer has a 100 percent ownership interest in company A throughout (almost) the whole calendar year, the threshold established in Paragraph 7(1) and (2) sentence 1 of the AStG (more than 50 percent of the shares or voting rights) is not met. This is because Paragraph 7(2) sentence 1 of the AStG provides that the level of control level is measured at the end of the CFC's fiscal year (here: one day after the sale).

According to Paragraph 8b(2) sentence 1 of the KStG a gain on the sale of the ownership interests in company A is excluded when determining the resident taxpayer's income. Only 5 percent of such gain are deemed to constitute non-deductible business expenses, Paragraph 8b(3) sentence 1 of the KStG. Hence, a gain on the sale of the ownership interests in company A is effectively 95 percent tax free.

2.1.3.4. ATAD compliance

To make the German rules for defining a CFC ATAD compliant the following amendments will be necessary:

- ▶ According to Paragraph 7(2) sentence 1 of the AStG the ownership interests are usually calculated based on share capital or voting rights. Should both not exist, the determination is made with respect to the relative ownership interests in the foreign company's property [Vermögen], Paragraph 7(2) sentence 3 of the AStG. This is not in line with Article 7(1)(a) of the ATAD, which requires to consider the entitlement to receive profits in any case, not only where legal control is not given. Furthermore, by referring to the foreign company's property [Vermögen], Paragraph 7(2) sentence 3 of the AStG seems to look at the relative ownership interest in the foreign company's assets, rather than at the entitlement to the foreign company's profits. The latter is, however, required under Article 7(1)(a) of the ATAD; and
- ▶ In the calculation of the level of control only indirect shareholdings through subsidiaries are considered, Paragraph 7(2) sentence 2, (3) of the AStG. However, according to Article 7(1) and Article 2(4) of the ATAD also sister- and parent companies have to be taken into account (Schnitger et al, 2016, p. 963).

2.1.4. Spain

2.1.4.1. Rules

2.1.4.1.1 Entities

Foreign company in terms of Article 91(1) of the Spanish Income Tax Act [Impuesto sobre la Renta de las Personas Físicas] ("IRPF") and Article 100(1) of the Spanish Corporate Tax Act [Ley del Impuesto sobre Sociedades] ("LIS") may only be a corporate entity, but neither a transparent entity nor a PE (Sanz Gadea, 2017, p. 15). Transparent entities and PEs are generally not subject to CFC taxation, as their income is basically taxed in Spain on a current basis. However, if the conditions in Article 22 of the LIS are met, income of a foreign PE is exempt in Spain

(De Juan Casadevall, 2018). Otherwise, income of a foreign PE is often exempt in Spain in accordance with a DTT.

2.1.4.1.2 Control

2.1.4.1.2.1 Type

Regarding control Article 91(1)(a) of the IRPF and Article 100 (1)(a) of the LIS look at the capital, voting rights (legal control), equity or results (economic control).

2.1.4.1.2.2 Level

Article 91(1)(a) of the IRPF and Article 100(1)(a) of the LIS determine that a resident taxpayer itself, or together with related persons or entities, has to have an ownership interest of at least 50 percent in the foreign entity.

Article 91(1)(a) of the IRPF also includes other taxpayers connected to the resident taxpayer by bonds of family, including the spouse, in direct or collateral line, by blood or marriage, to including the second grade. Related persons and entities are according to Article 18(2) of the LIS:

- ▶ An entity and its partners or shareholders;
- ▶ An entity and its directors (including shadow directors), except for the remuneration paid for exercising their activities;
- ▶ An entity and the spouses or persons connected by bonds of family in direct or collateral line, by blood or marriage, to the third grade to the partners, shareholder or directors (including shadow directors);
- ▶ Two entities belonging to the same group;
- ▶ An entity and the directors of another entity, if both belong to the same group;
- ▶ An entity and another entity, if one of them has an indirect interest of at least 25 percent in the capital or equity of the other;
- ▶ Two entities in which the same partners, shareholders or their spouses, or persons connected by bonds of family in direct or collateral line, by blood or marriage, to the third grade, have a direct or indirect interest of at least 25 percent in the capital or equity; and
- ▶ An entity resident in Spanish territory and its foreign PEs.

Where the relatedness is based on the relationship between the partners or shareholders with the entity, the ownership interest has to be at least 25 percent.

In the calculation of the level of control related persons and entities have to be considered, irrespective of whether they are resident persons/entities or not (Sanz Gadea, 2016, p. 1355).

The level of control is the sum of all direct ownership interests of the resident taxpayer and its related persons and entities in the foreign company and all indirect ownership interests of the resident taxpayer and its related persons and entities in the foreign company held through unrelated non-resident entities. In the latter case, each unrelated non-resident entity's ownership interest in the foreign company is multiplied with the resident taxpayer's or its related person's or entity's ownership interest in the unrelated non-resident entity (Aranzadi Insignis, n.da).¹²

Control has to be established at the end of the foreign company's year, Article 91(1)(a) of the IRPF and Article 100(1)(a) of the LIS.

2.1.4.2. *Issues*

2.1.4.2.1 Entities

According to Article 91(1) of the IRPF and Article 100(1) of the LIS foreign company may only be a corporate entity, but neither a transparent entity nor a PE. This allows the resident taxpayer to employ transparent entities or PEs to circumvent the Spanish CFC taxation, as detailed below (see "2.1.4.3.1 Establishing a PE").

2.1.4.2.2 Control

2.1.4.2.2.1 Non-resident related persons and entities

According to Article 91(1)(a) of the IRPF and Article 100(1)(a) of the LIS the control threshold has to be met by the resident taxpayer itself, or together with

¹² For a different calculation, which is, however, not line with the wording of Article 91(1)(a) of the IRPF/Article 100(1)(a) of the LIS see Badás Cerezo and Marco Sanjuán (2015, Chapter Transparencia fiscal internacional, I. Relación entre la persona residente y la sociedad instrumental no residente, para. Cuantificación del porcentaje de participación).

related persons or entities in terms of Article 18(2) of the LIS. Under Article 91(1)(a) of the IRPF ownership interests of certain other taxpayers connected to the resident taxpayer are also considered. Bearing in mind, that the related persons or entities in terms of Article 18(2) of the LIS may be both, resident or non- resident, this may lead to over-inclusive results, as the following example shows.

Example

Grandparents A and B have two sons, C and D, all residents in country A, a low tax jurisdiction. C is E's father. The latter is director of the taxpayer. D holds 50 percent of the ownership interests in company A, a joint venture, resident in country A. The other 50 percent are held by a third party, resident in country A. Director E looks for a possibility to invest excess capital of the taxpayer and turns to his uncle D. The latter sells to the taxpayer an ownership interest of 1 percent. Figure 13 illustrates the case at hand.

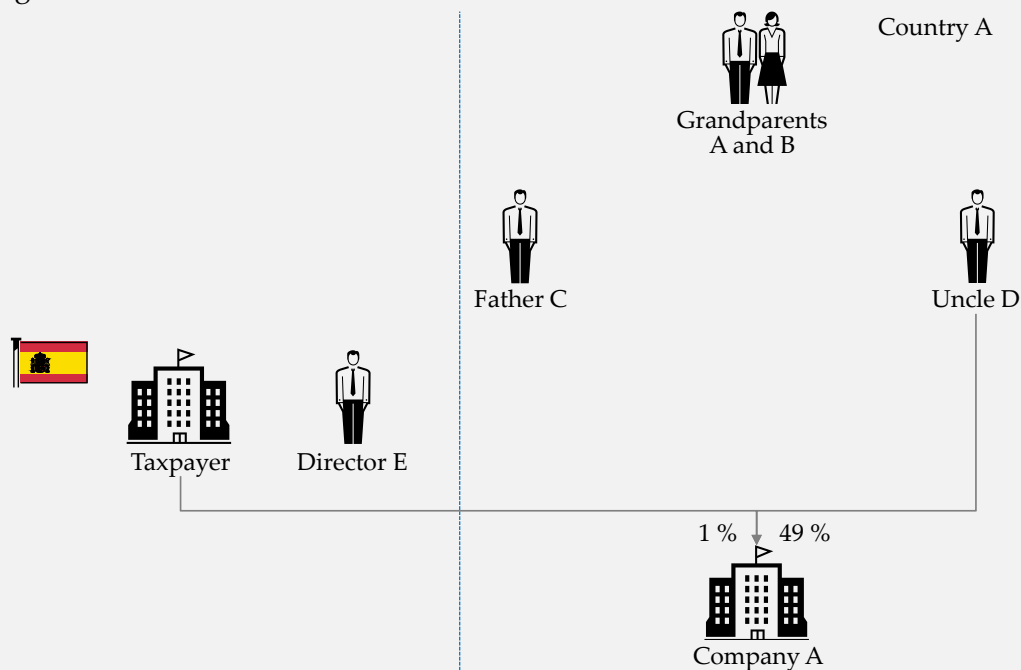


Figure 13. Illustration of the case at hand.

The control threshold of at least 50 percent is clearly not met by the resident taxpayer itself, however, according to Articles 18(2)(c) and 100(1)(a) of the LIS, in the calculation of the level of control, D's ownership interests is also considered as he is connected to E, the taxpayer's director, by bonds of family in collateral line, by blood and to the third grade. As a result, the control threshold provided in

Article 100(1)(a) of the LIS is met. This does not seem reasonable, considering that D and the third party, which together hold 99 percent of the ownership interests in company A, clearly have no interest in shifting profits to company A, as they are – just like company A – residents in country A. The resident taxpayer should neither have an interest in shifting profits to company A, as 49 percent of these profits correspond to D and 50 percent to the third party.

2.1.4.2.2.2 Indirect ownership interests

Where ownership interests in the foreign company are held by a resident taxpayer and its related persons and entities through unrelated non-resident entities, each unrelated non-resident entity's ownership interest in the foreign company is multiplied with the resident taxpayer's or its related person's or entity's ownership interest in the unrelated non-resident entity. As a result, the Spanish control threshold of 50 percent may not be met, even where the resident taxpayer can control the foreign unrelated entity and the latter can control the foreign company (see "2.1.3.2.2.2.3 Indirect ownership interests").

2.1.4.3. *Structurings*

2.1.4.3.1 Establishing a PE

Example

The resident taxpayer establishes a PE, in country A, a low tax jurisdiction and shifts passive income to the latter. Figure 14 illustrates the case at hand.

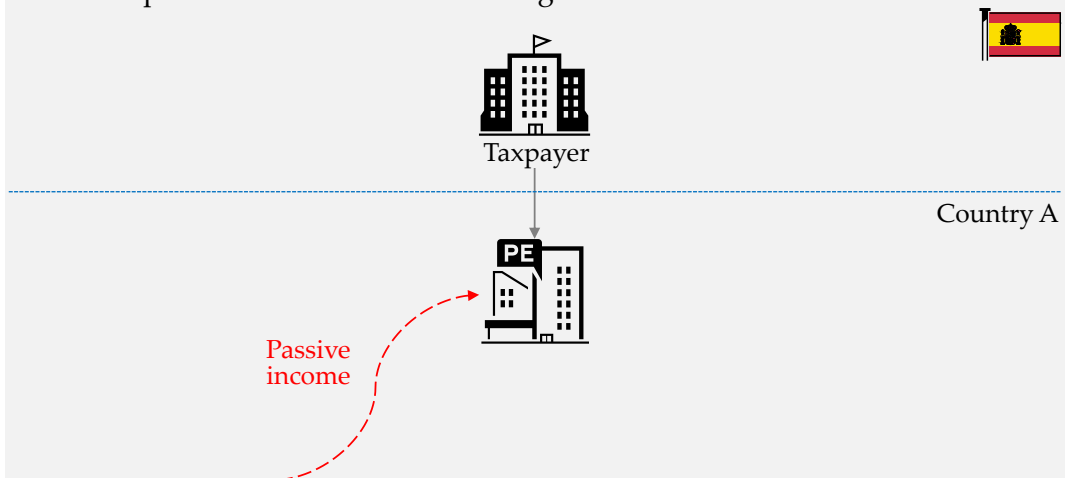


Figure 14. Illustration of the case at hand.

As a foreign company in terms of Article 100(1) of the LIS may only be a corporate entity, the PE is not a foreign company. Consequently, the CFC rules do not apply. Alternatively, the resident taxpayer may employ a transparent entity.

2.1.4.3.2 Cell company

The following example is based on Her Majesty's Revenue and Customs ("HMRC") International Manual ("INTM") 236500.

Example

Company A, resident in country A, establishes company B, a protected cell company in country B, a low tax jurisdiction. A protected cell company is a single legal entity which consists of a core and cells without legal personality (Bürkle, 2015, Chapter § 5 Captives, para. 15). The income, assets and liabilities of each cell are kept separate from all other cells. This allows shareholders to maintain sole ownership of an entire cell. Protected cell companies are commonly offered in the Crown Dependencies of Jersey, Guernsey and the Isle of Man. They are often used in relation to captive insurance, where a number of independent entities can each own a separate cell within the protected cell company, ensuring that their own assets are ring-fenced within the structure. However, in this example the Spanish resident unconnected companies C to J decide to employ company B to sidestep the CFC rules. Company B provides captive insurance facilities to companies C to L via ten unincorporated cells. Whereas the core shares have voting rights and are wholly owned by company A, company C owns all cell shares in the first cell, company D owns all cell shares in the second cell etc. Cell shares do not have voting rights. Although the insurance contracts are entered into by company B, the risks and benefits of the contract are specified to each cell. In this example company B provides management and underwriting services for each cell and derives the corresponding profits. The cells derive underwriting and investment profits. Figure 15 illustrates the case at hand.

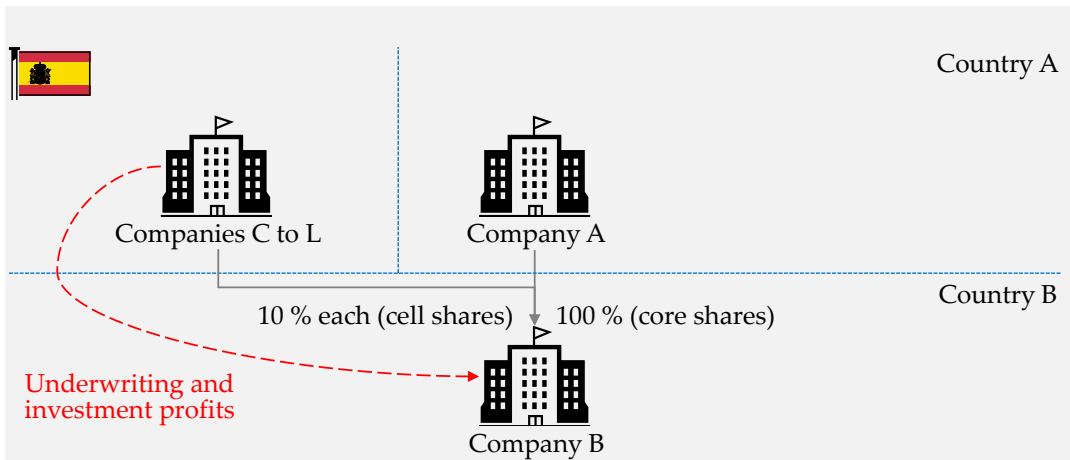


Figure 15. Illustration of the case at hand.

Company A owns all the core shares in company B and holds all the voting rights of company B. The Spanish resident unconnected companies C to L do not have legal control in terms of Article 100(1)(a) of the LIS, as each of them only owns 10 percent of the cell shares in company B, which do not have voting rights. They also should not have economic control, as none of companies C to L itself, or together with related persons or entities, is likely to be entitled to at least 50 percent of the equity or results of company B, in the example at hand. Considering that this structure replicates the effect of each shareholder controlling its own separate entity, the non-application of the CFC taxation does not seem reasonable. The profits that should be subject to CFC taxation are the underwriting and investment profits.

2.1.4.3.3 Passive investment companies

Example

Resident company A brings resident taxpayers 1 to 50 together. Each of them acquires 2 percent of the ownership interests in company B, resident in country B, a low tax jurisdiction. Company B earns passive investment income. Figure 16 illustrates the case at hand.

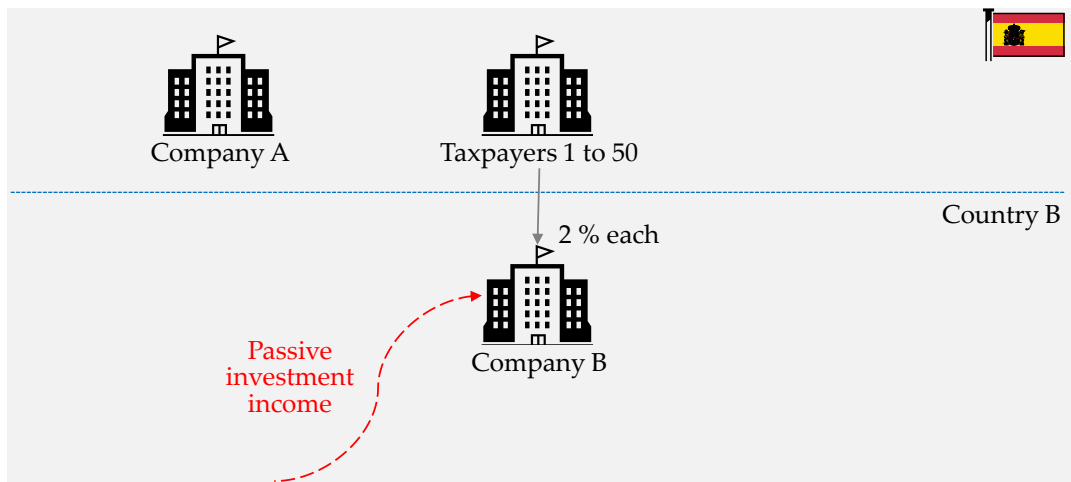


Figure 16. Illustration of the case at hand.

Article 100(1)(a) of the LIS determines that a resident taxpayer itself, or together with related persons or entities, has to have an ownership interest of at least 50 percent in the foreign entity. However, in this example the resident taxpayers 1 to 50 have ownership interests of 2 percent each in company B and are not related. Due to the lack of control, no CFC taxation occurs.

2.1.4.3.4 Further structurings

To avoid control a Spanish resident taxpayer may also employ the following structurings:

- ▶ Call option right (see “2.1.3.3.2.3 Call option right”); and
- ▶ Timing of the sale (see “2.1.3.3.2.6 Timing of the sale”).

2.1.4.4. *ATAD compliance*

Under Article 7(1) of the ATAD a CFC is defined as an entity or a PE. Thus, Article 100(1) of the LIS will have to be modified to do not only include corporate entities, but also transparent entities and PEs, to make the Spanish rules for defining a CFC ATAD compliant.

2.1.5. UK

2.1.5.1. Rules

2.1.5.1.1 Entities

According to Section 371AA(3) of the Taxation (International and Other Provisions) Act 2010 (“TIOPA”) a CFC may only be a company. As there is no specific definition of this term in Part 9A of the TIPOA the general definition provided in Section 1121 of the Corporation Tax Act 2010 (“CTA”) applies. Under this definition company means any body corporate or unincorporated association, but does not include a partnership, a local authority or a local authority association. Unincorporated cells and incorporated cells are to be treated as if they were non-UK resident companies for the purposes of the CFC definition (MacLachlan, 2012, para. 5.32). Pursuant to Section 371VE(2) and (3)(a) to (c) of the TIOPA an unincorporated cell is an identifiable part of a non-UK resident company, if:

- ▶ Assets and liabilities of the non-UK resident company are at least mainly allocable to the part of the company in question;
- ▶ Liabilities so allocated are met at least mainly out of assets so allocated; and
- ▶ There are members of the non-UK resident company whose rights are at least mainly limited to the assets so allocated.

An incorporated cell is an entity which has a legal personality distinct from that of the non-UK resident company, but which is not itself a company, Section 371VE(5)(a) and (b) of the TIOPA.

Foreign PEs are generally not subject to CFC taxation, as their income is basically taxed in UK on a current basis. However, the CFC rules apply to foreign PEs of UK resident companies in respect of which an election has been made under CTA Part 2 Chapter 3A to exclude profits or losses from the scope of corporation tax (MacLachlan, 2012, para. 5.6).

2.1.5.1.2 Control2.1.5.1.2.1 Type

Control is defined in Sections 371RB, 371RD (legal and economic control), and 371RE (control determined by reference to accounting standards).

Legal control looks at the holding of shares, the possession of voting rights, but also at any other document conferring powers (e.g. Articles of Association), Section 371RB(1)(a) and (b) of the TIOPA. The aforementioned documents are not limited to documents required by law in the foreign company's jurisdiction. A shareholders' agreement, for example, may also confer such power and therewith legal control (Whiting, & Gunn, 2019, Binder 5, para. D4.404).

According to Section 371RB(2)(a) to (c) of the TIOPA economic control looks at the:

- ▶ entitlement to sale proceeds, if the whole of the foreign company's share capital were to be disposed;
- ▶ profits, if the whole of the foreign company's income were distributed; and
- ▶ assets available for distribution, if the CFC were wound up or in any other circumstances.

Section 371RD of the TIOPA contains a supplementary provision for legal and economic control. Under this provision control may be established:

- ▶ through rights and powers which a person is or will become entitled to acquire at a future date, Section 371RD(3)(a) of the TIOPA;
- ▶ through rights and powers of other persons, which are or may be required to be exercised on the person's behalf, under the person's direction, or for the person's benefit, Section 371RD(3)(b) and (4)(a) of the TIOPA;
- ▶ if the person is UK resident, through rights and powers of another UK resident person connected with it, Section 371RD(3)(c) of the TIOPA; or
- ▶ where Section 371RD(3)(d) of the TIOPA is applicable.

Further, control can be established based on accounting standards, Section 371RE of the TIOPA.

2.1.5.1.2.2 Level

Legal control requires a resident taxpayer to have, based on shares, voting rights or other documents, the power to secure that the affairs of a company are conducted in accordance with its wishes, Sections 371AA(3) and (6) and 371RB(1) of the TIOPA.

Economic control is given, if a resident taxpayer is entitled to more than 50 percent of the economic rights, Sections 371AA(3) and (6) and 371RB(2) of the TIOPA. For the purposes of this calculation interests of relevant banks, as defined in Section 371RB(5) of the TIOPA, are ignored, Section 371RB(3) of the TIOPA.

In the calculation of both, legal and economic control, two or more persons are taken together. They do not have to be connected in any way, e.g. there is no requirement for them to be associated, Section 371RB(7) of the TIOPA (Harper, & Walton, 2017, para. 22.5).

Control based on accounting standards requires a resident taxpayer to be the foreign company's parent (defined as the person that would be required to prepare consolidated financial statements under FRS 102 whether they are actually prepared or not; Harper, & Walton, 2017, para. 22.5) and that at least 50 percent of the foreign company's chargeable profits would be apportioned to the resident taxpayer taken together with its resident subsidiary undertakings, Section 371RE of the TIOPA.

To catch specific joint venture arrangements, Section 371RC of the TIOPA provides, that control may also be established through two shareholders having each interests, rights and powers representing at least 40 percent of the holdings, rights and powers in respect of which they fall to be taken to have control over the foreign company, with one of them being a resident taxpayer. The other shareholder's interests, rights and powers over the foreign company may not exceed 55 percent of these holdings, rights and powers.

An ownership interest in the foreign company does not necessarily have to be held directly by a resident taxpayer. It may also be held indirectly through one or more foreign entities (Whiting, & Gunn, 2019, Binder 5, para. D4.404).

Example

A resident taxpayer holds 70 percent of the ownership interests in company A, resident in country A. Company A holds 70 percent of the ownership interests

in company B, resident in country B, a low tax jurisdiction. Company B earns passive income. Figure 17 illustrates the case at hand.

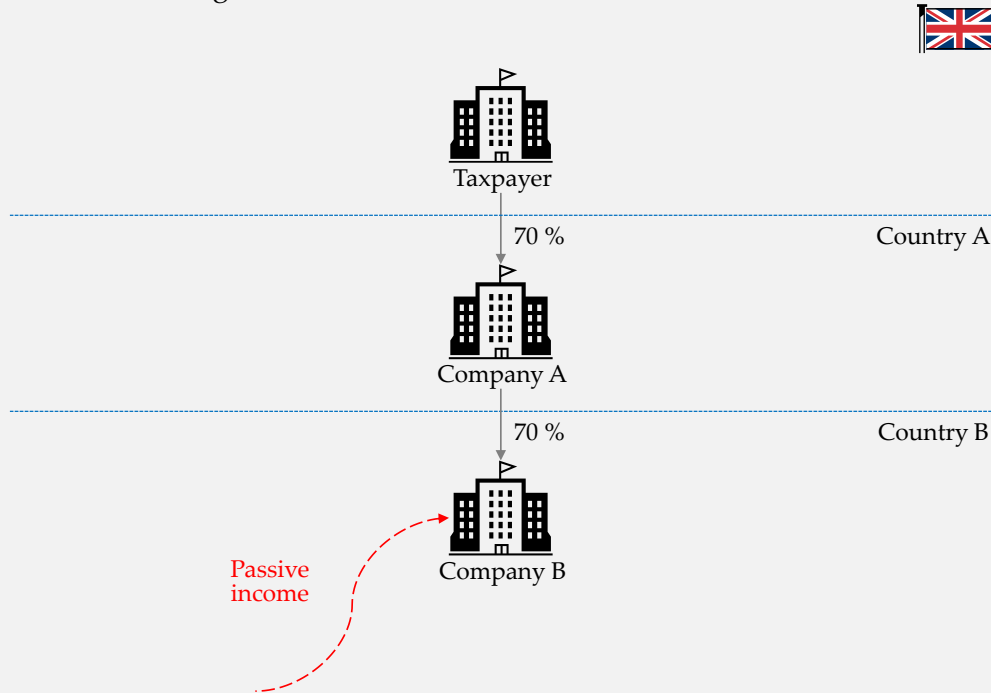


Figure 17. Illustration of the case at hand.

As the resident taxpayer has a majority ownership interests (70 percent) in company A, which in turn has a majority ownership interest (70 percent) in company B, the resident taxpayer has the power to secure that the affairs of company B are conducted in accordance with its wishes. Consequently, the resident taxpayer has legal control, although its indirect ownership interest in company B is not a majority interest (70 percent * 70 percent = 49 percent).

2.1.5.2. Issues

As indicated above, legal control requires one or more resident taxpayers to have, based on shares, voting rights or other documents, the power to secure that the affairs of a company are conducted in accordance with their wishes, Sections 371AA(3) and (6) and 371RB(1) of the TIOPA. For economic control one or more resident taxpayers have to be entitled to more than 50 percent of the economic rights, Sections 371AA(3) and (6) and 371RB(2) of the TIOPA. This leads to the following issues:

- ▶ Each resident taxpayer holding an ownership interest in the foreign company has to find out whether all resident taxpayers holding ownership interests in the foreign company have the power to secure that the affairs of this company are conducted in accordance with their wishes or whether they are entitled to more than 50 percent of the economic rights. As no individual minimum ownership interest is required, it is often difficult for minority ownership interest holders to determine whether the control level is actually met; and
- ▶ The resident taxpayers do not have to be related, acting together, etc. Consequently, resident taxpayers may accidentally meet the control level, e.g. resident taxpayers holding each an ownership interest of 0.01 percent as long as all resident taxpayers together have the power to secure that the affairs of the foreign company are conducted in accordance with their wishes or are entitled to more than 50 percent of the economic rights. Hence, the rules for defining control include also cases that clearly have no tax avoidance character.

2.1.5.3. *Structurings*

Example

Company A is resident in country A (which does not have CFC rules) and holds 100 percent of the ownership interests in a resident taxpayer. Company A and the resident taxpayer decide to enter into a joint venture. They establish Company B in country B, a low tax jurisdiction. The resident taxpayer shifts passive income to company B. Company A holds 55.01 percent of the holdings, rights and powers over company B, the resident taxpayer 44.99 percent. Figure 18 illustrates the case at hand.

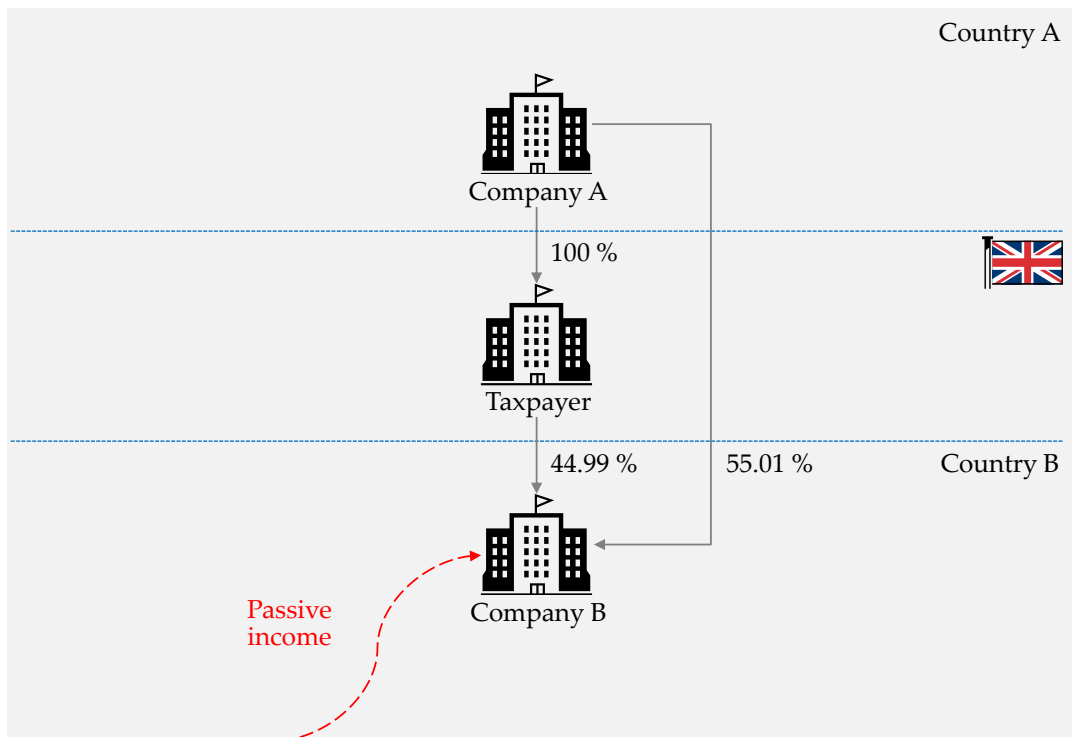


Figure 18. Illustration of the case at hand.

Section 371RC of the TIOPA, which is supposed to catch specific joint venture arrangements does not apply. Although both, company A and the resident taxpayer, hold each more than at least 40 percent of the holdings, rights and powers over company B, with one of them being a resident taxpayer, the other shareholder's holdings, rights and powers over company B exceed 55 percent.

2.1.5.4. ATAD compliance

According to Article 7(1) and Article 2(4) of the ATAD in the calculation of the level of control also ownership interests of sister- and parent companies have to be considered. However, according to Sections 371AA(3)(6) and 371RB of the TIOPA, in the calculation of the level of legal and economic control only indirect ownership interests through foreign subsidiaries are considered. Now, the Finance Bill 2018-19, published on 7 November 2018, contains legislation that addresses the incompliance. Thereunder, all ownership interests held by companies associated to a resident taxpayer are considered in the calculation of the level of control. A company is associated to a resident taxpayer, if it either has a direct/indirect 25 percent investment in the resident taxpayer (or vice versa), or if a third party has

25 percent of the ownership interests in both, the resident taxpayer and the associated company. Structurings, such as the one presented under “2.1.5.3 Structurings” would no longer be possible.

2.1.6. Recommendation

In light of the OECD/G20’s report on designing effective CFC rules, the minimum standard set out in the ATAD as well as the current CFC rules in Germany, Spain and the UK, I recommend to amend the German CFC rules as follows:

2.1.6.1. Entities

Regarding entities the minimum standard set out in Article 7(1) of the ATAD is to include also PEs of which the profits are not subject to tax or are exempt from tax in the taxpayer’s member state. This makes sense, as excluding PEs from the CFC definition would allow, as under the Spanish CFC rules, to shift passive income to a PE in a low tax jurisdiction, without being subject to CFC taxation. Excluding PEs from the German CFC definition would be even worse, as the German entity classification test allows to structure a lot of entities either as a corporate or as a transparent entity. Hence, the recommendation is to stick for transparent entities and PEs with the switch over from the exemption to the credit method, where income would be taxable as CFC income if this transparent entity or PE was a foreign company, Paragraph 20(2) of the AStG, however, with two amendments:

- ▶ The extent of the fiction to treat a foreign partnership or PE as a corporation should be clarified. In concrete, where an individual holds ownership interests in a foreign partnership or PE, Paragraph 20(2) of the AStG should provide that for the tax rate exemption the individual’s actual income tax rate is decisive and not the corporate tax rate of the CFC jurisdiction; and
- ▶ As shown above, a resident taxpayer may currently shift passive income into a PE, resident in a low tax jurisdiction, which the resident taxpayer holds indirectly through a foreign company, resident in a high tax

jurisdiction, without triggering CFC taxation. Paragraph 20(2) of the AStG should be amended to capture also such structurings.

Furthermore, including cell companies in the German CFC definition, as under the UK CFC rules, seems reasonable, considering that such structures replicate the effect of each shareholder controlling its own separate entity, which is quite different to holding a minority ownership interest in a foreign company.

2.1.6.2. *Control*

2.1.6.2.1 Type

Regarding the type of control the minimum standard set out in Article 7(1)(a) of the ATAD is to look at the holding of voting rights, capital (legal control) and at the entitlement to receive profits (economic control).

As detailed above, this requires two amendments to Paragraph 7(2) of the AStG. First, economic control will also have to look at the entitlement to receive profits, not only at the relative ownership interests in the CFC's property [Vermögen]. Second, the entitlement to receive profits has to be considered in any case, not only where share capital and voting rights (legal control) do not exist. Considering always the entitlement to receive profits helps also to avoid structurings with disproportionate profits distributions (see "2.1.3.3.2.2 Disproportionate profit distribution"). The entitlement to receive profits should be worded broad enough, to include also structurings with profit participation rights (see "2.1.3.3.2.1 Trust/profit participation right").

To avoid structurings with call option rights (see "2.1.3.3.2.3 Call option right") a Paragraph similar to Section 371RD(3) of the TIOPA should be included in the AStG, which provides that control may be established also through rights and powers which a person is or will become entitled to acquire at a future date and through similar cases. To address structurings with joint ventures (see "2.1.3.3.2.5 Joint venture"), the AStG might include a Paragraph based on Section 371RC of the TIOPA. The latter Section provides, that control may also be established through a resident and a non-resident shareholder having each interests, rights and powers representing at least 40 percent, but in the case of the non-resident shareholder no more than 55 percent, of the holdings, rights and powers in respect of which they fall to be taken to have control over the foreign

company. This seems adequate where the resident and the non-resident shareholder are third parties, to ensure that the resident shareholder has a certain level of influence on the foreign company. However, where both, the resident and the non-resident shareholder, are associated parties, their ownership interests should always be aggregated, to avoid structurings as the one mentioned under “2.1.5.3 Structurings”).

To avoid structurings where the taxpayer sells all ownership interests before the end of the fiscal year (see “2.1.3.3.2.6 Timing of the sale”), the fulfillment of the control requirement should not be checked at the end of the year. Instead, as proposed by the OECD/G20 in its final report on designing effective CFC rules (OECD, 2015c, para. 49), control at any point throughout the year should be sufficient.

2.1.6.2.2 Level

Article 7(1)(a) of the ATAD sets out as a minimum standard a control threshold of more than 50 percent, which may be met either by the taxpayer itself or together with its associated domestic and foreign enterprises. Control includes both direct and indirect control.

Apart from the definition of the term associated enterprise the German CFC rules go far beyond this minimum standard. Paragraph 7(1) of the AStG requires resident taxpayers to hold ownership interests of more than 50 percent in the foreign company, i.e. neither an individual ownership interest is required, nor do the resident taxpayers have to be related, acting together, etc. This makes it often difficult for minority ownership interest holders to determine whether the control level is actually met and control is also presumed where resident taxpayers hold accidentally more than 50 percent of the ownership interests in the foreign company. Furthermore, considering persons in terms of Paragraph 2 of the AStG makes it even harder to determine whether resident taxpayers hold ownership interests of more than 50 percent in the foreign company. In light of these issues I recommend to include in the German CFC rules a relatedness requirement. As under Article 91(1)(a) of the IRPF and Article 100(1)(a) of the LIS ownership interests of the resident taxpayer itself, or together with related persons or entities, should be considered in calculating the level of control (Heinsen, & Erb, 2018, p. 979). This would capture most structurings raising BEPS concerns, as they usually

include foreign companies owned by related parties, without the need for a fact-based acting-in-concert test, which would add complexity and compliance costs (OECD, 2015c, paras. 40, 41). A relatedness test would not be complex to apply and trigger limited compliance costs. The test only requires a group chart, which reflects all ownership interests held throughout the group. Such group chart is available in all groups. Only where the relatedness definition is too broad, such test may be complex. A less favorable definition of related persons or entities is included in the Spanish legislation. The definition is too broad and leads to over-inclusive results as shown under “2.1.4.2.2.1 Non-resident related persons and entities”. From my point of view it would be preferable, to consider in the calculation of the level of control, as under the current German CFC rules, only indirect ownership interests held through partnerships or foreign companies, Paragraph 7(2) sentence 2, (3) of the AStG, but also ownership interests held by sister- and parent companies of the taxpayer, as required by Articles 7(1) and 2(4) of the ATAD.

For ownership interests in foreign companies with passive investment income the level of control is lowered to at least 1 percent or even to any level of control, where the CFC earns (almost) exclusively passive investment income, Paragraph 7(6) sentences 1 and 3 of the AStG. Although this clearly infringes the principle to apply the CFC taxation only where resident taxpayers may control and influence the CFC on a legally secured basis, without such rule structurings as shown under “2.1.4.3.3 Passive investment companies” would be possible. Now, to strike the balance between generating over-inclusive results and allowing such structurings, the recommendation is to apply to companies with a high level of investment income, let’s say 75 percent, an acting-in-concert test. This means that a fact-based analysis is applied to determine whether shareholders are in fact acting together to influence the foreign company. If that is the case, the shareholders’ ownership interests are aggregated to determine the level of control (OECD, 2015c, paras. 40, 41). The increased complexity, compliance costs and uncertainty for resident taxpayers of this test are justified by the goal to prevent the circumvention of the CFC rules with structurings such as the one indicated under “2.1.4.3.3 Passive investment companies”. Furthermore, where resident taxpayers enter into structurings with passive investment companies for profit shifting purposes, which could not be achieved without such structurings, they set themselves the reason for increased complexity, compliance costs and uncertainty.

A further issue of the German level of control is that according to Paragraph 7(2) of the AStG a resident taxpayer only controls a lower tier foreign company held through another foreign company, if the following condition is met:

Formula

$$\begin{array}{l} \text{Taxpayer's ownership} \\ \text{interest in foreign company} \end{array} \times \begin{array}{l} \text{Foreign company's ownership} \\ \text{interest in lower tier foreign} \\ \text{company} \end{array} > 50 \%$$

As shown under “2.1.3.2.2.3 Indirect ownership interests” this allows a resident taxpayer to actually control the lower tier foreign company, by having the majority of ownership interests in the foreign company, which in turn has the majority of ownership interests in the lower tier foreign company, without establishing control in terms of Paragraph 7(2) sentence 2 of the AStG. Now, to avoid such structurings, the German rules should rather require a resident taxpayer to have the power to secure that the affairs of a foreign company are conducted in accordance with its wishes, as set out by Sections 371AA(3) and (6) and 371RB(1) of the TIOPA.

2.2. CFC EXEMPTIONS AND THRESHOLD REQUIREMENTS

2.2.1. BEPS

CFC exemptions and threshold requirements shall ensure that entities, which are not likely to be employed for BEPS, do not fall under the CFC rules, making these rules more targeted and effective as well as reducing the administrative burden. The OECD/G20 examined in their CFC Report three types of CFC exemptions and threshold requirements, namely a de minimis threshold, an anti-avoidance requirement and a tax rate exemption and held the latter as favorable, eventually combined with a whitelist (OECD, 2015c, paras. 50-52).

2.2.1.1. *De minimis threshold*

Under the de minimis threshold income that would usually be treated as CFC income (see “2.3 Definition of CFC income”) is not included in the parent company’s taxable income, if:

- ▶ the income does not exceed a certain percentage of the CFC’s income;

- ▶ the income does not exceed a fixed amount; or
- ▶ the taxable profits are less than a fixed amount (OECD, 2015c, p. 53).

Now, a de minimis threshold might be abused through fragmentation, i.e. by employing multiple subsidiaries, each of which falls below the threshold. Consequently, it should be combined with an anti-fragmentation rule. The OECD/G20 provide two examples, the German anti-fragmentation rule, which is discussed below in detail, and the US anti-fragmentation rule, which works as follows (OECD, 2015c, pp. 54-59):

Example

The US resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A earns passive income, but also active income. The US resident taxpayer shifts profits that previously arose in company A partially to its subsidiaries company B, resident in country B, and company C, resident in country C. Both countries are low tax jurisdictions. For the current taxable year companies A to C earn passive income, but also active income. The figures underlying the case at hand are provided in Table 2 below.

Table 2. Figures.

	Company A	Company B	Company C
Gross Income	6,000,000 \$	8,000,000 \$	7,000,000 \$
5 percent of gross income	300,000 \$	400,000 \$	350,000 \$
Attributable income	290,000 \$	380,000 \$	335,000 \$

Figure 19 illustrates the case at hand.

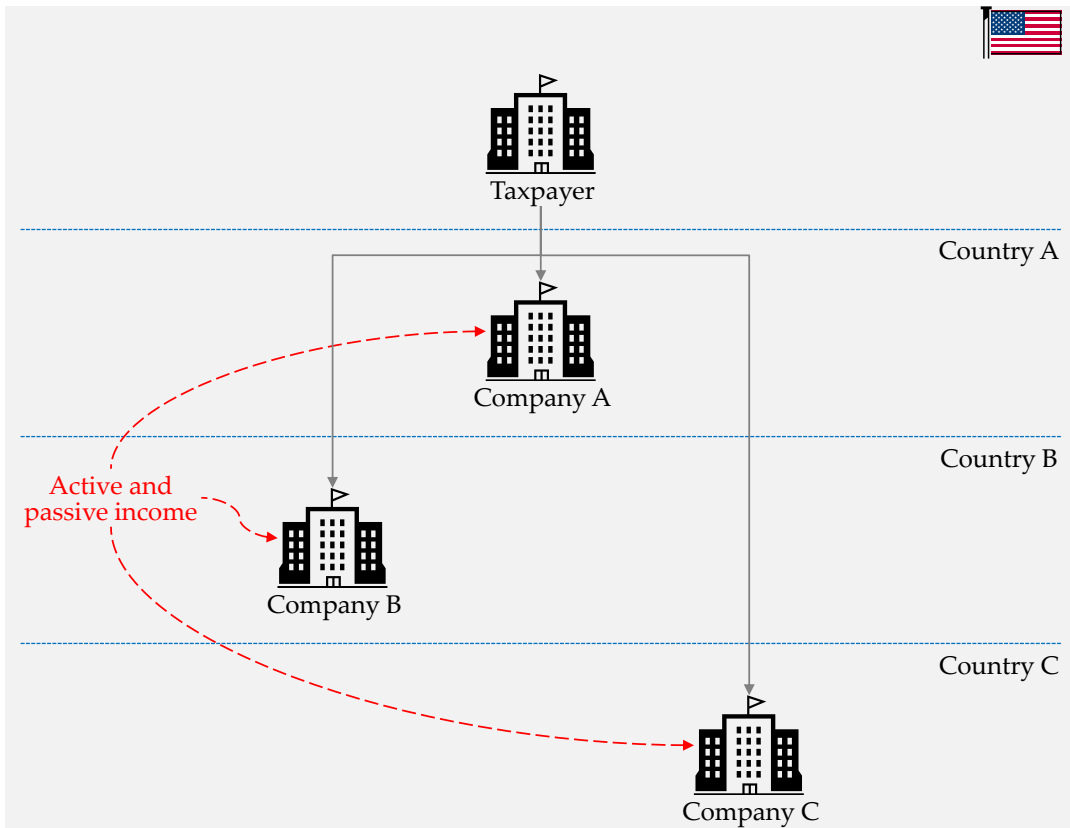


Figure 19. Illustration of the case at hand.

Under the US de minimis rule, if the attributable income for the tax year is less than the lesser of 5 percent of the gross income or 1,000,000 \$, then none of the CFC's gross income for the tax year will be treated as attributable income. By shifting profits that previously arose in company A partially to companies B and C, the US resident taxpayer basically falls under this de minimis rule as the attributable income of each company is less than 5 percent of its gross income and makes up at each company less than 1,000,000 \$. However, for purposes of applying the de minimis rule, the income of various CFCs is aggregated and treated as the income of a single CFC if the CFCs are related persons or if a principal purpose for separately organizing, acquiring, or maintaining such multiple CFCs is to prevent income from being treated as attributable under the de minimis threshold. In this example the US anti-fragmentation rule applies, as the principal purpose for the US resident taxpayer to shift income from company A to companies B and C is to prevent income from being treated as attributable income under the

de minimis threshold and the attributable income of the CFCs exceeds 1,000,000 \$ (290,000 \$ + 380.000 \$ + 335,000 \$ = 1,005,000 \$) .

2.2.1.2. *Anti-avoidance requirement*

An anti-avoidance requirement would only subject transactions and structures resulting from tax avoidance to CFC rules. Therefore, the CFC rules might be less effective as preventative measures and the administrative and compliance burden might be increased. Further, the OECD/G20 trust that such rule should not be necessary if the CFC income is defined properly targeted (OECD, 2015c, para. 60).

2.2.1.3. *Tax rate exemption*

The tax rate exemption exempts CFCs subject to a tax rate above a certain level and thereby ensures that CFC rules only apply to companies established in low-tax jurisdictions, which are more likely to be employed for profit shifting than companies in high- or medium-tax jurisdictions.

A rather mechanical approach to determine low-tax jurisdictions would be a black list. Jurisdictions included in this list are deemed to be low-tax jurisdictions. The contrary would be a white list. Jurisdictions included in this list are deemed to be high- or medium-tax jurisdictions (OECD, 2015c, paras. 61, 62).

Although less mechanical the OECD/G20 prefer a comparative approach on a case-by-case basis, eventually combined with a whitelist (OECD, 2015c, paras. 51, 52, 62). Under the comparative approach a benchmark is established, either as a fixed tax rate or as a percentage of the parent country's tax rate. Both approaches are equally relevant, but the benchmark should be meaningfully lower than the parent country's tax rate. The benchmark may be tested either to the statutory tax rate in the CFC jurisdiction or to the CFC's tax rate. The latter approach is preferable as it considers the tax base and other relevant tax provisions such as subsequent rebates of taxes paid or the non-enforcement of taxes (OECD, 2015c, paras. 63-66). The effective tax rate should be calculated as follows:

Formula

$$\text{Effective tax rate} = \frac{\text{Tax paid by the CFC}}{\text{Income earned by the CFC}}$$

The income earned by the CFC should be calculated either according to the parent jurisdiction or according to an international accounting standard, as a calculation according to the CFC jurisdiction would result in the statutory tax rate. Finally, the effective tax rate may be calculated for each item of income earned by a CFC, for each CFC or for all CFCs in one jurisdiction. The OECD/G20 prefer the calculation for each CFC as this approach reduces the administrative complexity and compliance burden compared to the other approaches (OECD, 2015c, para. 65, 69, 71).

2.2.2. ATAD

The ATAD provides two types of CFC exemptions and threshold requirements, namely a *de minimis* threshold and a tax rate exemption.

2.2.2.1. *De minimis* threshold

Where a member state uses a negative list (see “2.3.2.1.1 Negative list”) to determine the tax base of a taxpayer, the member state may opt according to Article 7(3) of the ATAD not to treat an entity or PE as a CFC:

- ▶ if no more than one third of its income is passive income; or
- ▶ in case of financial undertakings, if no more than one third of its passive income derives from transactions with the taxpayer or its associated enterprises.

Does a member state use instead of a negative list a principal purpose test (see “2.3.2.1.2 Principal purpose test”), the member state may exclude according to Article 7(4) of the ATAD entities or PEs from the scope of this test, if:

- ▶ the accounting profits amount to 750,000 € or less, and the non-trading income amounts to 75,000 € or less; or
- ▶ the accounting profits amount to 10 percent or less of the operating costs for the tax period. However, for this calculation the operating costs may not include the cost of goods sold outside the country where the entity is resident, or the PE is situated, for tax purposes and payments to associated enterprises.

2.2.2.2. Tax rate exemption

The tax rate exemption applies according to Article 7(1)(b) of the ATAD where the actual corporate tax paid on its profits by the entity or PE is equal or higher than the difference between the corporate tax that would have been charged on the entity or PE under the applicable corporate tax system in the member state of the taxpayer and the actual corporate tax paid on its profits by the entity or PE. In other words the tax rate exemption applies where the actual corporate tax paid by the entity or PE on its profits is at least 50 percent of the corporate tax as computed according to the rules of the member state of the taxpayer. In this calculation PEs of a CFC that are not subject to tax or tax exempt in the CFC jurisdiction are not considered, Article 7(1) of the ATAD.

Example

Company A, resident in country A, holds 100 percent of the ownership interests in company B, resident in country B. Company B earns passive income of 100, which is subject to the statutory corporate tax rate of 25 percent, i.e. 25. Company B also earns active income of 150, which is subject to a reduced tax rate of 10 percent, i.e. 15. In country A company B's active and passive income would be subject to a statutory corporate tax rate of 35 percent, i.e. 87.5 $((100 + 150) \times 35$ percent). Figure 20 illustrates the case at hand.

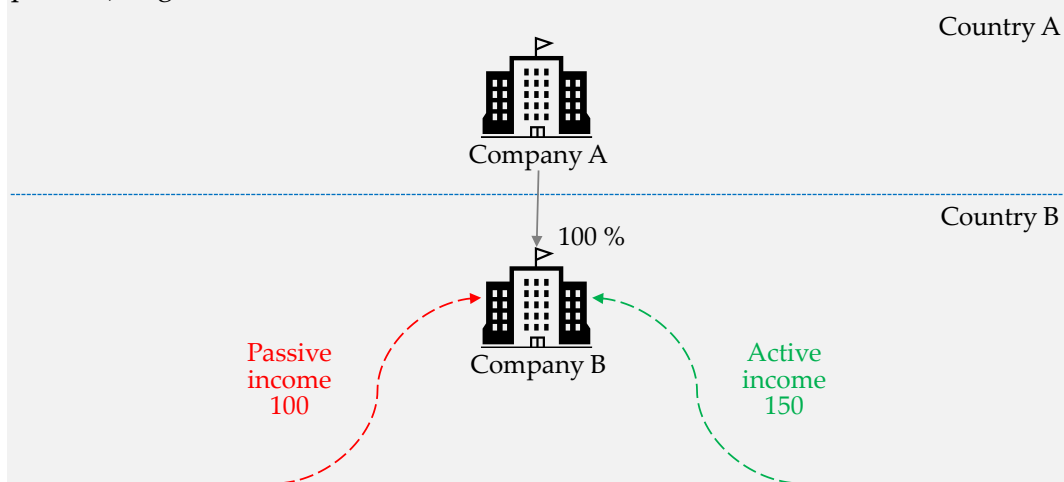


Figure 20. Illustration of the case at hand.

The actual corporate tax paid by company B on its profits $(25 + 15 = 40)$ is less than 50 percent of the corporate tax as computed according to the rules of country B (87.5). In light of the wording of Article 7(1)(b) of the ATAD the tax rate

exemption might not apply, as the article looks at the profits, neither differentiating between active and passive income, nor between various types of passive income. However, the rationale behind Articles 7 and 8 of the ATAD is to avoid that passive income is shifted into low tax jurisdictions. Consequently, it should be reasonable to look at the actual corporate tax paid on the passive income, not on the profits from active and passive income (Wenzel, 2017, p. 435). In this example the actual corporate tax paid on the passive income (25) makes up 71.43 percent of the corporate tax as computed according to the rules of country B (35). Hence, the tax rate exemption applies.

2.2.3. Germany

2.2.3.1. Rules

The German CFC rules work with a de minimis threshold and a tax rate exemption.

2.2.3.1.1 De minimis threshold

Under Paragraph 9 of the AStG passive income is disregarded if:

- ▶ the CFC's gross revenue underlying the passive income amounts to no more than 10 percent of the CFC's total gross revenue (threshold I);
- ▶ the total amount to be disregarded by a CFC under Paragraph 9 of the AStG does not exceed 80,000 € (threshold II); and
- ▶ the total amount to be disregarded by a resident taxpayer under Paragraph 9 of the AStG does not exceed 80,000 € (threshold III).

Gross revenue refers to accrued receipts net of pass-through items and net of any separately stated value added tax (BMF, 2004b, para. 9.0.1). Expenses or costs are not considered in the calculation of the gross revenue (Strunk et al, 2018, Chapter § 9, para. 17).

Threshold I shall ensure that CFCs with an overall active character are not subject to CFC taxation. Threshold II shall prevent that a resident taxpayer uses threshold I to shift passive income of more than 80,000 € to an active CFC. Threshold III shall avoid that a resident taxpayer shifts passive income to multiple CFCs (Heuermann, & Brandis, 2018, Chapter § 9, para. 5).

2.2.3.1.2 Tax rate exemption

The German CFC rules include only CFCs subject to a low level of taxation. Such low level of taxation exists according to Paragraph 8(3) of the AStG, if the CFC's income is subject to an income tax burden of less than 25 percent, unless this results from an offset against income from other sources. To calculate the level of taxation the income tax levied on the CFC's income has to be compared to its income. Only passive income is considered. The calculation has to be made separately, if the passive income from various activities is taxed at different rates. Otherwise high taxed income might be subject to CFC taxation, which is not in line with the paragraph's rationale. The level of taxation calculation considers all income taxes of the CFC, irrespective of whether they are imposed by their state of residence or by another state (Heuermann, & Brandis, 2018, Chapter § 8, paras. 184, 187). The level of taxation calculation considers also rights, which the state or territory of the CFC grants upon dividend distribution to the foreign company, resident taxpayers or any other party in which the taxpayer holds directly or indirectly share. The latter rule targets structurings exploiting that under such set-ups formally no low taxation of the CFC's income is given.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in Malta, which in turn holds 100 percent of the ownership interests in company B, also resident in Malta. Whereas company A is a holding company, company B is an operating company. Company B earns passive income of 100, which is subject to a statutory corporate tax rate of 35 percent, i.e. 35. Company B distributes the remaining 65 to company A. Upon the profit distribution the Maltese tax authorities refund – in line with the local law – 6/7 of the corporate tax paid, i.e. 30, to company A (Flick et al, 2018, Chapter § 8, para. 749; Kollruss, Lukas, & Rüst, 2010). Figure 21 illustrates the case at hand.

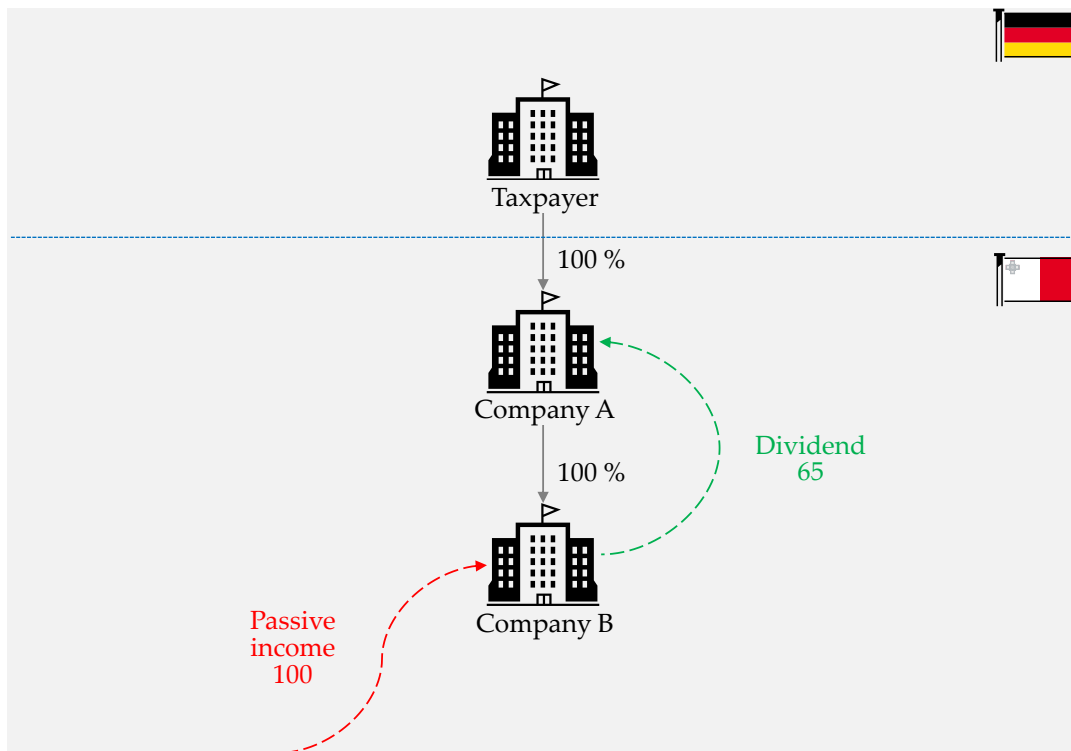


Figure 21. Illustration of the case at hand.

Formally no low taxation of company B's income is given, as it is subject to a statutory corporate tax rate of 35 percent. However, according to Paragraph 8(3) sentence 2 of the AStG (lex malta; Kollruss, 2016, p. 448), the tax refund, which the Maltese tax authorities grant upon the profit distribution to company A, in which the taxpayer holds all ownership interests, has to be considered in the calculation of the level of taxation. Thus, company B is subject to a low level of taxation $((35 - 30) / 100 = 5$ percent). The profit distribution from company B to company A is active income for the latter (see "2.3.3.1.1.8 Profit distributions").

A low level of taxation also exists where income taxes of at least 25 percent are owed de jure, but are not levied in fact, Paragraph 8(3) sentence 3 of the AStG.

2.2.3.2. Issues

2.2.3.2.1 De minimis threshold

Although threshold I is designed to ensure that CFCs with an overall active character are not subject to CFC taxation, the paragraph may also apply to cases

where the CFC does not have an overall active character (Heuermann, & Brandis, 2018, Chapter § 9, para. 3).

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A has gross revenue from sales of 1,200,000 €, resulting in an income of 65,000 € after deduction of expenses and costs, and gross revenue from interests of 75,000 €, not being subject to expenses or cost. The resident taxpayer does not hold ownership interests in other companies. Figure 22 illustrates the case at hand.

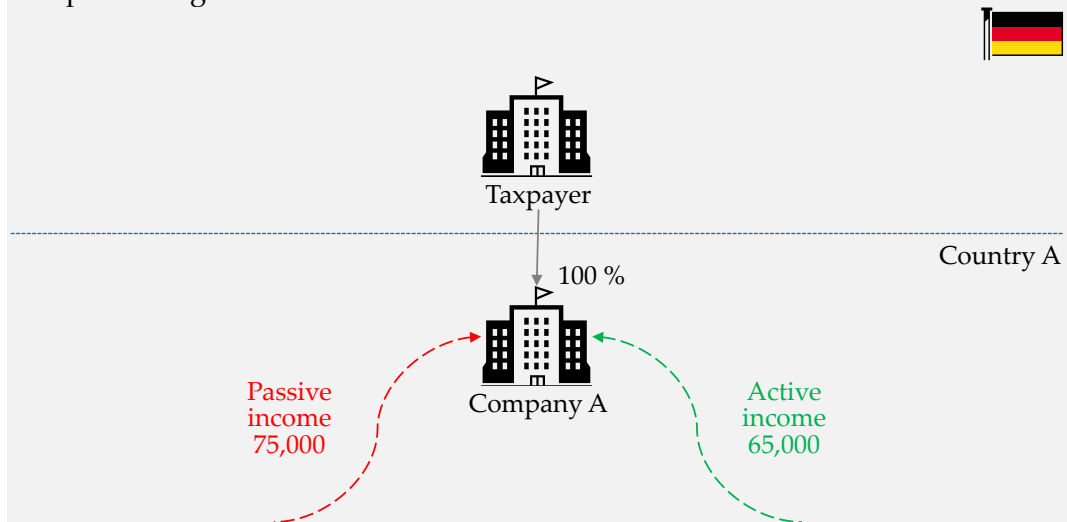


Figure 22. Illustration of the case at hand.

As the gross revenue underlying the passive income (75,000 €) amounts to no more than 10 percent of the CFC's total gross revenue $((1,200,000 + 75,000) \times 10\% = 127,500 \text{ €})$, threshold I is met, although the CFC does not have an overall active character, considering that the interest income (75,000 €) exceeds the sales income (65,000 €). Threshold II and III are met, as neither the total amount to be disregarded under Paragraph 9 of the AStG by company A, nor by the resident taxpayer is more than 80,000 € (75,000 €).

The idea to exclude CFCs with an overall active character from CFC taxation is limited significantly by thresholds II and III, which require that neither the total amount to be disregarded under Paragraph 9 of the AStG by a CFC, nor by a resident taxpayer is more than 80,000 €. Due to these thresholds Paragraph 9 of the AStG is of little practical relevance (Cortez, 2013, p. 190).

2.2.3.2.2 Tax rate exemption2.2.3.2.2.1 Low level of taxation

As detailed above, a low level of taxation exists, broadly, if the CFC's passive income is subject to an income tax burden of less than 25 percent, Paragraph 8(3) of the AStG. Historically, the low level of taxation was always aligned with the corporate tax rate (see "1.3.2 Legal development of German CFC rules"). However, with the [Unternehmensteuerreformgesetz 2008] as of 14 August 2007 the corporate tax rate was lowered to 15 percent for fiscal years from 2008 onwards, Paragraph 23(1) of the KStG (Roser, 2015, Chapter § 23, para. 1). Nevertheless the low level of taxation remained at less than 25 percent. This may be adequate if the resident taxpayer is an individual, as the following example shows.

Example

For fiscal year 2018 a resident taxpayer expects to have a taxable income of 300,000 €. The income tax thereon would be 118,562 € ($0.45 * 300,000 \text{ €} - 16,437.7 \text{ €}$), Paragraph 32a(1) number 5 of the EStG (Loschelder, 2018, Chapter § 32a, para. 8). Furthermore, the resident taxpayer would have to pay a solidarity surcharge of 5.5 percent on the income tax, i.e. 6,520.91 €, Paragraph 4 of the German Solidarity Surcharge Act ("SolzG 1995"). Consequently, income tax and solidarity surcharge would make up 41.69 percent of his taxable income ($(118,562 \text{ €} + 6,520.91 \text{ €}) / 300,000 \text{ €}$). To reduce the tax burden, the resident taxpayer decides to establish company A in the Netherlands and shift the income to the latter. The corporate tax rate in the Netherlands is 25 percent.¹³ However, a tax rate of 20 percent applies to the first € 200,000. Figure 23 illustrates the case at hand.

¹³ The corporate tax rate in the Netherlands is lowered 2019 to 24 percent, 2020 to 22.5 percent and 2021 to 21 percent, see Böing, Graupeter and Rometzki (2018, p. 65).

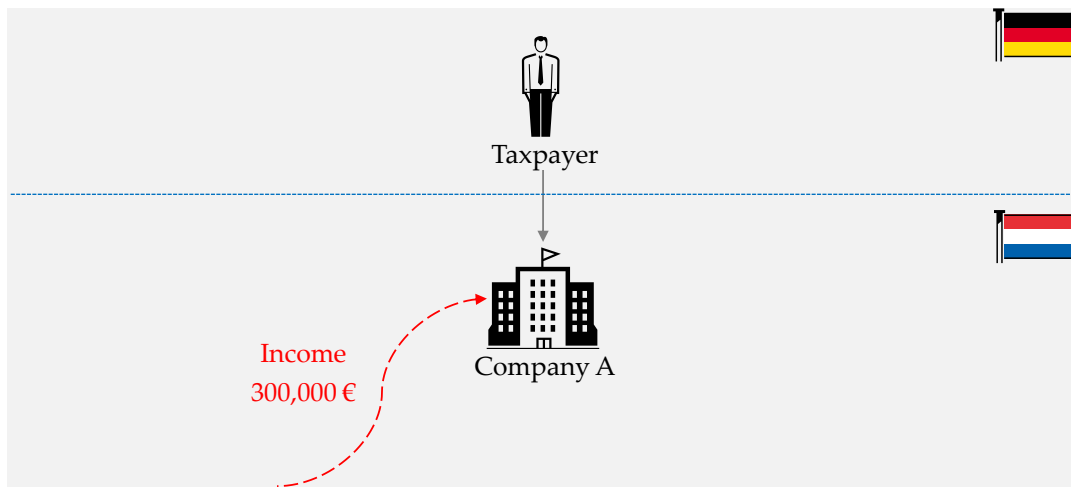


Figure 23. Illustration of the case at hand.

Company A's tax burden is 65,000 € ($200,000 \text{ €} \times 20 \text{ percent} + 100,000 \text{ €} \times 25 \text{ percent}$), i.e. 21.67 percent. Now, if the low level of taxation was lowered from less than 25 percent to e.g. less than 20 percent, the resident taxpayer might use this structuring to reduce the tax burden by 48.03 percent from 41.69 percent to 21.67 percent.

However, fixing the low level of taxation as under Paragraph 8(3) of the AStG also for corporate entities at less than 25 percent does not seem reasonable. As indicated above, the current corporate tax rate is only 15 percent, Paragraph 23(1) of the KStG. Even considering the solidarity surcharge of 5.5 percent on the corporate tax, Paragraph 4 of the SolzG 1995, and the trade tax, the tax burden in Germany is not significantly higher than the low level of taxation.

Trade tax

This paragraph summarizes briefly the scope of the trade tax and its calculation to show how it influences the tax burden of corporate entities in Germany. Trade tax is imposed on most commercial or industrial activities carried out in Germany, regardless of the legal form, Paragraph 2 of the GewStG (Rosengarten, Burmeister, & Klein, 2016, p. 102). It accrues to the municipality where a permanent establishment is maintained, Paragraph 4(1) sentence 1 of the GewStG (Rosengarten, Burmeister, & Klein, 2015, para. 460). Tax base for the trade tax is the trade income, Paragraph 6 of the GewStG. That is the business income determined according to the EStG or KStG, Paragraph 7 sentence 1 of the GewStG, applying certain additions, Paragraph 8 of the GewStG, and deductions, Paragraph

9 of the GewStG. The trade income is multiplied by 3.5 percent, Paragraph 11 of the GewStG. Thereon the municipality applies its multiplier, which has to be at least 200 percent, Paragraph 16(4) sentence 2 of the GewStG, but tends to be higher in urban areas (e.g. Berlin 410 percent, Hamburg 470 percent, Munich 490 percent, Cologne 475 percent and Frankfurt 460 percent). However, there are numerous trade tax havens throughout Germany (e.g. Dragun 200 percent, Höhenland 200 percent, Neu Zauche 200 percent, Rögnitz 200 percent, Zossen 200 percent).

The following Table 3 compares the tax burden of a corporate entity with a PE in Zossen to the tax burden of a corporate entity with a PE in Berlin:

Table 3. Tax burden comparison.

	Zossen		Berlin	
	Calculation	Rate	Calculation	Rate
Corporate tax		15 %		15 %
Solidarity surcharge	5.5 % x 15 %	0.825 %	5.5 % x 15 %	0.825 %
Trade tax	3.5 % x 200 %	7 %	3.5 % x 410 %	14.35 %
Total		22.825 %		30.175 %

Whereas the tax burden of a corporate entity with a PE in Zossen is even lower than the low level of taxation set out in Paragraph 8(3) of the AStG, the tax burden of a corporate entity with a PE in Berlin exceeds the low level of taxation of less than 25 percent. However, even in the latter case the tax burden is not significantly higher than the low level of taxation. Considering that profits are not shifted to jurisdictions with a higher or the same tax burden as the domestic one and that they are not likely to be shifted to jurisdictions with a slightly lower tax burden, the low level of taxation as established in Paragraph 8(3) of the AStG seems inadequately high for corporate entities.

Moreover, many countries have lowered their corporate tax rates to less than 25 percent throughout the last years, including many EU member states. Figure 24 shows the corporate tax rates of EU member states as of 1 January 2018.

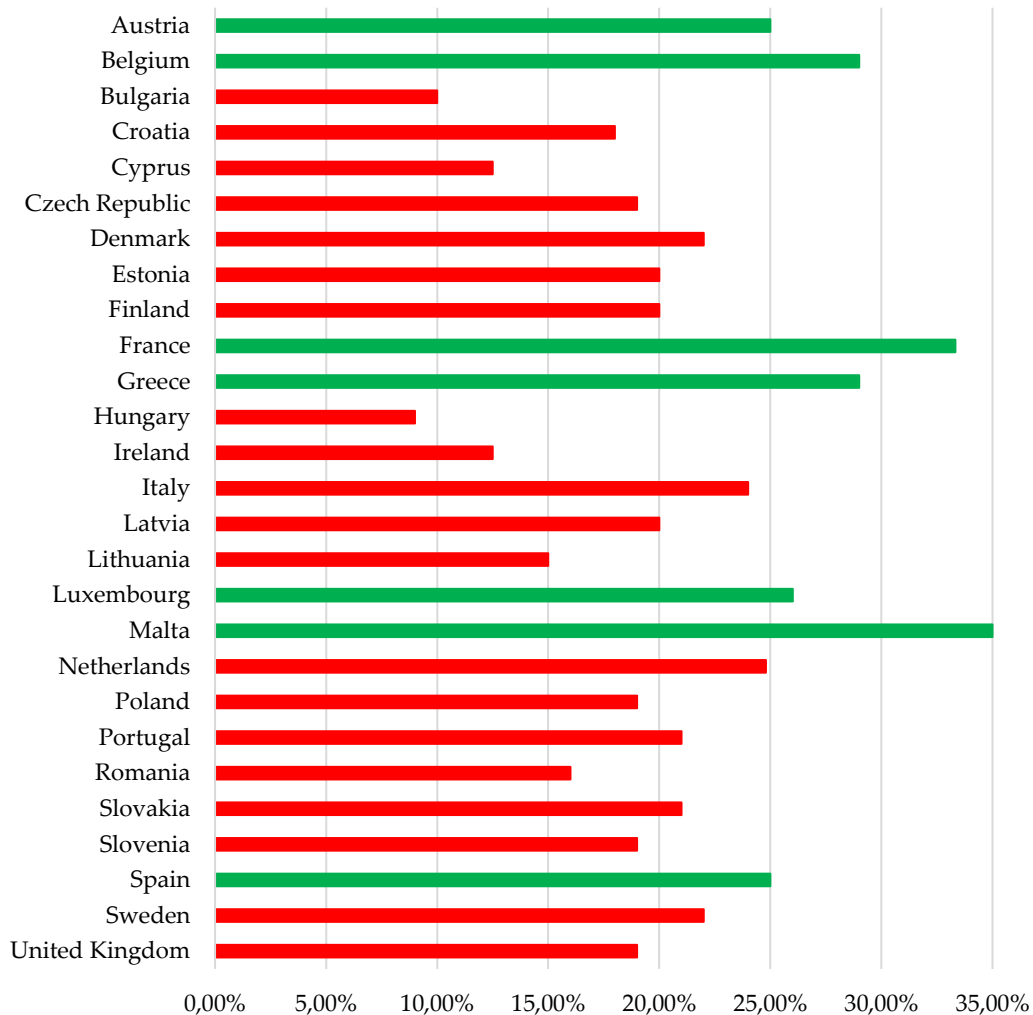


Figure 24. Illustration of the corporate tax rates of EU member states as of 1 January 2018.

The above list shows the maximum corporate tax rates of the EU member states. Some of the EU member states apply preferential corporate tax rates under certain conditions. In fact some of the above listed EU member states with a corporate tax rate of at least 25 percent are planning to lower this rate in the near future. For example Belgium will lower its current corporate tax rate from 29 percent to 25 percent as of 2020 and tax the first 100,000 € of taxable income under certain conditions only at a corporate tax rate of 20 percent (EY, 2018, p. 157), i.e. in several cases the tax burden will be less than 25 percent as of 2020. The French corporate tax rate shall be lowered to 25 percent for financial years beginning on or

after 1 January 2022 (EY, 2018, p. 495). The Greek corporate tax rate will be lowered (except for credit institutions) to 26 percent from the beginning of 2019 (EY, 2018, p. 582) and Maltese tax refunds of 6/7 (see the example under “2.2.3.1.2 Tax rate exemption”) or 5/7 lead to an effective corporate tax rate of 5 or 10 percent for most corporate entities (Flick et al, 2018, Chapter 8, para. 749).

Also the nominal corporate tax rate (federal tax) of the United States has been lowered lately by the “Tax Cuts and Jobs Act” (Nayin, & Schildgen, 2018, p. 686; Nolte, Gehrman, Heinen, & Dyllick, 2018, p. 221) from 35 percent (Bärsch, Sprengel, & Olbert, 2018, p. 1815) to 21 percent (Faßbender, & Goulet, 2018, p. 255). However, most states levy in addition a state tax. Bearing in mind that the state tax is deductible from the federal tax base, a state tax of slightly above 5 percent leads to a combined tax rate that meets the German 25 percent low level of taxation threshold. However, currently 13 states fall below the foregoing threshold (Schümmer, Leusder, & Weinrich, 2018, pp. 397, 398). Please note that the foregoing indication looks exclusively at the nominal tax rates and does not consider differences in the computation of income (Kraft, 2016a; Kraft, 2016b).

Last but not least, the gap between the statutory corporate tax rate of 15 percent, Paragraph 23(1) of the KStG, and the low level of taxation of less than 25 percent, Paragraph 8(3) of the AStG, may result in an overtaxation.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A. The corporate tax rate in country A is 24 percent. Company A has passive income of 100. Figure 25 illustrates the case at hand.

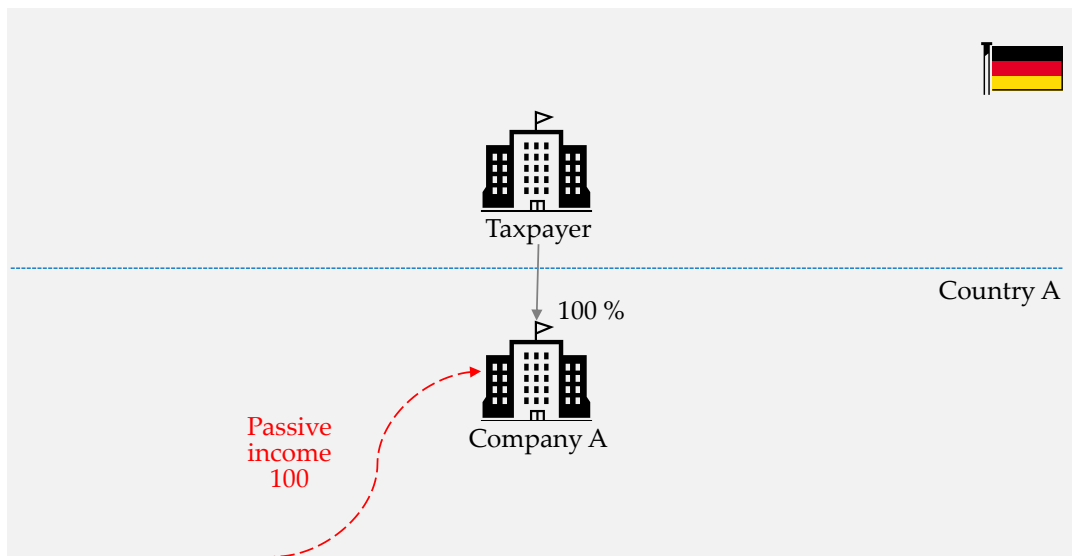


Figure 25. Illustration of the case at hand.

Company A's foreign corporate tax of 24 (24 percent \times 100) may only be credited against the German corporate tax of 15 (15 percent \times 100), but not against the German trade tax (see "4.3.2.2 Relief for foreign income taxes"), Article 12(1) sentence 1 of the AStG. Thus, foreign corporate tax of 9 may not be credited in Germany.

In fact, whenever the foreign corporate tax rate is more than 15 percent, but less than 25 percent, such overtaxation occurs. In these cases the overall tax burden on the underlying passive income is higher than it would be in similar domestic situations (Strunk et al, 2018, Chapter 8, para. 8). This may be an infringement of the free movement of capital (see "4.3.2.2 Relief for foreign income taxes"). Considering that the corporate tax rate in the following 15 EU member states is more than 15 percent, but less than 25 percent, this is an issue: Croatia (18 percent), Czech Republic (19 percent), Denmark (22 percent), Estonia (20 percent), Finland (20 percent), Italy (24 percent), Latvia (20 percent), Netherlands (< 25 percent), Poland (19 percent), Portugal (21 percent), Romania (16 percent), Slovakia (21 percent), Slovenia (19 percent), Sweden (22 percent) and UK (19 percent).

2.2.3.2.2.2 Calculation of passive income

According to Paragraph 8(3) of the AStG a low level of taxation exists, broadly, if the following condition is met:

Formula

$$\frac{\text{CFC's income tax burden}}{\text{CFC's income}} < 25 \text{ percent}$$

As mentioned above, only passive income is considered and the calculation has to be made separately, if the passive income from various activities is taxed at different rates (see “2.2.3.1.2 Tax rate exemption”). However, Paragraph 8(3) of the AStG does not provide how to compute the CFC’s income. It might be computed applying either the CFC jurisdiction’s tax law or according to the German tax law analogously. As Paragraph 8(3) of the AStG lacks clarity in this aspect, it is considered to be unconstitutional by parts of the German tax literature (Waldhoff, & Grefrath, 2013, pp. 481, 482). The BMF provides under Paragraph 8.3.2.1 of its letter as of 14 May 2004 (2004b), that: *“The income tax burden is determined by comparing the passive income as determined under German tax law with the taxes paid by the CFC (see Paragraph 10.1.1.1 below).”* Under the latter paragraph the Federal Ministry of Finance states that: *“For CFC taxation purposes, the entire income of the CFC from passive activities must be determined. The provisions of German tax law apply analogously for the determination of this income (Paragraph 10(3) of the AStG) [...]”*. Sentence 1 of Paragraph 10(3) of the AStG deals with the computation of the CFC income, which shall be done by *“applying the German tax law analogously”* (see “3.1.3.1 Rules”). Under the current German CFC rules this may be overburdensome.

Example

A resident taxpayer holds 0.01 percent of the ownership interests in company A, resident in country A. Further 50 percent of the ownership interests in company A are held by numerous other unrelated resident taxpayers. Company A has passive income of 100 and pays thereon corporate tax of 25. Figure 26 illustrates the case at hand.

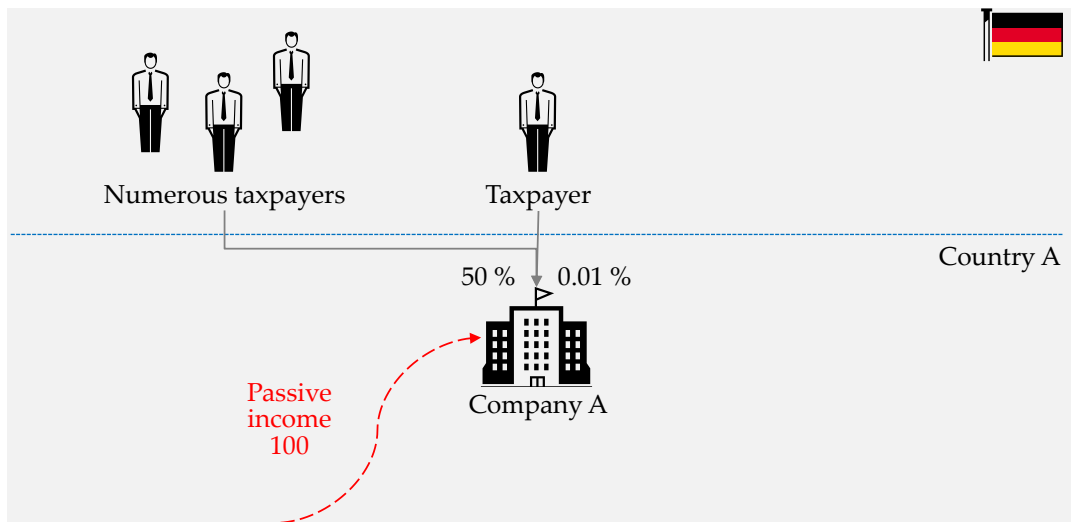


Figure 26. Illustration of the case at hand.

Company A is a CFC, as resident taxpayers hold ownership interests of more than 50 percent in it (see “2.1.3.1.2.2 Level”), Paragraph 7(1) of the AStG. Neither an individual minimum ownership interest, nor a relatedness etc. of the resident taxpayers are required. Consequently, in the case at hand, the resident taxpayer has to find out whether the tax rate exemption, Paragraph 8(3) of the AStG, applies. At a first glance this might be the case, as the corporate tax paid by company A makes up exactly 25 percent of its passive income. However, the resident taxpayer will have to consult an expert in country A’s tax law to ensure that differences between country A’s tax law and the German tax law do not raise the passive income as determined under German tax law analogously to more than 100. In the latter case the CFC’s income tax burden would become less than 25 percent, making the tax rate exemption not applicable.

2.2.3.3. Structurings

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A holds 100 percent of the ownership interests in companies B and C, both also residents in country A. Company A has gross revenue from sales of 625,000 €, resulting in an income of 30,000 € after deduction of expenses and costs, and gross revenue from interests of 75,000 €, not being subject to expenses or cost. The resident taxpayer does not hold ownership interests in other companies. Figure 27 illustrates the case at hand.

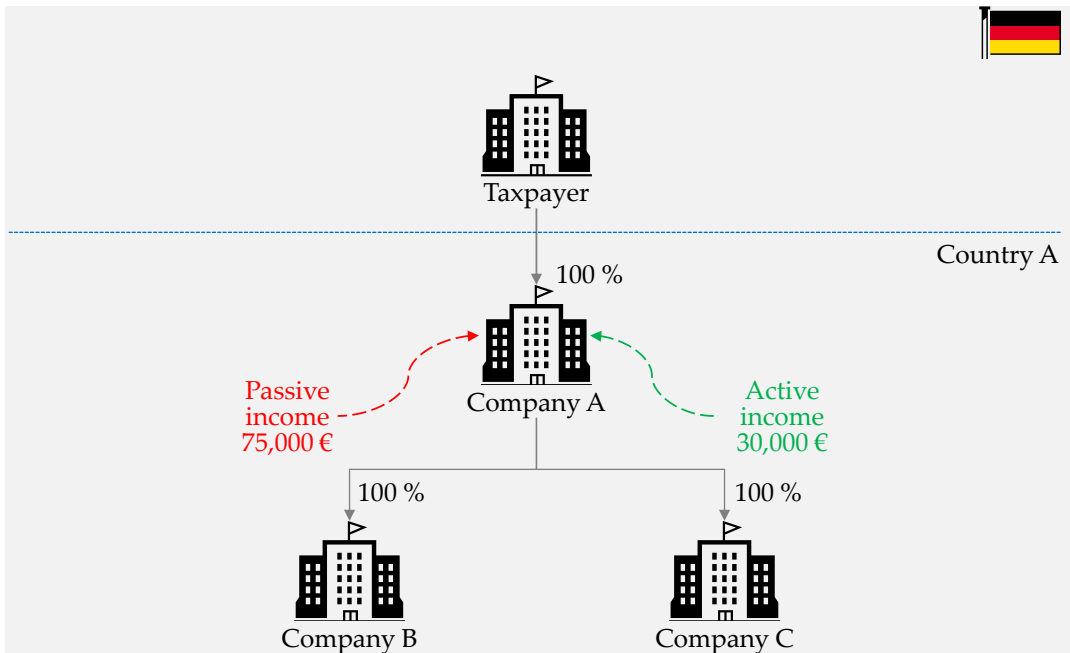


Figure 27. Illustration of the case at hand.

Threshold II and III of Paragraph 9 of the AStG (see “2.2.3.1.1 De minimis threshold”) are met, as neither the total amount to be disregarded under this paragraph by company A, nor by the resident taxpayer is more than 80,000 € (75,000 €). However, as the gross revenue underlying the passive income (75,000 €) amounts to more than 10 percent of company A's total gross revenue ($(625,000 \text{ €} + 75,000 \text{ €}) \times 10 \% = 70,000 \text{ €}$), threshold I is not met. Now, in the case at hand, company A may improve the aforementioned ratio by generating gross revenue through active activities, e.g. (Strunk et al, 2018, Chapter 9, para. 16):

- ▶ Company B and/or C might distribute profits to company A (see “2.3.3.1.1.8 Profit distributions”), Paragraph 8(1) number 8 of the AStG;
- ▶ Company A might sell its ownership interests in company B and/or C (see “2.3.3.1.1.9 Sale of a share in another company etc.”), Paragraph 8(1) number 9 of the AStG; and/or
- ▶ Company A might derive income from a reorganization in terms of Paragraph 8(1) number 10 of the AStG (see “2.3.3.1.1.10 Reorganizations”), e.g. merger of company B on company C.

2.2.3.4. *ATAD compliance*

According to Article 7(1)(b) of the ATAD the tax rate exemption applies, if the actual corporate tax paid by the CFC on its profits is at least 50 percent of the corporate tax as computed according to the rules of the member state of the taxpayer. Considering that the rationale behind Articles 7 and 8 of the ATAD is to avoid that passive income is shifted into low tax jurisdictions, Article 7(1)(b) of the ATAD should be interpreted to look at the actual corporate tax paid on the passive income, not on the profits from active and passive income (see “2.2.2.2 Tax rate exemption”). In light of this interpretation, not only the German de minimis threshold, but also the German low level of taxation threshold are ATAD compliant, as they go beyond the ATAD minimum standard (Wenzel, 2017, p. 435).

2.2.4. **Spain**

2.2.4.1. *Rules*

2.2.4.1.1 De minimis threshold

According to Article 91(5) of the IRPF and Article 100(5) of the LIS passive income as listed in Article 91(3) of the IRPF and Article 100(3) of the LIS is not being taxed, if the total passive income is less than 15 percent of the total income of the CFC, except for the passive income mentioned in Article 91(3)(g) of the IRPF and Article 100(3)(g) of the LIS. Passive income in terms of the latter article is income from credit, finance and insurance activities as well as service provisions. However, the aforementioned activities have to be provided directly or indirectly to related persons or entities in terms of Article 18 of the LIS resident in Spain. Furthermore, the consideration for these activities has to be a tax-deductible expense for the person or entity resident in Spain. Article 91(3)(g) of the IRPF and Article 100(3)(g) of the LIS are not applicable, if more than 50 percent of the income from credit, finance and insurance activities as well as service provisions is derived from unrelated persons or entities. Are the foregoing requirements met, the passive income in terms of Article 91(3)(g) of the IRPF and Article 100(3)(g) of the LIS is fully taxed, but not considered in the de minimis threshold calculation (Borrás Amblar, & Navarro Alcázar, 2017, p. 1386).

2.2.4.1.2 Tax rate exemption

Under Article 91(1)(b) of the IRPF and Article 100(1)(b) of the LIS a low level of taxation exists, if:

- ▶ The CFC pays a tax on any of the classes of income provided in Article 91(2) or (3) of the IRPF and Article 100(2) or (3) of the LIS;
- ▶ The tax is identical or comparable to the Spanish corporate tax (i.e. all taxes imposed on the income obtained by the foreign company; Lefebvre, 2018, para. 7453); and
- ▶ The tax, is less than 75 percent of the tax that would have been applicable according to the Spanish corporate tax rules (considering any necessary transfer pricing adjustments; Ferrer Vidal, 2017).

As the general tax rate for taxpayers subject to the Spanish corporate tax is 25 percent, Article 25(1) of the LIS, a low level of taxation means less than 18.75 percent.

2.2.4.2. *Issues*

As detailed above, a low level of taxation exists, if the tax paid by the CFC is less than 75 percent of the Spanish corporate tax, i.e. less than 18.75 percent. This holds true where the resident taxpayer is a corporate entity (Article 100(1)(b) of the LIS), but also where the resident taxpayer is an individual (Article 91(1)(b) of the IRPF). Individuals may use the tax rate exemption to reduce their effective tax rates significantly, as shown under “2.2.4.3.2 Tax rate exemption”.

2.2.4.3. *Structurings*

2.2.4.3.1 De minimis threshold

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A. The corporate tax rate in country A is 5 percent. Company A has an active income of 20,000,000 €. The resident taxpayer shifts passive income of 3,500,000 € to company A. Figure 28 illustrates the case at hand.

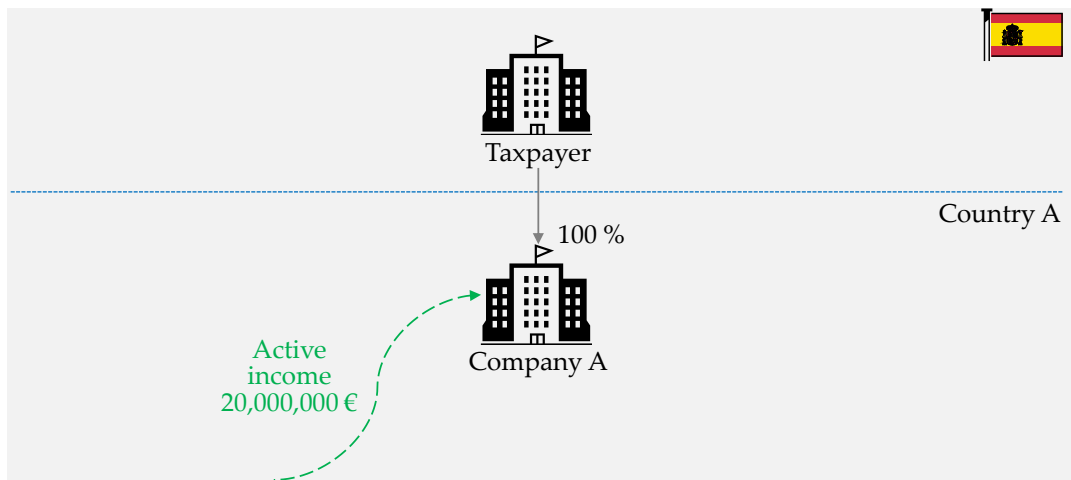


Figure 28. Illustration of the case at hand.

The passive income of company A (3,500,000 €) makes up less than 15 percent of company A's total income $((20,000,000 \text{ €} + 3,500,000 \text{ €}) \times 15 \text{ percent} = 3,525,000)$. The de minimis threshold provided in Article 100(5) of the LIS applies. In Spain the passive income would have been subject to a corporate tax rate of 25 percent $(3,500,000 \text{ €} \times 25 \text{ percent} = 875,000 \text{ €})$, in country A it is only subject to a corporate tax rate of 5 percent $(3,500,000 \text{ €} \times 5 \text{ percent} = 175,000 \text{ €})$. Throughout the group the corporate tax benefit amounts to 700,000 €.

2.2.4.3.2 Tax rate exemption

Example

For fiscal year 2018 a taxpayer, resident in Madrid, Spain, expects to have a taxable income of 300,000 €. The income tax thereon would be computed by applying the rates of the state tax scale (Article 63(1) of the IRPF) and the Madrid Autonomous Community tax scale¹⁴ as shown in Table 4:

¹⁴ Article 1 of the [Decreto Legislativo 1/2010, de 21 de octubre, del Consejo de Gobierno, por el que se aprueba el texto refundido de las disposiciones legales de la Comunidad de Madrid en materia de tributos cedidos por el estado].

Table 4. Computation of income tax.

	State tax			Madrid Autonomous Community tax		
	Taxable income	Tax rate	Tax	Taxable income	Tax rate	Tax
Part I	60,000 €	Fix	8,950.75 €	53,407.20 €	Fix	7,458.06 €
Part II	240,000 €	22.50 %	54,000.00 €	246,592.80 €	21 %	51,784.49 €
Total	300,000 €		62,950.75 €	300,000.00 €		59,242.54 €

From the state tax and the Madrid Autonomous Community tax a personal allowance of 1,054.50 € ($5,550 \text{ €} \times 9.5 \text{ percent} \times 2$) would be deducted, Article 57(1) of the IRPF. Consequently, the resident taxpayer would have to pay income tax of 120,084.29 € ($62,950.75 \text{ €} + 59,242.54 \text{ €} - 1,054.50 \text{ €}$) on the taxable income of 300,000 €. The effective tax rate would be 40.03 percent. To lower the effective tax rate, the resident taxpayer decides to establish company A in country A and shifts 150,000 € passive income to the latter. The corporate tax rate in country A is 20 percent. Figure 29 illustrates the case at hand.

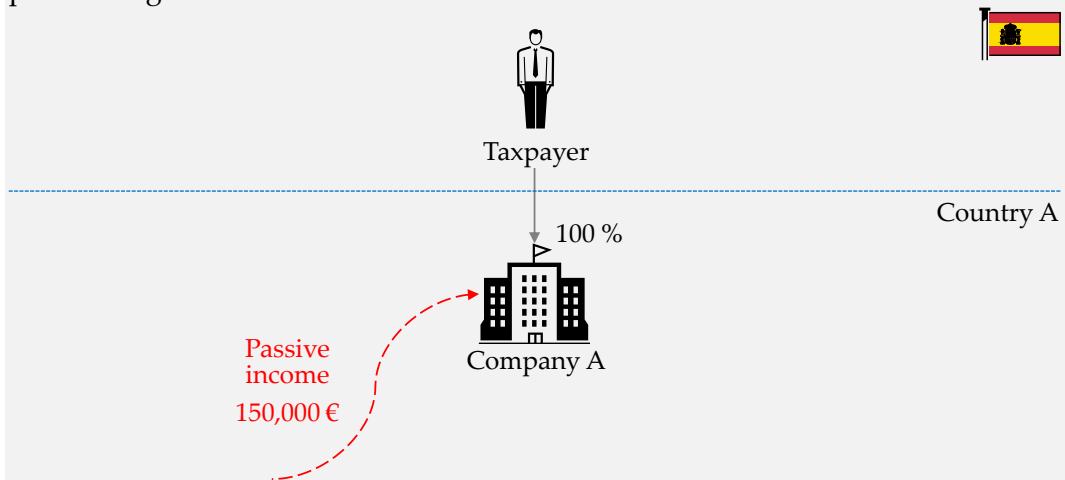


Figure 29. Illustration of the case at hand.

The tax rate exemption provided in Article 91(1)(b) of the IRPF applies. Company A pays 20 percent corporate tax on the passive income of 150,000 €, i.e. 30,000 €. This is not less than 75 percent of the Spanish corporate tax, i.e. 18.75 percent. Although the resident taxpayer could lower the effective tax rate on the 150,000 € from 40.03 percent by more than half to 20 percent, the tax rate exemption applies. Considering that the resident taxpayer's tax benefit is significant, linking

the low level of taxation for individuals to less than 75 percent of the Spanish corporate tax, i.e. 18.75 percent, seems too low to avoid profit shifting.

2.2.4.4. *ATAD compliance*

As mentioned above (see “2.2.3.4 ATAD compliance”), to determine whether a low level of taxation in terms of Article 7(1)(b) of the ATAD exists or not, it should be reasonable to look at the actual corporate tax paid on the passive income, not on the profits. In light of this interpretation, both, the Spanish de minimis threshold, and the Spanish low level of taxation threshold are ATAD compliant, as they go beyond the ATAD minimum standard (Wenzel, 2017, p. 435).

This holds also true for the above structuring example (see “2.2.4.3.2 Tax rate exemption”), where the resident taxpayer, an individual, lowers the effective tax rate on income of 150,000 € by more than half. At a first glance this seems not to be in line with the minimum standard set out in Article 7(1)(b) of the ATAD, which requires, broadly, that the actual tax paid by the CFC on its passive income is at least 50 percent of the tax as computed according to the resident taxpayer’s jurisdiction. However, the ATAD applies only to taxpayers that are subject to corporate tax (quod non), Article 1 of the ATAD.

2.2.5. UK

2.2.5.1. *Rules*

The UK CFC rules employ two de minimis thresholds (low profits and low profit margin) and three exemptions (tax rate, exempt period and excluded territories¹⁵) to exempt CFCs from CFC charge that pose only a low BEPS risk, Section 371BA(2)(b) of the TIOPA.

¹⁵ The UK CFC rules use the term “territory” instead of country, as the first also covers jurisdictions such as the Channel Islands or the Isle of Man, which are not completely independent, see Gibson, Wilson, Lindsay, Amin and Hayward (2018, para. 46.280ag).

2.2.5.1.1 De minimis thresholds2.2.5.1.1.1 Low profits

A CFC is exempt from CFC charge if its accounting profits or assumed taxable total profits for the accounting period do not exceed 50,000 £, Section 371LB(2) and (3) of the TIOPA. The threshold is increased to 500,000 £ if the amount of those profits representing non-trading income does not exceed 50,000 £, Section 371LB(4) and (5) of the TIOPA.

The foregoing low profits thresholds are reduced proportionately if the accounting period is less than 12 months, Section 371LB(6) of the TIOPA.

A CFC's accounting profits for an accounting period are its pre-tax profits for the period, Section 371VC(2) of the TIOPA. They are determined by reference to the amounts disclosed in the CFC's financial statements for the period, if they were prepared in accordance with an acceptable accounting practice, e.g. UK GAAP or IAS, Section 371VC(3) and (6) of the TIOPA. Otherwise, the CFC's pre-tax profits for the period have to be determined by reference to the amounts which would have been disclosed had such financial statements been prepared, Section 371VC(4) and (5) of the TIOPA.

A CFC'S assumed taxable total profits for an accounting period are what, applying certain corporation tax assumptions (see "3.1.5.1.2 Corporation tax assumptions"), would be the CFC's taxable total profits for the period for corporation tax purposes, Section 371SB(1) of the TIOPA.

Now, to ensure that the low profits threshold is not exploited by fragmentation of a business's profits into multiple CFCs, each of which falls below the threshold, the exemption is not applied for a CFC's accounting period:

- ▶ where an arrangement is entered into, with at least as one of the main purposes being to secure that the exemption applies for the accounting period or for the accounting period and further accounting periods of the CFC, Section 371LC(1)(2) of the TIOPA;
- ▶ where at any time during the accounting period, the CFC's business is, at least mainly, the provision of UK intermediary services, i.e. a UK resident individual personally performs, or is under an obligation to perform, services in the UK for a person, however, not under a contract directly

between these two parties, but under an arrangement involving the CFC, Section 371LC(3)(4) of the TIOPA; or

- ▶ for a CFC that falls within the exemption by virtue of the accounting profits limits (Whiting, & Gunn, 2019, Binder 5, para. D4.413), if in determining the CFC's assumed taxable total profits for the period the group mismatch schemes have effect so as to exclude an amount from being brought into account as a debit or credit for the purposes of the loan relationships or derivative contracts, Section 371LC(5) and (6) of the TIOPA.

2.2.5.1.1.2 Low profit margin

Section 371MB(1) of the TIOPA provides a low profit margin exemption, where a CFC's accounting profits (before any deduction of interest, Section 371MB(2) of the TIOPA) for its accounting period are no more than 10 percent of its operating expenditure brought into account in determining its accounting profits for the period, excluding:

- ▶ the cost of goods purchased by the CFC, unless they are used by the CFC in its territory of residence for this period; and
- ▶ any expenditure giving directly or indirectly rise to income of a person related to it, Section 371MB(3) TIOPA.

As the low profits exemption the low profit margin exemption does not apply where an arrangement is entered into, with at least one of the main purposes being to secure that the exemption applies for the accounting period or for the accounting period and further accounting periods of the CFC, Section 371MC of the TIOPA.

2.2.5.1.2 Exemptions

2.2.5.1.2.1 Tax rate

Section 371NB(1) of the TIOPA provides a tax rate exemption, if the local tax amount is at least 75 percent of the corresponding UK tax.

The local tax amount is the amount of tax which is paid in the CFC's territory in respect of the CFC's local chargeable profits (see "3.1.5.1.1 Chargeable profits") arising in the accounting period, reduced, broadly, by any items of net income or expenditure that would not be recognized for UK corporation tax purposes in order

to put the local and UK measures of taxable profit on a more comparable basis, Section 371NB(1)(Step 2) and Section 371NC of the TIOPA (MacLachlan, 2012, para. 5.200).

The corresponding UK tax is the amount of corporation tax which, applying the corporation tax assumptions (see “3.1.5.1.2 Corporation tax assumptions”), would be charged in respect of the CFC's assumed taxable total profits for the accounting period, ignoring any double taxation relief in respect of the local tax paid by the CFC in its territory of residence, Section 371NB(1)(Step 3) and Section 371NE of the TIOPA (Whiting, & Gunn, 2019, Binder 5, para. D4.415). However, according to the latter section deductions have to be made for:

- ▶ any UK income tax or corporation tax actually charged in respect of any income included in the CFC's assumed taxable total profits; and
- ▶ any UK income tax suffered by deduction which could be set off against the corporation tax liability, unless it has been repaid (Harper, & Walton, 2017, para. 22.12).

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A. Company A has local chargeable profits of 600,000 £. Therein included is income of 50,000 £, which relates to a UK PE. Company A pays in country A 57,000 £ tax. Furthermore, company A has a PE in Country B. In country B company A pays 30,000 £ tax. The 57,000 £ tax paid in country A is net of tax relief given by country A for the tax paid in country B. Figure 30 illustrates the case at hand.

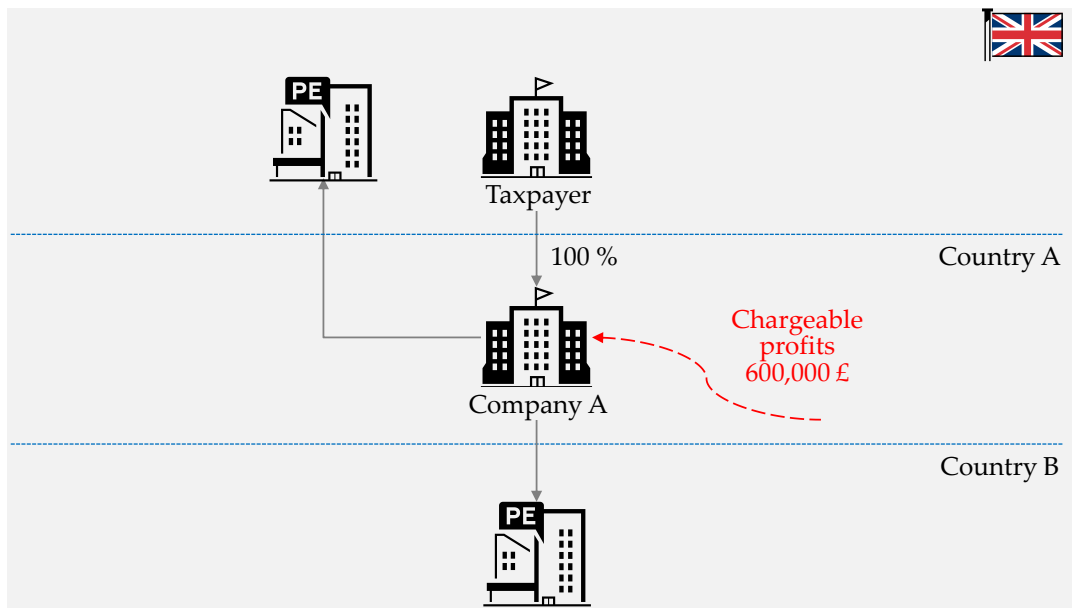


Figure 30. Illustration of the case at hand.

According to Section 371NB(1) of the TIOPA the tax rate exemption applies, if the local tax amount of 57,000 £ is at least 75 percent of the corresponding UK tax. The latter is determined as shown in Table 5.

Table 5. Calculation of 75 percent of corresponding UK tax.

UK tax on company A's chargeable profits	114,000	(600,000 £ x 19 percent)
Double tax credit (country B)	- 30,000 £	
UK tax paid on PE profits	- 9,500 £	(50,000 £ x 19 percent)
Corresponding UK tax	74,500 £	
75 percent of corresponding UK tax	55,875 £	

As the local tax amount of 57,000 £ is more than 75 percent of the corresponding UK tax (55,875 £) the tax rate exemption applies.

However, the tax rate exemption cannot apply for a CFC's accounting period:

- ▶ if no territory in which the CFC is resident for the accounting period can be determined by applying Section 371TB of the TIOPA, Section 371NB(1)(Step 1) of the TIOPA; or
- ▶ if the local tax amount for the accounting period is determined under designer rate tax provisions, Section 371NB(1)(Step 2) of the TIOPA. These are provisions which appear to the HMRC Commissioners to be

designed to enable companies to pay just the right amount of tax to fall under the tax rate exemption, and which are specified in regulations made by the HMRC Commissioners, Section 371ND(1) of the TIOPA (Whiting, & Gunn, 2019, Binder 5, para. D4.415). The provisions of Gibraltar, Guernsey, Isle of Man and Jersey have been specified as designer rate tax provisions in the Controlled Foreign Companies (Designer Rate Tax Provisions) Regulations 2000.

2.2.5.1.2.2 Exempt period

The exempt period exemption set out in Chapter 10 of Part 9A of the TIOPA provides, under certain conditions, a usually 12 months grace period to CFCs which are new joiners to the UK CFC rules (e.g. where a CFC is recently acquired by a UK resident taxpayer; MacLachlan, 2012, para. 5.173). The exempt period shall allow to analyze and restructure a CFC's affairs before the CFC rules apply (Whiting, & Gunn, 2019, Binder 5, D4.411). Upon request, it may be extended to more than 12 months by an officer of HMRC, Section 371JD(2) to (5) of the TIOPA.

The exempt period begins at any time during a CFC's accounting period, provided that:

- ▶ the CFC carries on a business immediately before its exempt period begins, or, if it is newly incorporated or formed to control one or more companies, where the exempt period is expected to apply at least to one of them (initial condition), Section 371JC(1)(a) and (2) of the TIOPA;
- ▶ without the exempt period exemption there would be at least one chargeable company (see "3.2.5.1.3 Chargeable company") liable to the CFC charge (charging condition), Section 371JC(1)(b) and (4) of the TIOPA (Whiting, & Gunn, 2019, Binder 5, para. D4.411); and
- ▶ the aforementioned condition was not met at any time during the 12 months preceding the begin of the CFC's exempt period, Section 371JC(1)(c) and (5) of the TIOPA.

The exempt period exemption applies for a CFC's accounting period, if:

- ▶ the accounting period ends during an exempt period of the CFC, Section 371JB(1)(a) of the TIOPA;

- ▶ the CFC does not cease to be a CFC during its first accounting period after the end of the exempt period and no CFC charge applies in relation to the accounting period (subsequent period condition), Section 371JB(1)(b)(2) of the TIOPA; and
- ▶ at all times during the exempt period and the subsequent period the abovementioned charging condition has to be met and each chargeable company must either be an original chargeable company or one which is connected with it (chargeable company condition; MacLachlan, 2012, para. 5.179). The following example illustrates how the chargeable company condition works.

Example

On 1 January 2018 a resident taxpayer, a production company, buys all ownership interests in company A, a trading company, resident in country A, a low tax jurisdiction. The accounting periods of the resident taxpayer and company A begin on 1 January and end on 31 December. The resident taxpayer restructures the group to ensure that no profits of company A pass through the CFC gateways. On 31 December 2018 the restructuring is completed. On 31 March 2019 the resident taxpayer is acquired by a competitor. The latter is only interested in the production company and instructs the resident taxpayer to sell its ownership interests in company A to a third party. The sale takes place on 30 September 2019. Figure 31 illustrates the case at hand.

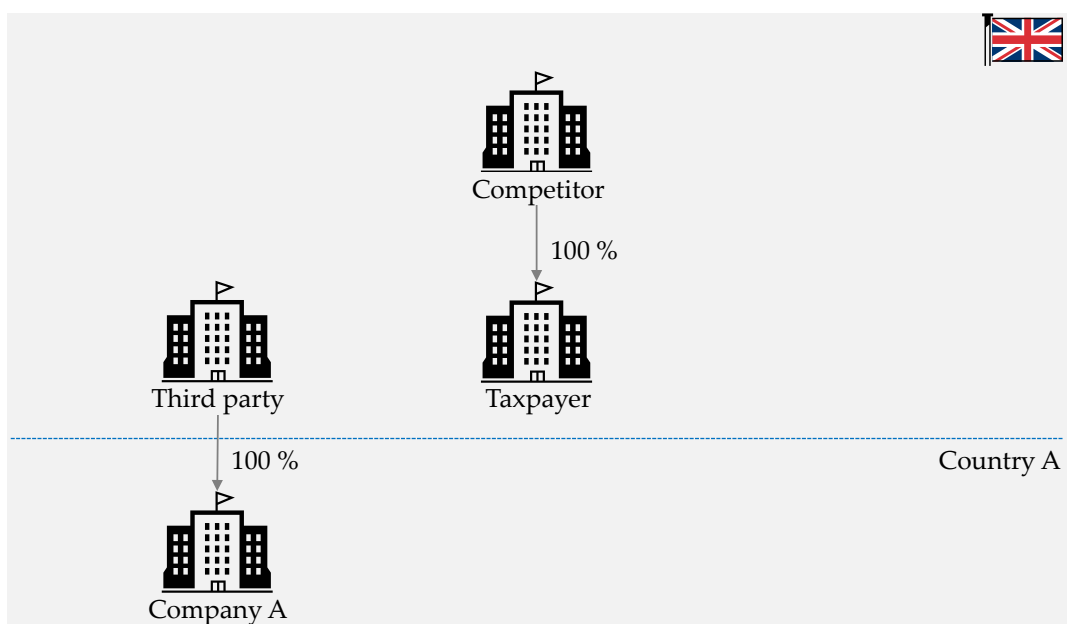


Figure 31. Illustration of the case at hand.

The resident taxpayer is a chargeable company for the exempt period, however, not throughout the whole subsequent period, as company A is sold on 30 September 2019 to the third party. Consequently, the chargeable company condition is not met. Reducing the length of the subsequent period should not lead to a different result, as the exempt period exemption is subject to Section 371JF of the TIOPA.

Section 371JF of the TIOPA contains anti-avoidance rules. Thereunder, the exempt period exemption does not apply to a CFC's accounting period, provided that:

- ▶ an arrangement is entered into, with at least one of the main purposes being to secure a tax advantage under this exemption for this and possibly further accounting periods of the CFC, and the arrangement involves the CFC holding income-producing monetary assets or IP (MacLachlan, 2012, para. 5.181); or
- ▶ an arrangement is entered into, reducing the length of any accounting period (e.g. the first accounting period after the end of the exempt period) of the CFC to less than 12 months, with at least one of the main purposes being to secure that this exemption applies for this and possibly further accounting periods of the CFC.

2.2.5.1.2.3 Excluded territories

Chapter 11 of Part 9A of the TIOPA sets out an excluded territories exemption. It shall avoid the application of the CFC rules to CFCs posing a low risk to the UK tax base, as they are resident in countries with corporate tax rates comparable to the UK corporation tax rate and meet certain further Exchequer protection requirements (MacLachlan, 2012, para. 5182). In concrete, the excluded territories exemption applies for a CFC's accounting period, provided that:

- ▶ The CFC is resident in terms of Section 371KC of the TIOPA in an excluded territory for the accounting period, Section 371KB(1)(a) of the TIOPA. The numerous excluded territories listed in Part 1 of the Schedule of the Controlled Foreign Companies (Excluded Territories) Regulations 2012 are the following:

Excluded territories

Afghanistan, Algeria, Angola, Argentina, Armenia, Aruba, Australia, Austria, Azerbaijan, Bangladesh, Barbados, Belarus, Belgium, Belize, Benin, Bolivia, Botswana, Brazil, Brunei, Burundi, Cameroon, Canada, China, Colombia, Croatia, Cuba, Czech Republic, Democratic Republic of the Congo, Denmark, Dominican Republic, Ecuador, Egypt, El Salvador, Falkland Islands, Faroe Islands, Fiji, Finland, France, Gabon, Gambia, Germany, Ghana, Greece, Guyana, Honduras, Iceland, India, Indonesia, Iran, Israel, Italy, Ivory Coast, Jamaica, Japan, Kenya, Lesotho, Libya, Luxembourg, Malawi, Malaysia, Malta, Mexico, Monaco, Morocco, Namibia, The Netherlands, New Zealand, Nigeria, Norway, Pakistan, Panama, Papua New Guinea, Peru, Philippines, Poland, Portugal, Puerto Rico, Republic of Korea, Russia, Saudi Arabia, Senegal, Sierra Leone, Slovakia, Slovenia, Solomon Islands, South Africa, Spain, Sri Lanka, Swaziland, Sweden, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Turkey, Uganda, Ukraine, United States of America, Uruguay, Venezuela, Vietnam, Zambia and Zimbabwe.

- ▶ The bad income threshold condition (MacLachlan, 2012, para. 5.187) is met, i.e. the total of a CFC's category A, B, C and D income (as defined below) for the accounting period is no more than 10 percent of the CFC's accounting profits (see "2.2.5.1.1.1 Low profits") for the accounting period, or, if more, 50,000 £ (reduced proportionately for accounting

periods of less than 12 months), Sections 371KB(1)(b) and 371KD(1) and (2) of the TIOPA;

- ▶ The IP condition (as defined below) is met, Section 371KB(1)(c) of the TIOPA; and
- ▶ The CFC is not, at any time during the accounting period, involved in an arrangement with at least one of the main purposes of which is to obtain a tax advantage for any person, Section 371KB(1)(d) of the TIOPA.

A CFC's category A income for an accounting period consists of any gross amount of income, so far as it is:

- ▶ exempt from tax in the CFC's territory (apart from any distribution of a company), Section 371KE(3) of the TIOPA;
- ▶ subject to a reduced tax rate in the CFC's territory by virtue of an investment incentive (e.g. tax holiday), Section 371KE(4) of the TIOPA; or
- ▶ taxed in the CFC's territory, but subject to certain tax repayment schemes, Section 371KE(5) of the TIOPA.

Does a CFC have category A income arising from a PE in another excluded territory, it must also be taken into account in determining whether or not the CFC meets the bad income threshold condition, Section 371KF of the TIOPA (MacLachlan, 2012, para. 5.188).

A CFC's category B income for an accounting period consists of any notional interest which is deducted from any of the CFC's non-trading income under the law of the CFC's or its PE's territory (e.g. Belgium; MacLachlan, 2012, para. 5.187; Schönfeld, 2017a, p. 949) so that the aforementioned income is effectively subject to a reduced tax rate, and where that deduction would not be available for UK corporation tax purposes, Section 371KG(1) of the TIOPA (Harper, & Walton, 2017, para. 22.9).

A CFC's category C income for an accounting period means amounts from a settlement in relation to which the CFC is a settlor or beneficiary and the CFC's share of income of a partnership of which the CFC is a partner, Sections 371KH and 371VD(4) of the TIOPA.

A CFC's category D income for an accounting period means income from transactions between the CFC and any company connected to it that is reduced in the CFC's territory according to the local transfer pricing rules without any

corresponding increase in any other territory so that the income is effectively subject to a reduced tax rate, Section 371KI(2) of the TIOPA (Whiting, & Gunn, 2019, Binder 5, para. D4.412). Furthermore, a CFC has Category D income so far as the tax which falls to be paid in respect of the income in the CFC's territory is reduced due to a decision or an arrangement made in relation to the CFC by a governmental authority in this territory, Section 371KI(4) of the TIOPA.

Should income fall under various of the aforementioned categories, it is only considered once in determining whether or not the CFC meets the bad income threshold condition, Section 371KB(4) of the TIOPA.

The IP condition is set out in Section 371KJ of the TIOPA. According to its Paragraph 2 the IP condition is met, unless:

- ▶ The CFC's assumed total profits for the accounting period include amounts arising from its IP;
- ▶ At least parts of the aforementioned IP were either transferred to the CFC by a UK related person or otherwise derived out of or from IP held by a UK related person. Only transfers or other derivations which occurred during the accounting period and the six previous years are considered; and
- ▶ The transfer or other derivation led to a significant reduction of the value of the IP held by the UK related person.

If only parts of the CFC's IP were so transferred or otherwise derived, they have to make up a significant part of the CFC's IP, or generate profits for the CFC that are significantly higher than what they would otherwise have been, Section 371KJ(2)(d) and (3) of the TIOPA. IP in terms of the IP condition is according to Section 371VA of the TIOPA any patent, trademark, registered design, copyright, design right or any license or other right in relation to the foregoing. In essence, the IP has to be capable of being legally owned or controlled as opposed to some broader concept of economic intangibles (MacLachlan, 2012, para. 5.189).

Regulation 4 of the Controlled Foreign Companies (Excluded Territories) Regulations 2012 provides a simplified excluded territories exemption. Thereunder, the requirements of Section 371KB(1)(b) and (c) of the TIOPA (bad income threshold and IP condition) do not have to be met, if the CFC is resident in Australia, Canada, France, Germany, Japan or the United States of America, unless

the CFC's business is carried on through a foreign PE at any time during the accounting period (Harper, & Walton, 2017, para. 22.9).

2.2.5.2. *Issues*

2.2.5.2.1 Low profit margin

Broadly, where a CFC's accounting profits do not exceed 10 percent of its operating expenditure for an accounting period, the low profit margin exemption applies, Section 371MB of the TIOPA. This can be a useful exemption for CFCs that perform routine functions, utilize minimal business assets, and bear only minor risks. Such CFCs usually incur no losses, but rather realize small but relatively stable profits (BMF, 2005). However, excluding any expenditure giving directly or indirectly rise to income of a person related to it, Section 371MB(3) TIOPA, limits the scope of the low profit margin in practice (Whiting, & Gunn, 2019, Binder 5, para. D4.414).

2.2.5.2.2 Exempt period

The exempt period exemption may prove to be of limited assistance, especially because (Delaney, & Murray, 2012, para. 6.1):

- ▶ It lasts only 12 months, Section 371JD(1) of the TIOPA. As a practical matter, in the context of an acquisition of a foreign company or group, a CFC review is ideally part of the foregoing due diligence process. Otherwise the acquirer will have to do or complete the CFC review throughout the exempt period, thus abbreviating the time to make any necessary changes (Whiting, & Gunn, 2019, Binder 5, para. D4.411); and
- ▶ The subsequent period condition has to be met (see "2.2.5.1.2.2 Exempt period"), Section 371JB(2) of the TIOPA, i.e. the exempt period exemption does not apply to a CFC's accounting period if the CFC is sold or ceases to carry on business before having at least one accounting period which begins after the end of the exempt period (Whiting, & Gunn, 2019, Binder 5, para. D4.411).

2.2.5.2.3 Excluded territories

According to Section 371KB(1)(d) of the TIOPA the excluded territories exemption applies for a CFC’s accounting period only if the CFC is not, at any time throughout the period, involved in an arrangement with at least one of the main purposes being to obtain a tax advantage for any person. The broad draft of the foregoing anti-avoidance section could in some cases result in uncertainty as to whether the excluded territories exemption is applicable (MacLachlan, 2012, para. 5.190).

2.2.5.3. *Structurings*

2.2.5.3.1 Low profits

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. The resident taxpayer shifts income to company A. As a result company A’s accounting profits/assumed taxable total profits for the period accounting period amount to 475,000 £, thereof 45,000 £ representing non-trading income. Figure 32 illustrates the case at hand.

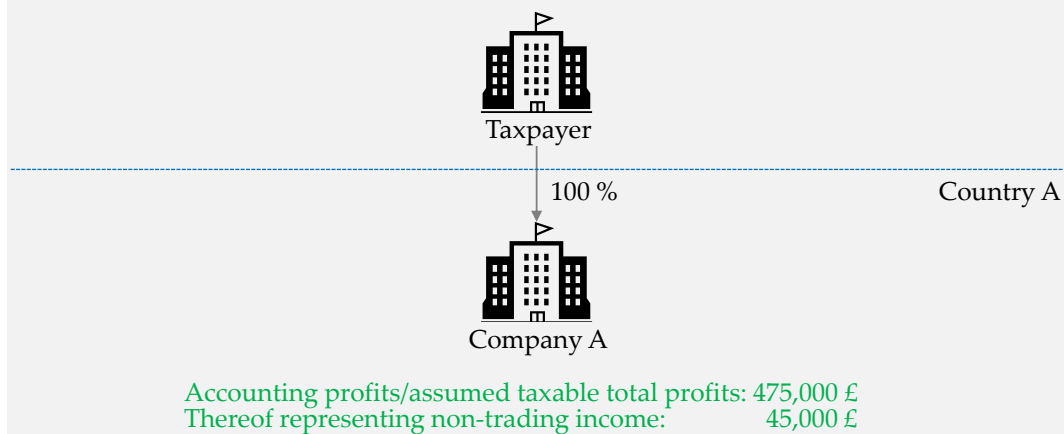


Figure 32. Illustration of the case at hand.

According to Section 371LB of the TIOPA the CFC is exempt from CFC charge as its accounting profits/assumed taxable total profits for the accounting period do not exceed 500,000 £ and no more than 50,000 £ thereof represent non-trading income. Section 371LC of the TIOPA (anti-avoidance) is not applicable as it shall

avoid that the low profits threshold is exploited by fragmentation of a business's profits into multiple CFCs, each of which falls below the threshold. However, exploiting the threshold with a single CFC is possible and may be attractive for smaller companies.

2.2.5.3.2 Acceptable accounting practice

For the purposes of applying the low profits threshold, the low profit margin threshold and the excluded territories exemption, it may be necessary to compute the CFC's accounting profits for an accounting period (MacLachlan, 2012, para. 5.54). These are the CFC's pre-tax profits per the financial statements, if they have been prepared in accordance with an acceptable accounting practice, Section 371VC(2) and (3) of the TIOPA (Harper, & Walton, 2017, para. 22.10). According to paragraph 6 of the latter section, acceptable accounting practices are:

- ▶ International accounting standards;
- ▶ UK generally accepted accounting practice; and
- ▶ Accounting practice which is generally accepted in the territory in which the CFC is resident for the accounting period.

This allows structurings such as the following.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. The resident taxpayer shifts income to company A. As a result company A's accounting profits for its accounting period are 1,000,000 £. These are its pre-tax profits per the financial statements prepared in accordance with the generally accepted accounting practice in country A. According to both, international accounting standards and UK generally accepted accounting practice, the pre-tax profits and therewith company A's accounting profits would have been 1,500,000 £. The operating expenditure brought into account in determining company A's accounting profits is in any case 12,000,000 £. Figure 33 illustrates the case at hand.

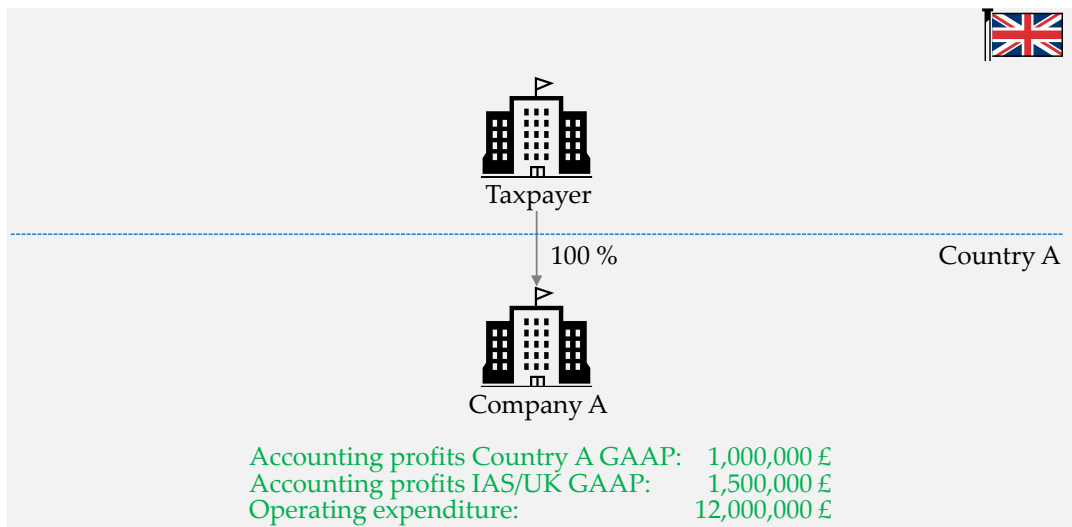


Figure 33. Illustration of the case at hand.

The low profit margin provided in Section 371MB of the TIOPA applies, as company A's accounting profits for its accounting period (1,000,000 £) are no more than 10 percent of its operating expenditure (12,000,000 £) brought into account in determining these profits. That this would be different according to international accounting standards and UK generally accepted accounting practice (1,500,000 £ / 12,000,000 £ > 10 percent) is not relevant. This allows structurings in jurisdictions with favorable generally accepted accounting practices. Section 371MC of the TIOPA (anti-avoidance) is not applicable as computing the pre-tax profits per the financial statements prepared in accordance with the generally accepted accounting practice in country A is not an arrangement entered into, with at least one of the main purposes being to secure that the low profit margin exemption applies.

2.2.5.4. ATAD compliance

The ATAD allows only two types of CFC exemptions and threshold requirements, namely a de minimis threshold and a tax rate exemption.

Where a member state uses, as recommended below (see "2.3.6 Recommendation") a negative list (see "2.3.2.1.1 Negative list") to determine the tax base of a taxpayer, the member state may opt according to Article 7(3) of the ATAD not to treat an entity or PE as a CFC, if no more than one third of its income is passive income or, in case of financial undertakings, if no more than one third of

its passive income derives from transactions with the taxpayer or its associated enterprises. In contrast under the UK CFC rules the low profits threshold is a fixed amount. According to Section 371LB of the TIOPA a CFC's accounting profits or assumed taxable total profits for the accounting period may not exceed:

- ▶ 50,000 £; or
- ▶ 500,000 £ if the amount of those profits representing non-trading income does not exceed 50,000 £.

This may be ATAD non-compliant.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A has an income/accounting profits of 450,000 £, thereof 50,000 £ representing non-trading income. The passive income included in company A's income is 200,000 £. Figure 34 illustrates the case at hand.

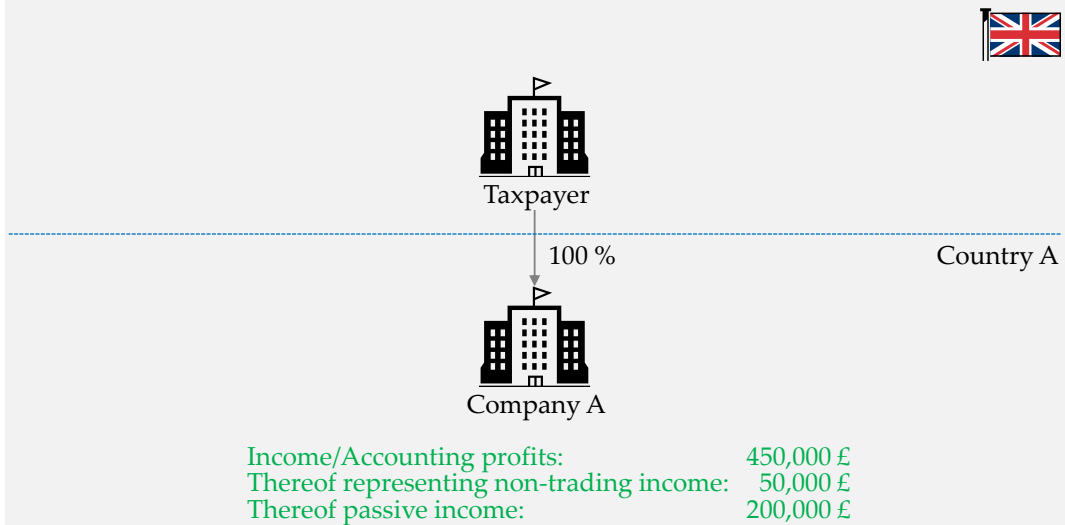


Figure 34. Illustration of the case at hand.

According to Article 7(3) of the ATAD the de minimis threshold is 150,000 £ (450,000 £ / 3). The passive income (200,000 £) exceeds this threshold. According to Section 371LB of the TIOPA the de minimis threshold is 500,000 £, as no more than 50,000 £ of company A's accounting profits represent non-trading income (exactly 50,000 £). As the accounting profits amount to 450,000 £, the de minimis threshold is met.

According to Article 7(1)(b) of the ATAD the tax rate exemption applies, if the actual corporate tax paid by the CFC on its profits is at least 50 percent of the corporate tax as computed according to the rules of the member state of the taxpayer. Considering that the rationale behind Articles 7 and 8 of the ATAD is to avoid that passive income is shifted into low tax jurisdictions, Article 7(1)(b) of the ATAD should be interpreted to look at the actual corporate tax paid on the passive income, not on the profits from active and passive income (see “2.2.2.2 Tax rate exemption”). In light of this interpretation, the UK tax rate exemption is ATAD compliant, as it goes beyond the ATAD minimum standard.

The low profit margin, the exempt period exemption and the exempt territory exemption are not in line with the ATAD.

2.2.6. Recommendation

As indicated above, de minimis thresholds and exemptions may help to avoid that entities, which are not likely to be employed for BEPS, fall under CFC rules, making these rules more targeted and effective as well as reducing the administrative burden. However, applying a tax rate exemption may be an extremely compliance heavy process. A more pragmatic approach is the de minimis threshold. Therefore, the recommendation is to avail of both aforementioned possibilities included in the ATAD, as detailed in the following. De minimis thresholds and exemptions that are not ATAD compliant (see “2.2.5.4 ATAD compliance”) are not considered.

2.2.6.1. De minimis threshold

According to Article 7(3) of the ATAD member states using a negative list – as recommended below (see “2.3.6 Recommendation”) – to determine the tax base of a taxpayer, may opt not to treat an entity or PE as a CFC, if no more than 33.33 percent of its total income is passive income. Special rules are provided for financial undertakings. As shown under “2.2.5.4 ATAD compliance” for the UK CFC rules the de minimis threshold may not only be a fixed amount. It has to be a percentage of the CFC’s total income. The Spanish CFC rules fix the percentage at 15 percent, Article 91(5) of the IRPF and Article 100(5) of the LIS, the German CFC rules at 10 percent, Paragraph 9 of the AStG. As indicated under “2.2.4.3.1 De minimis

threshold” defining the de minimis threshold exclusively as a percentage of the CFC’s total income allows to shift significant amounts of income to CFCs in low tax jurisdictions, exploiting the de minimis threshold. Now, to avoid such exploitation, passive income should only be disregarded if – in addition – the total amount to be disregarded by a CFC/by a resident taxpayer under the de minimis threshold does not exceed a certain amount.

In order to ensure that only CFCs with an overall active character are not subject to CFC taxation, it does not seem adequate to fix the de minimis threshold as under Article 7(3) of the ATAD to no more than 33.33 percent of the CFC’s total income. On the other hand fixing the de minimis threshold as under Paragraph 9 of the AStG to no more than 10 percent of the CFC’s total gross revenue may limit its practical relevance. The Spanish de minimis threshold seems to strike with 15 percent a good balance between the foregoing percentages (Wenzel, 2017, p. 438). As provided above, to avoid structurings exploiting the de minimis threshold, a further requirement should be that the total amount to be disregarded by a CFC/by a resident taxpayer under the de minimis threshold does not exceed a certain amount. Fixing the latter at 80,000 € as under Paragraph 9 of the AStG has proven to limit severely the German de minimis threshold in practice (Moser, & Beck, 2013, p. 2300). Preferable seems the approach of the UK CFC rules, which provides different fix amounts depending on the type of income, Section 371LB of the TIOPA. Considering that especially dividends, interests, insurance income, royalties, IP (Haase, 2017a, p. I) income and sales and service income are geographically mobile (OECD, 2015c, para. 77) and thus may easily be shifted to CFCs in low tax jurisdictions, the fix amount for such geographically mobile income should be lower than for other passive income. The fix amount for the aforementioned geographically mobile income might be increased slightly from 80,000 € to 100,000 €. Where the foregoing condition is met, the fix amount for all passive income might be set at 600,000 €, i.e. slightly higher than under Section 371LB of the TIOPA (500,000 £).

2.2.6.2. *Tax rate exemption*

As a minimum standard, the ATAD requires under Article 7(1)(b) that the actual corporate tax paid by the entity or PE on its passive¹⁶ income is at least 50 percent of the corporate tax as computed according to the rules of the member state of the taxpayer. Both, the Spanish and the UK CFC rules fix the percentage at 75 percent, Article 91(1)(b) of the IRPF, Article 100(1)(b) of the LIS and Section 371NB(1) of the TIOPA. Whereas the ATAD, the Spanish and the UK CFC rules determine the low level of taxation as a percentage of the tax as computed according to the rules of the respective parent country, the German CFC rules fix the low level of taxation at less than 25 percent of the tax base as computed according to the German rules, Paragraph 8(3) of the AStG.

Basically, both approaches may limit the scope of CFC rules to companies established in low-tax jurisdictions, i.e. to companies that are more likely to be employed for profit shifting than companies in high- or medium-tax jurisdictions. However, the German low level of taxation of less than 25 percent of the tax base as computed according to the German rules may be adequate if the resident taxpayer is an individual, but not for corporate entities, as their tax burden may be lower, equal or at least not significantly higher than the low level of taxation, depending on the applicable trade tax rate (see “2.2.3.2.2.1 Low level of taxation”). Furthermore, as also shown under “2.2.3.2.2.1 Low level of taxation”, the gap between the statutory corporate tax rate of 15 percent, Paragraph 23(1) of the KStG, and the low level of taxation of less than 25 percent of the tax base as computed according to the German rules, may result in an overtaxation, which may infringe the free movement of capital. Hence, the recommendation is, to use separate low levels of taxation for individuals and corporate entities. Each low level of taxation should be a percentage (Jacobsen, 2018, p. 439) of the income/corporate tax as computed according to the parent country’s rules (including the trade tax rate) and not a fix percentage (e.g. 7.5 percent (Haase, 2017d; Scheffler, 2017) or 15 percent (Dehne, 2018, p. 138; Wissenschaftlichen Beirat Steuern der Ernst & Young GmbH, 2013, p. 554) of the tax base as computed according to the parent country’s rules. This allows to consider progressive tax rates for individuals as well as the various trade tax rates. Please note that in case of individuals the percentage of the tax as

¹⁶ See “2.2.2.2 Tax rate exemption”.

computed according to the parent country's rules should not look at the corporate tax as under the current Spanish CFC rules (see "2.2.4.3.2 Tax rate exemption"), but at the income tax. The minimum percentage of the tax as computed according to the respective parent country's rules required for the tax rate exemption to apply, should be fixed as under the Spanish and the UK CFC rules at 75 percent. In both countries the tax rate exemption does not seem to be exploited for structurings. This might, however, be different, if the foregoing percentage was lowered to 50 percent as possible under the ATAD.

If the foregoing recommendation is applied to determine a low level of taxation, the latter may also be the result of different tax bases considered in both jurisdictions, e.g. due to special investment schemes, different capitalization/depreciation rules or recognition of revenue in different periods. As a result there might be a low level of taxation in some years, whereas the level is exceeded in other years. To avoid such volatility one might consider to determine the low level of taxation as an average of various years. However, it is questionable whether this would be in line with Article 7(1)(b) of the ATAD.

Example

A Spanish resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A. The corporate tax rate in Spain is 25 percent, in country A 21 percent. Company A holds an asset (initial book value 100) that is depreciated over 5 years in country A. In Spain such asset would have to be depreciated over 10 years. Company A's income before the depreciation is in each year 100. Figure 35 illustrates the case at hand.

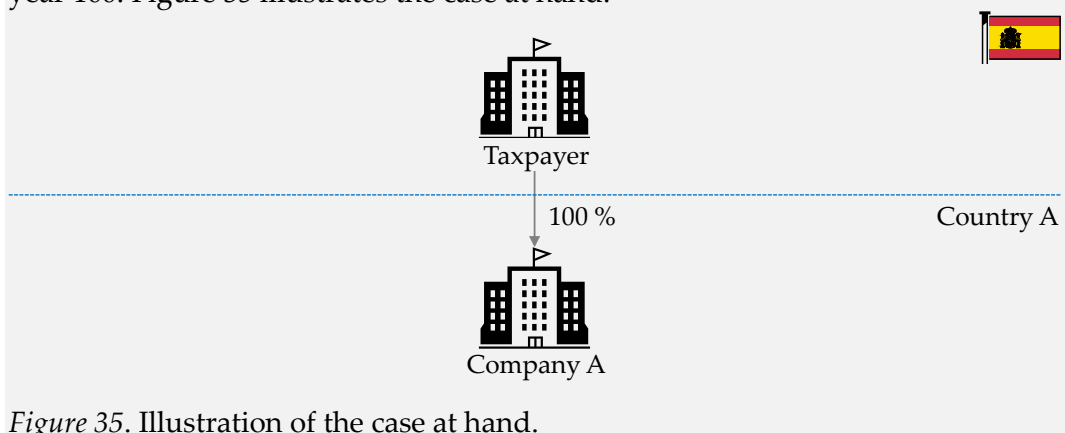


Figure 35. Illustration of the case at hand.

Over ten years the level of taxation is 84 percent (189/225), as can be derived from Table 6.

Table 6. Level of taxation.

Year	Country A				Spain			
	Asset	Depreciation	Taxable income	Tax	Asset	Depreciation	Taxable income	Tax
1	100	20	80	16.8	100	10	90	22.5
2	80	20	80	16.8	90	10	90	22.5
3	60	20	80	16.8	80	10	90	22.5
4	40	20	80	16.8	70	10	90	22.5
5	20	20	80	16.8	60	10	90	22.5
6	0	0	100	21	50	10	90	22.5
7	0	0	100	21	40	10	90	22.5
8	0	0	100	21	30	10	90	22.5
9	0	0	100	21	20	10	90	22.5
10	0	0	100	21	10	10	90	22.5
Total			900	189			900	225
Rate				21 %				25 %

However, looking at the first five years the level of taxation is only 74.67 percent. The tax rate exemption is not applicable as the tax for these years is less than 75 percent of the tax that would have been applicable according to the Spanish corporate tax rules, Article 100(1)(b) of the LIS.

Although computing the CFC's passive income applying the German tax law analogously may be overburdensome under the current German CFC rules (see "2.2.3.2.2.2 Calculation of passive income"), there is no real alternative. Applying instead an international accounting standard analogously would not lower the burden, and a calculation according to the CFC jurisdiction would result in the statutory tax rate. Furthermore, changing the level of control as recommended under "2.1.6.2.2 Level" would reduce notably the resident taxpayers affected by the burden.

Last but not least, the German anti avoidance rules as detailed above (see “2.2.3.1.2 Tax rate exemption”) avoid effectively that the tax rate exemption is exploited so that the recommendation is to stick with these rules.

2.3. DEFINITION OF CFC INCOME

2.3.1. BEPS

The OECD/G20 recommend to define CFC income to ensure that it covers income earned by a CFC that is of the type that raises BEPS concerns. Therefore, the OECD/G20 provide a non-exhaustive list of possible approaches, which might be combined with each other, as detailed in the following.

2.3.1.1. *Categorical analysis*

According to the OECD/G20 existing CFC rules focus on a variety of factors, e.g. whether income is geographically mobile, whether income was generated from or with the assistance of related parties, the source of income or the CFC’s level of activity (OECD, 2015c, paras. 73, 74).

Geographically mobile income comprises especially dividends, interests, insurance income, royalties and IP income as well as sales and service income (OECD, 2015c, paras. 77, 78):

- ▶ Dividends could be used to shift income not derived from any underlying activity into a CFC. This is however not the case if dividends are paid out active income of an affiliate, if dividends would have been exempted in the parent jurisdiction had they been earned by the parent company or if the CFC deals in securities and the dividends are linked to the CFC’s trade or business;
- ▶ Interests and financing income is easy to shift and raises BEPS concerns especially when it is earned from related parties, when the CFC is overcapitalized (unless such capitalization is required by capitalization rules), the underlying activities are located outside the CFC jurisdiction, or when the income is not a result of an active financing business;
- ▶ Insurance income may be separated from the jurisdictions where the risks arise into low-tax jurisdictions. Indicators for BEPS are particularly if a

CFC is overcapitalized compared to similar companies, if policy holder, annuitant, beneficiary or risks ensured are outside the CFC jurisdiction, or if the underlying insurance contract or policy is concluded with a related party, especially if the latter may deduct the insurance premium. However, no BEPS concerns arise in case of regulated insurance companies, given the severe regulatory environment;

- ▶ Income from IP assets (royalties and IP income, including income from digital goods and services) can easily be diverted from the place of value creation and thus raises BEPS concerns. Challenging for CFC rules is that IP assets can be exploited and distributed in various forms, they are usually hard to value given the lack of comparables, and IP income can often not be separated from income derived from associated products or services. In light of the above, the OECD/G20 trust that existing CFC rules are often not sufficient, as many of them only treat royalties as attributable;
- ▶ Sales and service income is usually derived from activity in the CFC and therefore commonly excluded from the definition of CFC income. Such income may, however, raise BEPS concerns, if it is paid for goods or services purchased by a CFC from a related party without adding (hardly) any value, or if IP is shifted into a CFC, to which the latter adds (hardly) any value and benefits afterwards from the common exclusion of sales and service income.

Instead of focusing on whether income is geographically mobile, some jurisdictions test whether income is generated from or with the assistance of related parties or combine both approaches, as between related parties it is easier and more likely to shift profits. However, the necessary level of involvement of related parties differs in these jurisdictions (OECD, 2015c, para. 79).

As income derived from activities in the respective CFC jurisdiction raises less BEPS concerns than income earned from other jurisdictions, some jurisdictions focus on the source of income. To prevent stripping of the parent jurisdiction's base, income derived from sales to parties, services or investments in the parent jurisdiction is deemed CFC income. To prevent also foreign-to-foreign stripping, income derived from sales to parties, services or investments in any other than the CFC jurisdiction might be deemed CFC income. Another approach would be to

exclude geographically mobile income from the CFC income if it was earned from activities in the CFC jurisdiction (OECD, 2015c, para. 80).

2.3.1.2. *Substance analysis*

A substance analysis looks to whether a CFC was able to earn its income itself, using a variety of proxies, such as people, premises, assets and risks (OECD, 2015c, para. 81).

It can apply either as an all-or-nothing or a proportionate approach. Under the first approach a certain level of substance allows to exclude all income of the CFC, otherwise, all income is included. However, the OECD/G20 prefer the second (proportionate) approach, which they trust is also more likely to comply with EU law. Under the proportionate approach is identified through certain proxies such as the aforementioned in how far the CFC was able to earn its income itself (e.g. 75 percent) and only the residual percentage (25 percent) of the CFC's income is treated as CFC income. The proportionate approach shall also prevent that just the right type and amount of substance is assigned to a CFC in order to benefit from the all-or-nothing approach (OECD, 2015c, para. 82).

As a substance analysis is a rather qualitative measure, it tends to be more accurate than mechanical measures, but also increases administrative and compliance burdens. To limit these burdens, substance analysis could be applied only to certain types of income, as an all-or-nothing test, or be based on rather objective proxies such as expenditure (OECD, 2015c, paras. 83, 84).

The OECD/G20 provide the following non-exhaustive options to design a substance analysis (OECD, 2015c, para. 85):

- ▶ Analyzing whether the CFC's employees made a substantial contribution to the CFC's income;
- ▶ Determining in light of the significant functions assumed by group entities whether the CFC would most likely own/assume particular assets/risks if the entities were unrelated;
- ▶ Looking at whether the CFC counted with the required business premises and establishment in the CFC jurisdiction to actually earn its income, as well as with sufficient skilled employees to assume most of the CFC's key functions; or

- ▶ Excluding income that fulfils the requirements set out by the nexus approach (OECD, 2015b, paras. 23. et seq.; Weigel, & Schega, 2018, p. 670) from CFC income, while considering other income from qualifying IP assets as defined by the approach as CFC income.

2.3.1.3. *Excess profits analysis*

A further approach developed by the OECD/G20 is the excess profit analysis. Thereunder income earned by a CFC in a low tax jurisdiction, is deemed CFC income so far as it exceeds a normal return. The latter is calculated by multiplying a risk-free rate of return plus a premium reflecting the risk associated with the equity investment (rate of return) with the equity invested in assets used for the active conduct of the CFC's trade or business (eligible equity; OECD, 2015, paras. 87, 89, 90). Hence, the CFC income can be calculated according to the following formula:

Formula

$$\text{CFC income} = \text{CFC's income} - \text{rate of return} \times \text{eligible equity}$$

The excess profits analysis may especially prove helpful in the context of IP, as the following example, which is based on OECD (2015c, paras. 92, 93), shows:

Example

Company A, resident in country A, holds 100 percent of the ownership interests in company B, resident in country B, a low tax jurisdiction. Company B produces and sells product P in country B. Therefore it avails of IP purchased in fiscal year 1 at 800,000 from company A. In the same year company B invested 600,000 in its production facilities. Company B's profits from sales of product P in fiscal year 2 amount to 500,000. The rate of return shall be 10 percent. Figure 36 illustrates the case at hand.

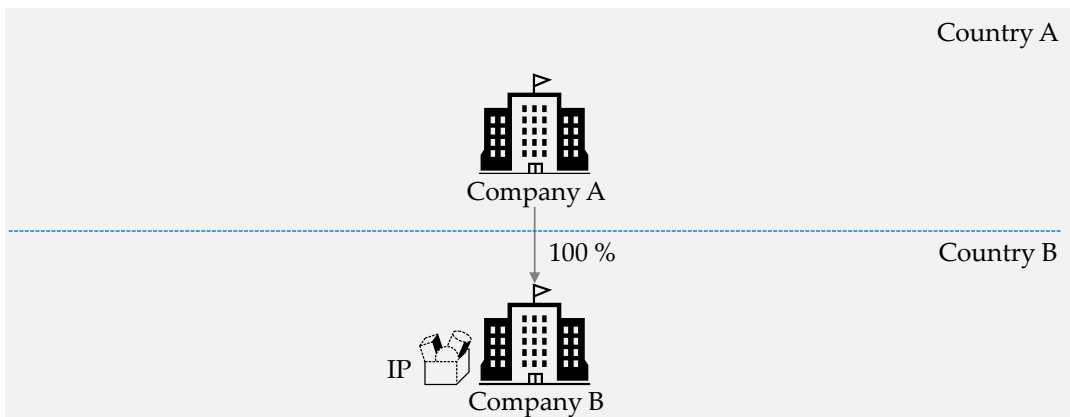


Figure 36. Illustration of the case at hand.

According to the above provided formula the CFC income is calculated as follows:

$$360,000 = 500,000 - 10 \text{ percent} \times (800,000 + 600,000)$$

Generally company B cannot expect to earn a profit in excess of the normal return from simply producing and selling, unless the foregoing activities involve the use of IP (OECD, 2015c, para. 87). The excess return, i.e. the CFC income of 360,000, shall reflect the use of IP in this example.

The excess profit analysis may be combined with other approaches, such as the relatedness of parties.

Questionable is whether the excess profit analysis targets shifted income with sufficient accuracy. Besides, quantifying the normal return is challenging (OECD, 2015c, para. 94).

2.3.1.4. Transactional and entity approaches

Regardless of how CFC income is defined, jurisdictions have to decide, whether they apply an entity-by-entity or a transactional approach. The first approach is an all-or-none approach, i.e. if more than 50 percent of the CFC's income falls under the definition of CFC income, all income is attributed, otherwise none. Instead the transactional approach focuses on each stream of income and determines whether it is attributable or not. Whereas the transactional approach is more targeted than the entity approach, which may be either over- or under-inclusive and therefore possibly more consistent with both, EU law and the aims of

the BEPS project, the transactional approach may increase administrative burdens and compliance costs (OECD, 2015c, paras. 95-97).

2.3.2. ATAD

2.3.2.1. CFC income

According to Article 7(2) of the ATAD each member state may choose between two alternative minimum standards (Böhmer, Gebhardt, & Krüger, 2018, p. 849), a negative list and a principal purpose test, to define CFC income (Linn, 2016, pp. 646, 647).

2.3.2.1.1 Negative list

The first alternative is provided under Article 7(2)(a) of the ATAD, which establishes that non-distributed income from the following categories is CFC income:

- ▶ Financial assets (in particular interests). According to an opinion in the German tax literature (Becker, & Loose, 2018b; Schnitger et al, 2016, p. 967) financial assets shall only comprise fixed assets, but not current assets. The opinion is based on the German translation of Article 7(2)(a)(i) of the ATAD. Therein the term financial assets is translated as [Finanzanlagevermögen], i.e. financial fixed assets. However, from my point of view this is a mere translation error;
- ▶ IP (especially royalties);
- ▶ Profits distributions;
- ▶ Disposal of shares;
- ▶ Financial leasing. It may therefore be inferred, a contrario sensu, that income from operating leasing is not CFC income (Schnitger et al, 2016, p. 968);
- ▶ Financial activities (exceeding mere asset management (Schnitger et al, 2016, p. 968), e.g. insurance and banking); and
- ▶ Invoicing companies, i.e. companies that earn sales and services income from goods and services purchased from and sold to associated enterprises without adding (hardly) any economic value (e.g. low risk distributors; Schnitger et al, 2016, p. 969). Please note that the German

translation defines invoicing companies as companies that earn sales and services income from goods and services purchased from or sold to associated enterprises without adding (hardly) any economic value. Again, this should be a mere translation error (Becker, & Schmelz, 2017, pp. 802, 803).

2.3.2.1.2 Principal purpose test

According to the second alternative CFC income is the non-distributed income arising from non-genuine arrangements entered into with the main purpose to obtain a tax advantage, Article 7(2)(b) of the ATAD. A non-genuine arrangement is an arrangement so far as a CFC would not own/assume the assets/risks which generate at least part of its income, if it were not controlled by a company, where the significant people functions, which are relevant to those assets/risks, are carried out and are crucial in generating the CFC's income, Article 7(2)(b)(2) of the ATAD.

2.3.2.2. *Activity clause*

Even if income earned by a CFC is income from categories set forth in the negative list (see "2.3.2.1.1 Negative list"), it is not deemed CFC income where the CFC carries on a substantive (Köhler, 2018b) economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances, Article 7(2)(a)(2) of the ATAD. Is a CFC resident/situated in a country that is party to the EEA Agreement, the foregoing activity clause is mandatory. Otherwise, member states may decide not to apply the foregoing clause (Kahlenberg, 2019, p. 13).

2.3.3. Germany

2.3.3.1. *Rules*

Other than the ATAD the German CFC rules do not use a negative list to define CFC income. Instead they set out a positive list under Paragraph 8(1) of the AStG to excluded income from certain categories from the CFC income (active income). Income from categories not mentioned in the positive list is deemed –

subject to the proof to the contrary (see “2.3.3.1.2 Proof to the contrary”) – CFC income (passive income).

A CFC may have both, active and passive income. Basically, each of the CFC’s transactions is considered separately. However, income derived from passive ancillary activities that are economically connected to active principal activities, is deemed active income according to the functional approach (Heuermann, & Brandis, 2018, Chapter § 8, paras. 1, 13, 14).

2.3.3.1.1 Positive list

The positive list provided in Paragraph 8(1) numbers 1 to 10 of the AStG is exhaustive. It comprises:

2.3.3.1.1.1 Agriculture and forestry

According to Paragraph 8(1) number 1 of the AStG income from agriculture and forestry in terms of Paragraph 13 of the EStG is not considered CFC income (Strunk et al, 2018, Chapter § 8, para. 44). Agriculture and forestry comprise the entire land management of a non-commercial nature, targeted at the production and marketing of plant or animal products (Heuermann, & Brandis, 2018, Chapter § 8, para. 19). They also comprise gains from the disposal of the underlying assets (Strunk et al, 2018, Chapter § 8, para. 45).

2.3.3.1.1.2 Production

Paragraph 8(1) number 2 of the AStG provides that income from manufacturing, machining, processing, or assembly of tangible property, generation of energy, and exploration for and extraction of mineral resources is not deemed CFC income.

The key terms of the preceding paragraph are defined as follows:

- ▶ Manufacturing means creating a new, previously non-existent tangible property. It does not matter whether the material therefore is self-created or purchased and how the manufacturing takes place work;
- ▶ Machining and processing is the material modification or improvement of existent tangible property. The latter may be property of the CFC or of a third-party (Strunk et al, 2018, Chapter § 8, para. 46). However, a mere

delivery through a CFC without machining and processing is trade, Paragraph 8(1) number 4 of the AStG (Heuermann, & Brandis, 2018, Chapter § 8, para. 22);

- ▶ Assembly means assembling prefabricated parts or assemblies into a finished product at the place of installation or operation (Heuermann, & Brandis, 2018, Chapter § 8, para. 23);
- ▶ The generation of energy includes the conversion of energy and its transport;
- ▶ The exploration for and extraction of mineral resources comprises exploration, development of fields and extraction, either for own account or for third-parties (Heuermann, & Brandis, 2018, Chapter § 8, para. 25);
- ▶ Tangible property can relate to both, moveable and immovable property. Hence, the scope of Paragraph 8(1) number 2 of the AStG covers the complete construction sector. However, tangible property is neither the human body, nor intangible property (Strunk et al, 2018, Chapter § 8, para. 47).

According to the functional approach, the activities in terms of Paragraph 8(1) number 2 of the AStG include all ancillary operational activities, e.g. purchase of raw materials and operating equipment, gains from the disposal of fixed assets, manufacturing preparation and organization, as well as the sale of the produced tangible property and energy (Heuermann, & Brandis, 2018, Chapter § 8, para. 25).

Production in terms of Paragraph 8(1) number 2 of the AStG may be differentiated from other categories listed under Paragraph 8(1) of the AStG as follows: Generally, trade in terms Paragraph 8(1) number 4 of the AStG means purchase and disposal of a property, whereas production means creating a new property or a property with a different marketability. The latter is the result of a more than marginal machining or processing of a purchased property by the CFC (Strunk et al, 2018, Chapter § 8, para. 47). However, marking, repackaging, refilling, sorting, compiling acquired objects to form collective groups, and affixing control characters do not qualify as production (BMF, 2004b, para. 8.1.2.2).

2.3.3.1.1.3 Banks and insurance companies

No CFC income is pursuant to Paragraph 8(1) number 3 of the AStG income from the operation of banks and insurance companies that, for their business,

maintain an organization that is equipped in a commercial manner. This does not hold true, if more than half of the business is transacted with resident taxpayers holding ownership interests in the CFC in terms of Paragraph 7 of the AStG or with parties that are related to such taxpayers in terms of Paragraph 1(2) of the AStG.

The key terms of the preceding paragraph are defined as follow:

- ▶ Bank is a bank in terms of Paragraph 1 of the KWG, i.e. a company engaged in banking, the banking is run as a business or the scale of the transactions requires an organization that is equipped in a commercial manner (Strunk et al, 2018, Chapter § 8, para. 54). Banking comprises according to the prevailing view in German tax literature (Heuermann, & Brandis, 2018, Chapter § 8, para. 28) e.g. deposit-, payment-, and credit transactions, netting, cash-management, derivate- and custody-transactions, financial advice, risk-management and recourse- or non-recourse factoring, so far as they economically qualify as credit transactions. This holds true even if the CFC does not count with a licence required for banking in its country of residence (Flick et al, 2018, Chapter § 8, para. 96). Generally not sufficient for banking is a holding activity or mere asset management (Strunk et al, 2018, Chapter § 8, para. 55). An organization that is equipped in a commercial manner is e.g. required in the credit business, if there are more than 20 individual loans with a total credit volume of 500,000 € or more than 100 individual loans, irrespective of the total credit volume (Haun et al, 2018, Chapter § 8, para. 231);
- ▶ Based on Paragraph 1 of the VAG (Heuermann, & Brandis, 2018, Chapter § 8, para. 27) and Paragraph 341 of the HGB (Flick et al, 2018, Chapter § 8, para. 749) an insurance company is a company engaged in the insurance business. Insurance business requires that an insurer assumes certain (predefined) demands (guarantee promises) in the event of a certain occurrence (insured event), for value (premium), whereby the risk is being pooled among a multitude of insurance holders being exposed to the same risk (Strunk et al, 2018, Chapter § 8, para. 60). The insurance business must aim at generating profits (e.g. damage-, liability-, fire-, life-, accident- and reinsurance) and invest the insurance premiums of the insured persons safely (Heuermann, & Brandis, 2018, Chapter § 8, para. 29). Furthermore, the insurance company has to maintain an organization

that is equipped in a commercial manner, i.e. it must count with sufficient human and technical resources to be able to assume its insurance business (Strunk et al, 2018, Chapter § 8, para. 64). However, certain outsourcing such as management may not be harmful (Heinsen, & Handwerker, 2011, p. 84); and

- ▶ Related party in terms of Paragraph 1(2) of the AStG means only such a party if subject to limited or unlimited tax liability in Germany (BMF, 2004b, para. 8.1.3.5).

According to the functional approach, investment income or income from activities which, taken separately, is not banking/insurance business, may nevertheless fall under Paragraph 8(1) number 3 of the AStG, e.g. investment of funds in land, ownership interests and similar assets, if connected to the banking/insurance business (Heuermann, & Brandis, 2018, Chapter § 8, para. 29).

Granting credits is an activity that may fall under Paragraph 8(1) number 3 and number 7 of the AStG. As the various categories of the positive list are equivalent, it is sufficient, if the income from granting credits falls under one of the categories to exclude it from the CFC income (Strunk et al, 2018, Chapter § 8, para. 71).

2.3.3.1.1.4 Trade

According to Paragraph 8(1) number 4 of the AStG income from trade is generally excluded from CFC income.

Trade means the commercial purchase and sale of property and securities without significant machining or processing (Heuermann, & Brandis, 2018, Chapter § 8, para. 38). In German tax literature a narrow opinion holds that trade only covers the trade of tangible movable property, whereas others – including the BFH, according to its decision as of 29 November 2000 (I R 84/99) – want to include as well rights and immovable property. The latter interpretation seems preferable, as the provision seeks to treat trade as an economic activity, and not to differentiate between various forms of trade (Haase, 2017b, para. 532).

Under the functional approach, ancillary activities to trade may be e.g. warehousing, logistics, transport as well as certain services such as customer care, maintenance and financing (Strunk et al, 2018, Chapter § 8, para. 78).

A CFC is not engaged in trade, but in services in terms of Paragraph 8(1) number 5 of the AStG, if it assumes only parts of the trade function, e.g. market-analysis, initiation of business transactions, marketing and management of sales forces (Heuermann, & Brandis, 2018, Chapter § 8, para. 38). Furthermore, factoring is not trade. Although the factor purchases a receivable, recovering the receivable is from an economic perspective rather a financing of the seller than a sale and thus basically banking business in terms of Paragraph 8(1) number 3 AStG (Kraft, 2019, Chapter § 8, para. 223).

Although trade is generally excluded from CFC income, Paragraph 8(1) number 4 of the AStG provides two exceptions so far as:

- ▶ a resident taxpayer holding ownership interests in the CFC in terms of Paragraph 7 of the AStG or a person related to such a taxpayer in terms of Paragraph 1(2) of the AStG that is subject to tax (Strunk et al, 2018, Chapter § 8, para. 81) with its income from trade in Germany, provides the CFC with control over the traded goods or merchandise, Paragraph 8(1) number 4(a) of the AStG; or
- ▶ the CFC provides to such a taxpayer or to such a related person the control over these goods or merchandise, Paragraph 8(1) number 4(b) of the AStG.

In other words the foregoing exceptions apply to foreign sales companies and to foreign purchase companies.

Provision of control over the goods or merchandise means that, as the case may be, the CFC, the resident taxpayer or the person related to the taxpayer are enabled to dispose in their own name of the goods or merchandise. Where a third party is involved in the supply chain between the resident taxpayer and the CFC, Paragraph 8(1) number 4(a) and (b) of the AStG is not applicable, unless the third party is related to the taxpayer (Strunk et al, 2018, Chapter § 8, para. 83).

Should income from trade be deemed in light of the aforementioned rules CFC income, it is nevertheless excluded (exception to the exceptions), if the taxpayer proves that the CFC:

- ▶ maintains a business organization that is equipped in a commercial manner for such trade transactions;
- ▶ participates in general commerce; and

- ▶ carries out the activities associated with preparing, entering into, and performing the transactions without the involvement of a resident taxpayer or a related person as set forth Paragraph 8(1) number 4(a) of the AStG.

The CFC maintains a business organization that is equipped in a commercial manner if it counts with sufficient technical and human resources to prepare, enter into, and perform the trading transactions in question while participating in general commerce (BMF, 2004b, para. 8.1.4.2.1). Whether this requirement is fulfilled has to be determined on a case-by case basis (Strunk et al, 2018, Chapter § 8, para. 86). The participation in general commerce has to proceed from the business organization of the CFC that earns the income. According to the decision of the BFH as of 29 November 2000 (I R 84/99), an indirect participation in general commerce via another dependent group company is not sufficient.

A participation in general commerce is given, if the CFC offers with its business organization the respective transactions to a nonnegligible extent to an undefined number of people (Haase, 2017b, para. 535). For a participation in general commerce it is sufficient that the CFC participates only on the purchase side or on the sales side in general commerce (Strunk et al, 2018, Chapter § 8, para. 87). No participation in general commerce is given, if the CFC deals on both sides exclusively with group companies (Heuermann, & Brandis, 2018, Chapter § 8, para. 45). A participation in general commerce is also present where the undefined number of people is limited to a narrow circle of people due to the subject of the transaction. According to the decision of the BFH as of 29 August 1984 (I R 68/81), the same holds true, if the number of people is limited, but undefined and the change of these people forms part of the business organization.

A harmful involvement is given, if activities are carried out by a resident taxpayer or a related person as set forth in Paragraph 8(1) number 4(a) of the AStG that functionally form part of the preparation, conclusion or execution of the respective transaction, e.g. acting for the CFC as a distributor, assuming its financing functions or its risks (BMF, 2004b, para. 8.1.4.3.1). Such involvement is even harmful, if the consideration is at arm's length (Heuermann, & Brandis, 2018, Chapter § 8, para. 46). However, are single transactions of marginal significance executed in the course of a trade activity with the involvement of such a resident taxpayer or such a related person, this is not harmful (Haase, 2017b, p. 535). A

harmful involvement is not present, if the activity of a manager (Mühlhaus, & Wenzel, 2014) in the exterior is limited to representative and control functions. The same holds true for support and assistance services (Becker, & Loose, 2018a, p. 20).

2.3.3.1.1.5 Services

Income from services is generally excluded from CFC income, Paragraph 8(1) number 5 of the AStG. Services may be defined as personal performances of a CFC to others for consideration (Kraft, 2019, Chapter § 8, para. 282). Owed is the performance, not the success (Heuermann, & Brandis, 2018, Chapter § 8, para. 51). Services may be services of any kind, Paragraph 611(2) of the BGB, i.e. technical services, administrative services, intermediary services, consulting services etc. (Strunk et al, 2018, Chapter § 8, para. 93). No service is the management of own assets, e.g. the management of the CFC's shareholdings, patents or lands (Heuermann, & Brandis, 2018, Chapter § 8, para. 52). Asset management may only be a service, if others' assets are managed on behalf of someone else. Control and management may also be performed as services on behalf of someone else, e.g. where a holding company delegates certain functions connected to the management of its shareholdings to another company (Strunk et al, 2018, Chapter § 8, para. 96).

The performance of services is often connected to other activities such as production, trade or insurance. Thus, on a case-by-case basis has to be determined whether there is a separate service or whether the performance forms functionally part of another activity of the CFC (Strunk et al, 2018, Chapter § 8, para. 98).

As under Paragraph 8(1) number 4 of the AStG there are two exceptions to the foregoing general rule:

- ▶ Paragraph 8(1) number 5(a) of the AStG provides that income from services is considered CFC income, so far as the CFC makes to a more than negligible extent (Schwarz, 2012, p. 864; BMF, 2004b, para. 8.1.5.3.2) use of a resident taxpayer holding ownership interests in the CFC in terms of Paragraph 7 of the AStG or a person related to such a taxpayer in terms of Paragraph 1(2) of the AStG that is subject to tax (Strunk et al, 2018, Chapter § 8, para. 103) with its income from services in Germany, in performing these services. This requires the transfer of functions to such a resident taxpayer or to such a related party that are owed by the CFC to

the service recipient (Strunk et al, 2018, Chapter § 8, para. 101). The reasoning behind this exception is the legislator's assumption that income is shifted to foreign jurisdictions where the service is de facto performed by certain resident taxpayers (Kaligin et al, 2015, Chapter § 8, para. 61);

- ▶ In the opposite situation, i.e. a CFC provides services to such a resident taxpayer or to such a related person, the income from services is also deemed CFC income, Paragraph 8(1) number 5(b) of the AStG. Service recipient is the person on whose account/in whose interest the service is performed (Strunk et al, 2018, Chapter § 8, para. 105).

Should income from services be deemed in light of the latter exception CFC income, it is nevertheless excluded (exception to the latter exception), if the taxpayer proves that the CFC:

- ▶ maintains a business organization that is equipped to render such services;
- ▶ participates in general commerce; and
- ▶ carries out the activities associated to the services without the involvement of a resident taxpayer or a related person as set forth in Paragraph 8(1) number 5(a) of the AStG.

A harmful involvement is given, if a person exercises activities that functionally form part of the respective service, especially by providing personnel or establishments therefore or by planning the service (BMF, 2004b, para. 8.1.5.3.2). Apart from that, the comments to Paragraph 8(1) number 4 of the AStG regarding the harmful involvement (see "2.3.3.1.1.4 Trade") also hold true for Paragraph 8(1) number 5(b) of the AStG.

2.3.3.1.1.6 Letting and leasing

Paragraph 8(1) number 6 of the AStG establishes that income from letting and leasing is not deemed CFC income. Both terms are taken from Paragraph 21 of the EStG and stand for the temporary provision of assets (Heuermann, & Brandis, 2018, Chapter § 8, para. 66). According to the functional approach, letting and leasing also comprise gains from the disposal of the underlying assets (Strunk et al, 2018, Chapter § 8, para. 115). However, there are several exceptions:

- ▶ Income from licensing the use of rights, plans, samples, procedures, experience, and knowledge is only excluded from CFC income, if the CFC is exploiting the results of its own research and development work, which was carried out without the involvement of a resident taxpayers holding ownership interests in the CFC in terms of Paragraph 7 of the AStG or a person related to such taxpayers in terms of Paragraph 1(2) of the AStG, Paragraph 8(1) number 6(a) of the AStG. Therewith practically all types of rights protected by copyright, but also knowledge and experience, which are not protected by copyright, are subject to the exception (Strunk et al, 2018, Chapter § 8, para. 116). As shown in Table 7, research and development comprises according to Paragraph 51(1) number 2(u) sentence 4 of the EStG:

Table 7. Research and development.

Research	Development	
Gain of any new scientific knowledge and experience of general nature.	New development of products or manufacturing processes.	Further development of products or manufacturing processes, so far as significant changes to these products or manufacturing processes are developed.

- ▶ Income from letting and leasing of land is only excluded from CFC income, if the taxpayer proves that it would have been exempt under the terms of a DTT, had the resident taxpayer holding ownership interests in the CFC in terms of Paragraph 7 of the AStG earned it directly, Paragraph 8(1) number 6(b) of the AStG. The term land also includes buildings and parts of buildings (Kraft, & Bildstein, 2017, p. 2971; Kraft, & Mauch, 2017, p. 141; Strunk et al, 2018, Chapter § 8, para. 124).
- ▶ The letting and leasing of moveable property is only excluded from CFC income, if the taxpayer proves that the CFC maintains a commercial letting or leasing organization, participates in general commerce, and carries out all activities associated with such commercial letting or leasing without the involvement of a resident taxpayer holding ownership interests in the CFC in terms of Paragraph 7 of the AStG or a person related to such a taxpayer in terms of Paragraph 1(2) of the AStG, Paragraph 8(1) number 6(c) of the AStG. Movable property is movable

property in terms of Paragraph 90 of the German Civil Code [Bürgerliches Gesetzbuch] (“BGB”), i.e. movable tangible items, Chapter § 8, para. 129. The required commercial letting or leasing organization is – despite the wording – nothing else than the business organization required by various of the aforementioned categories of Paragraph 8(1) of the AStG (Heuermann, & Brandis, 2018, Chapter § 8, para. 66). A participation in general commerce is present, if the movable property is let or leased to a third party. In contrast, letting and leasing exclusively to other group companies is according to the prevailing view in German tax literature not a participation in general commerce (Strunk et al, 2018, Chapter § 8, para. 132).

2.3.3.1.1.7 Financing

Income from raising and lending of capital is usually deemed CFC income, if outside the scope of Paragraph 8(1) number 3 of the AStG. However, it is excluded from CFC income according to Paragraph 8(1) number 7 of the AStG, if the taxpayer proves that such capital is raised solely on foreign capital markets and not from a person related to the taxpayer or to the CFC in terms of Paragraph 1(2) of the AStG, and that such capital is provided either to foreign businesses or PEs that derive their gross revenue exclusively or almost exclusively from the categories listed in Paragraph 8(1) numbers 1 to 6 of the AStG, or to domestic businesses or PEs. The reasoning behind Paragraph 8(1) number 7 of the AStG is not to impede that globally operating German controlled groups access foreign capital markets via foreign financing companies, resident there (Strunk et al, 2018, Chapter § 8, para. 135).

The key terms of the preceding paragraph are defined as follows:

- ▶ Raising of capital means raising debt, not equity (Haun et al, 2018, Chapter § 8, para. 450);
- ▶ Lending of capital means making capital for a limited period of time available to a borrower, usually against fixed or variable interest, and subject to a repayment obligation (Paragraph 488 of the BGB). Mode and term of the repayment obligation are irrelevant (Kaligin et al, 2015, Chapter § 8, para. 108);

- ▶ Capital market in terms of Paragraph 8(1) number 7 of the AStG is the market for both, long and short-term borrowings (Flick et al, 2018, Chapter § 8, para. 249);
- ▶ Regarding the raising of capital on foreign capital markets please see “2.3.3.2.1.7 Financing”;
- ▶ Capital is not raised from a person related to the taxpayer or to the CFC in terms of Paragraph 1(2) of the AStG, just because such a person provides securities or guarantees in favour of the CFC (Flick et al, 2018, Chapter § 8, para. 258); and
- ▶ Almost exclusively means that at least 90 percent of the foreign business’s/PE’s gross revenue have to be derived from the categories listed in Paragraph 8(1) numbers 1 to 6 of the AStG (Mössner, 2017, para. 204).

The capital raised has to be identical to the capital lent (Heuermann, & Brandis, 2018, Chapter § 8, para. 78).

2.3.3.1.1.8 Profit distributions

Pursuant to Paragraph 8(1) number 8 of the AStG profit distributions of corporations are excluded from CFC income. Profit distributions include distributions in kind and hidden profit distributions (Strunk et al, 2018, Chapter § 8, para. 164). Controversially discussed is whether this holds also true for payments under a profit participation right (Heuermann, & Brandis, 2018, Chapter § 8, para. 93). Irrelevant is the level of ownership interests held in the CFC, as well as the holding period. The same holds true for the residency of the corporation distributing its profits, the latter’s activity and the tax burden of the distributed profits (Strunk et al, 2018, Chapter § 8, para. 164).

2.3.3.1.1.9 Sale of a share in another company etc.

No CFC income is according to Paragraph 8(1) number 9 of the AStG income from:

- ▶ the sale of a share in another company;
- ▶ the liquidation of another company; or
- ▶ the reduction of another company's capital.

However, where a share in another company is sold (Heuermann, & Brandis, 2018, Chapter § 8, para. 105), the taxpayer has to prove that the capital gain is allocable to assets of the other company which are used to carry on activities other than those described in:

- ▶ Paragraph 8(1) number 6(b) of the AStG, to the extent the income in question is that of a company within the meaning of Paragraph 16 of the German Real-Estate-Investment-Trust Act [Gesetz über deutsche Immobilien-Aktiengesellschaften mit börsennotierten Anteilen] (“REITG”); or
- ▶ Paragraph 7(6a) of the AStG.

This applies analogously so far as the gain is allocable to assets of this type of a company in which the other company holds an ownership interest (Mühlhausen, & Schmelz, 2018, pp. 1643, 1644).

On the other hand, losses from the sale of shares in another company, from the liquidation of another company or from the reduction of another company's capital are only considered to the extent the taxpayer proves that they are attributable to assets used in carrying on activities described in:

- ▶ Paragraph 8(1) number 6(b) of the AStG, to the extent the income in question is that of a company within the meaning of Paragraph 16 of the REITG; or
- ▶ Paragraph 7(6a) of the AStG.

The key terms of Paragraph 8(1) number 9 of the AStG are defined as follows:

- ▶ Sale of a share is the transfer of the beneficial ownership of a share for consideration (Strunk et al, 2018, Chapter § 8, para. 169);
- ▶ Share in a company means share in an entity whose profit distributions would not be deemed CFC income according to Paragraph 8(1) number 8 of the AStG (Strunk et al, 2018, Chapter § 8, para. 171). Ownership interests in partnerships do not fall under the foregoing definition (Flick et al, 2018, Chapter § 8, para. 304). Irrelevant is – as for profit distributions - the level of ownership interests held in the CFC, as well as the holding period. The same holds true for the residency of the corporation whose shares are being sold (Strunk et al, 2018, Chapter § 8, para. 173).

2.3.3.1.1.10 Reorganizations

Last but not least income from reorganizations that, disregarding Paragraph 1(2) and (4) of the German Reorganization Tax Act [Umwandlungssteuergesetz] (“UmwStG”), could take place at book value, is basically excluded from CFC income, Paragraph 8(1) number 10 of the AStG. This does not hold true so far as a reorganization includes a share in a corporation, the sale of which would not fulfill the requirements set out under Paragraph 8(1) number 9 of the AStG. The legislator’s intention behind Paragraph 8(1) number 10 of the AStG is to treat foreign and domestic reorganization, broadly, identical. Foreign reorganizations shall only trigger the German CFC taxation under very limited circumstances ([Bundestag-Drucksache] 16/3369 as of 9 November 2006, p. 15). Paragraph 8(1) number 10 of the AStG applies to income from reorganizations at both, shareholder and company level (Strunk et al, 2018, Chapter § 8, para. 182.2). Please note that Paragraph 8(1) number 10 of the AStG does not require that the reorganization takes place at book value. It is sufficient that it could take place at book value (Heuermann, & Brandis, 2018, Chapter § 8, para. 128).

2.3.3.1.2 Proof to the contrary

By judgment as of 12 September 2006 (C-196/04) the ECJ ruled regarding the UK CFC rules that the freedom of establishment is restricted, if profits earned by a CFC, resident in an EU member state, are included in the UK resident taxpayers tax base, just because they are subject in the foreign state to a lower level of taxation than in the UK. The ECJ holds that the foregoing might keep UK resident taxpayers from establishing CFCs in countries with a low level of taxation. However, the restriction is justified, if “the specific objective of such a restriction is to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.” If a company uses the different corporate tax rates of EU member states to reduce its tax burden, this does not in itself constitute an abuse. Furthermore, objective factors which are ascertainable are required. Only if “the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host member state, the creation of that CFC must be regarded as having the characteristics of a

wholly artificial arrangement. That could be so in particular in the case of a “letterbox” or “front” subsidiary.”

Paragraph 8(2) of the AStG is the German legislator’s response to the above summarized judgment (Quilitzsch, 2012, p. 645). It provides that notwithstanding Paragraph 8(1) of the AStG, a company with its registered office or management in a member state of the EU or in a treaty country of the EEA Agreement is not a CFC with respect to income for which resident taxpayers holding ownership interests in the company in terms of Paragraph 7(2) or (6) of the AStG prove that insofar the company carries on genuine economic activity in the state in question. However, this does neither apply for income of a lower tier company that is attributable to the CFC according to Paragraph 14 of the AStG, nor for income of a PE, where the lower tier company has neither its registered office nor its management in a member state of the EU or a treaty country of the EEA Agreement, or where the PE is located outside this area. A further requirement is that Germany and the state in question provide each other – based on the Mutual Assistance Directive pursuant to Paragraph 2(2) of the German EU Administrative Assistance Act [EU-Amtshilfegesetz] (“EUAHiG”), or pursuant to a comparable bilateral or multilateral agreement – with the information that is necessary to carry out the taxation. Only income derived through the CFC's genuine economic activity shall be attributed to this activity, and such attribution shall occur only so far as the arm's length principle in terms of Paragraph 1 of the AStG has been complied with.

2.3.3.2. *Issues*

2.3.3.2.1 Positive list

2.3.3.2.1.1 Positive list instead of negative list

Parts of the German tax literature criticize that the German CFC rules employ a positive list instead of a negative list. They argue that employing a positive list is a brake on new business models, as the German legislator hardly updated the positive list in the past (Haase, 2019, Chapter § 8, para. 5). E.g. the German legislator could not include new developments such as factoring, franchising, forfeiting, options, swaps etc. (Eilers, & Hennig, 2015). Difficult is also the classification of digital transactions, such as data analytics (analysis of customer data to optimize

marketing, sales, pricing, production, warehousing and harvesting of feedback to improve products), digital distribution, 3D printing, cloud (digital services, data, content, games), sharing industry, artificial intelligence, robotics. The classification of the foregoing transactions under the positive list has to be made always on a case-by-case basis. Relevant may be especially the categories services or letting and leasing (Heuermann, & Brandis, 2018, Chapter § 8, para. 3).

On the other hand the resident taxpayers are familiar with the positive list, there is administrative guidance and jurisprudence. Thus, it might be preferable to stick with a positive list, which should, however, be updated more frequently.

2.3.3.2.1.2 Production

According to Paragraph 8(1) number 2 of the AStG income from manufacturing is, inter alia, not deemed CFC income. Questionable is, whether the CFC has to manufacture the property itself or may subcontract the manufacturing to either third parties or to other group companies. Parts of the German tax literature trust that subcontracting is not harmful as long as the CFC controls the manufacturing process and bears the manufacturing risk (Strunk et al, 2018, Chapter § 8, para. 46). Others believe that the CFC has to perform the manufacturing itself with own manufacturing plants and personnel (Kraft, 2019, Chapter § 8, para. 88).

2.3.3.2.1.3 Banks and insurance companies

Generally, Paragraph 8(1) number 3 of the AStG provides that, under certain conditions, income from the operation of banks and insurance companies is not considered CFC income. As an exception to the general rule, such income is deemed CFC income, if more than half of the business is transacted with resident taxpayers holding ownership interests in the CFC in terms of Paragraph 7 of the AStG or with parties that are related to such taxpayers in terms of Paragraph 1(2) of the AStG. Hence, where the foregoing threshold is exceeded, the transactions with such taxpayers or such related parties infect the other income from the operation of banks and insurance companies (Heuermann, & Brandis, 2018, Chapter § 8, para. 27). Considering that under the general rule such other income is only excluded from CFC income, if for the business an organization is maintained that is equipped in a commercial manner, this seems clearly over-inclusive. It

would have been more appropriate to consider only the income derived from the business transacted with such resident taxpayers or such related parties as CFC income, where such transactions make up more than half of the CFC's business. The foregoing threshold of more than half might be reduced to more than 25 percent, to reduce the attractiveness of structurings as the one described under "2.3.3.3.1 Banks and insurance companies". Does an infringement occur under the current Paragraph 8(1) number 3 of the AStG this is likely to be an infringement of the freedom of establishment, Article 49 of the Treaty on the Functioning of the European Union (TFEU), as the operation of banks and insurance companies are business activities protected by the TFEU (Strunk et al, 2018, Chapter § 8, para. 65).

Controversially discussed is whether a financing company that provides its services exclusively to group companies may be a bank in terms of Paragraph 8(1) number 3 of the AStG. The question is answered by the BMF without explanation in the negative (BMF, 2004b, para. 8.1.3.3). The German tax literature points out that where single transactions of a group financing company are banking transactions, the CFC does not necessarily have to be a bank in the overall picture. According to the prevailing view in the German tax literature the group financing company has to provide the banking transactions in a banking industry fashion also to clients outside the group on the free market (Heuermann, & Brandis, 2018, Chapter § 8, para. 27). Others trust that depending on the volume of business and the risk allocation also a financing company providing its services exclusively to group companies may be a bank (Strunk et al, 2018, Chapter § 8, para. 58).

As for banks, there is a controversial discussion whether a captive insurance company may be an insurance company in terms of Paragraph 8(1) number 3 of the AStG. Again, the question is answered by the BMF in the negative (BMF, 1997). The prevailing opinion in the German tax literature argues that a captive insurance company is not engaged in an insurance business, because it does not – as required therefore – intend a risk balancing based on the law of large numbers (Flick et al, 2018, Chapter § 8, para. 304). Others hold that a captive insurance company may be an insurance company in terms of Paragraph 8(1) number 3 of the AStG, if it is actually engaged in the risk business and if its business has an actuarial basis (Strunk et al, 2018, Chapter § 8, para. 62).

Considering that financing income is easy to shift, it may have been shifted by a resident taxpayer to a CFC, especially when it has been earned from a related

party. Also insurance income is easy to shift from the jurisdiction in which the insured risk is located to a low tax jurisdiction. The foregoing concern is in particular raised, if the insurance income has been earned from a contract or policy with a related party (OECD, 2015c, para. 78). Therefore, I trust that captive finance and insurance companies should not fall under Paragraph 8(1) number 3 of the AStG.

2.3.3.2.1.4 Trade

According to Paragraph 8(1) number 4 of the AStG income from trade is excluded from CFC income, unless certain resident taxpayers/related persons provide the CFC with control over the traded goods/merchandise or vice versa. But even in the latter case income from trade is not deemed CFC income, if certain conditions are met, inter alia that the activities associated with preparing, entering into, and performing the transactions are carried out without the involvement of such a resident taxpayer/related person.

Parts of the German tax literature criticize that intra-group trading as detailed above is per se under the general suspicion of abusive conduct. They trust that income from such trading should generally be excluded from CFC income, if the arm's length principle (Paragraph 1(1) sentence 1 of the AStG) is observed. This shall hold true even where such a resident taxpayer/related person is involved in preparing, entering into, and performing the transactions (Haase, 2017c, p. 126).

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. The resident taxpayer produces product P. Company A purchases product P at an arm's length price from the resident taxpayer and sells it in country A. The resident taxpayer is involved in preparing the transactions. In return company A pays an arm's length fee to the resident taxpayer. Figure 37 illustrates the case at hand.

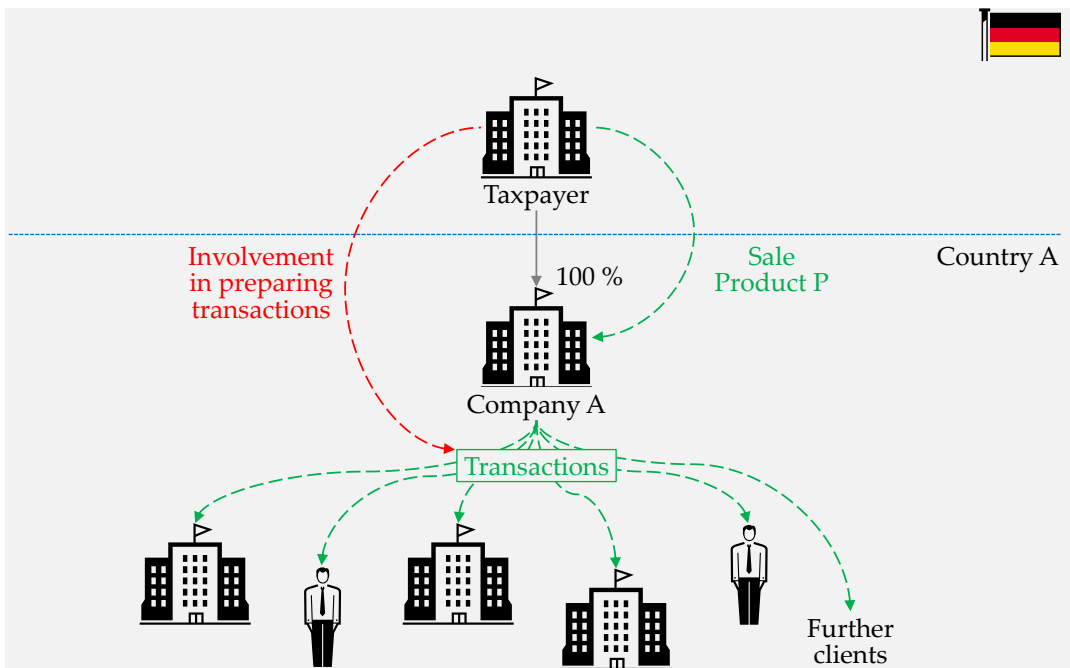


Figure 37. Illustration of the case at hand.

Under Paragraph 8(1) number 4 of the AStG company A's income from trade is deemed CFC income as the resident taxpayer is a resident taxpayer holding ownership interests in company A in terms of Paragraph 7 of the AStG, provides the CFC with control over product P, and is involved in preparing the transactions.

According to the foregoing suggestion of parts of the German tax literature company A's trade income would be excluded from CFC income, as the arm's length principle is observed.

From my point of view the latter approach is favorable.

First of all in light of the German transfer pricing rules the profit shifting risk is very limited where resident taxpayers/related persons in terms of Paragraph 8(1) number 4(a) of the AStG provide the CFC with control over the traded goods/merchandise or vice versa. Does such a resident taxpayer/related person provide the CFC with control over the traded goods/merchandise, the price for the sale from such a resident taxpayer/related person to the CFC has to be less than the arm's length price to really raise profit shifting concerns. Does the CFC provide such a resident taxpayer/related person with control over the traded goods/merchandise, the price for the sale from the CFC to such a resident taxpayer/related person has to be more than the arm's length price to actually raise

profit shifting concerns. However, such mispricing is addressed by Paragraph 1(1) sentence 1 of the AStG. The latter provides, broadly, that transfer prices differing from the arm's length price are adjusted to the arm's length price.

The same holds true for the involvement of such a resident taxpayer/related person in activities associated with preparing, entering into, and performing the CFC's transactions. Only where the fee paid for the involvement is lower than the arm's length fee real profit shifting concerns may arise. Again, mispricing would be adjusted under Paragraph 1(1) sentence 1 of the AStG.

However, following the abovementioned suggestion of parts of the German tax literature would allow to shift arm's length profits to low tax jurisdictions. Nevertheless the risk is remote. The fewer functions are assumed/risks borne and assets employed by the CFC, the less profit corresponds to the CFC from an arm's length perspective (Engler, & Wellmann, 2015, Chapter N, para. 475). Hence, where a resident taxpayer/related person is significantly involved in activities associated with preparing, entering into, and performing the CFC's transactions, the profit that corresponds to the CFC is low.

Following the abovementioned suggestion of parts of the German tax literature would also stop the uncertainty about the scope of some of the terms set out in Paragraph 8(1) number 4 of the AStG, such as business organization that is equipped in a commercial manner and involvement.

2.3.3.2.1.5 Services

According to Paragraph 8(1) number 5 of the AStG income from services is excluded from CFC income, unless the CFC:

- ▶ makes use of certain resident taxpayers/related persons in performing these services; or
- ▶ provides services to such a resident taxpayer/related person.

If income from services is deemed in light of the latter exception CFC income, it is nevertheless excluded if certain conditions are met, inter alia that the activities associated to the services are carried out without the involvement of such a resident taxpayer/related person.

As for trade (see "2.3.3.2.1.4 Trade") parts of the German tax literature criticize that intra-group services as detailed above are per se under the general

suspicion of abusive conduct. They suggest that income from such services should generally be excluded from CFC income, if the arm's length principle (Paragraph 1(1) sentence 1 of the AStG) is observed, even where such a resident taxpayer/related person is involved in preparing, entering into, and performing the transactions (Haase, 2017c, p. 126).

In light of the arguments provided above (see "2.3.3.2.1.4 Trade"), which hold true analogously for services, the latter approach is favorable. Moreover, income from services is always CFC income if the CFC makes use of certain resident taxpayers/related persons in performing these services, Paragraph 8(1) number 5(a) of the AStG. Other than under Paragraph 8(1) numbers 4(a) and (b) and 5(b) of the AStG, the taxpayer may not prove that the CFC maintains a business organization that is equipped in a commercial manner for such trade transaction/to render such services, participates in general commerce and carries out the activities associated thereto without the involvement of certain resident taxpayers/related persons (Strunk et al, 2018, Chapter § 8, para. 99).

A further issue is the scope of Paragraph 8(1) number 5 of the AStG. Services in the broadest sense include also financial services (Strunk et al, 2018, Chapter § 8, para. 97). However, the BMF argues that intra-group financial services fall exclusively under Paragraph 8(1) numbers 3 and 7 of the AStG (BMF, 2004b, para. 8.1.5.1.1). The prevailing view in German tax literature shares this point of view only for the lending of capital in terms of Paragraph 8(1) number 7 of the AStG and holds that Paragraph 8(1) numbers 5 and 7 of the AStG are independent of one another, i.e. income is excluded from CFC income if the requirements of one of the foregoing numbers are fulfilled (Flick et al, 2018, Chapter § 8, para. 178).

2.3.3.2.1.6 Letting and leasing

According to Paragraph 8(1) number 6(a) of the AStG income from licensing the use of rights, plans, samples, procedures, experience, and knowledge is only excluded from CFC income, if the CFC is exploiting the results of its own research and development work, which was carried out without the involvement of certain resident taxpayers/related persons.

The foregoing paragraph condemns the development of IP by or with the involvement of certain resident taxpayers/related parties, which generates later on income in a low tax jurisdiction and compensates the preferential taxation with an

ongoing CFC taxation in Germany. The latter is criticized by parts of the German tax literature. Where IP is developed by or with the involvement of certain resident taxpayers/related parties and generates later on income in a low tax jurisdiction, profit shifting concerns arise where such IP is transferred or licensed to the CFC at a price below an arm's length price. It would be more straightforward to address these concerns, as the case may be, via exit taxation, Paragraph 4(1) sentences 3 to 5 of the EStG, Paragraph 12(1) of the KStG/price adjustments to the arm's length price, Paragraph 1(1) sentence 1 of the AStG; Haase, 2017c, p. 178).

Furthermore, income from IP may be CFC income under Paragraph 8(1) number 6(a) of the AStG even if it was not developed with the involvement of certain resident taxpayers/related parties.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A purchases IP from a third party and licenses it to company B, both also resident in country A. Figure 38 illustrates the case at hand.

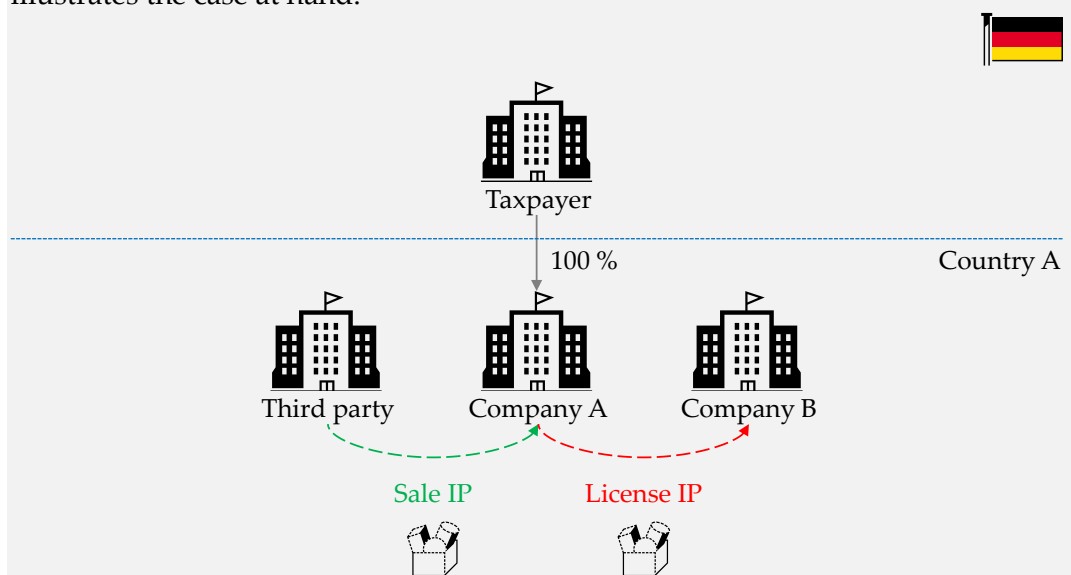


Figure 38. Illustration of the case at hand.

According to Paragraph 8(1) number 6(a) of the AStG income from licensing may only be excluded from CFC income, if the CFC exploits the results of its own research and development work. However, the exploitation of purchased research

and development results is always deemed CFC income, irrespective from whom the IP was purchased (Strunk et al, 2018, Chapter § 8, para. 120). Parts of the German tax literature criticize that this goes far beyond the aim of the CFC rules, as they do not see any reasons why the resident taxpayer should pay tax in Germany on income from licensing, which the CFC earns from IP purchased from third parties or foreigners (Flick et al, 2018, Chapter § 8, para. 224).

As noted above, income from licensing may only be excluded from CFC income, if the CFC exploits the results of its own research and development work, Paragraph 8(1) number 6(a) of the AStG. In light of this wording parts of the German tax literature hold that the CFC has to perform the research and development work with own facilities and personnel (Strunk et al, 2018, Chapter § 8, para. 120). However, the BFH in its decision as of 13 October 2010 (I R 61/09), the BMF (2001) and the prevailing view in German tax literature (Strunk et al, 2018, Chapter § 8, para. 120) assume own research and development results also if the CFC does not work exclusively with own personnel, but engages contract researchers and developers, provided that the CFC is contractually entitled to the research and development results, bears the financial risks of the research and development work and has an instruction right regarding the key measures. Furthermore the CFC has to count with qualified personnel to actually exercise the instruction right (Heuermann, & Brandis, 2018, Chapter § 8, para. 67).

Under Paragraph 8(1) number 6(b) of the AStG the letting and leasing of land in Germany may be an issue, as the following example shows.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A leases land situated in Germany to a third party, resident in Germany. The DTT between Germany and country A provides that income from the lease of land situated in Germany may be taxed exclusively in Germany. Company A is not subject to German trade tax. Figure 39 illustrates the case at hand.

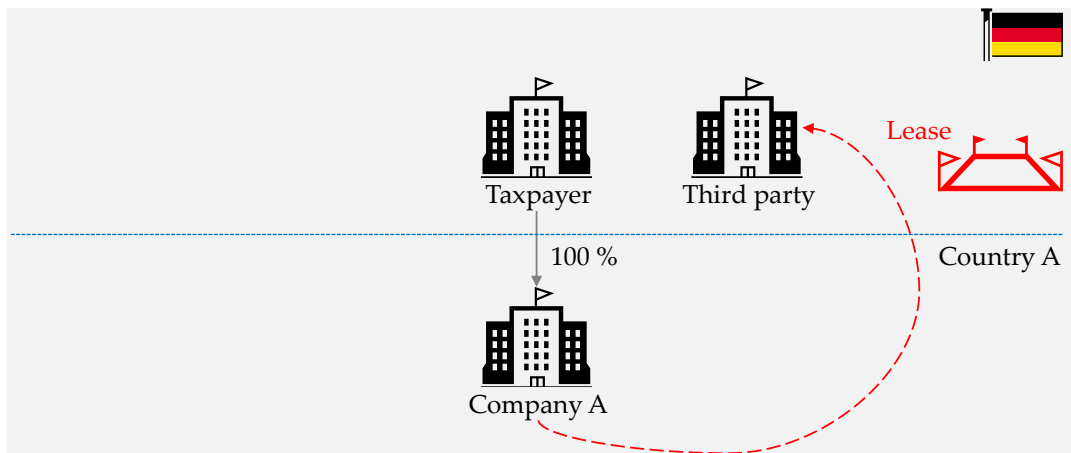


Figure 39. Illustration of the case at hand.

Company A is a CFC. It is subject to limited corporate tax liability with its income from the lease of land situated in Germany, Paragraph 2 of the KStG. The corporate tax rate is 15 percent, Paragraph 23(1) of the KStG. Thus company A's income is subject to a low level of taxation in terms of Paragraph 8(3) of the AStG. The income from the lease of land situated in Germany is also CFC income. According to Paragraph 8(1) number 6(b) of the AStG the letting and leasing of land is only excluded from CFC income, if the taxpayer proves that it would have been exempt under the terms of a DTT, had the resident taxpayer holding ownership interests in the CFC in terms of Paragraph 7 of the AStG earned it directly. However, in this example no DTT at all would have been applicable, had the resident taxpayer earned the income from the lease of land situated in Germany directly (Strunk et al, 2018, Chapter § 8, para. 127.1). Voices in the German tax literature find it hard to understand that a low taxation, which is based on the Germans legislator's decision, shall trigger CFC taxation at the level of the resident taxpayer (Flick et al, 2018, Chapter § 8, para. 226).

2.3.3.2.1.7 Financing

Income from raising and lending of capital is excluded from CFC income according to Paragraph 8(1) number 7 of the AStG, if the taxpayer proves:

- ▶ that such capital is raised solely on foreign capital markets and not from a person related to the taxpayer or to the CFC in terms of Paragraph 1(2) of the AStG; and

- ▶ that such capital is provided either to foreign businesses or PEs that derive their gross revenue exclusively or almost exclusively from the categories listed in Paragraph 8(1) numbers 1 to 6 of the AStG, or to domestic businesses or PEs.

Furthermore, the capital raised has to be identical to the capital lent.

Controversially discussed is under which circumstances capital is raised on foreign capital markets. The BMF (2004b, para. 8.1.7.2) considers that capital is raised on foreign capital markets where it:

- ▶ is raised from bonds issued exclusively on foreign capital markets;
- ▶ is raised by borrowing from foreign credit pooling sources; or
- ▶ is otherwise made available on foreign capital markets by persons resident in a foreign country,

provided no capital is indirectly raised on the domestic capital market.

The prevailing view in German tax literature holds that the BMF replaces thereby unlawfully the condition “raised on foreign capital markets” by “raised from persons resident in a foreign country”. To their understanding only the place where the loan is made available is relevant. As they consider that the residency of the person making the loan available is irrelevant, they also do not share the BMF’s opinion, according to which capital made available by persons related to the taxpayer/CFC is not considered to have been raised on foreign capital markets (Flick et al, 2018, Chapter § 8, para. 250; BMF, 2004b, para. 8.1.7.2). Furthermore, as indicated above, the BMF considers capital raised indirectly on the domestic capital market to be harmful, whereas the prevailing view in German tax literature, again, looks at where the market activity took place. A key argument for the latter opinion is that a CFC often does not know whether and where the person making the loan available is refinanced (Flick et al, 2018, Chapter § 8, paras. 249, 251; Mössner, 2017, para. 192).

Apart from that, voices in the German tax literature criticize that the requirement to raise capital on foreign capital markets discriminates the domestic capital market, which is likely to be an infringement of EU law. Moreover, they point out that Paragraph 8(1) number 7 of the AStG may also harm Germany as a location to do banking business, because from a tax perspective the recommendation to a financing CFC must always be to raise capital on foreign

capital markets in order to avoid CFC taxation (Strunk et al, 2018, Chapter § 8, para. 147).

As indicated above, income from lending of capital raised solely on foreign capital markets to a foreign business/PE is only excluded from CFC income, if the foreign business/PE derives its gross revenue at least almost exclusively from the categories listed in Paragraph 8(1) numbers 1 to 6 of the AStG. Thus, CFC taxation may be triggered in cases where both, raising and lending of capital occur exclusively in one or more foreign countries.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A raises capital on the capital market of country A and lends it to company B, also resident in country A. However, company B does not derive its gross revenue almost exclusively from the categories listed in Paragraph 8(1) numbers 1 to 6 of the AStG. Figure 40 illustrates the case at hand.

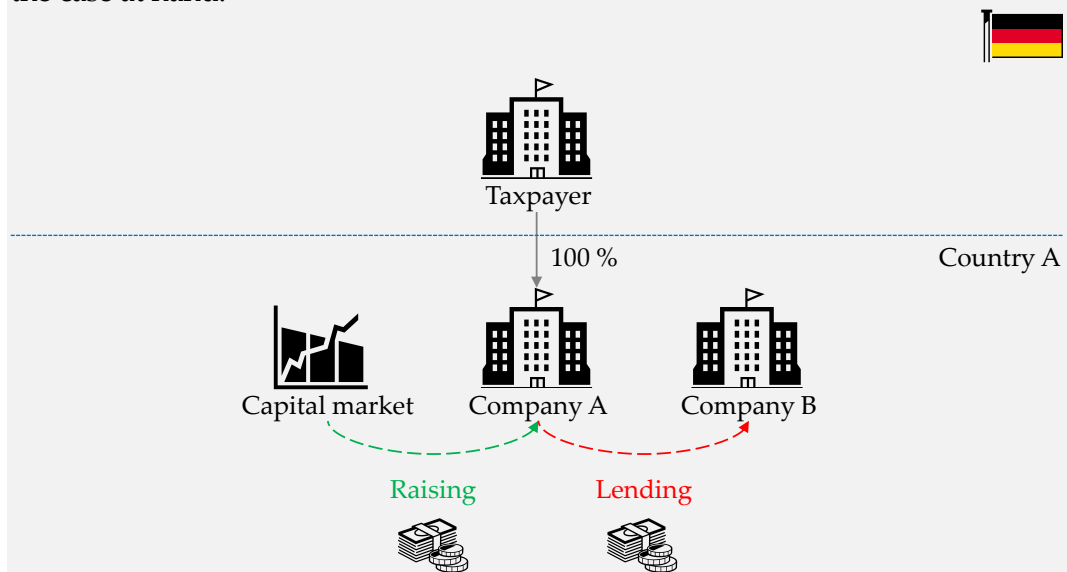


Figure 40. Illustration of the case at hand.

According to Paragraph 8(1) number 7 of the AStG the income from lending the capital raised on the capital market of country A is deemed CFC income, because company B does not derive its gross revenue almost exclusively from the categories listed in Paragraph 8(1) numbers 1 to 6 of the AStG. Parts of the German tax literature consider that a CFC taxation is only justified in foreign cases as the

one at hand, if the foreign transaction is from an economic perspective a domestic transaction, which is only formally transacted through the CFC (Kraft, 2019, Chapter § 8, para. 424).

Last but not least, it is almost impossible to demonstrate that the capital raised is identical to the capital lent. The capital lent is usually credited to a bank account of the CFC. On this bank account it is already mixed with other bank receivables. Unless the credited capital is immediately used for an explicit purposes, any movement on the bank account in the meantime makes it impossible to proof that the capital raised is identical to the capital lent (Flick et al, 2018, Chapter § 8, para. 242).

2.3.3.2.1.8 Sale of a share in another company etc.

According to Paragraph 8(1) number 9 of the AStG a gain of a CFC from a sale of a share in another company etc. is only excluded from CFC income, if it is not allocable to assets of the latter which are used to carry on activities in terms of:

- ▶ Paragraph 8(1) number 6(b) of the AStG, to the extent the income in question is that of a company within the meaning of Paragraph 16 of the REITG; or
- ▶ Paragraph 7(6a) of the AStG.

The German tax literature criticizes that therewith a gain from a sale of a share in another company etc. is treated differently from profit distributions in terms of Paragraph 8(1) number 8 of the AStG, as the latter paragraph does not look at the use of the underlying assets (Heuermann, & Brandis, 2018, Chapter § 8, para. 105).

Moreover, the German tax literature means that the taxpayer always bears the burden of proof. This does not hold only true in case of a gain from the sale of a share in another company etc., but also in case of a loss therefrom. In the latter case the taxpayer has to demonstrate that the loss is attributable to assets used in carrying on activities described in:

- ▶ Paragraph 8(1) number 6(b) of the AStG, to the extent the loss in question is that of a company within the meaning of Paragraph 16 of the REITG; or

- ▶ in Paragraph 7(6a) of the AStG (Strunk et al, 2018, Chapter Vor §§ 7-14, para. 29).

Last but not least, so far as a gain of a CFC from a sale of a share in another company etc. is allocable to assets of the latter which are used to carry on activities in terms of Paragraph 7(6a) of the AStG a double taxation occurs, as:

- ▶ on the one hand the ongoing CFC income with investment character is usually subject to CFC taxation; and
- ▶ on the other hand the gain from the actual sale of the share in the other company etc. is usually subject to CFC taxation (Haase, 2017c, p. 16).

2.3.3.2.1.9 Reorganizations

As detailed above, income from a reorganization that, disregarding Paragraph 1(2) and (4) of the UmwStG, could take place at book value, is excluded from CFC income, unless such reorganization includes a share in a corporation, the sale of which would not fulfill the requirements set out under Paragraph 8(1) number 9 of the AStG. In light of the reference to the latter paragraph, the issues presented thereunder hold also true for Paragraph 8(1) number 10 of the AStG. In practice the latter paragraph impedes a lot of reorganizations (Kraft, & Seydewitz, 2016).

2.3.3.2.1.10 Sale of assets

Does a CFC sell an asset, a gain therefrom is attributed to the category of income, which was exercised with the asset before the sale. Is the category not included in the positive list provided under Paragraph 8(1) of AStG, such income is deemed CFC income. However, the category of income exercised with the asset may have changed between its initial purchase and the sale. In such cases the gain has to be allocated pro rata temporis to the categories of income. This may be difficult, especially where the initial purchase occurred a long time ago (Haase, 2017b, para. 543).

2.3.3.2.2 Proof of the contrary

Paragraph 8(2) of the AStG provides, broadly, that a company resident in an EU/EEA member state is not a CFC with respect to income for which the resident

taxpayer demonstrates that insofar the company carries out a genuine economic activity in the state in question. In practice is often questionable what a genuine economic activity is, which leads to significant uncertainty regarding the concrete substance requirements for the foreign company (e.g. in case of cash-pooling; Mühlhaus, & Wenzel, 2013).

Parts of the German tax literature hold with the ECJ in its judgment as of 12 September 2006 (C-196/04) that the resident taxpayer is best placed to produce evidence that the foreign company is actually established and that its activities are genuine. Nevertheless they consider that such typification combined with reversing the general burden of proof, is questionable from a European law perspective in light of the principle of proportionality. The resident taxpayer has to be able to obtain the required information, which may be impossible for minority shareholders. The European Commission shares these concerns and holds that the imposition of the burden of proof has to be made on a case-by-case basis (Strunk et al, 2018, Chapter Vor §§ 7-14, para. 29.1).

Last, but not least pursuant to Paragraph 20(2) of the AStG the substance analysis according to Paragraph 8(2) of the AStG is not available for foreign partnerships/PEs. Such difference in treatment between partnerships and PEs on the one hand, and corporate entities on the other hand, is unacceptable within the EU/EEA area (Flick et al, 2018, Chapter § 20, para. 154).

2.3.3.3. *Structurings*

2.3.3.3.1 Banks and insurance companies

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A operates a bank. For fiscal year 2018 the latter's income therefrom is expected to amount to 100. Thereof 55 are the result of business transacted with the resident taxpayer. Now, to reduce the CFC income, the resident taxpayer decides to establish company A2 in country A. The latter shall assume business transacted between company A and the resident taxpayer amounting to an income of 15. Figure 41 illustrates the case at hand.

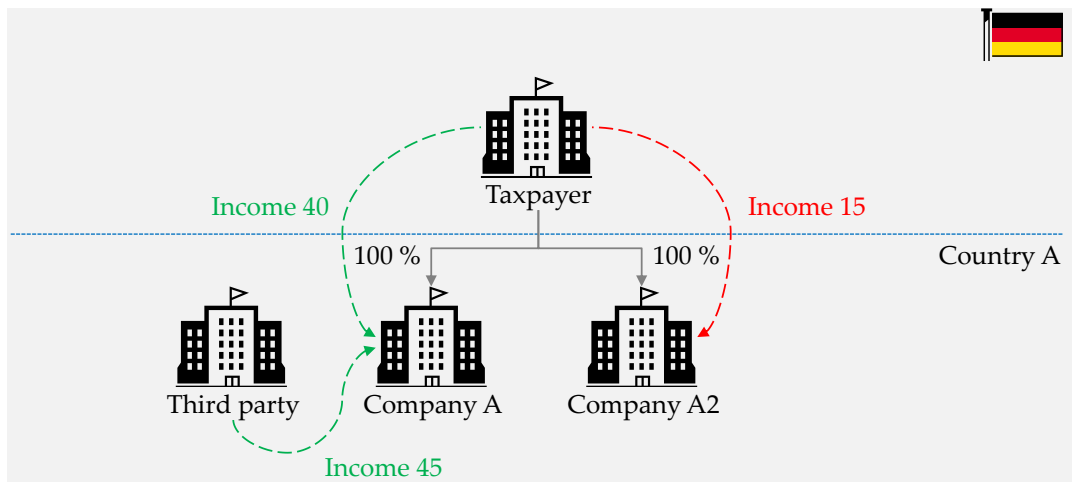


Figure 41. Illustration of the case at hand.

Generally, Paragraph 8(1) number 3 of the AStG provides that, under certain conditions, income from the operation of banks and insurance companies is not considered CFC income, unless more than half of the business is transacted with certain resident taxpayers/related parties. Initially, in this example 55 percent of the business were expected to be transacted with the resident taxpayer. Hence, all of company A's income from the operation of a bank, i.e. 100, would have been deemed CFC income. In contrast under the depicted structure 47.06 percent of the business is expected to be transacted with resident taxpayers, i.e. none of company A's income from the operation of a bank would be deemed CFC income. Company A2's income is considered CFC income as it is earned exclusively from transactions with the resident taxpayer. However, the CFC income is reduced through this structuring from 100 to 15.

2.3.3.3.2 Trade

Example

A resident taxpayer holds 100 percent of the ownership interests in company A and B, resident in country A and B respectively. Whereas country A is a low tax jurisdiction, country B is a high tax jurisdiction, however, without CFC rules. The resident taxpayer produces product P and sells it to company A. The latter sells the product to third parties in country A. The resident taxpayer is involved in preparing the sales in country A. To avoid that company A's income is deemed

CFC income, the resident taxpayer decides to sell product P through company B to company A. Figure 42 illustrates the case at hand.

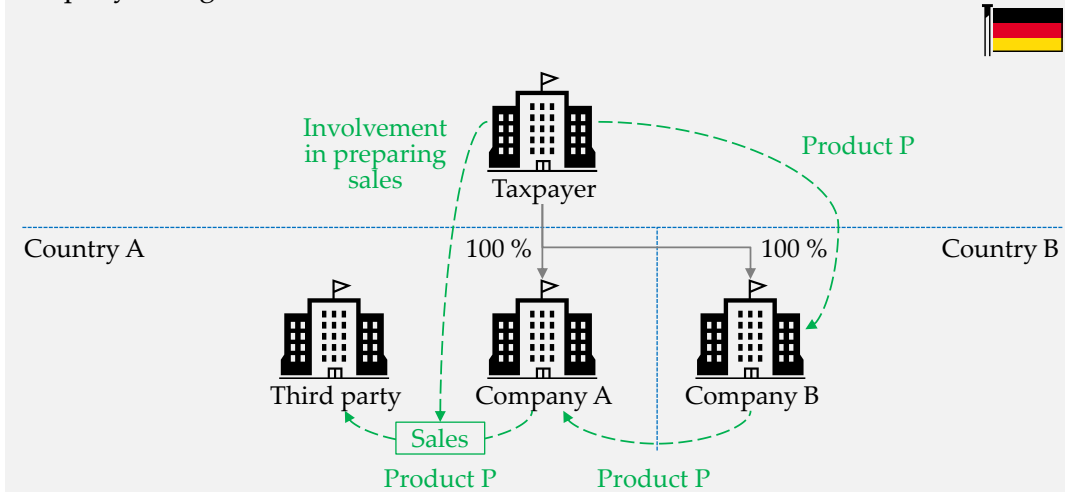


Figure 42. Illustration of the case at hand.

Under the initial structure company A's income from trade is deemed CFC income, as the resident taxpayer provides company A with control over product P and is involved in preparing the sales in country A, Paragraph 8(1) number 4(a) of the AStG. Through structuring the supply chain (Strunk et al, 2018, Chapter § 8, para. 84) as depicted above, the resident taxpayer ceases to provide company A with control over product P. Such a control is now provided by company B. However, as the latter is not subject to tax with its income from trade in Germany the conditions set forth in Paragraph 8(1) number 4(a) of the AStG are not met. As a result company A's income from trade is excluded from CFC income under the general rule, Paragraph 8(1) number 4 of the AStG. That the resident taxpayer is involved in preparing the sales in country A is irrelevant.

Instead of the foregoing structuring the resident taxpayer might cease its involvement in preparing the sales in country A. Such an involvement could henceforward be assumed by company B. Figure 43 illustrates the case at hand.

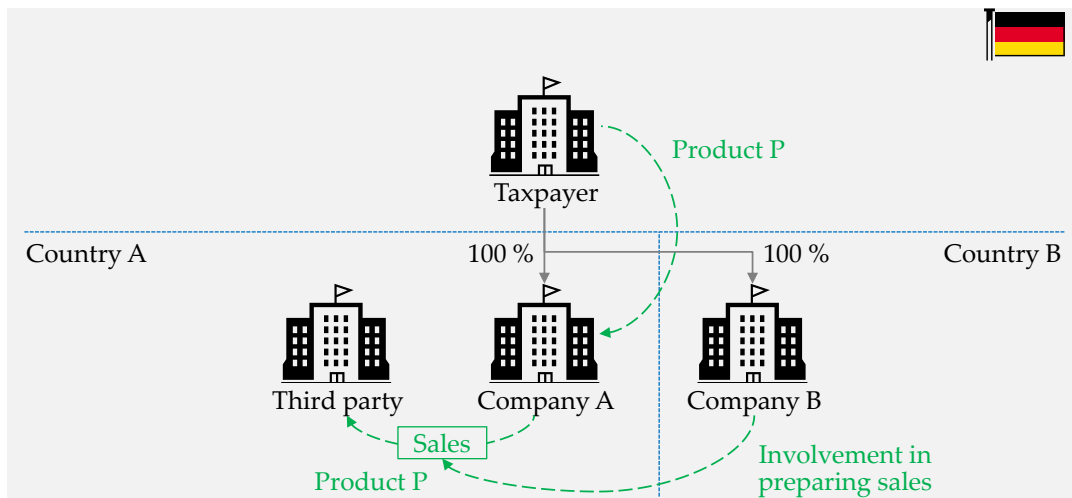


Figure 43. Illustration of the case at hand.

As a result company A's income from trade is excluded from CFC income. Although the resident taxpayer provides company A with control over product P it is not involved in preparing the sales in country A, Paragraph 8(1) number 4 of the AStG. According to the prevailing view in German tax literature the involvement of company B is not harmful, as the latter is not subject to tax in Germany (Kaligin et al, 2015, paras. 55, 63, 81).

The aforementioned structurings work analogously where company A provides the resident taxpayer with control over a product purchased from a third party. Does company A sell the product through company B to the resident taxpayer, the conditions set forth in Paragraph 8(1) number 4(b) of the AStG are not met, i.e. company A's income is excluded from CFC income. Whether the resident taxpayer is involved in the purchase in country A is irrelevant. Alternatively, again, the resident taxpayer might cease its involvement in the purchase in country A and let company B assume such an involvement henceforward, Paragraph 8(1) number 4 of the AStG.

2.3.3.3.3 Services

The structurings presented above (see "2.3.3.3.2 Trade") work analogously for Paragraph 8(1) number 5 of the AStG. However, there is one exception. Does a CFC make use of certain resident taxpayers/related persons in performing its services, this is always harmful according to Paragraph 8(1) number 5(a) of the AStG. Other than under Paragraph 8(1) number 5(b) of the AStG, the resident

taxpayer may not prove that the CFC maintains a business organization that is equipped in a commercial manner to render such services, participates in general commerce and carries out the activities associated thereto without the involvement of certain resident taxpayers/related persons. Nevertheless, Paragraph 8(1) number 5(a) of the AStG allows a further structuring opportunity.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A performs services to third parties in country A. Company A makes use of the resident taxpayer in performing these services. To avoid that all of company A's income from services is deemed CFC income, it ceases to make use of the resident taxpayer in performing these services. Instead the resident taxpayer enters henceforward regarding its involvement in company A's services into separate agreements with the third parties. Figure 44 illustrates the case at hand.

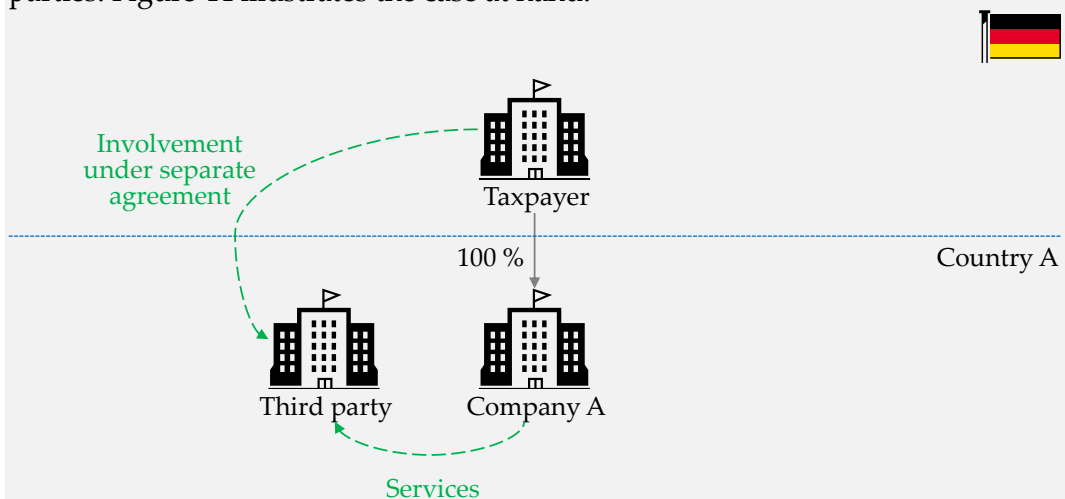


Figure 44. Illustration of the case at hand.

Initially company A makes use of the resident taxpayer in performing its services to third parties. Thus, its income from services is deemed CFC income according to Paragraph 8(1) number 5(a) of the AStG. Through the structuring depicted above the services are split (Strunk et al, 2018, Chapter § 8, para. 101) into services owed and performed exclusively by company A and the further involvement owed and performed by the resident taxpayer. As a result company A makes no longer use of the resident taxpayer in performing its services. Hence,

company A's income from services is excluded from CFC income under the general rule, Paragraph 8(1) number 5 of the AStG.

2.3.3.3.4 Letting and leasing

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, which in turn holds 100 percent of the ownership interests in company B. Company A and B are resident in country A, a low tax jurisdiction. Company A licenses product and production know-how to company B. The latter uses the know-how to produce product P. The know-how is the results of research and development work, which company A carried out with the involvement of the resident taxpayer. To avoid that the income from the know-how is deemed CFC income, company A decides to produce product P itself. Figure 45 illustrates the case at hand.

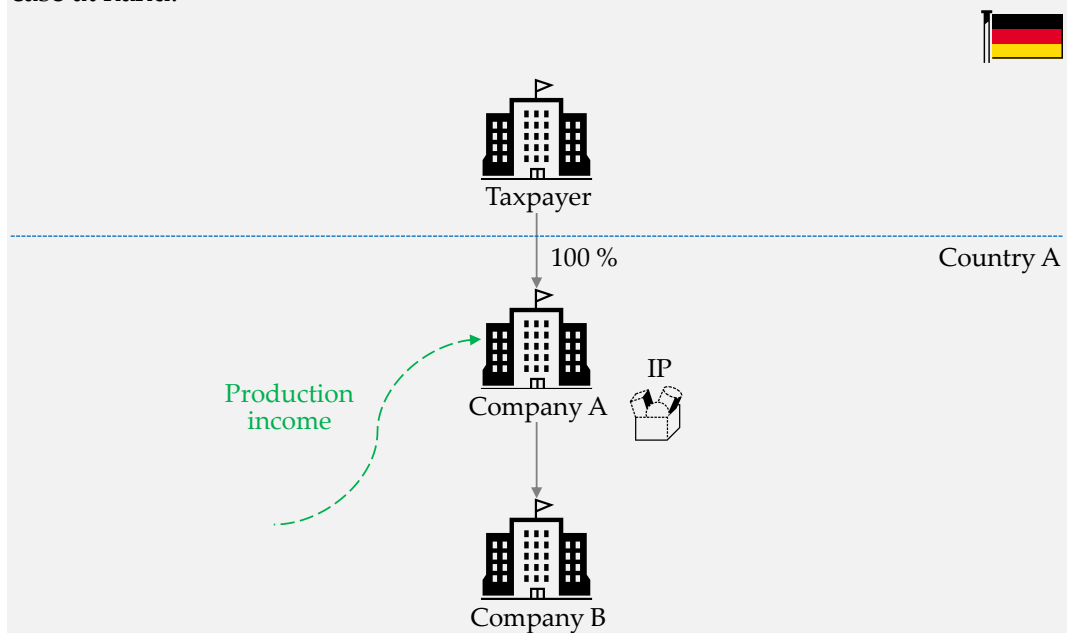


Figure 45. Illustration of the case at hand.

Initially the income from licensing the product and production know-how is deemed CFC income, as the know-how is the results of research and development work, which company A carried out with the involvement of the resident taxpayer, Paragraph 8(1) number 6(a) of the AStG. However, through the structuring depicted above, company A ceases to earn income from licensing and starts earning

income from production, which is excluded from CFC income (Heuermann, & Brandis, 2018, Chapter § 8, para. 25).

2.3.3.3.5 Sale of a share in another company etc.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, which in turn holds 100 percent of the ownership interests in company B. Company A and B are resident in country A, a low tax jurisdiction. Company A wants to sell its shares in company B to a third party at 1,000. This would exceed the book value of 800 by 200 (hidden reserves). The capital gain of 200 would be allocable to assets of company B which are used to carry on activities in terms of Paragraph 7(6a) of the AStG. Figure 46 illustrates the case at hand.

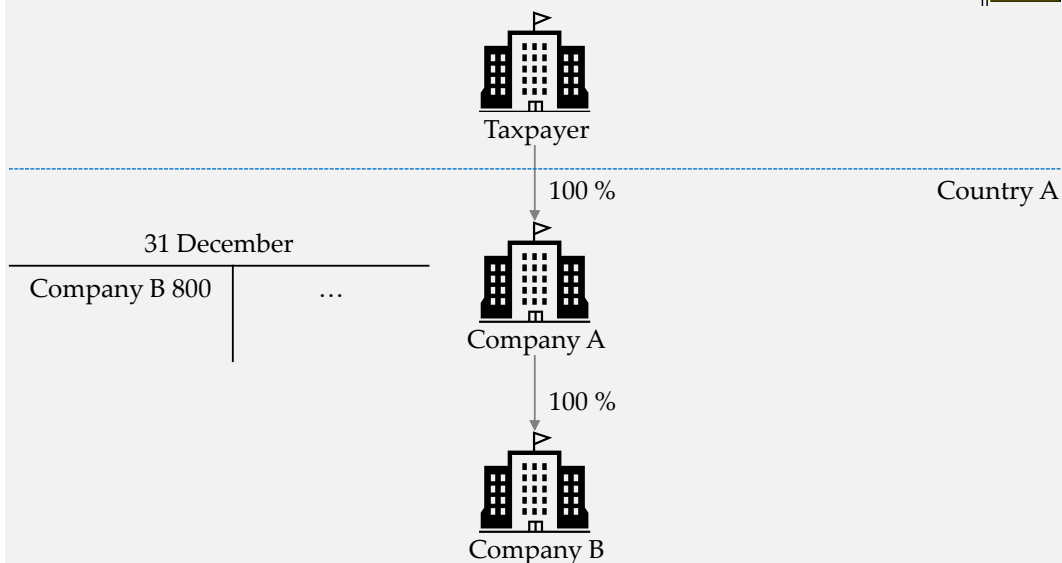


Figure 46. Illustration of the case at hand.

According to Paragraph 8(1) number 9 of the AStG income from the sale of a share in another company is, generally, active. However, such income is inter alia passive, if it is allocable to assets of the other company which are used to carry on activities in terms of Paragraph 7(6a) of the AStG. Hence, in the case at hand, the capital gain of 200 would be deemed CFC income. Now, to avoid a CFC taxation, company B might instead distribute first profits of 200 (active according to Paragraph 8(1) number 8 of the AStG) and sell afterwards its shares in company B

at 800 to the third party (Wassermeyer, 2018, p. 746). As the sales price would be equal to the book value of 800, no capital gain would arise.

2.3.3.3.6 Sale of assets

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A holds an asset with significant hidden reserves. Since the purchase of the asset company A has earned with it income from other categories than those listed under Paragraph 8(1) of the AStG. Company A wants to sell the asset. To avoid CFC taxation the resident taxpayer considers to sell its ownership interests in company A instead. Figure 47 illustrates the case at hand.

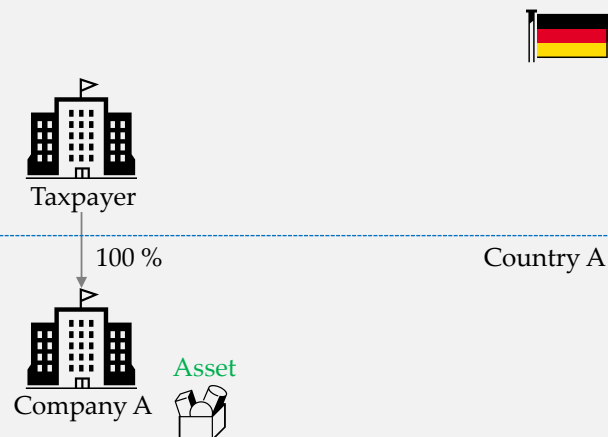


Figure 47. Illustration of the case at hand.

Would company A sell the asset directly, a gain therefrom would be deemed CFC income, as the asset was used since its purchase to earn income from other categories than those listed under Paragraph 8(1) of the AStG (see “2.3.3.2.1.10 Sale of assets”). By selling the ownership interests in company A instead, a CFC taxation of the significant hidden reserves may be avoided. Gains therefrom are taxed at the level of the resident taxpayer according to the general rules, i.e. they are effectively 95 percent tax free, Paragraph 8b(2) and (3) of the KStG (Haase, 2017b, para. 542). The relevant DTT usually grants the exclusive taxation right for such gains to Germany.

Alternatively such an asset could be transferred indirectly in the course of a reorganization that falls under Paragraph 8(1) number 10 of the AStG without

triggering a CFC taxation of the hidden reserves (Strunk et al, 2018, Chapter § 8, para. 182.2).

2.3.3.4. ATAD compliance

To make the German definition of CFC income ATAD compliant, the following amendments will be necessary:

- ▶ The current Paragraph 8(1) number 3 of the AStG provides that, under certain conditions, income from the operation of banks and insurance companies is not considered CFC income. However, Article 7(2)(a)(v) of the ATAD, deems non-distributed income from insurance and banking activities to be CFC income.

Furthermore, income from financial leasing by banks may be active under Paragraph 8(1) number 3 of the AStG, if for the business an organization is maintained that is equipped in a commercial manner, provided such business is not transacted predominantly with resident taxpayers holding ownership interests in the CFC in terms of Paragraph 7 of the AStG or with parties that are related to such taxpayers within the meaning of Paragraph 1(2) of the AStG. However, according to Article 7(2)(a)(iv) of the ATAD income from financial leasing has to be passive.

Nevertheless, the impact of amending Paragraph 8(1) number 3 of the AStG accordingly may be limited, as banks and insurances are likely to carry on a substantive economic activity supported by staff, equipment, assets and premises, i.e. a CFC taxation is usually not triggered in light of the activity clause provided under Article 7(2)(a) of the ATAD, at least if the latter applies, as recommended, worldwide (see “2.3.6.3 Proof to the contrary”);

- ▶ Pursuant to Article 7(2)(a)(vi) of the ATAD income of invoicing companies that earn sales/service income from goods/services purchased from and sold to associated enterprises, without adding more than little economic value, is deemed CFC income. In light of the foregoing article Paragraph 8(1) number 4 and 5 of the AStG will have to be amended, as thereunder income from goods/services purchased from and sold to persons related in terms of Paragraph 1(2) of the AStG to a resident taxpayer holding ownership interests in the CFC in terms of Paragraph 7

of the AStG, is always active, unless such a related persons is liable to tax in Germany with its income (Schnitger et al, 2016, p. 969);

- ▶ Paragraph 8(1) number 6(a) of the AStG establishes that income from licensing the use of rights, plans, samples, procedures, experience, and knowledge is not deemed CFC income, if the CFC is exploiting the results of its own research and development work, which was carried out without the involvement of a resident taxpayer holding ownership interests in the CFC in terms of Paragraph 7 of the AStG or a person related to such a taxpayer in terms of Paragraph 1(2) of the AStG. This is not in line with Article 7(2)(a)(ii) of the ATAD according to which royalties or any other income generated from IP has to be deemed CFC income (Wenzel, 2017, p. 437);
- ▶ The current Paragraph 8(1) number 7 of the AStG provides that raising and lending of capital is active, if the taxpayer proves that such capital is raised solely on foreign capital markets and not from a person related to the taxpayer or to the CFC in terms of Paragraph 1(2) of the AStG, and that such capital is provided either to foreign businesses or PEs that derive their gross revenue exclusively or almost exclusively from the business activities listed in Paragraph 8(1) numbers 1 to 6 of the AStG, or to active or passive domestic businesses or PEs. However, under Article 7(2)(a)(i) of the ATAD any income generated by financial assets has to be passive (Wenzel, 2017, p. 437); and
- ▶ According to Article 7(2)(a)(iii) of the ATAD dividends and income from the disposal of shares have to be deemed CFC income. However, pursuant to Paragraph 8(1) numbers 8 and 9 of the AStG dividends are always excluded from CFC income (see “2.3.3.1.1.8 Profit distributions”) and income from the disposal of shares is generally deemed active income (see “2.3.3.1.1.9 Sale of a share in another company etc.”). Hence, Paragraph 8(1) numbers 8 and 9 of the AStG has to be amended to become ATAD compliant. However, the impact of such an amendment may be limited. According to Article 7(1)(b) of the ATAD the tax rate exemption applies where the actual corporate tax paid by the entity or PE on its profits is at least 50 percent of the corporate tax as computed according to the rules of the member state of the taxpayer. Under the German tax rules

dividends and income from the disposal of shares are often fully tax exempt (Paragraph 8b of the KStG), partially tax exempt (40 percent, Paragraph 3 number 40 of the EStG) or taxed at a preferential tax rate (25 percent, Paragraph 32d of the EStG). Thus, the aforementioned tax rate exemption, but also the German tax rate exemption, once amended as recommended above (see “2.2.6.2 Tax rate exemption”), are likely to exclude most dividends and income from the disposal of shares in the future.

Please note that parts of the German tax literature (Schnitger, & Gebhardt, 2018, pp. 217, 218) hold that the current German CFC rules regarding the qualification of dividends as active income is in line with the ATAD, as the German CFC taxation is – other than the ATAD – also applicable where a dividend is actually distributed. One voice of the German tax literature even trusts that the current German CFC rules regarding the sale of a share in another company etc. are in line with the ATAD (Becker, & Loose, 2018b). I do not share the foregoing views considering the clear wording of Article 7(2)(a)(iii) of the ATAD.

2.3.4. Spain

2.3.4.1. Rules

Broadly, under the Spanish CFC rules CFC income is determined as follows. In a first step the CFC’s substance is tested. Is the result of the test negative, generally, all income of the CFC is considered CFC income. There are, however, exceptions for dividends, shares in profits and income derived from the transfer of shares, i.e. especially holding companies are not subject to a substance test (Sanz Gadea, 2016, p. 1363). Is the result of the substance test positive, generally, only income from the sources set forth in Article 91(3) of the IRPF and Article 100(3) of the LIS is subject to CFC taxation. Irrespective of the result of the substance test, a taxpayer may prove for a CFC, resident in an EU member state, the latter’s activity. Does the taxpayer prove the foregoing, no CFC taxation occurs.

2.3.4.1.1 Substance test

According to Article 91(2) of the IRPF and Article 100(2) of the LIS the taxpayers pay tax on the total income earned by a CFC, if the latter does not have

the corresponding organization of material and human resources to earn the income, even if the operations have a recurring character. This does not apply, if the taxpayer can prove that the aforementioned operations are realized with material and human resources of a non-resident entity, belonging to the same group in terms of Article 42 of the Spanish Commercial Code [Código de Comercio] (“CCo”), regardless of its residence or obligation to file consolidated annual accounts, or if the CFC's incorporation and operation ground on valid economic reasons. However, in the case of dividends, shares in profits, or income derived from the transfer of shares, Article 91(4) of the IRPF and Article 100(4) of the LIS prevail.

2.3.4.1.2 Negative list

If Article 91(2) of the IRPF and Article 100(2) of the LIS do not apply, Article 91(3) of the IRPF and Article 100(3) of the LIS provide that only the positive income from each of the following sources is taxed (i.e. not necessarily all income of the CFC; Alonso Alonso, 2017, p. 878):

- (a) Ownership of lands and buildings or rights in rem thereon, unless connected to an economic activity (e.g. hotel business or letting of garages or warehouses; Borrás Amblar, & Navarro Alcázar, 2017, p. 1379), or made available for use for a given period to non-resident entities belonging to the same group of companies of the owner in terms of Article 42 of the CCo, regardless of its residence or obligation to file consolidated annual accounts, if connected to economic activity of the non-resident entity (Caamaño Anido, 2017, p. 1547);
- (b) Participation in the equity of any type of entity (especially dividend income; Borrás Amblar, & Navarro Alcázar, 2017, p. 1380) or the transfer of own capital to third parties (especially interest income; Borrás Amblar, & Navarro Alcázar, 2017, p. 1380) in terms of Article 25(1) and (2) of the IRPF. However, positive income from the following financial assets is excluded:
 - ▶ Financial assets being held to comply with legal and regulatory obligations, resulting from the exercise of economic activities (concerns particularly banks and insurances; Mellado Benavente, 2017, p. 859);

- ▶ Financial assets that incorporate credit claims, resulting from contractual relations established in the course of exercising economic activities;
- ▶ Financial assets being held as a consequence of exercising intermediary activities on official securities markets; and
- ▶ Financial assets being held by credit institutions and insurers as a consequence of exercising their activities, subject to Article 91(3)(g) of the IRPF and Article 100(3)(g) of the LIS.

The positive income from the transfer of own capital to third parties is deemed to be derived from the realization from credit and financial activities in terms of Article 91(3)(g) of the IRPF and Article 100(3)(g) of the LIS, if creditor and debtor, belong to the same group of companies in terms of Article 42 of the CCo, regardless of the residence or obligation to file consolidated annual accounts, if at least 85 percent of the debtor's income proceeds from the exercise of economic activity;

- (c) Capitalization and insurance operations, which have the CFC (Caamaño Anido, 2017, p. 1548) itself as beneficiary;
- (d) Industrial and intellectual property, technical assistance, movable property, image rights, leasing and sub-leasing of businesses or mines. The foregoing does not comprise income from technical assistance, which is rendered in connection with an economic activity. The same holds true for income from letting of movable property, e.g. cars or containers, if the letting is an economic activity (Sanz Gadea, 2016, p. 1362);
- (e) Capital gains from the transfer of the aforementioned assets and rights;
- (f) Derivative financial instruments except for those designated to cover a specific risk derived from economic activities;
- (g) Credit, financial, insurance and service activities provided to related persons or entities, resident in Spain, so far as they give rise to tax-deductible expenses for the foregoing resident entities, unless the income earned by the CFC from the aforementioned activities is derived to more than 50 percent from non-related persons or entities. For each of the aforementioned activities the threshold has to be calculated separately (Borrás Amblar, & Navarro Alcázar, 2017, p. 1383).

According to Article 91(4) of the IRPF and Article 100(4) of the LIS income in terms of Article 91(3)(b) and (e) of the IRPF and Article 100(3)(b) and (e) of the LIS (especially dividends, interests and capital gains) is not taxed, if the CFC holds 5 percent or more of the capital or equity of the entity from which the income is derived for at least one year in order to manage the latter and provided that it counts with the appropriate human and material resources. However, the entity from which the income is derived has to exercise an economic activity (Sanz Gadea, 2016, p. 1367). Where entities form a group, the requirements regarding the percentage of capital/equity held and regarding the management of the entity from which the income is derived have to be fulfilled at group level.

Income from sources listed under Article 91(3) of the IRPF and Article 100(3) of the LIS is not taxed according to Article 91(5) of the IRPF and Article 100(6) of the LIS, if it gives rise to non-tax-deductible expenses for entities resident in Spain.

2.3.4.1.3 Principal purpose test

Article 91(15) of the IRPF and Article 100(16) of the LIS provide that the CFC rules do not apply to CFCs resident in the EU provided that the taxpayer proves that the incorporation and operation of the CFC respond to valid economic reasons and that the CFC carries out an economic activity or that the CFC is a certain collective investment institution.

2.3.4.2. *Issues*

2.3.4.2.1 Substance test

Article 91(2) of the IRPF and Article 100(2) of the LIS provide broadly that the total income of a CFC is deemed CFC income, if neither the CFC nor a non-resident group entity counts with the corresponding organization of material and human resources to earn it. This does not hold true, if the taxpayer proves that the CFC's incorporation and operation ground on valid economic reasons.

A substance test is a more qualitative measure than a categorical analyses and may be more accurate than the latter. However, the inclusion of a substance test leads to an increased administrative and compliance burden (OECD, 2015c, para. 83). Now, to strike the balance between the foregoing advantage and disadvantage, substance should only be tested for income from certain narrow categories.

However, according to Article 100(2) of the LIS substance has to be tested for income from almost all categories. Only dividends, shares in profits, and income derived from the transfer of shares is excluded.

Furthermore, the substance test according to Article 91(2) of the IRPF and Article 100(2) of the LIS may be clearly over-inclusive.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. The resident taxpayer produces product P and sells it to company A. The latter sells product P in various countries. Company A's total income amounts to 100. Company A counts with the corresponding organization of material and human resources to earn 90 percent of it. Only 10 percent of company A's total income is earned with material and human resources of the resident taxpayer. Figure 48 illustrates the case at hand.

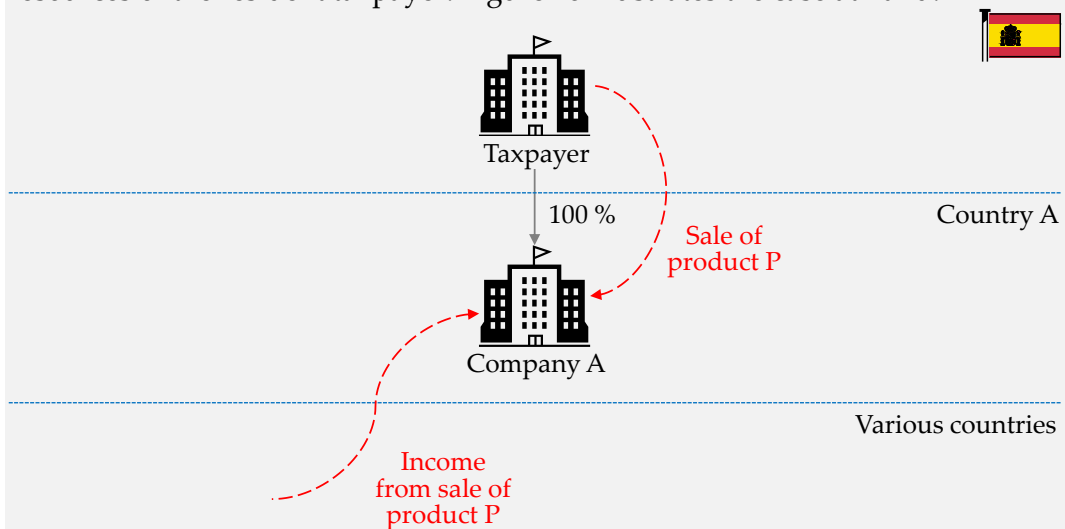


Figure 48. Illustration of the case at hand.

According to the wording of Article 100(2) of the LIS the total income of company A is deemed CFC income, as neither the latter nor a non-resident group entity counts with the corresponding organization of material and human resources to earn the total income of company A, unless the resident taxpayer proves that the CFC's incorporation and operation ground on valid economic reasons.

Now, Article 91(2) of the IRPF and Article 100(2) of the LIS could be less over inclusive, if instead of requiring that the CFC and further non-resident group

entities count with the corresponding organization of material and human resources to earn the total income of the CFC, it was sufficient to count with such an organization to earn a certain percentage of the CFC's total income, e.g. more than 75 percent. Is the percentage met, all income of the CFC is excluded from CFC income, otherwise all income is included. Apparently this would usually lead to over- or under-inclusive results. Furthermore it allows to locate just the right type and amount of activity in a CFC (OECD, 2015c, para. 82). Preferable would be therefore to apply the substance test as a proportionate test, i.e. where a CFC e.g. counts with such an organization to earn 60 percent of its total income, 40 percent of the CFC's income should be deemed CFC income. Although this would increase the administrative and compliance burden, limiting the substance test, as proposed above, to income from certain categories should hold the burden at a manageable level.

Last but not least, the Spanish legislator might consider to do not only look under Article 91(2) of the IRPF and Article 100(2) of the LIS at the corresponding organization of material and human resources, but also at the ownership of IP and at the management/control of risks.

2.3.4.2.2 Negative list

2.3.4.2.2.1 Lands etc.

Article 91(3)(a) of the IRPF and Article 100(3)(a) of the LIS provide, generally, that the positive income from the ownership of lands and buildings or rights in rem thereon is deemed CFC income. The idea behind this general rule seems to be to avoid treaty shopping.

Example

A resident taxpayer wants to purchase land in country L, a low tax jurisdiction, and lease it to company L. However, as usually, Article 6(1) of the DTT between Spain and country L provides that "income derived by a resident of a contracting state (Spain) from land situated in the other contracting state (country L) may be taxed in that other state (country L). Furthermore, the method article of the foregoing DTT provides that Spain applies the credit method to avoid double taxation. Now to avoid a taxation in Spain, the resident taxpayer decides to incorporate company A in country A, a low tax jurisdiction, and funds the latter

sufficiently to purchase the land in country L. After purchasing the land company A leases it to company L. Figure 49 illustrates the case at hand.

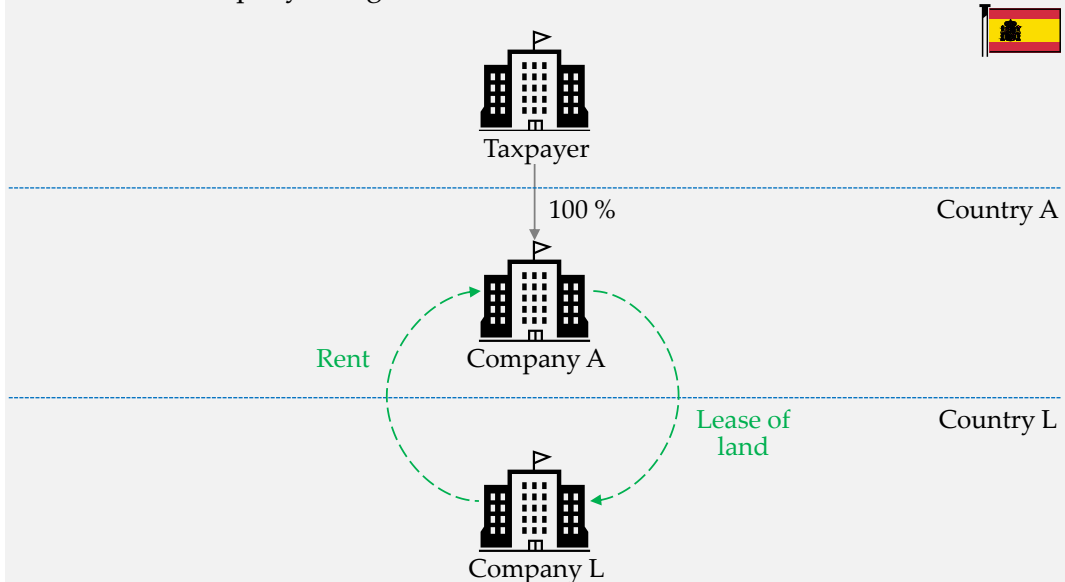


Figure 49. Illustration of the case at hand.

Again, Article 6(1) of the DTT between country A and country L provides that "income derived by a resident of a contracting state (country A) from land situated in the other contracting state (country L) may be taxed in that other state (country L). However, the method article of the foregoing DTT provides that country A applies the exemption method to avoid double taxation. Hence, the income from the lease of the land in country L would be only subject to low taxation in country L. Now, Article 100(3)(a) of the LIS considers the foregoing income CFC income. Are the further conditions met, a CFC taxation is triggered.

Although the CFC taxation of the lease of land may be reasonable in the foregoing example, the rule is clearly over-inclusive. Imagine a CFC, which earns in its jurisdiction of residence income from production (not included in the negative list) and pays tax thereon. The CFC is not likely to invest its income after tax into land to lease it afterwards, as it would be always taxed due to the CFC taxation at the Spanish level. In light of the foregoing the recommendation is to address treaty shopping concerns in targeted anti-treaty shopping rules, but not in CFC rules.

2.3.4.2.2.2 Interests

According to Article 91(3)(b) of the IRPF and Article 100(3)(b) of the LIS interests are generally deemed CFC income. However, they are privileged, if they are earned from intragroup financing and the non-resident debtor earns at least 85 percent of its income from the exercise of economic activity (Article 91(3)(b) of the IRPF and Article 100(3)(b) of the LIS). The UK CFC rules contain a similar provision which is currently subject to a state aid investigation of the European Commission (see “2.3.5.2.2.1 State aid”).

2.3.4.2.2.3 Industrial property etc.

According to Article 91(3)(d) of the IRPF and Article 100(3)(d) of the LIS inter alia the positive income from industrial and intellectual property, technical assistance and image rights is deemed CFC income. The foregoing articles go beyond the German rule (Paragraph 8(1) number 6(a) of the AStG) and seem clearly over-inclusive, considering that CFC income is even assumed where the CFC develops or purchases the underlying industrial property etc. in its jurisdiction of residence, i.e. in pure foreign cases (see also “2.3.3.2.1.6 Letting and leasing”).

2.3.4.3. *Structurings*

2.3.4.3.1 Negative list

2.3.4.3.1.1 Financial assets

Broadly, Article 91(3)(b) of the IRPF and Article 100(3)(b) of the LIS provide that dividends and interests are deemed CFC income. However, according to Article 91(3)(b)(1) of the IRPF and Article 100(3)(b)(1) of the LIS, positive income from financial assets being held to comply with legal and regulatory obligations, resulting from the exercise of economic activities (e.g. banking or insurance business) is excluded. As some states have proven very creative to help foreign parents to avoid the application of the CFC rules in their countries of residence (see “2.2.3.1.2 Tax rate exemption”), there is a risk that they might unduly raise especially the legal and regulatory obligations for banks and insurance companies to hold financial assets.

2.3.4.3.1.2 Credit etc.

According to Article 91(3)(g) of the IRPF and Article 100(3)(g) of the LIS the positive income from credit, financial, insurance and service activities provided to related persons or entities, resident in Spain, is taxed, so far as it gives rise to tax-deductible expenses for the foregoing resident entities. This does not hold true, if the income earned by a CFC from the aforementioned activities is derived to more than 50 percent from non-related persons or entities. However, if the income earned by a CFC from the aforementioned activities is derived to 50 percent or less from non-related persons or entities the resident taxpayer might incorporate a second CFC and shift some of the income earned from related persons or entities to the latter in order to meet the 50 percent threshold. Thereby, the CFC taxation may be reduced significantly (see “2.3.3.3.1 Banks and insurance companies”).

Furthermore, the threshold established in Article 91(3)(g) of the IRPF and Article 100(3)(g) of the LIS may simply be exploited.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A. The corporate tax rate in country A is 5 percent. Company A provides services to unrelated persons and derives therefrom an income of 4,000,000 €. The resident taxpayer decides to shift various group functions (HR, IT etc.) to company A, which provides them henceforward under a service agreement to the resident taxpayer at a consideration of 3,500,000 €. The consideration is a tax-deductible expense for the resident taxpayer. Figure 50 illustrates the case at hand.

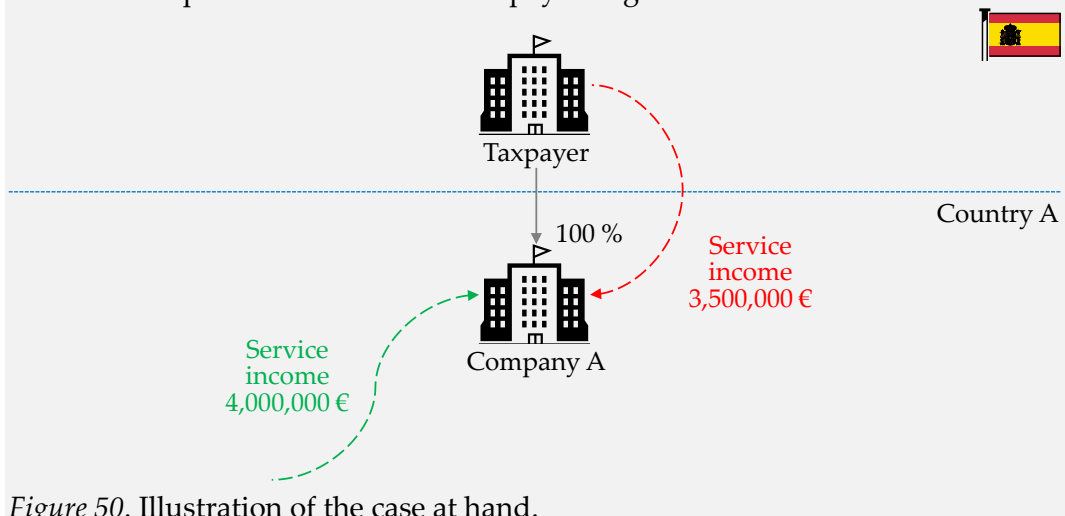


Figure 50. Illustration of the case at hand.

Basically company A's income earned from services provided to the resident taxpayer is deemed CFC income under Article 100(3)(g) of the LIS. However, as more than 50 percent of company A's total income from services is derived from non-related persons or entities, all service income is excluded from CFC income, Article 100(3)(g) of the LIS. Throughout the group the corporate tax benefit from shifting various group functions (HR, IT etc.) to company A amounts to 700,000 € (3,500,000 € x 25 percent - 3,500,000 € x 5 percent). Now, to avoid such an exploitation the relative threshold could be combined with an absolute threshold.

2.3.4.4. ATAD compliance

To make the Spanish definition of CFC income ATAD compliant, the following amendments will be necessary (Sanz Gadea, 2017, p. 43):

- ▶ Currently certain interests and dividends are not deemed CFC income (see "2.3.4.1.2 Negative list"). However, Article 7(2)(a)(i) and (iii) of the ATAD provides that all interests and dividends have to be considered CFC income;
- ▶ Income from financial leasing has to be included in the negative list, Article 7(2)(a)(iv) of the ATAD;
- ▶ Income from insurance, banking and other financial activities has to be included in the negative list, Article 7(2)(a)(v) of the ATAD; and
- ▶ Pursuant to Article 7(2)(a)(vi) of the ATAD income of invoicing companies that earn sales/service income from goods/services purchased from and sold to associated enterprises, without adding more than little economic value, have to be deemed CFC income.

However, the impact of the aforementioned required amendments may be limited:

- ▶ Interests are currently privileged, if they are earned from intragroup financing and the non-resident debtor earns at least 85 percent of its income from the exercise of economic activity (Article 100(3)(b) of the LIS). In the future such interests may remain excluded from the CFC income in light of the activity clause (see "2.3.2.2 Activity clause"; Sanz Gadea, 2017, p. 44);
- ▶ Dividends are currently not deemed CFC income, if they are connected to certain economic activities (Article 100(3)(b) of the LIS) or if at least 5

percent of the capital or equity of an entity are held for at least one year in order to manage the latter and provided that it counts with sufficient substance (Article 100(4) of the LIS). Again, in the future such dividends may remain excluded from CFC income under the activity clause. However, regarding the latter alternative should be noted that holding capital or equity in an entity in order to manage it, is – by itself – not sufficient to fulfill the requirements set forth in the activity clause (Sanz Gadea, 2017, pp. 43, 44);

- ▶ As for interests and dividends, in the future the activity clause is likely to exclude income from insurance, banking, other financial activities and financial leasing from the CFC income, as such income is usually income from a substantive economic activity (Sanz Gadea, 2017, p. 43); and
- ▶ Income from invoicing companies is currently often deemed CFC income under Article 100(2) of the LIS. However, this does not hold true, if the CFC or another non-resident group entity counts with the corresponding organization of material and human resources to earn such income. The foregoing exception will no longer be possible in light of Article 7(2)(a)(vi) of the ATAD (Sanz Gadea, 2017, p. 44).

2.3.5. UK

2.3.5.1. Rules

According to Section 371AA(5)(b) of the TIOPA the following gateways filter from the assumed total profits (see “2.3.5.1.1 Profits attributable to UK activities”; Whiting, & Gunn, 2019, Binder 5, para. D4.425) of a CFC those profits which will be subject to CFC charge:

- ▶ Profits attributable to UK activities, Chapter 4 of the TIOPA;
- ▶ Non-trading finance profits, Chapter 5 of the TIOPA;
- ▶ Trading finance profits, Chapter 6 of the TIOPA;
- ▶ Captive insurance business, Chapter 7 of the TIOPA; and
- ▶ Solo consolidation, Chapter 8 of the TIOPA.

To reduce the compliance burden that the above chapters could impose on UK corporates, Chapter 3 of the TIOPA establishes in what situations these gateway tests apply (initial gateway; Delaney, & Murray, 2012, para. 8).

2.3.5.1.1 Profits attributable to UK activities

2.3.5.1.1.1 Initial gateway

If one of the following conditions is met during the accounting period, Chapter 4 of Part 9A of the TIOPA does not apply, Section 371CA(1) of the TIOPA:

- ▶ The CFC does not hold at any time during the accounting period assets or bear risks under an arrangement, of which at least one of the main purposes is to reduce or eliminate any liability of any person to UK tax or duty, and in consequence of the arrangement, at any time the CFC expects its business to be more profitable than it would be otherwise. Further, there has to be an expectation that at least one person will have its liability to tax or duty imposed under the law of any territory reduced or eliminated and it must be reasonable to suppose that, but for that expectation, the arrangement would not have been made, Section 371CA(2) to (4) of the TIOPA;
- ▶ The CFC does not have at any time during the accounting period UK managed assets or bear UK managed risks, Section 371CA(5) of the TIOPA. UK managed asset or risk means that the acquisition, creation, development or exploitation of the asset, or the taking on, or bearing of the risk, is managed or controlled to any significant extent by way of activities carried on in the UK by the CFC, unless through a UK PE, or by companies connected with the CFC under arrangements which would reasonably not be entered into by unconnected companies, Section 371CA(9) and (10) of the TIOPA;
- ▶ The CFC has itself at any time during the accounting period the capability to ensure that its business would be commercially effective were UK managed assets and risks stopped being UK managed, Section 371CA(6) of the TIOPA; or
- ▶ The CFC's assumed total profits consist only of non-trading finance and/or property business profits, Section 371CA(11) of the TIOPA.

As the foregoing conditions are alternatives, a CFC only needs to meet only one of them. Especially the main purpose motive test above is considered to exclude many CFCs from this gateway (Harper, & Walton, 2017, para. 22.17).

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction and in company B, resident in country B. Company A licenses IP to company B. Initially the IP was purchased by company A in country A from a third party. Since then, the further development and the exploitation of the IP are assumed by company A's local personnel. Company A also bears the risks resulting therefrom. Figure 51 illustrates the case at hand.

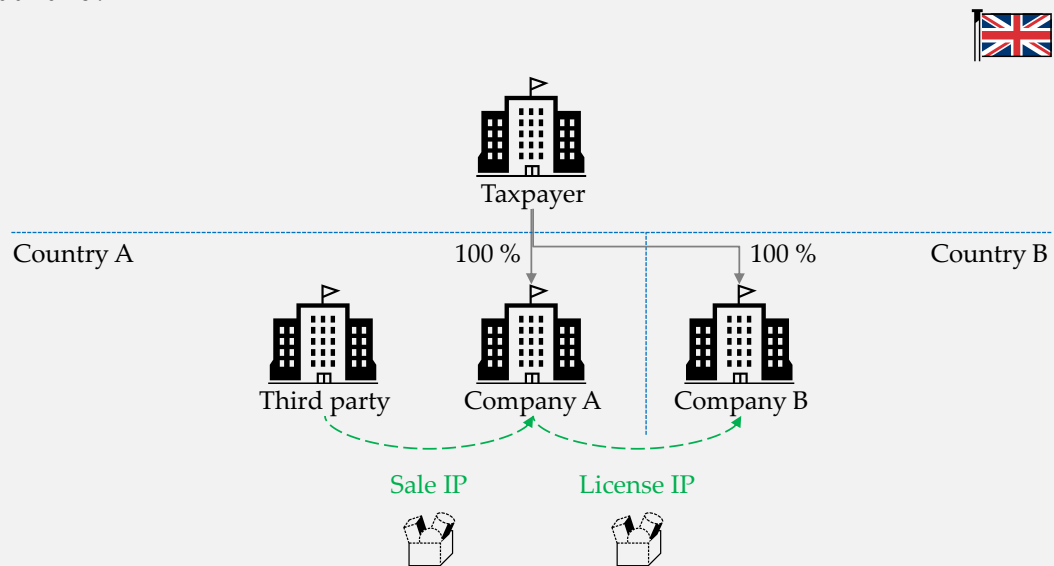


Figure 51. Illustration of the case at hand.

As neither the acquisition, further development or exploitation of the IP, nor the bearing of the risk, are managed or controlled to any extent by way of activities carried on in the UK by the CFC, the latter does not have UK managed assets or risks. Hence the exclusion provided under Section 371CA(5) of the TIOPA is met, i.e. Chapter 4 of Part 9A of the TIOPA does not apply, Section 371CA(1) of the TIOPA. Although this result seems totally adequate, as the case at hand does not raise any profit shifting concerns, the German and the Spanish CFC rules would come to different results (see “2.3.3.2.1.6 Letting and leasing” and “2.3.4.2.2.3 Industrial property etc.”).

2.3.5.1.1.2 Profits passing through the gateway

Does Chapter 4 of Part 9A of the TIOPA apply, the CFC's profits falling within this chapter are determined according to Section 371DA(1) of the TIOPA as follows:

- ▶ First, the CFC's relevant assets and risks have to be identified, i.e. assets and risks from which amounts included in the CFC's assumed total profits have arisen, Section 371DB(1) Step 1 of the TIOPA. A relevant asset or risk is excluded if the CFC's assumed total profits are only negligibly higher than what they would be if the CFC had not held or borne the asset or risk, Section 371DB(1) Step 2 and (2) of the TIOPA;
- ▶ Then the significant people functions and key entrepreneurial risk-taking functions ("SPFs") carried out by the CFC group (assuming it was a single company) which are relevant to the economic ownership of the assets, or the assumption and management of the risks included in the relevant assets and risks, have to be identified, Sections 371DA(3)(f) and 371DB(1) Step 3 of the TIOPA. Neither the provision of an advisory function, nor of supervisory function (e.g. deciding on a proposal) are SPFs. The same holds true for governance arrangements (Harper, & Walton, 2017, para. 22.17);
- ▶ The SPFs identified are divided in UK SPFs, i.e. SPFs carried out in the UK by the CFC, unless through a UK PE, or by a company connected with the CFC, and non-UK SPFs, Sections 371DA(3)(g) and (h) and 371DB(1) Step 4 of the TIOPA:
 - ▶ Are all SPFs non-UK SPFs, this gateway test is not met and the CFC's assumed total profits are not subject to CFC charge (Whiting, & Gunn, 2019, Binder 5, para. D4.425);
 - ▶ Are there UK SPFs, they are deemed to be carried out by a UK PE of the CFC and, accordingly, the extent to which the assets and/or risks included in the relevant assets and risks would be attributed to the UK PE is determined, Section 371DB(1) Step 5 of the TIOPA.
- ▶ In the next step the assets and/or risks to which Section 371DC of the TIOPA applies are excluded from the relevant assets and risks, Section 371DB(1) Step 6 of the TIOPA. This is the case where the following condition is met:

Formula

<p>Total of the gross amounts of the CFC's income and additional expenses which would not have become receivable or which would not have been incurred during the accounting period had the CFC not held and/or borne the asset and/or risk, so far as attributed to the UK PE</p>	$\leq 50\%$	<p>Total of the gross amounts of the CFC's income and additional expenses which would not have become receivable or which would not have been incurred during the accounting period had the CFC not held and/or borne the asset and/or risk to any extent at all</p>
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In other words all profits attributable to assets and risks of the CFC which are not mainly allocable to a deemed UK PE arising from the existence of UK SPFs are excluded from CFC charge (MacLachlan, 2012, para. 5.100);

- ▶ Finally, the CFC's assumed total profits are re-determined, assuming that the CFC does not hold and/or bear assets and/or risks included in the relevant assets and risks, so far as they would be attributed to the UK PE. So far as the CFC's assumed total profits are left out of the re-determined profits, they fall within Chapter 4 of Part 9A of the TIOPA, however, subject to the following exclusions, Section 371DB Steps 7 and 8 of the TIOPA:

- ▶ According to Section 371DD(2) of the TIOPA amounts are to be excluded, if the net economic value (Section 371DD(3) of the TIOPA) to the CFC group which results from the holding of the asset, or the bearing of the risk, exceeds what it would have been had the asset been held or the risk been borne by UK resident companies connected with the CFC, and the relevant non-tax value (371DD(4) of the TIOPA) is a substantial proportion, i.e. 20% or greater (MacLachlan, 2012, para. 5.101), of this excess value;
- ▶ Section 371DE(2) of the TIOPA excludes amounts if it is reasonable to suppose that, were the UK SPFs not to be carried out by companies connected with the CFC, it would enter into the same arrangements (in relation to structure and commercial effect on its business) with unconnected companies;

- ▶ Finally, Section 371DF(1) of the TIOPA provides an exclusion for trading profits, if the safe harbor conditions (Harper, & Walton, 2017, para. 22.17) are met.

Save harbor conditions

Under the business premises condition provided in Section 371DG(1) and (2) of the TIOPA, the CFC must have at all times during the accounting period, in its territory of residence, premises with a reasonable degree of permanence, from which its activities in that territory are at least mainly carried on. Premises may be a building or a part of a building, a place of extraction of natural resources, or a building site or the site of a construction or installation project, unless the building work or project has a duration of less than 12 months, Section 371DG(3) of the TIOPA.

According to the income condition stipulated in Section 371DH(2) of the TIOPA no more than 20 percent of the CFC's trading income (excluding income arising from the sale of goods in the UK that were produced by the CFC in its territory of residence, Section 371DH(3) of the TIOPA) may be derived from UK resident persons or UK PEs of non-UK resident companies. Instead, if, at any time during the accounting period, the CFC's main business is banking business and the CFC is regulated in its territory of residence, the CFC's trading income derived from UK resident persons or UK PEs of non-UK resident companies (excluding interest received from UK resident companies which are connected or associated) may be no more than 10 percent of its trading income, Section 371DH(4) to (6) of the TIOPA. However, where a company has made a foreign branch exemption election under Section 18A of the UK Corporation Tax Act 2009 ("CTA"), income is disregarded if the corresponding expense is taken into account in the calculation of the foreign PE's amount, Section 371DH(7) of the TIOPA (Whiting, & Gunn, 2019, Binder 5, para. D4.426).

Pursuant to the management expenditure condition provided in Section 371DI(1) of the TIOPA the UK related management expenditure, i.e. management expenditure which relates to members of staff or other individuals who carry out relevant management functions in the UK, Section 371DI(4) of the TIOPA, may be no more than 20 percent of the total related management expenditure as defined in Section 371DI(3) of the TIOPA. A person carries out a relevant management function if it manages or controls any assets or risks included in the relevant assets

or risks (e.g. acquisition, creation, development or exploitation of such assets, or taking on, or bearing, of such risks. Should all conditions mentioned in Section 371DF of the TIOPA be met, except for this management expenditure condition, trading profits arising from an asset or risk are nevertheless excluded, if the UK related management expenditure is no more than 50 percent of the total related management expenditure for that asset or risk, Section 371DI(7) to (9) of the TIOPA.

The IP condition is met according to Section 371DJ(2), (3) and (5) of the TIOPA, unless:

- ▶ the CFC's assumed total profits include amounts arising from its IP;
- ▶ at least parts of this IP were transferred to the CFC by UK persons related to the CFC at times during the accounting period and the previous six years or otherwise derived at times during that period out of or from IP held at times during that period by UK persons related to the CFC;
- ▶ as a consequence of those transfers or other derivations the value of the IP held by those persons related to the CFC, taken together, has been significantly reduced from what it would otherwise have been; and
- ▶ if only parts of this IP were so transferred or otherwise derived, these parts, taken together, make up a significant part of this IP, or result in the CFC's assumed total profits being significantly higher than what they would otherwise have been.

Under the export of goods condition, Section 371DK(2) of the TIOPA, no more than 20 percent of the CFC's trading income may arise from goods exported from the UK, excluding goods exported from the UK to the CFC's territory of residence.

The trading profits exclusion is subject to Section 371DL of the TIOPA, Section 371DF(3) of the TIOPA. Where an arrangement involves the CFC group organizing or reorganizing a significant part of its business in order to secure that one or more of the above conditions are met, they are deemed not to be met, Section 371DL (2) and (3) of the TIOPA.

The following example, which is based on Harper and Walton (2017, para. 22.17), shows, how the safe harbor conditions work.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A is engaged in production and sale. It has production plant P1 in country A and production plant P2 in the UK. 70 percent of the production takes place in production plant P1, 30 percent in production plant P2. Of the products produced in the latter 40 percent are exported to country A, 60 percent are sold in the UK. Company A earns 35 percent of its total trading income from sales in the UK. 50 percent of that UK income are derived from sales of products produced in country A. 15 percent of the CFC's total related management expenditure is incurred in relation to individuals carrying out relevant management functions in the UK. Company A holds IP which the resident taxpayer transferred to it two years ago. Company A developed the IP further. The value of the resident taxpayer's IP was reduced thereby significantly. However, company A earns only 5 percent of its total income from the transferred IP. Figure 52 illustrates the case at hand.

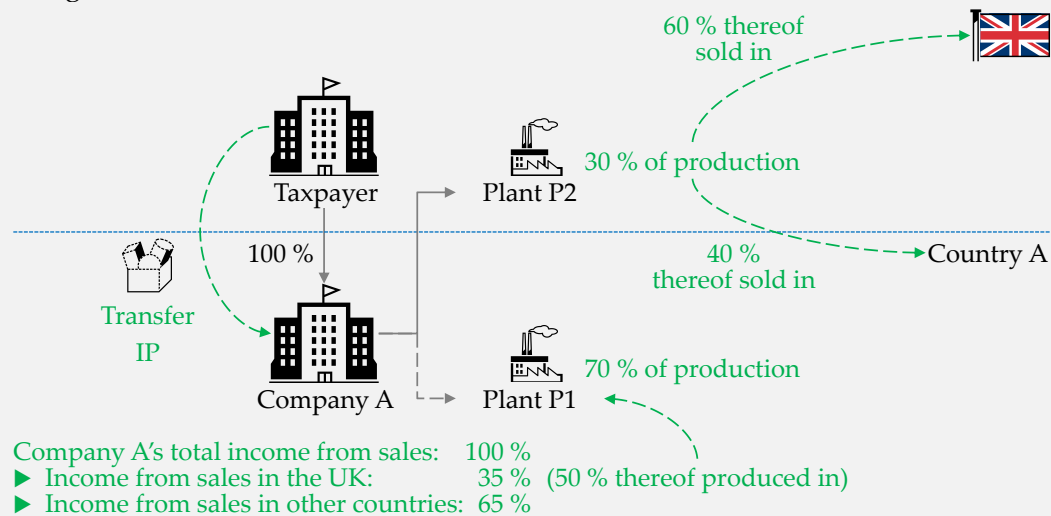


Figure 52. Illustration of the case at hand.

The business premises condition provided in Section 371DG of the TIOPA is met, as company A counts in country A with production plant P1, from which its activities in country A are mainly carried on.

The income condition stipulated in Section 371DH of the TIOPA is met, because no more than 20 percent of company A's trading income (excluding income arising from the sale of goods in the UK that were produced by company

A in country A) are derived from UK resident persons or UK PEs of non-UK resident companies (35 percent – 50 percent x 35 percent = 17.5 percent).

Also the management expenditure condition provided in Section 371DI of the TIOPA is met, as the UK related management expenditure is only 15 percent of the total related management expenditure.

Regarding the IP condition provided under Section 371DJ of the TIOPA, company A's assumed total profits include amounts arising from its IP, the IP was transferred to the CFC by the resident taxpayer two years ago, the value of the IP held by the resident taxpayer has been significantly reduced, however, company A's profits are not significantly higher than what they would otherwise have been. In fact the transferred IP only generates 5 percent of company A's total income. Hence, the IP condition is met.

Last but not least, the export of goods condition, Section 371DK of the TIOPA, is met, as no more than 20 percent of company A's trading income arise from products exported from the UK, excluding goods exported from the UK to country A. Whilst 18 percent points (30 percent points x 60 percent) of the products produced in production plant P2 are not exported at all, 12 percent points are exported to country A and thus excluded from the products exported from the UK. As no products exported from the UK remain, the income therefrom is also 0.

The anti-avoidance rule laid down in Section 371DL of the TIOPA is not applicable, as no arrangement involving the CFC group organizing or reorganizing a significant part of its business in order to secure that at least one of the above safe harbor conditions is met, is present.

2.3.5.1.2 Non-trading finance profits

2.3.5.1.2.1 Initial gateway

Chapter 5 of Part 9A of the TIOPA applies, subject to Sections 371CC and 371CD of the TIOPA for a CFC's accounting period if the CFC has non-trading finance profits. Non-trading finance profits are defined in Sections 371VA and 371VG as any amounts included in the CFC's assumed total profits for the accounting period that are non-trading profits from loan relationships, from non-exempt distributions or from relevant finance leases (Harper, & Walton, 2017, para.

22.18). However, profits from the investment of funds held by a CFC for the following purposes carried on by the CFC are excluded:

- ▶ Trade, where no trading profit pass through the CFC charge gateway for the accounting period, Section 371CB(3) of the TIOPA;
- ▶ UK or overseas property, Section 371CB(4) of the TIOPA.

The foregoing exclusions for trading and/or property business profits do not apply in relation to funds held:

- ▶ at least mainly because of a prohibition or restriction on the CFC making distributions imposed under the law of the CFC's territory of incorporation or formation, documents regulating the CFC (e.g. articles of association), or any arrangement entered into by or in relation to the CFC, Section 371CB(5)(a) of the TIOPA;
- ▶ with a view to making distributions at a time after the end of the relevant 12 months period, Section 371CB(5)(b) of the TIOPA;
- ▶ with a view to acquiring shares in any company or making any capital contribution to a person, Section 371CB(5)(c) of the TIOPA;
- ▶ with a view to investing in land at a time after the end of the relevant accounting period, Section 371CB(5)(d) of the TIOPA;
- ▶ at least mainly for contingencies, Section 371CB(5)(e) of the TIOPA; or
- ▶ at least mainly for the purpose of reducing or eliminating a tax or duty imposed by any territory, Section 371CB(5)(f) of the TIOPA.

If a CFC is a group treasury company, its trading finance profits may be treated upon notice to an officer of HMRC as non-trading finance profits, Section 371CB(2) and (4) of the TIOPA. Are trading finance profits of a CFC treated as non-trading finance profits, they do not fall under Section 371CB(3) or (4) of the TIOPA (exclusions for trading/property business profits; Whiting, & Gunn, 2019, Binder 5, para. D4.427).

According to Sections 371CB(1) and 371CC(1) to (3) of the TIOPA Chapter 5 of Part 9A of the TIOPA does not apply for an accounting period, if the CFC has:

- ▶ trading and/or property business profits; and/or
- ▶ exempt distribution income and, throughout the whole accounting period, a substantial part of its business is the holding of shares or securities in companies which are its 51 percent subsidiaries; and

- ▶ the CFC's non-trading finance profits are no more than 5 percent of the relevant amount (total trading and property business profits before interest deduction, tax or duty and/or exempt distribution income).

The following example is based on Delaney and Murray (2012, para. 10.1).

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A, in turn, holds all ownership interests in company B. Company A's trading profits before interests and taxes for the accounting period amount to 3,500. Furthermore, company A receives exempt distribution income from company B of 1,500. Whereas the latter did not earn any non-trading finance profits throughout the period, company A's non-trading finance profits for the period amount to 200. Figure 53 illustrates the case at hand.

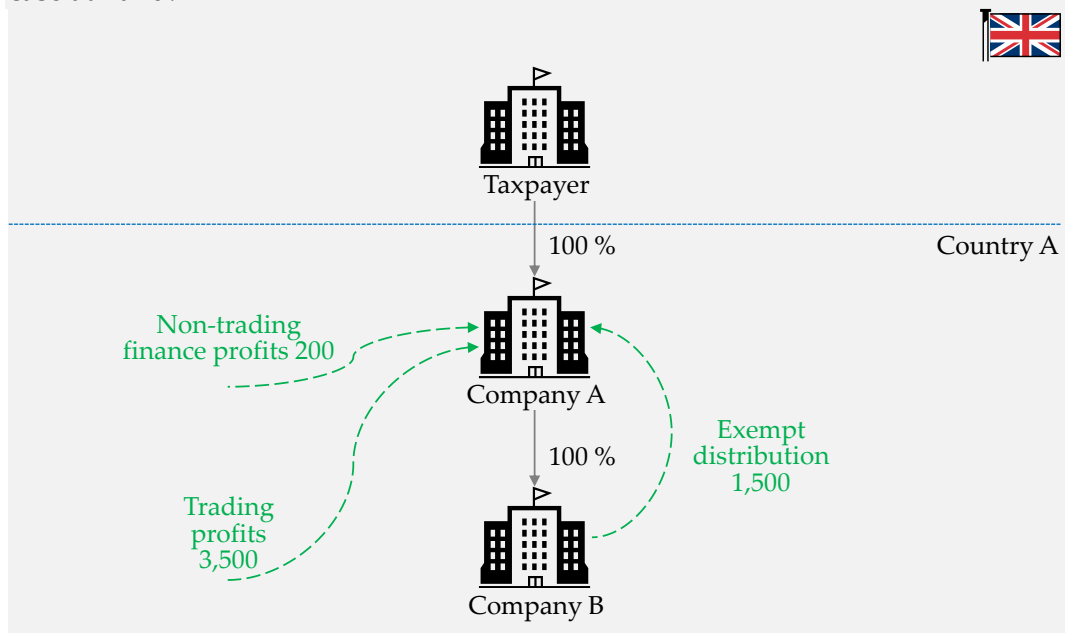


Figure 53. Illustration of the case at hand.

According to Section 371CB of the TIOPA Chapter 5 of Part 9A of the TIOPA does not apply, as company A's non-trading finance profits of 200 are no more than 5 percent of the sum of its trading profits and exempt distribution income amount to $(5 \text{ percent} \times (3,500 + 1,500) = 250)$.

Are the CFC's non-trading finance profits more than 5 percent of the relevant amount, Chapter 5 of Part 9A of the TIOPA nevertheless does not apply according

to Section 371CD(1) to (3) of the TIOPA, if the CFC's adjusted non-trading finance profits (i.e. non-trading finance profits excluding any trading or property business profits) are no more than 5 percent of the total of the CFC's exempt distribution income.

2.3.5.1.2.2 Finance company exemption

According to Section 371IA(1) of the TIOPA a chargeable company (being the UK resident shareholder which will suffer the CFC charge; Harper, & Walton, 2017, para. 22.22) may make a claim for exemption of certain intra-group non-trading finance profits that fall within the non-trading finance profits gateway (Harper, & Walton, 2017, para. 22.22), if the CFC's non-trading finance profits include qualifying loan relationship profits and the business premise condition (Section 371DG of the TIOPA) is met. Excluded from the CFC's non-trading finance profits are trading/property business profits, profits falling within Chapter 8 (see "2.3.5.1.5 Solo consolidation") and profits arising from a relevant financial lease, Section 371IA(9) of the TIOPA.

Qualifying loan relationship

In brief, a loan relationship of a CFC is a qualifying loan relationship, if the following conditions are met, Section 371IG(1) of the TIOPA (MacLachlan, 2012, para. 5.148):

- ▶ The loan relationship is a money debt arising from a transaction for the lending of money, Section 371IA(10) of the TIOPA;
- ▶ The CFC is the creditor;
- ▶ The ultimate debtor is a company connected with the CFC (not within the charge to UK tax in respect of the debt payments; Harper, & Walton, 2017, 22.22);
- ▶ The ultimate debtor is controlled by the same UK resident persons as the CFC; and
- ▶ The loan relationship is not excluded from being a qualifying loan relationship as specified under certain circumstances.

To determine the extent to which the profits are exempt, first, the qualifying resources rule or the 75 percent exemption rule are applied and afterwards, if relevant, the matched interest rule:

- ▶ Under the qualifying resource rule the profits of a qualifying loan relationship are determined taking the following steps, Section 371IF of the TIOPA:
 - ▶ In step 1 the credits from the qualifying loan relationship which are brought into account in determining the CFC's non-trading finance profits are determined;
 - ▶ Pursuant to step 2 the credits/debits which are brought into account in determining the CFC's non-trading finance profits are determined so far as they are from any arrangement entered into by the CFC as a hedge of risk in connection with the qualifying loan relationship and are attributable to the hedge of risk (step 2 credits);
 - ▶ In steps 3 and 4 credits/debits not reflected in the step 2 credits are brought into account to determine the CFC's non-trading finance profits for the accounting period by addition to or subtraction from the step 2 credits of a just and reasonable proportion of credits/debits to give the CFC's qualifying loan relationship profits for the respective qualifying loan relationship (Harper, & Walton, 2017, para. 22.22).

According to Section 371IB of the TIOPA the profits of a qualifying loan relationship are exempt if, at all times during the relevant period, the principal outstanding on the relevant loan is funded by the CFC wholly out of qualifying resources, and that the ultimate debtor is resident at all times during this period in the same territory. Qualifying resources means profits of the CFC's business so far as it consists of the making of loans to relevant members of the CFC group which are used solely for the purpose of the CFC group in the relevant territory, or (subject to the conditions in Section 371IB(7) of the TIOPA) assets received by the CFC in relation to shares held by the CFC in/issued by the CFC to members of the CFC group, Section 371IB(6) of the TIOPA;

- ▶ Pursuant to the 75 percent exemption rule provided in Section 371ID of the TIOPA 75 percent of the profits of the qualifying loan relationship are exempt if Section 371IB of the TIOPA does not apply;
- ▶ The matched interest rule provided in Section 371IE of the TIOPA establishes that the profits from qualifying loan relationships which are not exempt after applying the qualifying resources rule or the 75 percent

exemption rule will also be exempt in some circumstances where the worldwide debt cap applies to the CFC group (Montes Manzano, & Gordon, 2018, para. 45.11).

2.3.5.1.2.3 Profits passing through the gateway

Does Chapter 5 of Part 9A of the TIOPA apply, Section 371EA of the TIOPA provides that the CFC's profits falling within this Chapter are its non-trading finance profits falling under Sections 371EB to 371EE of the TIOPA:

- ▶ Non-trading finance profits fall within Section 371EB of the TIOPA so far as they would be included in the provisional Chapter 4 profits determined by taking steps 1 to 5 and 7 in Section 371DB(1) of the TIOPA (see "2.3.5.1.1.2 Profits passing through the gateway") as if references in this Section to the CFC's assumed total profits were made to its non-trading finance profits, Section 371EB of the TIOPA;
- ▶ Non-trading finance profits fall within Section 371EC of the TIOPA so far as they arise from:
 - ▶ Assets which represent or derive from any capital contribution to the CFC made by a UK connected company, Section 371EC(4)(a) of the TIOPA (e.g. in relation to an issue of shares in the CFC; Whiting, & Gunn, 2019, Binder 5, para. D4.427);
 - ▶ Assets which represent or derive from profits previously CFC charged, Section 371EC(4)(b) of the TIOPA;
 - ▶ Assets which represent or derive from any amounts which, by virtue of certain transfer pricing adjustments, are left out of account in determining the CFC's assumed total profits for the accounting period or any earlier accounting period, Section 371EC(4)(c) of the TIOPA; or
 - ▶ Other assets received by the CFC from a UK connected company, Section 371EC(4)(d) of the TIOPA.
- ▶ Non-trading finance profits fall within Section 371ED of the TIOPA so far as they arise from an arrangement with a UK resident company connected with the CFC, or non-UK resident company connected with the CFC with a UK PE, where it is reasonable to suppose that the arrangement is made as an alternative to the CFC making distributions to the other company, and at least one of the main reasons for the

arrangement is relating to a (potential) liability of any person to tax or duty imposed under the law of any territory, Section 371ED of the TIOPA; or

- ▶ Non-trading finance profits fall within Section 371EE of the TIOPA so far as they arise from a finance lease from the CFC to its connected UK resident company or connected non-UK resident company with a UK PE, where it is reasonable to assume that the arrangement is made as an alternative to the other company purchasing the asset, which is subject of the lease or making an arrangement, whereby the other company purchases rights to use the relevant assets (e.g. licence to use a patent; Whiting, & Gunn, 2019, Binder 5, para. D4.427), and at least one of the main reasons for the arrangement is relating to a (potential) liability of any person to tax or duty imposed under the law of any territory, Section 371EE of the TIOPA.

2.3.5.1.3 Trading finance profits

2.3.5.1.3.1 Initial gateway

According to Section 371CE(1) of the TIOPA Chapter 6 of Part 9A of the TIOPA applies for a CFC's accounting period if the CFC has

- ▶ trading finance profits; and
- ▶ at any time during the period, assets which derive from UK connected capital contributions.

Trading finance profits are defined in Section 371VG(4) of the TIOPA as profits from trading loan relationships, distributions treated as trading income and trading profits arising from a relevant finance lease (Harper, & Walton, 2017, para. 22.19).

As indicated above, trading finance profits are deemed to be non-trading finance profits if the CFC is a group treasury company in the accounting period as defined in Section 371CE(4) of the TIOPA, and a notice is given to an officer of HMRC, Section 371CE(2) and (6) to 8 of the TIOPA.

2.3.5.1.3.2 Profits passing through the gateway

Does Chapter 6 of Part 9A of the TIOPA apply, the CFC's profits falling within this Chapter are determined, subject to Sections 371FD and 371FE of the TIOPA, as follows, Section 371FA(1) of the TIOPA:

- ▶ First has to be determined if, during the accounting period, the CFC's free capital exceeds what is reasonable to suppose its free capital would be, were it a company which is not a 51 percent subsidiary of any other company, Section 371FA(1) Step 1 of the TIOPA;
- ▶ If the CFC carries on insurance business during the accounting period, in a second step is determined if, during this period, the CFC's free assets exceed what is reasonable to suppose its free assets would be, were it a company which is not the 51 percent subsidiary of any other company, Section 371FA(1) Step 2 of the TIOPA;
- ▶ The profits falling within Chapter 6 of the TIOPA are the CFC's trading finance profits so far as it is reasonable to suppose that those profits arise from the investment or other use of the excess free capital and/or excess free assets or, if less, the CFC's free capital and/or assets so far as deriving from UK connected capital contributions, Section 371FA(1) Step 3 of the TIOPA.

The following example is based on Delaney and Murray (2012, para. 11).

Example

A resident taxpayer subscribes for share capital of 50,000,000 € in company A, resident in country A. The latter, in turn, subscribes for share capital of 80,000,000 € in company B, resident in country B, a low tax jurisdiction. Thereof, 30,000,000 € are sourced from company A's own reserves, the retained profits of which have no previous UK connection. Company B's total free capital amounts to 80,000,000 €. However, if company B was not a 51 percent subsidiary of any other company its free capital would be 15,000,000 €. Company B is engaged in banking business. Figure 54 illustrates the case at hand.

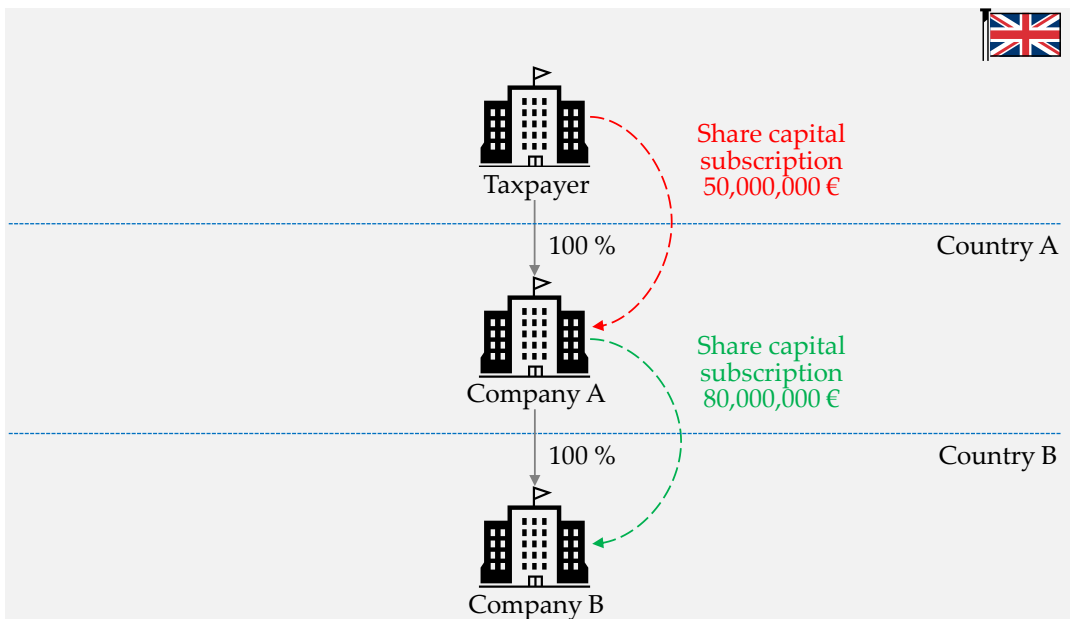


Figure 54. Illustration of the case at hand.

According to Section 371FA(1) Step 1 of the TIOPA company B's excess free capital amounts to 65,000,000 €. The profits falling within Chapter 6 of the TIOPA are company B's trading finance profits so far as it is reasonable to suppose that they arise from the investment or other use of the company B's free capital so far as deriving from UK connected capital contributions (i.e. 50,000,000 €), Section 371FA(1) Step 3 of the TIOPA.

Free capital is the CFC's funding for its business so far as it does not give rise to debits which are brought into account in determining its non-trading finance profits or trading finance profits, Section 371FA(2) of the TIOPA. Free assets are the amount by which the value of the CFC's assets exceeds its loan capital, Section 371FA(3) of the TIOPA.

In the following situations the value of the CFC's free capital/assets is lowered/increased:

- ▶ The value of assets held by the CFC is to be deducted from the CFC's free assets, if the CFC, acting outside its insurance business, gives a guarantee against losses of an insurance business of another company which is connected with it, necessary to meet regulatory requirements applicable to the other company's insurance business, and therefore regulatory requirements require the CFC to hold more assets than otherwise, and the

CFC holds assets solely to meet these requirements, Section 371FA(5) of the TIOPA;

- ▶ If the CFC is the ultimate debtor in relation to a qualifying loan relationship (see “2.3.5.1.2.2 Finance company exemption”) of another CFC, E percent of the principal outstanding during the CFC’s accounting period on the loan which is subject to the qualifying loan relationship is to be added to the CFC’s free capital/assets, Section 371FB(1) and (2) of the TIOPA. E percent is according to Section 371FB(3) and (4) of the TIOPA:

Formula

$$100 \% \times \frac{\text{The total amount of the profits of the qualifying loan relationship which are exempt, pro-rated according to the \% of the CFC's chargeable profits which are apportioned to the chargeable company (and which fall at least partly in the CFC's accounting period; Whiting, & Gunn, 2019, Binder 5, para. D4.428)}}{\text{The total amount of the profits of the qualifying loan relationship}}$$

- ▶ Under Section 371FC(2) of the TIOPA 75 percent of the principal outstanding during the CFC's accounting period on the loan which is subject of the qualifying loan relationship is to be added to the CFC's free capital/assets, if:
 - ▶ A company has elected to exempt profits or losses of foreign PEs, Section 371FC(1)(a) of the TIOPA;
 - ▶ The company has a creditor relationship which, applying certain assumptions, would be a qualifying loan relationship of the company in relation to which the CFC would be the ultimate debtor, Section 371FC(1)(b) of the TIOPA;
 - ▶ The company makes a claim for exemption of certain intra-group non-trading finance profits, Section 371FC(1)(c) of the TIOPA (Whiting, & Gunn, 2019, Binder 5, para. D4.428); and
 - ▶ The relevant accounting period falls at least partly in the CFC’s accounting period, Section 371FC(1)(d) of the TIOPA.

Where certain conditions are met, the Controlled Foreign Companies (Excluded Banking Business Profits) Regulations SI 2012 No 3041 provide an

exclusion from a CFC charge for certain profits of finance trading companies, including banks (Harper, & Walton, 2017, para. 22.19).

2.3.5.1.4 Captive insurance business

2.3.5.1.4.1 Initial gateway

According to Section 371CF of the TIOPA Chapter 7 of Part 9A of the TIOPA applies for a CFC's accounting period if, at any time during this period, the main part of the CFC's business is insurance business, and its assumed total profits include amounts derived from a contract of insurance entered into with:

- ▶ a connected UK resident company;
- ▶ a connected non-UK resident company, acting through a UK PE; or
- ▶ entered into with a UK resident person, and linked to the provision of goods or services to the UK resident person by a UK connected company (e.g. a UK retail group may establish a captive insurance company offshore and market warranty plans, written by the captive insurance company, to UK resident persons at the point of sale of its retail goods; Harper, & Walton, 2017, para. 22.20).

2.3.5.1.4.2 Profits passing through the gateway

Does Chapter 7 of Part 9A of the TIOPA apply, the profits falling within this Chapter are any amounts included in the CFC's assumed total profits so far as they arise from its insurance business, if it derives from a contract of insurance entered into with one of the aforementioned companies or persons, Section 371GA(1) and (2) of the TIOPA. However, excluded are premiums paid under a contract of insurance if the UK resident company has elected to exempt profits or losses of foreign PEs, and the premium is wholly brought into account for the purpose of determining any exemption adjustment, Section 371GA(4) of the TIOPA.

A contract of reinsurance is only covered so far as the original contract of insurance is entered into with a connected UK resident company or connected non-UK resident company, acting through a UK PE, Section 371GA(2)(a) and (5) of the TIOPA. This holds also true if there is a chain of reinsurance between the original contract of insurance and the ultimate contract of reinsurance (Whiting, & Gunn, 2019, Binder 5, para. D4.429).

Where the CFC is resident in an EEA state for the accounting period, and the profits do not arise from the activities of a PE which the CFC has in a non-EEA state territory, they pass through this gateway so far as they derive from a contract of insurance if the insured has no significant UK non-tax reason for entering into the contract of insurance, or in case of reinsurance, if the original insured has no significant UK non-tax reasons for entering into the original contract of insurance, Section 371GA(6) to (10) of the TIOPA. UK non-tax reasons are reasons that are not related to a (potential) liability of any person to UK tax/duty, Section 371GA(8) of the TIOPA. Is a CFC not resident in an EEA state, or is it resident there but acts via a PE in a non-EEA state territory, profits from a contract of re-/insurance are chargeable whether or not entered into for UK non-tax reasons (MacLachlan, 2012, para. 5.134).

2.3.5.1.5 Solo consolidation

2.3.5.1.5.1 Initial gateway

Pursuant to Section 371CG(1) of the TIOPA Chapter 8 of Part 9A of the TIOPA applies for a CFC's accounting period if one of the following conditions is met:

- ▶ The CFC is a subsidiary undertaking which is the subject of a solo consolidation waiver under section BIPRU 2.1 of the Prudential Regulation Authority ("PRA") Handbook, and its parent undertaking in relation to that waiver is a UK resident company, Section 371CG(2) of the TIOPA. Solo consolidation is an arrangement whereby the PRA allows a regulated financial company, upon the latter's application, to treat an unregulated subsidiary for regulatory purposes as if it were a division of the regulated company rather than a separate entity, Section 371CG(2) of the TIOPA (Whiting, & Gunn, 2019, Binder 5, para. D4.430); or
- ▶ At any time during the accounting period the CFC is controlled by a UK resident bank which holds shares in the CFC, meets the requirements of the PRA Handbook in relation to its capital, and any fall in the value of the shares held in the CFC would be ignored for the purpose of determining if the UK resident bank meets those requirements of the PRA Handbook. Furthermore, at least one of the main purposes, of the UK resident bank holding the shares in the CFC must be to obtain a tax

advantage for itself or any connected company, Section 371CG(3) of the TIOPA.

2.3.5.1.5.2 Profits passing through the gateway

Does Chapter 8 of Part 9A of the TIOPA apply, the profits falling within this Chapter are the CFC's assumed total profits which would not be treated as exempt profits under an overseas PE election, if the CFC were deemed to be an overseas PE, Section 371HA of the TIOPA (Harper, & Walton, 2017, para. 22.20).

2.3.5.2. *Issues*

2.3.5.2.1 Profits attributable to UK activities - Principal purpose test

According to Section 371CA(1) to (4) of the TIOPA Chapter 4 of Part 9A of the TIOPA only applies, if a CFC holds at any time during the accounting period assets or bear risks under an arrangement, of which at least:

- ▶ a main purposes is to reduce or eliminate any liability of any person to UK tax or duty; and
- ▶ in consequence of the arrangement, at any time the CFC expects its business to be more profitable than it would be otherwise.

Further, there has to be an expectation that at least one person will have its liability to tax or duty imposed under the law of any territory reduced or eliminated and it must be reasonable to suppose that, but for that expectation, the arrangement would not have been made.

The foregoing principal purpose test is criticized in UK tax literature, as its subjective nature may cause problems for some taxpayers, considering that tax efficiency is usually taken into account to some extent in setting-up any commercial arrangement. Thus, genuine tax mitigation strategies should not be deemed tax avoidance (Delaney, & Murray, 2012, para. 9.2). However, drawing the borderline between the aforementioned concepts is difficult. To limit the application of the principal purposes test, it seems preferable, to employ first a categorical analysis and to allow afterwards a carve-out under a principal purpose test, as e.g. under the Spanish CFC rules (see “2.3.4.1.2 Negative list” and “2.3.4.1.3 Principal purpose test”). The same holds true for the UK managed asset or risk test,

Section 371CA (5) and (9) of the TIOPA, as well as for the commercial independence test, Section 371CA (6) and (7) of the TIOPA.

2.3.5.2.2 Non-trading finance profits

2.3.5.2.2.1 State aid

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. The latter, in turn holds 100 percent of the ownership interests in company B, resident in country B. The resident taxpayer provides capital to company A. Company A, in turn, provides an interest bearing loan to company B. Company A counts with business premises in terms of Section 371DG(2) and (3) of the TIOPA. Company B, the ultimate debtor, is resident at all times during the accounting period in country B. Figure 55 illustrates the case at hand.

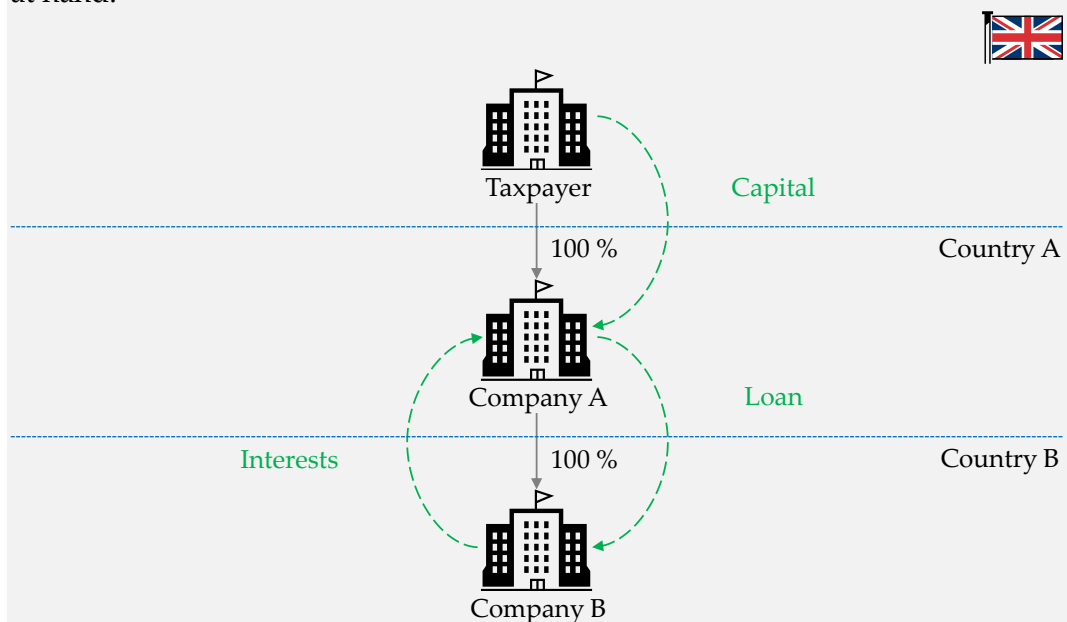


Figure 55. Illustration of the case at hand.

Generally, Chapter 5 of Part 9A of the TIOPA applies for company A's accounting period as the latter earns interests, i.e. it has non-trading finance profits (see "2.3.5.1.2.1 Initial gateway"). However, under Section 371IA(1) of the TIOPA the resident taxpayer may make a claim to exempt the interest as the business

premise condition is met and the interest is derived from a qualifying loan relationship. The loan relationship is a qualifying loan relationship in terms of Section 371IG(1) of the TIOPA because it is a money debt arising from a transaction for the lending of money, company A is the creditor, company B is the ultimate debtor and connected to company A, both companies are controlled by the resident taxpayer and there is no exclusion applicable. The extent to which the interests are exempt depends on whether the qualifying resources rule or the 75 percent exemption rule is applied (see “2.3.5.1.2.2 Finance company exemption”). As in the case at hand the loan should not be funded out of qualifying resources in terms of Section 371IB(6) and (7) of the TIOPA, the 75 percent rule is likely to be the only option.

Now, the European Commission’s preliminary view is that the finance company exemption constitutes state aid within the meaning of Article 107(1) of the TFEU (European Commission, 2017). According to the latter article a state measure is state aid, if it favors certain undertakings or the production of certain goods, i.e. if it confers a selective advantage. Generally, selectivity is tested according to the case-law of the European Union judiciary in three steps. First, the common or normal regime has to be determined. Then, has to be demonstrated that the state measure derogates from the aforementioned regime and thereby differentiates between economic operators who are in a comparable situation. If the foregoing derogation not justified, selectivity is present. Selectivity may not only be *de jure*, but also *de facto* (Blumenberg, 2017, pp. 21, 22). In the case at hand, the European Commission trusts that the appropriate reference system are the UK CFC rules and that the finance company exemption is a derogation to the reference system. This is because the finance company exemption treats CFCs which carry out finance transactions involving certain related foreign debtors better than CFCs which carry out such transactions involving related UK or third party debtors, although all of them are in a comparable legal and factual situation considering the objective of the UK CFC rules. Furthermore, the European Commission holds that the foregoing derogation is not justified (European Commission, 2017).

2.3.5.2.2.2 Qualifying resource rule

The finance company exemption (see “2.3.5.1.2.2 Finance company exemption”) is rather complex and not always easy to apply, as the following example shows.

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. The latter, in turn, holds 100 percent of the ownership interests in company B, resident in country B. Company A has profits from a qualifying loan relationship. At the beginning of the accounting period the principal outstanding on the loan of 100 is fully funded out of qualifying resources. At midyear the principal outstanding on the loan is increased by 100 to 200 out of non-qualifying resources. Company B, the ultimate debtor, is resident at all times during the accounting period in country B. Figure 56 illustrates the case at hand.

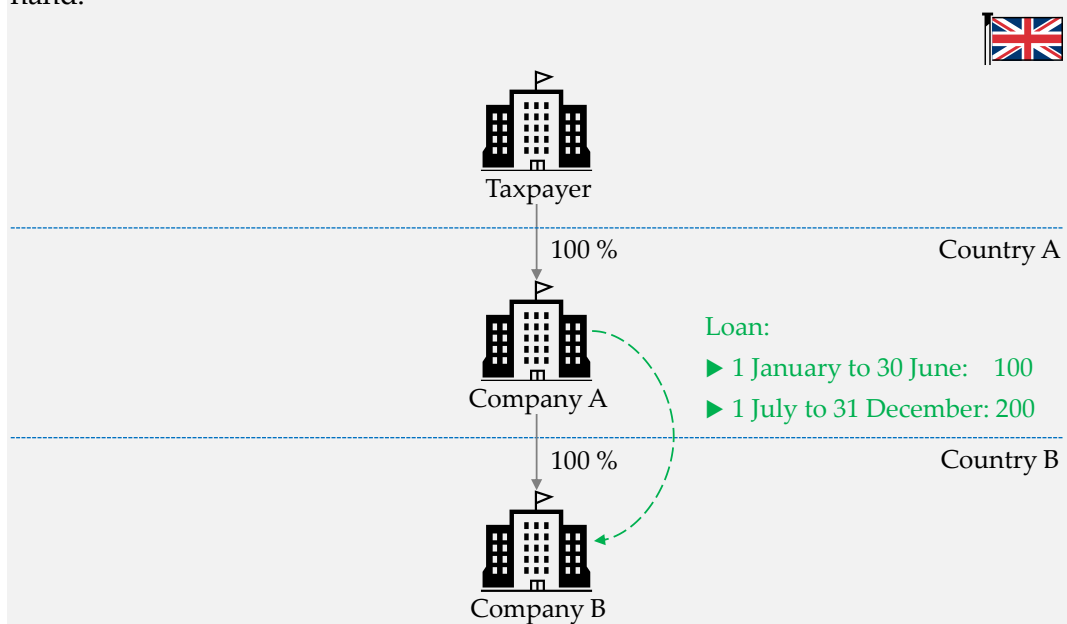


Figure 56. Illustration of the case at hand.

According to the qualifying resource rule provided under Section 371IB of the TIOPA (see “2.3.5.1.2.2 Finance company exemption”) profits from a loan relationship are exempt if, at all times during the accounting period, the principal outstanding on the loan is funded by the CFC wholly out of qualifying resources. Furthermore, the ultimate debtor has to be resident at all times during this period

in the same territory. Whereas the latter condition is obviously met in the case at hand, the UK tax literature discusses controversially for such cases the percentage of profits that are exempt in the first accounting period under the qualifying resource rule.

Parts of the UK tax literature (Whiting, & Gunn, 2019, Binder 5, para. D4.431) argue that in the first accounting period the loan is fully funded from qualifying resources for the first six months and afterwards partially at 50 percent. Thus, over the year the percentage of profits that are exempt should be 75 percent and the resident taxpayer should specify its claim accordingly for the first accounting period.

Others (Harper, & Walton, 2017, para. 22.22) hold that the exemption only applies to a minimum proportion of the loan that is funded throughout the whole first accounting period from qualifying resources, i.e. in the case at hand 50 percent. Therefore, the resident taxpayer should specify its claim for the first accounting period to 50 percent.

In any case, the claim under Section 371B of the TIOPA for the second accounting period can only be specified to 50 percent, assuming that the principal outstanding on the loan remains at 200.

2.3.5.2.2.3 Capital investment from the UK

Example

A resident taxpayer acquires 100 percent of the ownership interests in company A, resident in country A. Company A is the head of the A group and holds ownership interests in various subsidiaries, one of them being company B, a finance company resident in country B, a low tax jurisdiction. Company A funded company B with a capital of 100. The 100 were used by company B to make a loan to another non-UK company. The resident taxpayer considers to provide further capital to company B. The requirements set out under Section 371CB of the TIOPA (initial gateway) are met. Figure 57 illustrates the case at hand.

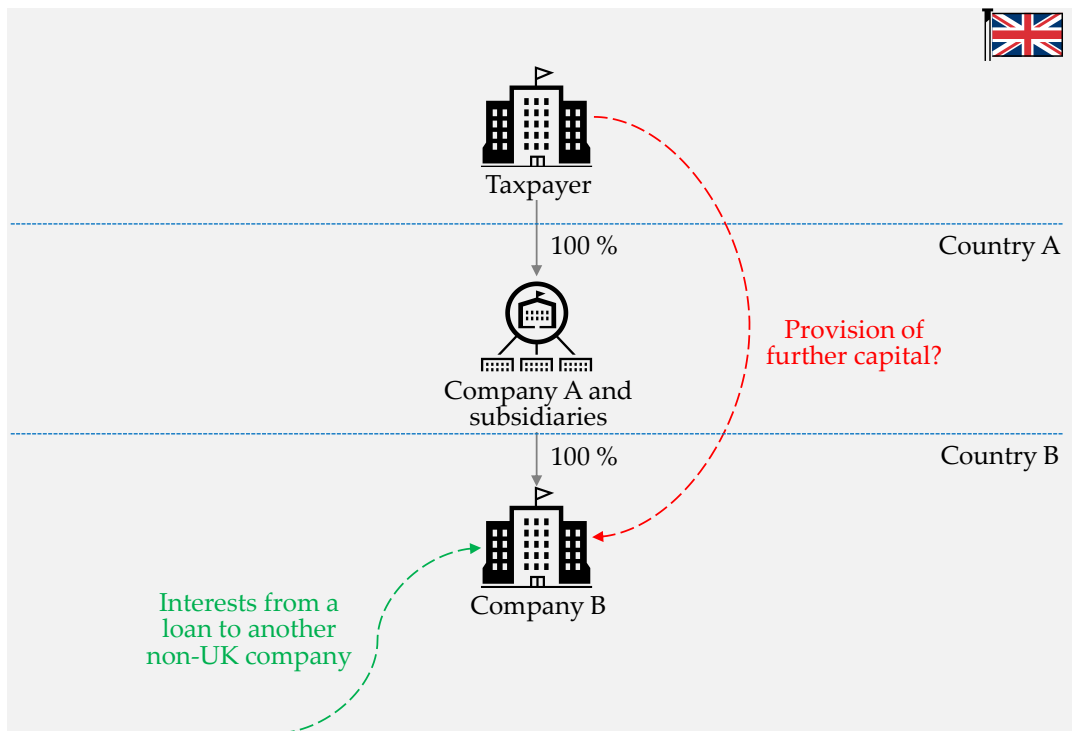


Figure 57. Illustration of the case at hand.

Non-trading finance profits fall inter alia within Section 371EC of the TIOPA so far as they arise from assets which represent or derive from any capital contribution to the CFC made by a UK connected company, Section 371EC(4)(a) of the TIOPA. In the case at hand HMRC points out under INTM 203590 that the current loan was clearly funded by a non-UK investment and consequently does not comprise relevant assets in terms of Chapter 5 of Part 9A of the TIOPA. However, does the resident taxpayer provide company B with further capital, it would be necessary to split company B's interest income into interest income earned from the current capital and into interest income earned from the further capital. In practice this may not be easy to prove. Hence, the recommendation is to form a new finance CFC for the UK investment and to run both finance companies in parallel (Whiting, & Gunn, 2019, Binder 5, para. D4.427).

2.3.5.2.3 Trading finance profits – Profits from excess free capital/assets

As detailed above (see “2.3.5.1.3.2 Profits passing through the gateway”), the profits falling within Chapter 6 of Part 9A of the TIOPA are, broadly, the CFC's trading finance profits so far as it is reasonable to suppose that those profits arise

from the investment or other use of the excess free capital and/or assets or, if less, the CFC's free capital and/or assets so far as deriving from UK connected capital contributions, Section 371FA(1) Step 3 of the TIOPA.

Both, the determination of the excess free capital and/or assets and the assumption that a certain amount of the trading finance profits derives therefrom are highly subjective and likely to cause some debate in the course of a tax audit. This holds even more true considering that Section 371FA(1) Step 3 of the TIOPA does not only seek to apportion a share of the CFC's trading finance profits, but rather to identify those profits that are actually attributable to the excess free capital and/or assets (Delaney, & Murray, 2012, para. 11).

2.3.5.3. *Structurings*

2.3.5.3.1 Profits attributable to UK activities

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. The latter has profits attributable to UK activities, which pass through the initial gateway, Section 371CA of the TIOPA. However, the resident taxpayer wants to ensure that they do not pass through the gateway, Section 371DA to 371DL of the TIOPA. In light of the exclusion provided under Sections 371DB(1) Step 6 and 371DC of the TIOPA (UK activities a minority of total activities) the resident taxpayer decides to relocate certain management functions outside the UK (MacLachlan, 2012, para. 5.100). Figure 58 illustrates the case at hand.

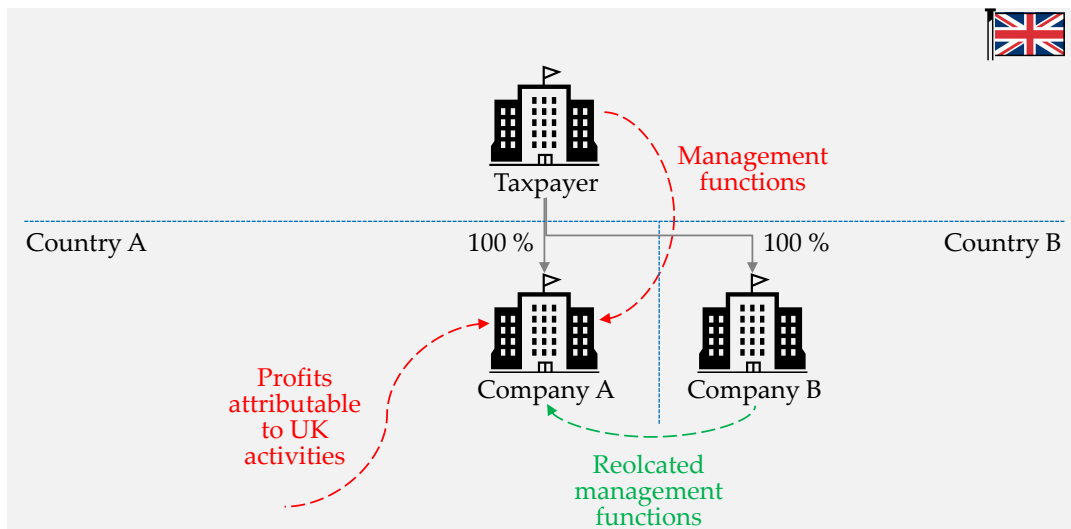


Figure 58. Illustration of the case at hand.

According to Sections 371DC(1) Step 6 and 371DC of the TIOPA profits attributable to assets and risks of a CFC, which are not mainly allocable to a deemed UK PE arising from the existence of UK SPFs are excluded from CFC charge. Should the resident taxpayer relocate sufficient management functions outside the UK to meet the foregoing threshold, the foregoing exclusion applies.

2.3.5.3.2 Non-trading finance profits

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction (0 percent). The latter, in turn holds 100 percent of the ownership interests in company B, resident in country B, a high tax jurisdiction (30 percent) without CFC rules. The resident taxpayer provides capital of 1,000 to company A. Company A, in turn, provides these 1,000 under an interest bearing loan agreement (5 percent) to company B. Company A counts with business premises in terms of Section 371DG(2) and (3) of the TIOPA. Company B, the ultimate debtor, is resident at all times during the accounting period in country B. Figure 59 illustrates the case at hand.

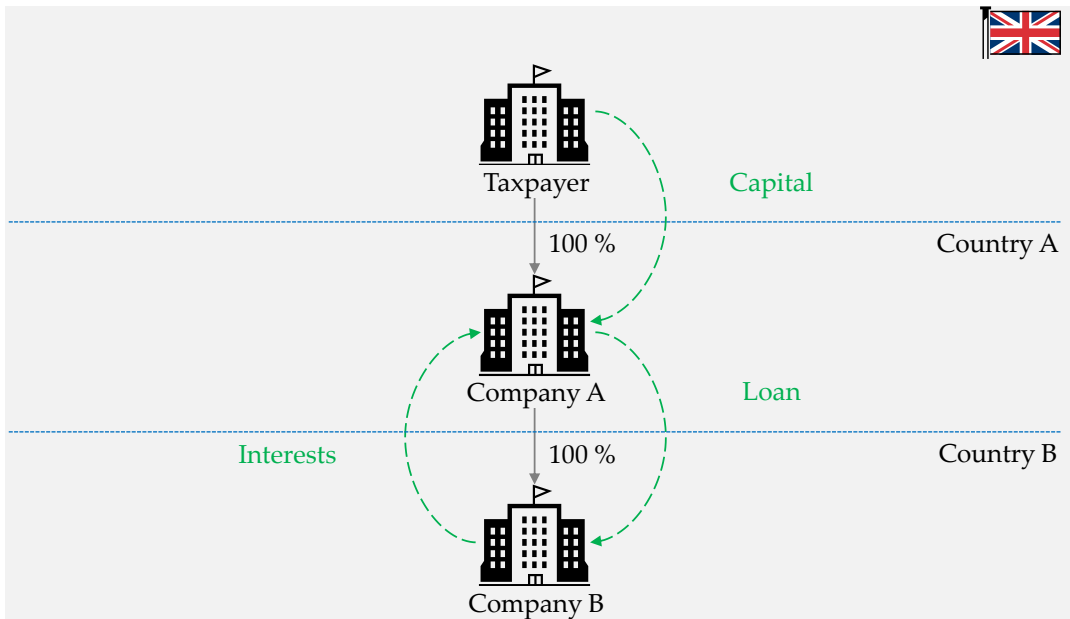


Figure 59. Illustration of the case at hand.

As detailed above (see “2.3.5.2.2.1 State aid”), generally, Chapter 5 of Part 9A of the TIOPA should apply for company A’s accounting period as the latter has non-trading finance profits. However, pursuant to Section 371IA(1) of the TIOPA the resident taxpayer may make a claim to exempt the interests as the business premise condition is met and the interests are derived from a qualifying loan relationship. The extent to which the interests are exempt depends on whether the qualifying resources rule or the 75 percent exemption rule is applied (see “2.3.5.1.2.2 Finance company exemption”). Considering that in the case at hand the loan should not be funded out of qualifying resources in terms of Section 371IB(6) and (7) of the TIOPA, the qualifying resource rule should not be available. Instead, under the 75 percent rule 75 percent of the interests should be exempt. Hence, company B may reduce its corporate tax by 15 ($1,000 \times 5 \text{ percent} \times 30 \text{ percent}$), company A’s interest income is taxed at 0 percent in country A and the resident taxpayer may make a claim to exempt 75 percent of the interests. However, in light of the state aid investigation (see “2.3.5.2.2.1 State aid”) such structuring is not recommendable anymore.

2.3.5.4. *ATAD compliance*

Under the current UK CFC rules non-trading finance profits of a CFC earned from UK activities, capital investment from the UK, arrangements in lieu of dividends etc. to UK resident companies etc. and leases to UK resident companies etc. fall under Chapter 5 of Part 9A of the TIOPA. However, under certain conditions the resident taxpayer may make a claim to exempt the non-trading finance profits of a CFC, Section 371IA(1) of the TIOPA. The extent to which the interests are exempt depends on whether the qualifying resources rule or the 75 percent exemption rule is applied (see “2.3.5.1.2.2 Finance company exemption”). The foregoing finance company exemption was held to be incompliant with the ATAD (Wesel, & Wyatt, 2016, p. 12). Now, the Finance Bill 2018-19, published on 7 November 2018, contains legislation that addresses the incompliance. In concrete non-trading finance profits of a CFC which fall within Chapter 5 of Part 9A of the TIOPA by virtue of UK activities shall no longer be exempt under the finance company exemption.

2.3.6. Recommendation

2.3.6.1. *Positive list*

2.3.6.1.1 Positive list instead of negative list

Currently the German CFC rules set forth a positive list of income from categories that is not deemed CFC income, Paragraph 8(1) of the AStG. As detailed above (see “2.3.3.2.1.1 Positive list instead of negative list”), parts of the German tax literature would prefer a negative list as in Spain (see “2.3.4.1.2 Negative list”) instead, to do not put a brake on new business models. However, considering that the resident taxpayers are familiar with the positive list, there is administrative guidance and jurisprudence, the recommendation is to stick with the positive list. However, it should be updated more frequently.

2.3.6.1.2 Production

Regarding income from manufacturing, which is deemed active according to Paragraph 8(1) number 2 of the AStG, is questionable, whether the CFC has to manufacture the property itself or may subcontract the manufacturing to either

third parties or to other group companies (see “2.3.3.2.1.2 Production”). The latter should not be harmful as long as the CFC controls the manufacturing process and bears the manufacturing risk. This would allow to employ common manufacturing models such as toll manufacturing (Engler, & Wellmann, 2015, Chapter N, para. 443) and contract manufacturing (Engler, & Wellmann, 2015, Chapter N, para. 444). The toll/contract manufacturer only assumes routine functions. Usually the remuneration is based on the cost-plus method (Endres, & Spengel, 2016, p. 1092). This ensures that the routine functions are compensated with a small profit. E.g. a mark-up on a toll manufacturer’s costs of 5 to 10 percent was often not questioned in the past by the German tax authorities (Engler, & Wellmann, 2015, Chapter N, para. 452). This shows that the possibility to shift income to a toll/contract manufacturer is very limited. Furthermore, toll/contact manufacturing agreements are usually not tax driven. The idea behind such agreements is rather to centralize routine production functions in a cost efficient region (Endres, & Spengel, 2016, p. 1091).

2.3.6.1.3 Banks and insurance companies

Broadly, Paragraph 8(1) number 3 of the AStG provides that, under certain conditions, income from the operation of banks and insurance companies is not considered CFC income. However, Article 7(2)(a)(v) of the ATAD, deems non-distributed income from insurance and banking activities to be passive. Furthermore, as detailed under “2.3.3.4 ATAD compliance”, to become ATAD compliant, income from financial leasing, which may be active according Paragraph 8(1) number 3 of the AStG where certain conditions are met, has to be passive in the future. Thus, the mandatory recommendation is to amend Paragraph 8(1) number 3 of the AStG accordingly.

2.3.6.1.4 Trade

Looking at Paragraph 8(1) number 4 of the AStG, the recommendation is to exclude income from trade generally from CFC income, if the arm’s length principle (Paragraph 1(1) sentence 1 of the AStG) is observed. In such cases the profit shifting risk is very limited (see “2.3.3.2.1.4 Trade”). Structurings as the one proposed under “2.3.3.3.2 Trade” would then no longer be necessary. Furthermore, the employment of limited risk distributors, commission agents, commercial

agents, sales support service providers or representative offices is usually not tax driven. The reasoning behind the employment of such routine (Engler, & Wellmann, 2015, Chapter N, paras. 474, 484, 495) distributors, agents, etc. is primarily to better satisfy the customer requirements and customer relationships (Endres, & Spengel, 2016, p. 1091). However, in light of Article 7(2)(a)(vi) of the ATAD income of invoicing companies that earn sales income from goods purchased from and sold to associated enterprises, without adding more than little economic value, may no longer be excluded from CFC income under Paragraph 8(1) number 4 of the AStG.

2.3.6.1.5 Services

As for trade, the recommendation regarding Paragraph 8(1) number 5 of the AStG is to exclude income from services generally from CFC income, if the arm's length principle (Paragraph 1(1) sentence 1 of the AStG) is observed. In such cases the profit shifting risk is very limited (see "2.3.3.2.1.5 Services"). Structurings as those proposed under "2.3.3.3.3 Services" would then no longer be necessary. Furthermore, the employment of control or coordination centers is usually not tax driven. Such centers are rather established to benefit from cost savings and synergy effects. A duplication of costs in areas that do not form part of the local enterprises' operative business shall be avoided, without giving up market proximity and in particular responsiveness to changing conditions (Endres, & Spengel, 2016, p. 1094). However, in light of Article 7(2)(a)(vi) of the ATAD income of invoicing companies that earn service income from services purchased from and sold to associated enterprises, without adding more than little economic value, may no longer be excluded from CFC income under Paragraph 8(1) number 5 of the AStG.

2.3.6.1.6 Letting and leasing

Under the current Paragraph 8(1) number 6(a) of the AStG income from licensing the use of rights, plans, samples, procedures, experience, and knowledge is only excluded from CFC income, if the CFC is exploiting the results of its own research and development work, which was carried out without the involvement of certain resident taxpayers/related persons. As detailed under "2.3.3.2.1.6 Letting and leasing" it would be preferable to exclude income from licensing of IP generally from CFC income. However, the minimum standard set forth in Article

7(2)(a)(ii) of the ATAD provides exactly the opposite, as thereunder all royalties or any other income generated from IP has to be deemed CFC income in the future. Now, to ensure that especially CFCs which are active in the software industry do not always earn CFC income in the future, the activity clause (see “2.3.2.2 Activity clause”) should also be applicable where the CFC is resident or situated in a third country that is not party to the EEA Agreement. This would allow a CFC, resident/situated in such country and active in the software industry, to evidence at least that it carries on a substantive economic activity supported by staff, equipment, assets and premises, Article 7(2)(a) of the ATAD. In light of the minimum standard provided under Article 7(2)(a)(ii) of the ATAD structurings such as the one proposed under “2.3.3.3.4 Letting and leasing” (instead of licensing IP from the CFC to its subsidiary, which uses the IP to produce product P, the CFC decides to produce product P itself) are likely to be employed more frequently.

Paragraph 8(1) number 6(b) of the AStG provides that income from letting and leasing of land is only excluded from CFC income, if the taxpayer proves that it would have been exempt under the terms of a DTT, had the resident taxpayer holding ownership interests in the CFC in terms of Paragraph 7 of the AStG earned it directly. However, does a CFC let or lease land situated in Germany no DTT at all would have been applicable, had the resident taxpayer earned the income from letting or leasing of the land directly, i.e. such income is always deemed CFC income. Considering that in the latter case the income from the letting and leasing of the land is taxed according to the German tax rules, the recommendation is to exclude income from the letting and leasing of land situated in Germany without further requirements (see “2.3.3.3.4 Letting and leasing”).

2.3.6.1.7 Financing

The current Paragraph 8(1) number 7 of the AStG provides that raising and lending of capital is active, if the taxpayer proves that such capital is raised solely on foreign capital markets and not from a person related to the taxpayer or to the CFC in terms of Paragraph 1(2) of the AStG, and that such capital is provided either to foreign businesses or PEs that derive their gross revenue exclusively or almost exclusively from the business activities listed in Paragraph 8(1) numbers 1 to 6 of the AStG, or to active or passive domestic businesses or PEs. However, under Article 7(2)(a)(i) of the ATAD any income generated by financial assets has to be

passive. Thus, the mandatory recommendation is to amend Paragraph 8(1) number 7 of the AStG accordingly. The issues raised under “2.3.3.2.1.7 Financing” would disappear thereby.

2.3.6.1.8 Profit distributions, sale of a share in another company etc.

Pursuant to Paragraph 8(1) numbers 8 and 9 of the AStG dividends are always excluded from CFC income (see “2.3.3.1.1.8 Profit distributions”) and income from the disposal of shares is generally deemed active income (see “2.3.3.1.1.9 Sale of a share in another company etc.”). However, according to Article 7(2)(a)(iii) of the ATAD dividends and income from the disposal of shares have to be deemed CFC income. Thus, the mandatory recommendation is to amend Paragraph 8(1) numbers 8 and 9 of the AStG accordingly. Considering that under the German tax rules dividends and income from the disposal of shares are often fully tax exempt, partially tax exempt or taxed at a preferential tax rate, the tax rate exemption is likely to exclude most dividends and income from the disposal of shares in the future (see “2.3.3.4 ATAD compliance”). Furthermore, the issues raised under “2.3.3.2.1.8 Sale of a share in another company etc.” would disappear through the mandatory amendment. The same holds true for the structurings presented under “2.3.3.3.6 Sale of assets” (active sale of the ownership interests in a CFC instead of passive sale of an asset of the latter) and “2.3.3.3.5 Sale of a share in another company etc.” (profit distribution before sale of shares in lower tier foreign company). However, should the sale of a share in another company etc. trigger CFC taxation, the resident taxpayer might consider to sell the CFC’s assets instead. A gain therefrom is attributed to the category of income, which was exercised with the asset before the sale. Is the category included in the positive list provided under Paragraph 8(1) of AStG, such income is excluded from CFC income.

2.3.6.1.9 Reorganizations

As the sale of a share in another company etc. will have to be deemed CFC income in the future, Article 7(2)(a)(iii) of the ATAD, resident taxpayers might consider a reorganization instead. Broadly, income from reorganizations that, disregarding Paragraph 1(2) and (4) of the UmwStG, could take place at book value, is excluded from CFC income, Paragraph 8(1) number 10 of the AStG. However,

considering that under the German tax rules income from the disposal of shares is often fully tax exempt, partially tax exempt or taxed at a preferential tax rate, the tax rate exemption is likely to exclude also most income from the disposal of shares in the future (see “2.3.3.4 ATAD compliance”). Consequently, the cases where a reorganization may be preferential to a sale of shares are limited. Therefore, the recommendation is to stick with the current Paragraph 8(1) number 10 of the AStG to do not avoid economically reasonable foreign restructurings. However, the reference to Paragraph 8(1) number 9 of the AStG will have to be deleted.

2.3.6.2. *Substance test*

The recommendation is further to include a substance test. A substance test is a more qualitative measure than a categorical analyses and may be more accurate than the latter. The Spanish substance test (see “2.3.4.1.1 Substance test”) may serve as a model. Thereunder, broadly, the total income of a CFC is deemed CFC income, if neither the CFC nor a non-resident group entity counts with the corresponding organization of material and human resources to earn it, unless the taxpayer proves that the CFC's incorporation and operation ground on valid economic reasons. However, the inclusion of a substance test also leads to an increased administrative and compliance burden (OECD, 2015c, para. 83). Now, to strike the balance between the foregoing advantage and disadvantage, substance should only be tested, other than under the current Spanish rule, for income from certain categories. Considering that the German CFC rules employ a positive list, substance should be tested where income is earned from the activities set forth under Paragraph 8(1) numbers 4 (trade) and 5 (services) of the AStG, as these are geographically mobile (OECD, 2015c, para. 78). The latter holds also true for dividends, interests, insurance income, royalties and IP income. However, irrespective of substance, income from the foregoing categories will have to be deemed CFC income under the future positive list (see “2.3.3.4 ATAD compliance”). Moreover, the substance test should be applied as a proportionate test (see “2.3.4.2.1 Substance test”).

2.3.6.3. *Proof to the contrary*

Paragraph 8(2) of the AStG provides, broadly, that a company resident in an EU/EEA member state is not a CFC with respect to income for which the resident

taxpayer demonstrates that insofar the company carries out a genuine economic activity in the state in question.

In practice such demonstration may be impossible for minority shareholders. Amending the level of control as recommended above (see “2.1.6 Recommendation”) should solve this issue.

As a further issue has been identified above (see “2.3.3.2.2 Proof of the contrary”), that according to Paragraph 20(2) of the AStG the proof to the contrary is not available for foreign partnerships/PEs. The difference in treatment between partnerships/PEs on the one hand, and corporate entities on the other hand is difficult to justify, considering that income earned by a CFC from a genuine economic activity in the state in question raises only limited profit shifting concerns. The same holds true for the difference in treatment between CFCs resident in an EU/EEA member state and those resident in other states. Therefore, the recommendation is to extend the proof to the contrary to partnerships/PEs and to CFCs resident or situated in a third country that is not party to the EEA Agreement, Article 7(2)(a) of the ATAD. Parts of the German tax literature even consider that an extension of the proof to the contrary to CFCs resident or situated in a third country that is not party to the EEA Agreement, is mandatory (Kahlenberg, & Schiefer, 2017, p. 897).

2.3.6.4. UK definition of CFC income

As shown above (see “2.3.5 UK”), the UK definition of CFC income is rather complex and imposes a high compliance burden for the resident taxpayers. The compliance burden is high, but not excessive, as it is reduced through the numerous de minimis thresholds (see “2.2.5.1.1 De minimis thresholds”) and exemptions (see “2.2.5.1.2 Exemptions”). However, considering that most of the de minimis thresholds and exemptions are not in line with the ATAD (see “2.2.5.4 ATAD compliance”), adapting the German definition of CFC income to the UK definition of CFC income would lead to a clearly excessive compliance burden for the resident taxpayers. Such an adaptation is therefore not recommended.

3. CONSEQUENCES OF A CFC TAXATION

3.1. RULES FOR COMPUTING INCOME

3.1.1. BEPS

Computing income requires to determine which rules should apply. The OECD/G20 recommend to apply the parent jurisdiction's rules, which is particularly logically consistent, if CFC rules shall protect against stripping the parent jurisdiction's base and reduces costs for the tax administration. Using instead the CFC jurisdiction's rules would be less consistent, as it may allow to attribute less income. Furthermore, applying foreign rules should increase the administrative burden. Using a common standard has the charm of international consistency between all CFC and parent jurisdictions, increases, however, administrative and compliance costs, since most countries currently do not use such standards (OECD, 2015c, para. 100). Furthermore, the OECD/G20 recommend to include a specific rule allowing to offset a CFC's losses only against profits of the same CFC or any other CFC in the same jurisdiction, to prevent loss manipulation in the CFC jurisdiction. Alongside a further rule might establish that passive losses of a CFC may only be offset against passive profits of the same CFC (OECD, 2015c, para. 103). Finally, countries might implement rules to prevent loss importation, e.g. if a CFC incurred losses before being characterized as a CFC or if an activity generating losses is shifted to the CFC to soak up profits (OECD, 2015c, para. 108).

3.1.2. ATAD

Article 8(1) of the ATAD provides that where a member state uses a negative list to determine the tax base of a taxpayer (see "2.3.2.1.1 Negative list"), the income to be included in the taxpayer's tax base is calculated according to the rules of the corporate tax law of the taxpayer's member state of residence. However, losses of a CFC are not included in the taxpayer's tax base, but may be carried forward, according to national law.

It is unclear whether the income from the categories provided in Article 7(2)(a) of the ATAD has to be calculated separately or as a whole. This may be problematic with regard to losses. Only if the income is calculated as a whole, losses from a certain category provided under Article 7(2)(a) of the ATAD may be offset against profits from other categories provided in this article (Schnitger et al, 2016, p. 971).

Does a member state apply a principal purpose test (see “2.3.2.1.2 Principal purpose test”) the income to be included in the taxpayer’s tax base is limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company. The attribution of CFC income is calculated in accordance with the arm’s length principle, Article 8(2) of the ATAD.

3.1.3. Germany

3.1.3.1. Rules

According to Paragraph 10(3) of the AStG CFC income is computed by applying the provisions of the German tax law analogously, including Paragraph 8(3) sentence 2 (hidden profit distribution)/sentence 3 (hidden contribution) of the KStG. The BFH confirmed the foregoing in its decision as of 13 June 2018 (I R 94/15; Mattern, 2019, pp. 83, 84; Intemann, 2018, p. 8). Hence, where a remuneration is not at arm’s length, the non-arm’s length part is, as the case may be, either a hidden profit distribution or a hidden contribution (Kortendick, Joisten, & Ekinci, 2018; Weiss, 2018, p. 875):

- ▶ Is a remuneration received below the arm's length value or does a remuneration paid exceed the arm's length value, there is, subject to further conditions, a hidden profit distribution; and
- ▶ Does a remuneration received exceed the arm's length value or is a remuneration paid below the arm's length value, there is, again subject to further conditions, a hidden contribution.

However, the following provisions of the German tax law are disregarded in computing a CFC’s income:

- ▶ Tax preferences that are linked to an unlimited tax liability or to the existence of a domestic business/PE;

- ▶ The interest limitation rules, Paragraph 4h of the EStG and Paragraph 8a of the KStG (Kramer, 2018);
- ▶ The license limitation rule, Paragraph 4j of the EStG;
- ▶ The exemption of dividends and capital gains, Paragraph 8b(1) and (2) of the KStG; and
- ▶ The provisions of the UmwStG so far as income from a reorganization is deemed passive under Paragraph 8(1) number 10 of the AStG (see "2.3.3.1.1.10 Reorganizations").

Passive income is only attributed, if a positive amount results from aggregating all passive income generated by the CFC, including passive income of lower tier CFCs, which is attributable to the CFC, Paragraph 10(1) sentence 4 of the AStG (Heuermann, & Brandis, 2018, Chapter § 10, para. 106). Parts of the German tax literature criticize the foregoing rule (Kraft, 2016c, pp. 909, 910).

To the extent losses incurred with respect to passive income exceed the income which is disregarded under Paragraph 9 of the AStG (see "2.2.3.1.1 De minimis threshold"), they may be deducted by applying Paragraph 10d of the EStG analogously. Where a deduction of taxes according to Paragraph 10(1) of the AStG (see "3.2.3.1 Rules") leads to a negative amount, the aforementioned losses are increased accordingly.

In computing CFC income, only those business expenses may be deducted which are economically connected to such income, Paragraph 10(4) of the AStG.

Gains of a CFC from the sale of shares in another foreign company or a company within the meaning of Paragraph 16 of the REIT Act, from the liquidation of such a company, or from the reduction of such a company's capital, which fall within Paragraph 8 of the AStG, are excluded from the attributable income, so far as the taxpayer proves that the income of the other company or of a subsidiary of the latter from activities described in Paragraph 7(6a) of the AStG was subject to income or corporate tax as attributed income in terms of Paragraph 10(2) of the AStG for the same calendar or fiscal year or for the preceding seven calendar or fiscal years and that such income has not been distributed, Paragraph 11 of the AStG.

3.1.3.2. *Issues*

Parts of the German tax literature criticize that the CFC's profit has to be determined according to the German rules, as in practice this leads almost always to a deviation from the tax base as determined under the foreign rules, which is time- and cost-consuming, requires personnel resources, but is also systematically questionable. The latter is because the profit which is available for distributions of a foreign company is determined according to the foreign rules. Considering that a profit distribution shall conceptually be substituted by attributing the CFC income, it seems hardly reasonable to consider different tax bases (Haase, 2017c, p. 152). However, I do not share the foregoing criticism of parts of the German tax literature. CFC income is only attributed, if a CFC earns CFC income and the CFC exemptions/threshold requirements are not met. Such circumstances generally raise BEPS concerns. As indicated above, using the CFC jurisdiction's rules to determine the tax base may lead to a significantly lower income attribution than would have corresponded according to the German rules. This would allow to strip the tax base in Germany. Therefore, I trust that the time- and cost-consuming redetermination of the tax base according to the German rules, which also requires personnel resources, is justified in cases to which the German CFC taxation applies.

According to Paragraph 10(3) sentence 4 of the AStG certain tax preferences are disregarded in computing CFC income. Consequently, the determination of profits for CFC purposes is stricter than the determination of profits for resident taxpayers. In light of the fundamental freedoms this is only justifiable under very strict conditions (Schönfeld, 2017b, p. 727). First of all, excluding tax preferences that are connected to an unlimited tax liability or to the existence of a domestic business/PE seems reasonable, to avoid that tax preferences which aim at encouraging certain domestic situations are available for computing the income of a CFC (Flick et al, 2018, Chapter § 10, para. 343). The same holds true for the interest limitation rules (Haase, 2017c, p. 152), Paragraph 4h of the EStG and Paragraph 8a of the KStG, and the license limitation rule, Paragraph 4j of the EStG, as these exclusions shall ensure that no double taxation occurs. However, the exclusion of Paragraph 8b(1) and (2) of the KStG, i.e. the exemption of dividends and capital gains, should be deleted. Pursuant to the current Paragraph 8(1) numbers 8 and 9 of the AStG dividends are always excluded from CFC income (see "2.3.3.1.1.8 Profit distributions") and income from the disposal of shares is generally deemed active

income (see “2.3.3.1.1.9 Sale of a share in another company etc.”). This makes the exclusion of Paragraph 8b(1) and (2) of the KStG in Paragraph 10(3) sentence 4 of the AStG in most cases redundant. However, in light of Article 7(2)(a)(iii) of the ATAD dividends and income from the disposal of shares have to be deemed CFC income in the future. Although, the tax rate exemption is likely to apply in most of these cases (see “2.3.3.4 ATAD compliance”), the exclusion of Paragraph 8b(1) and (2) of the KStG should be deleted, to ensure that in other cases the determination of profits for CFC purposes is insofar not stricter than the determination of profits for resident taxpayers and therewith in line with the fundamental freedoms.

3.1.3.3. *ATAD compliance*

Article 8(1) of the ATAD provides that losses of a CFC may be carried forward, according to national law. Paragraph 10(3) sentence 5 of the AStG provides that Paragraph 10d of the EStG is applicable to losses of a CFC analogously. However, the latter paragraph does not only allow a loss carry forward, but also a loss carry backward. To make the German rules for computing income ATAD compliant, the possibility to carry losses backward has to be deleted (Schnitger et al, 2016, p. 967).

3.1.4. **Spain**

3.1.4.1. *Rules*

Article 91(8) of the IRPF and Article 100(9) of the LIS provide that the amount of positive income to be attributed is computed according to the principles and criteria established in the LIS and in other provisions relating to the corporate tax to determine the tax base. For the computation the exchange rate at the end of the CFC’s business year is used.

However, in no case an amount exceeding the total income of the CFC is attributed, i.e.:

- ▶ Is the total income of the CFC 0 or negative, the passive income is not attributed at all; and

- Is the total income of the CFC positive, but less than the total passive income, the latter is only partially attributed (Borrás Amblar, & Navarro Alcázar, 2017, p. 1386; Mellado Benavente, 2017, p. 862).

Losses of a CFC may not be included in the taxpayer's tax base (Martín Queralt, Tejerizo López, & Álvarez Martínez, 2018). However, they may be carried forward according to Article 26 of the LIS (Sanz Gadea, 2016, p. 1378).

3.1.4.2. Issues

Example

A resident taxpayer holds 100 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. Company A earns active negative income of 100. The resident taxpayer decides to shift passive positive income in the same amount to the latter to benefit from the low tax rate in country A. Figure 60 illustrates the case at hand.

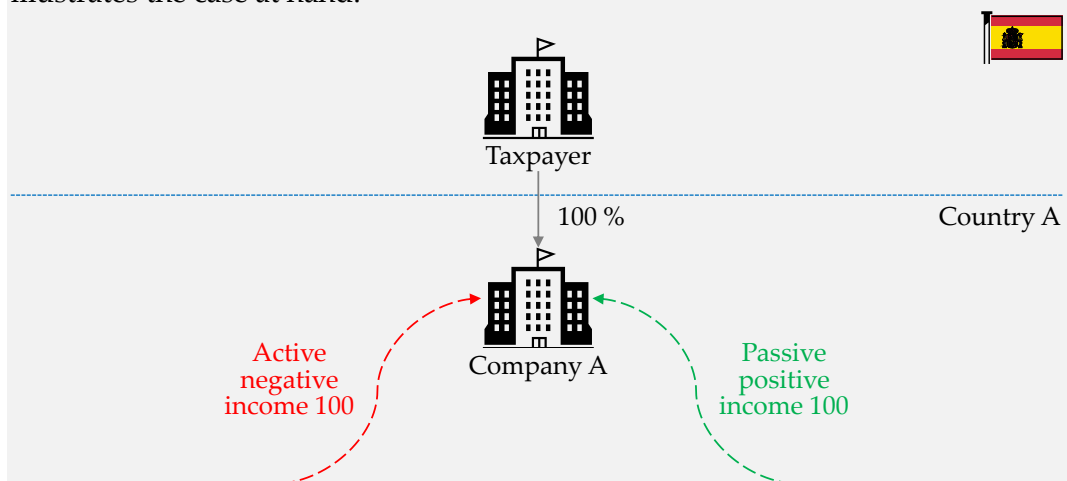


Figure 60. Illustration of the case at hand.

Considering that according to Article 100(9) of the LIS in no case an amount exceeding the total income of the CFC is attributed, the resident taxpayer has shifted exactly the right amount of passive positive income to company A to offset the latter's negative active income to 0.

In light of the foregoing structuring, it would be preferable to attribute under Article 91(9) of the IRPF and Article 100(9) of the LIS also amounts exceeding the total income of the CFC.

3.1.4.3. *ATAD compliance*

The Spanish rules for computing income are ATAD compliant (Almudí Cid, Ferreras Gutiérrez, & Hernández González-Barreda, 2017, p. 320).

3.1.5. UK

3.1.5.1. *Rules*

3.1.5.1.1 Chargeable profits

A CFC's chargeable profits, which are subject to CFC charge (Whiting, & Gunn, 2019, Binder 5, para. D4.420), are determined as follows:

According to Section 371BA(3) of the TIOPA a CFC's chargeable profits for an accounting period are its assumed taxable total profits for this period, however:

- ▶ limited to only so much of those profits as pass through the CFC charge gateway; and
- ▶ net of a just and reasonable proportion of any management expenses or other deductions against total profits for corporation tax purposes (MacLachlan, 2012, para. 5.55).

A CFC's assumed taxable total profits for an accounting period are what, applying the corporate tax assumptions (see "3.1.5.1.2 Corporation tax assumptions"), would be the CFC's taxable total profits for the period, as calculated under a normal tax computation, Section 371SB(1) and (2) of the TIOPA. However, chargeable gains are ignored, but income arising to trustees where a CFC is a settlor or beneficiary of a settlement, is added, Section 371SB(3) to (8) of the TIOPA (Harper, & Walton, 2017, para. 22.13).

According to Section 371SB(9) of the TIOPA, the CFC's assumed total profits for an accounting period are its assumed taxable total profits for the period before deducting any reliefs against total profits (Whiting, & Gunn, 2019, Binder 5, para. D4.420).

3.1.5.1.2 Corporation tax assumptions

As indicated above, the following corporation tax assumptions have to be applied inter alia when computing a CFC's assumed taxable total profits, Section 371SC(1) and (2)(a) of the TIOPA:

- ▶ The CFC is UK resident at all times during the relevant accounting period, has been UK resident from the beginning of its first accounting period, will continue to be UK resident until it ceases to be a CFC, and is, has been and will continue to be within the charge to corporation tax, Section 371SD(1) of the TIOPA. A determination of the CFC's assumed taxable total profits has been made for all previous accounting periods back to (and including) the CFC's first accounting period, Section 371SD(4) of the TIOPA;
- ▶ The CFC is not a close company, Section 371SE of the TIOPA;
- ▶ In relation to any relief under the CTA which is dependent upon the making of a claim or election, the CFC has made that claim or election which gives the maximum amount of relief within any applicable time limit, Section 371SF(1) of the TIOPA. This does not hold true for claims or elections under the exemption for profits or losses of foreign PEs, the relief for unremittable income, the designated currency of a UK resident investment company, or the election for lease to be treated as long funding lease, Section 371SF(2)(a) to (d) of the TIOPA. Furthermore, the CFC is deemed to have not claimed any roll-over relief in case of reinvestment, or made any provisional declaration of entitlement to such relief, Sections 371SF(3) and 371SK(5) of the TIOPA. Under certain conditions this assumption can be disapplied, Section 371SG of the TIOPA;
- ▶ Any intangible fixed asset acquired or created by the CFC before the CFC's accounting period which begun when it became a CFC is assumed to have been acquired or created by the beginning of the latter accounting period at a cost equal to its value recognized for accounting purposes at that time (assuming that the CFC has not claimed any roll-over relief in case of reinvestment, or made any provisional declaration of entitlement to such relief), Section 371SK(2), (3) and (5) of the TIOPA;

- ▶ The CFC is neither a member of a group of companies nor a member of a consortium for the purposes of any provision of the Tax Acts, Section 371SL(1) of the TIOPA. The main effect of this corporation tax assumption is to avoid that the group loss relief provisions apply (Whiting, & Gunn, 2019, Binder 5, para. D4.421);
- ▶ If the CFC incurred any capital expenditure on plant or machinery for the purposes of its trade before its first accounting period in which it falls within the CFC regime it is assumed that the foregoing expenditure was incurred for other purposes than trade, and was not brought into use for trade purposes until the beginning of the CFC's first accounting period, Section 371SM(1) and (2) of the TIOPA (Harper, & Walton, 2017, para. 22.14);
- ▶ Does the application of the CTA depend upon a test considering whether a purpose of an arrangement or other conduct is to obtain a tax advantage, the provisions also apply where the arrangement or other conduct has at least as one of its main purposes to avoid or reduce a CFC charge, Section 371SO of the TIOPA (Harper, & Walton, 2017, para. 22.14); and
- ▶ According to Section 371SR of the TIOPA the double taxation relief anti avoidance provisions apply also in computing the creditable tax of a CFC (Whiting, & Gunn, 2019, Binder 5, para. D4.421).

Further corporation tax assumptions are provided in relation to the CFC's designated currency for UK tax purposes, Sections 371SH and 371SI of the TIOPA, long funding leases, Section 371SJ of the TIOPA, unremittable overseas income, Section 371SN of the TIOPA, arrangements giving rise to a return in the nature of disguised interest, Section 371SP of the TIOPA and shares accounted for as liabilities, Section 371SQ of the TIOPA.

3.1.5.2. *Issues*

Under the UK CFC rules it is necessary to determine the chargeable profits of a CFC. As detailed above, these are, broadly, the latter's profits (excluding chargeable gains) so far as they pass through the CFC charge gateway on which corporation tax would have been chargeable, had the CFC been resident only in the UK, and on the corporation tax assumptions (see "3.1.5.1.2 Corporation tax

assumptions"; MacLachlan, 2012, para. 5.203). In light of the corporation tax assumptions the CFC's chargeable profits always deviate from the tax base as determined under the foreign rules. Considering the complexity of the corporation tax assumptions, computing the CFC's chargeable profits thereunder is likely to be even more time- and cost-consuming and requiring more personnel resources than determining the CFC's profit according to the German rules. The corporation tax assumptions might be simplified, however, one has to bear in mind that in light of the numerous de minimis thresholds (see "2.2.5.1.1 De minimis thresholds") and exemptions (see "2.2.5.1.2 Exemptions") as well as considering that the profits have to pass through the CFC charge gateway (see "2.3.5.1 Rules"), the chargeable profits of a CFC only have to be determined in a minority of cases.

3.1.5.3. *ATAD compliance*

The UK rules for computing income are ATAD compliant.

3.1.6. **Recommendation**

The German rules for computing income have proven effective in practice. The only recommendation is to delete from Paragraph 10(3) sentence 4 of the AStG the exclusion of Paragraph 8b(1) and (2) of the KStG (see "3.1.3.2 Issues").

3.2. RULES FOR ATTRIBUTING INCOME

3.2.1. **BEPS**

Once the amount of CFC income has been calculated, it has to be attributed. Rules for attributing income have to determine to whom how much income is when and how attributed and which tax rate shall apply (OECD, 2015c, para. 110).

The OECD/G20 hold that income should be attributed to taxpayers meeting the minimum control threshold as this leads to administrative simplicity and reduces compliance burdens. Besides, this ensures the taxpayers' possibility to gather the required information regarding the CFC's income and activity. However, also other attribution thresholds may be used, as long as they ensure that

at least the income of taxpayers who can influence the CFC is attributed (OECD, 2015c, paras. 113, 114).

As established in all existing CFC rules the OECD/G20 recommend to attribute income in proportion to each taxpayer's ownership, either based on the last day of the year, as long as this accurately captures the taxpayer's influence (e.g. because voting is determined based on ownership on the last day of the year), or on the period of ownership. Attribution rules should provide that an attribution of more than 100 percent of the CFC's income is not possible (e.g. legal and economic control might lead together to more than 100 percent; OECD, 2015, paras. 115, 116).

Under most existing CFC rules taxpayers have to include the attributed income in the tax return for the taxable year in which the CFC's accounting period ends (OECD, 2015c, para. 117).

Attributed income may be treated according to the OECD/G20 as deemed dividends, i.e. existing domestic dividend rules would apply, or as having been earned by the taxpayer directly, i.e. income is characterized under the existing domestic rules (OECD, 2015c, para. 118).

Finally, the OECD/G20 recommend to apply the tax rate of the parent jurisdiction to the CFC income. An alternative, the top-up-tax (difference between tax actually paid and a certain threshold), is considered to do not necessarily eliminate BEPS incentives, as such threshold may be significantly below the parent jurisdiction's tax rate and consequently not recommended (OECD, 2015c, paras. 119, 120).

3.2.2. ATAD

According to Article 8(3) of the ATAD the income to be included in the tax base shall be calculated in proportion to the taxpayer's participation in the entity in terms of Article 7(1)(a) of the ATAD. Consequently, the taxpayer's participation is determined based on its direct or indirect holding of the voting rights or capital or its entitlement to receive profits of the CFC.

Problematic is that Article 8(3) of the ATAD provides no hierarchy between these three bases for determining the taxpayer's participation. Considering always the highest base for determining the taxpayer's participation would lead in many cases to double taxation.

The following example is based on Schnitger et al (2016, pp. 971, 972).

Example

German resident taxpayer R1 holds 30 percent of the voting rights, 70 percent of the capital and is entitled to 70 percent of the profits of company A, resident in country A, a low tax jurisdiction. German resident taxpayer R2 holds 70 percent of the voting rights, 30 percent of the capital and is entitled to 30 percent of the profits of company A. Company A earns passive income. Figure 61 illustrates the case at hand.

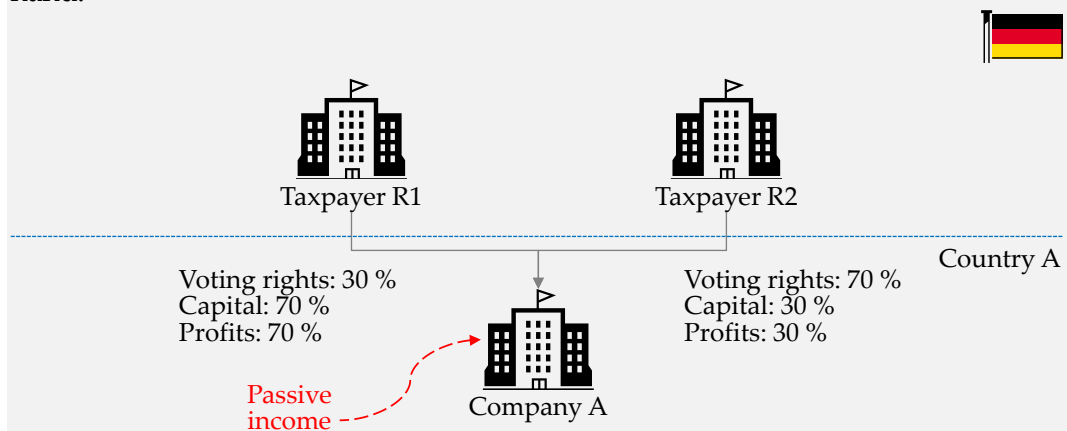


Figure 61. Illustration of the case at hand.

Would the highest base be considered to determine the participation of the resident taxpayers R1 and R2, overall 140 percent of company A's passive income would have to be included in their tax bases.

The income to be included in the tax base shall be included in the tax period of the taxpayer in which the tax year of the CFC ends, Article 8(4) of the ATAD.

3.2.3. Germany

3.2.3.1. Rules

The CFC income is taxable for each of the resident taxpayers so far as it is attributable to the respective resident taxpayer's ownership interest in the CFC's nominal capital, Paragraph 7(1) of the AStG. Ownership interest in terms of Paragraph 7(1) of the AStG may only be a direct ownership interest (Heuermann, & Brandis, 2018, Chapter § 7, para. 19). However, if the profits of a CFC are not

distributed in accordance with the ownership interests in its nominal capital, or if a CFC has no nominal capital, the income is attributed based on the criterion which is relevant for the distribution of profits, Paragraph 7(5) of the AStG.

Where a foreign company, either alone or together with resident taxpayers, holds an ownership interest as defined in Paragraph 7 of the AStG (nominal capital (Kollruss, 2017a, p. 449), not criterion which is relevant for the distribution of profits (Kollruss, 2018, p. 1192) in another foreign company (lower tier company), the latter's low taxed income is attributed according to Paragraph 14(1) of the AStG to the foreign company in proportion to its ownership interest in the lower tier company's nominal capital, unless it is demonstrated that the lower tier company earns such income from:

- ▶ The categories set forth under Paragraph 8(1) numbers 1 to 10 of the AStG; or
- ▶ Other activities that are directly connected to an own active activity set forth in Paragraph 8(1) numbers 1 to 6 of the AStG of the foreign company, excluding income in terms of Paragraph 7(6a) of the AStG.

Paragraph 14(1) of the AStG applies accordingly where the lower tier company is held through a chain of foreign companies, Paragraph 14(3) of the AStG.

The legislator preferred the above solution over a direct attribution to the resident taxpayer to take into account operations between the foreign company and the lower tier company (e.g. profit distributions; Heuermann, & Brandis, 2018, Chapter § 14, para. 3).

According to Paragraph 10(2) sentence 1 of the AStG the attributed income constitutes income in terms of Paragraph 20(1) number 1 of the EStG (dividends) and is deemed to have been received immediately after the close of the CFC's relevant fiscal year. Where ownership interests in a CFC are held as business assets, the attributed income constitutes income from commercial business activity, from agriculture and forestry, or from independent personal services and increases the profit determined for the business according to the EStG or KStG for the fiscal year that ends after the close of the CFC's relevant fiscal year, Paragraph 10(2) sentence 2 of the AStG. However, Paragraph 3 number 40 sentence 1(d) of the EStG (40 percent exemption from income tax), Paragraph 32d of the EStG (25 percent flat

tax) and Paragraph 8b(1) of the KStG (full exemption from corporate tax) are not applicable to the attributed income, Paragraph 10(2) sentence 3 of the AStG. Paragraph 3c(2) of the EStG (partial deduction prohibition) applies accordingly.

To the attributed income the German tax rate is applied.

3.2.3.2. *Issues*

Paragraph 14(1) of the AStG is only applicable where a foreign company, either alone or together with resident taxpayers, holds an ownership interest as defined in Paragraph 7 of the AStG in a lower tier company. However, in tax literature is discussed controversially whether this references is only made to Paragraph 7(2) of the AStG or also to Paragraph 7(6) of the AStG.

Parts of the German tax literature trust that an ownership interest as defined in Paragraph 7 of the AStG may only be an ownership interest in terms of Paragraph 7(2) of the AStG, as Paragraph 7(6) of the AStG, other than Paragraph 7(2) of the AStG, does not define the term ownership interest, but rather contains special conditions for the CFC taxation of passive investment income. Furthermore, they argue that according to the wording of Paragraph 14(1) of the AStG the lower tier company's low taxed income is attributed to the foreign company in proportion to its ownership of the lower tier company's nominal capital. This may not be accurate where more than one resident taxpayers hold indirectly different percentages of ownership interests in a lower tier company with passive investment income (Flick et al, 2018, Chapter § 14, para. 98).

Example

Resident taxpayer R1 holds 1 percent, resident taxpayer R2 10 percent and a non-resident taxpayer NR 89 percent of the ownership interests in company A, resident in country A, which in turn holds 40 percent in company B, resident in country B, a low tax jurisdiction. Company B earns passive investment income. Figure 62 illustrates the case at hand.

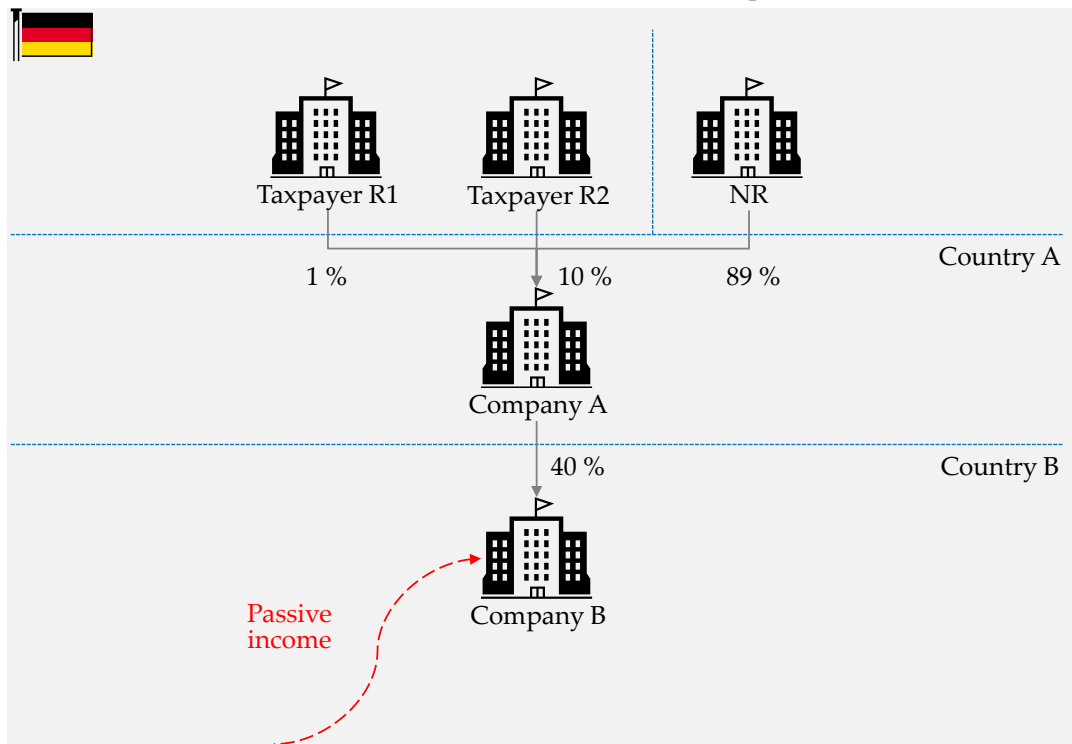


Figure 62. Illustration of the case at hand.

Applying the above rules in a first step 40 percent of company B's passive investment income would be attributed to company A, and in a second step thereof 1 and 10 percent respectively to the resident taxpayers R1 and R2. Consequently, resident taxpayer R1 would be subject to CFC taxation, although it only holds indirectly an ownership interest of 0.4 percent in company B.

Other parts of the German tax literature hold that ownership interest as defined in Paragraph 7 of the AStG may be both, an ownership interest in terms of Paragraph 7(2) of the AStG, as well as an ownership interest in terms of Paragraph 7(6) of the AStG. Inaccurate results, as in the above example shall be avoided by a teleological reduction of the scope of Paragraph 14(1) of the AStG to the indirect ownership interest (Strunk et al, 2018, Chapter § 14, para. 33). Would one follow instead the first opinion, i.e. require an ownership interest in terms of Paragraph 7(2) of the AStG a CFC taxation of passive investment income could be avoided by simply interposing a foreign company (Heuermann, & Brandis, 2018, Chapter § 14, para. 7).

Low taxed income of a lower tier company is not attributed under Paragraph 14(1) of the AStG to its parent foreign company, if it is demonstrated that the lower tier company earns such income from categories included in the positive list (see “2.3.3.1.1 Positive list”) or from other activities directly connected to an own active activity set forth in Paragraph 8(1) numbers 1 to 6 of the AStG of the foreign company, excluding income in terms of Paragraph 7(6a) of the AStG. Consequently, the foregoing has to be demonstrated for all lower tier companies that might be subject to a low level of taxation. Considering that the question whether or not a low level of taxation is given has to be determined according to German tax law, this leads to a high administrative and declaration burden for the resident taxpayer (Strunk et al, 2018, Chapter Vor §§ 7-14, para. 28).

3.2.3.3. *ATAD compliance*

To make the German rules for attributing income ATAD compliant the income has to be included in the taxpayer’s tax return for the period in which the tax year of the CFC ends, Article 8(4) of the ATAD. This is not always the case under the current German rules. According to Paragraph 10(2) sentence 1 of the AStG the attributed income is deemed to have been received immediately after the close of the CFC's relevant fiscal year, and under Paragraph 10(2) sentence 2 of the AStG the attributed income increases the profit determined for the business under the EStG or KStG for the fiscal year that ends after the close of the CFC's relevant fiscal year. Consequently, where the resident taxpayer’s and the CFC's fiscal year end on the same day, the attribution is postponed by one year.

3.2.4. **Spain**

3.2.4.1. *Rules*

According to Article 91(1)(a) of the IRPF and Article 100(1)(a) of the LIS positive income is attributed to taxpayers meeting the minimum control threshold (see “2.1.4.1.2 Control”). The amount of positive income to be attributed is determined in proportion to the taxpayer’s participation in the results or, subsidiarily, in proportion to the taxpayer's participation in the capital, equity or voting rights of a CFC. Between the latter three criteria exists no hierarchy (Borrás Amblar, & Navarro Alcázar, 2017, p. 1388). According to Article 91(6) of the IRPF

and Article 100(7) of the LIS, both, direct and indirect participations through one or more non-resident entities in a CFC are considered. In the latter case the amount of positive income is the one corresponding to the indirect participation.

The taxation is realized in the tax period which comprises the day on which the CFC's business year ends, Article 91(7) of the IRPF and Article 100(8) of the LIS. For these purposes, the CFC's business year may not be considered to have more than 12 months.

The Spanish tax rate is applied to the attributed CFC income.

3.2.4.2. *Issues*

Problematic is that Article 91(1)(a) of the IRPF and Article 100(1)(a) of the LIS do not provide a hierarchy between the three subsidiary criteria (capital, equity and voting rights) to determine a taxpayer's participation. As mentioned above (see "3.2.2 ATAD"), considering always the highest criteria for determining the taxpayer's participation would lead in many cases to a double taxation.

3.2.4.3. *ATAD compliance*

The Spanish rules for attributing income are ATAD compliant.

3.2.5. **UK**

3.2.5.1. *Rules*

A CFC's chargeable profits are attributed as follows:

- ▶ First, the UK resident persons having relevant interests in the CFC at any time throughout the accounting period have to be determined, Section 371BC(1) Step 1 of the TIOPA;
- ▶ Then, the CFC's creditable tax for the accounting period is determined (see "4.5.1.3 Relief for foreign income taxes"), Section 371BC(1) Step 2 of the TIOPA;
- ▶ Afterwards the chargeable profits and the tax determined in step 2 are apportioned to the UK resident relevant persons, Section 371BC(1) Step 3 of the TIOPA;

- ▶ For each UK resident relevant person has to be tested, if it is a chargeable company, Section 371BC(1) Step 4 of the TIOPA; and
- ▶ Finally, the CFC charge is charged as laid down in Section 371BC(1) Step 5 of the TIOPA.

3.2.5.1.1 Relevant interest

A UK resident company's interest in a CFC is a relevant interest, unless it is an indirect interest which the UK resident company has by virtue of having an interest in another UK company, Section 371OC(1) and (2) of the TIOPA.

The following example is based on Whiting and Gunn (2019, Binder 5, para. D4.436).

Example

The resident taxpayer R1 holds all ownership interests in resident taxpayer R2. The latter, in turn, holds all ownership interests in company A, resident in country A, a low tax jurisdiction. Figure 63 illustrates the case at hand.

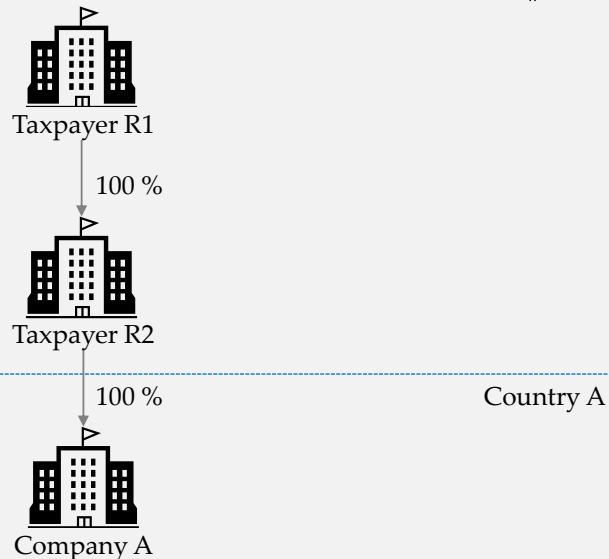


Figure 63. Illustration of the case at hand.

According to Section 371OC(1) and (2) of the TIOPA only the lower tier resident taxpayer R2's ownership interest in company A is a relevant interest.

If a UK resident company has a relevant interest in a CFC, an interest of a non UK resident company, who is connected or associated with the UK resident company, in the CFC, is also a relevant interest, Section 371OD(1) to (3) of the TIOPA, except:

- ▶ so far as the related person's interest is an indirect interest which the related person has by virtue of having an interest in a UK resident company or another related person, Section 371OD(4) of the TIOPA; or

Example

Company A, resident in country A, holds all ownership interests in the resident taxpayer. The latter, in turn, holds all ownership interests in company B, resident in country B, a low tax jurisdiction. Figure 64 illustrates the case at hand.

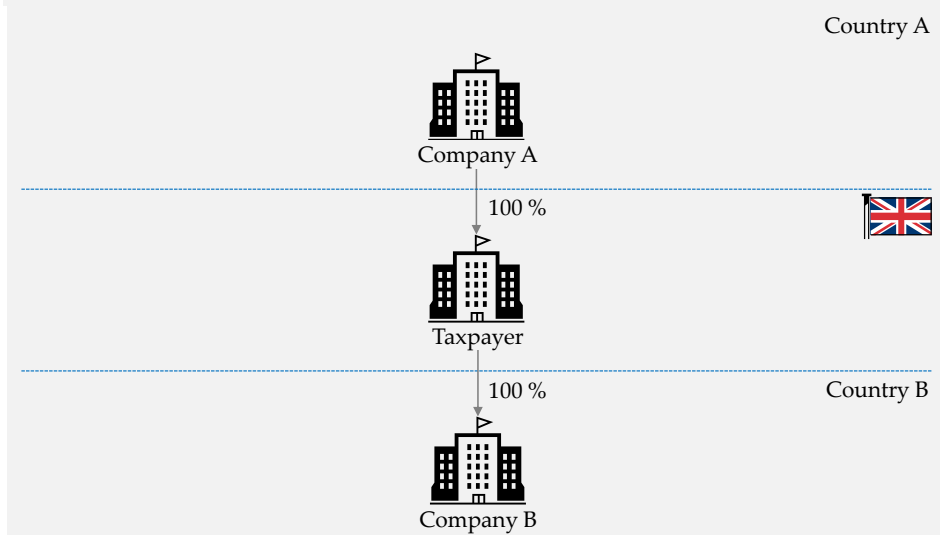


Figure 64. Illustration of the case at hand.

According to Section 371OD(4) of the TIOPA the resident taxpayer's ownership interest in company B is a relevant interest (Whiting, & Gunn, 2019, Binder 5, para. D4.436).

- ▶ so far as the related person's interest is the same as the UK resident company's relevant interest in the CFC by virtue of the UK resident company having an interest in the related person, Section 371OD(5) of the TIOPA.

Example

The resident taxpayer holds all ownership interests in company A, resident in country A. The latter, in turn, holds all ownership interests in company B, resident in country B, a low tax jurisdiction. Figure 65 illustrates the case at hand.

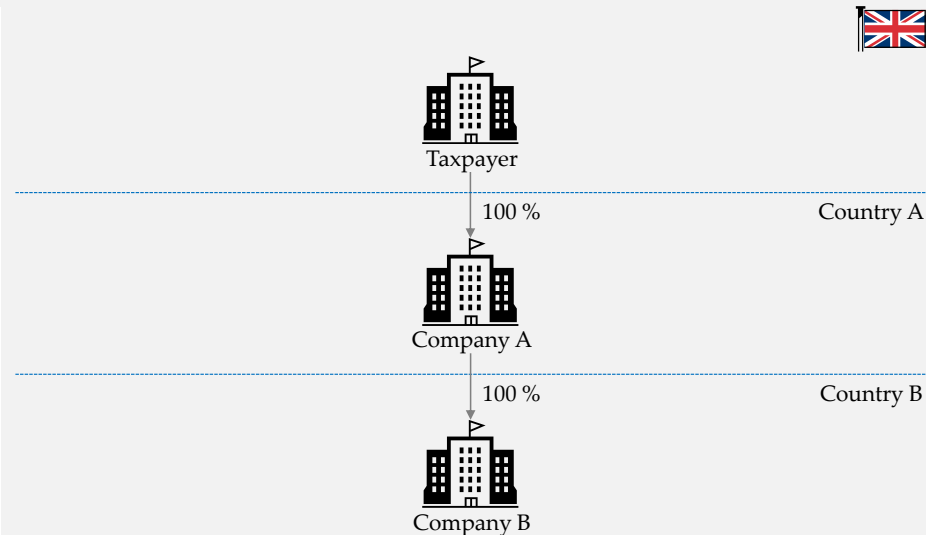


Figure 65. Illustration of the case at hand.

According to Section 371OD(5) of the TIOPA only the resident taxpayer's ownership interest in company B is a relevant interest (Whiting, & Gunn, 2019, Binder 5, para. D4.436).

If a person has a direct interest in a CFC which is not a relevant interest by virtue of Section 371OC or 371OD of the TIOPA, this interest is a relevant interest, except so far as it is the same as another person's relevant interest in the CFC by virtue of the other person having an interest in the person in terms of Section 371OC or 371OD of the TIOPA, Section 371OE of the TIOPA.

The following example is based on MacLachlan (2012, para. 5.66).

Example

A resident taxpayer holds 65 percent of the ownership interests in company A, resident in country A. The latter, in turn, hold all ownership interests in company B, resident in country B, a low tax jurisdiction. Figure 66 illustrates the case at hand.

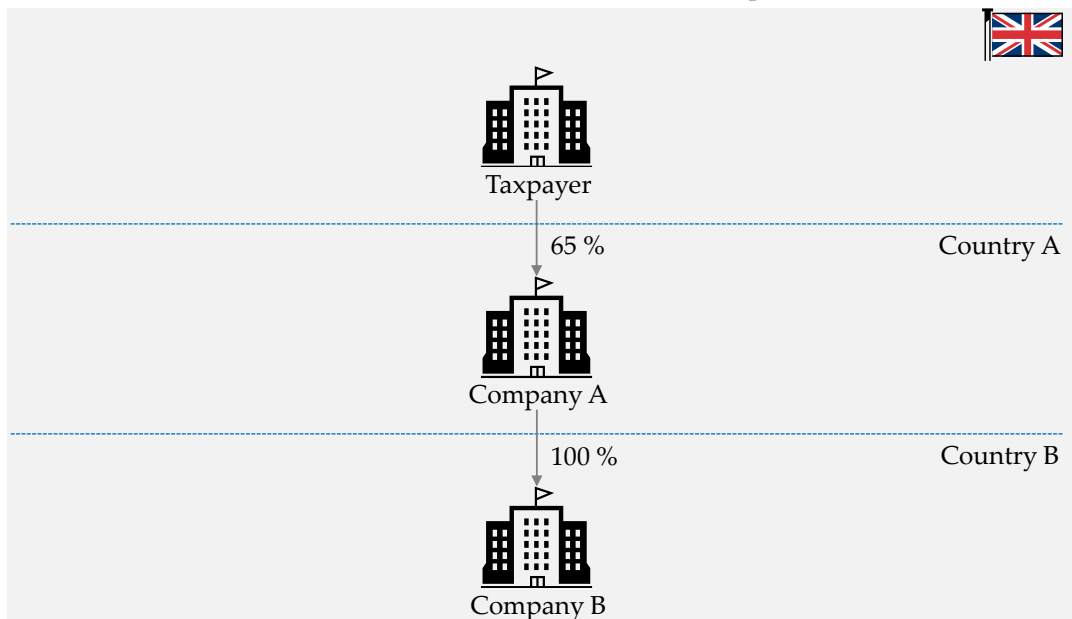


Figure 66. Illustration of the case at hand.

According to Section 371OE of the TIOPA company A's 100 percent ownership interest in company B is only a 35 percent relevant interest. The resident taxpayer's indirect 65 percent ownership interest in company B is also a relevant interest.

At least one of the relevant persons has to be a UK resident at a time during the accounting period when it has a relevant interest in the CFC ("UK residence condition"), Section 371BC(1)(2) of the TIOPA. Otherwise the CFC charge is not charged in relation to the accounting period.

3.2.5.1.2 Apportionment

According to Sections 371QC(1) and (3) to (5) and 371QD(1) to (3) of the TIOPA the chargeable profits of a CFC are to be apportioned among the relevant persons by determining the percentage of the issued ordinary shares in the CFC represented by each relevant person's relevant interest, and apportioning this percentage of the CFC's chargeable profits to this relevant person, if the following conditions are met:

- ▶ All relevant persons have their relevant interests by virtue only of their direct or indirect holding of ordinary shares in the CFC;

- ▶ Each relevant person is at all times during the accounting period UK resident or non-UK resident; and
- ▶ No company with an intermediate interest in the CFC at any time in the accounting period has that interest otherwise than by virtue of its direct or indirect holding of ordinary shares in the CFC.

Does the percentage of the issued ordinary shares in the CFC represented by a relevant person's relevant interest vary during the accounting period, that percentage is taken to be the percentage equal to the sum of the time-weighted percentages for each holding period, i.e. for each part of the accounting period during which the percentage of the issued ordinary shares in the CFC represented by the relevant person's relevant interest did not vary, Section 371QF of the TIOPA.

The following example is based on Whiting and Gunn (2019, Binder 5, para. D4.438).

Example

A resident taxpayer holds for 200 days 70 percent and for 165 days 80 percent of the issued ordinary shares in company A, resident in country A, a low tax jurisdiction, as a relevant interest. Figure 67 illustrates the case at hand.

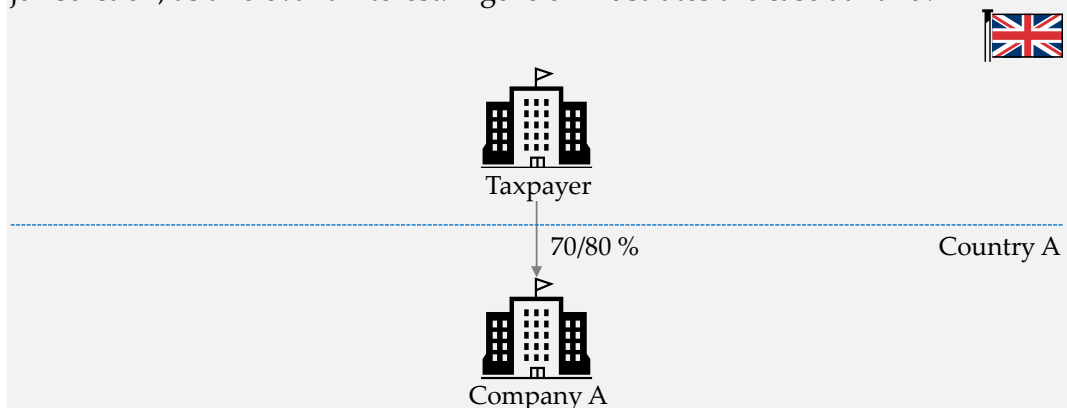


Figure 67. Illustration of the case at hand.

The percentage of company A's issued share capital that the resident taxpayer's relevant interest represents in the accounting period is according to Section 371QF of the TIOPA: $200/365 * 70 \% + 165/365 * 80 \% = 74.52 \%$

Where a relevant person has a relevant interest by virtue of holding, indirectly, ordinary shares in a CFC, the percentage of the issued ordinary shares in the CFC represented by the relevant person's relevant interest is determined

according to the formula $P * S$, Section 371QE(1) and (2) of the TIOPA. P means the product of the appropriate fractions (as defined in Section 371QE(3) of the TIOPA) of the relevant person and each of the share-linked companies through which the relevant person indirectly holds the relevant shares, other than the share-linked company which directly holds the relevant shares. S means the percentage of the issued ordinary shares in the CFC which the relevant shares represent. For different indirect holdings of shares in a CFC, the apportionment is made separately in relation to each holding, and then added together, Section 371QE(4) of the TIOPA.

The following example is based on Harper and Walton (2017, para. 22.26).

Example

A resident taxpayer holds 90 percent of the shares in company A, resident in country A. The latter holds, in turn, 80 percent of the shares in company B, resident in country B, which holds 80 percent of the issued ordinary shares in company C, resident in country C, a low tax jurisdiction (indirect holding 1). Furthermore, the resident taxpayer holds 60 percent of the shares in company D, resident in country D. The latter holds 20 percent of the issued ordinary shares in company C (indirect holding 2). Figure 68 illustrates the case at hand.

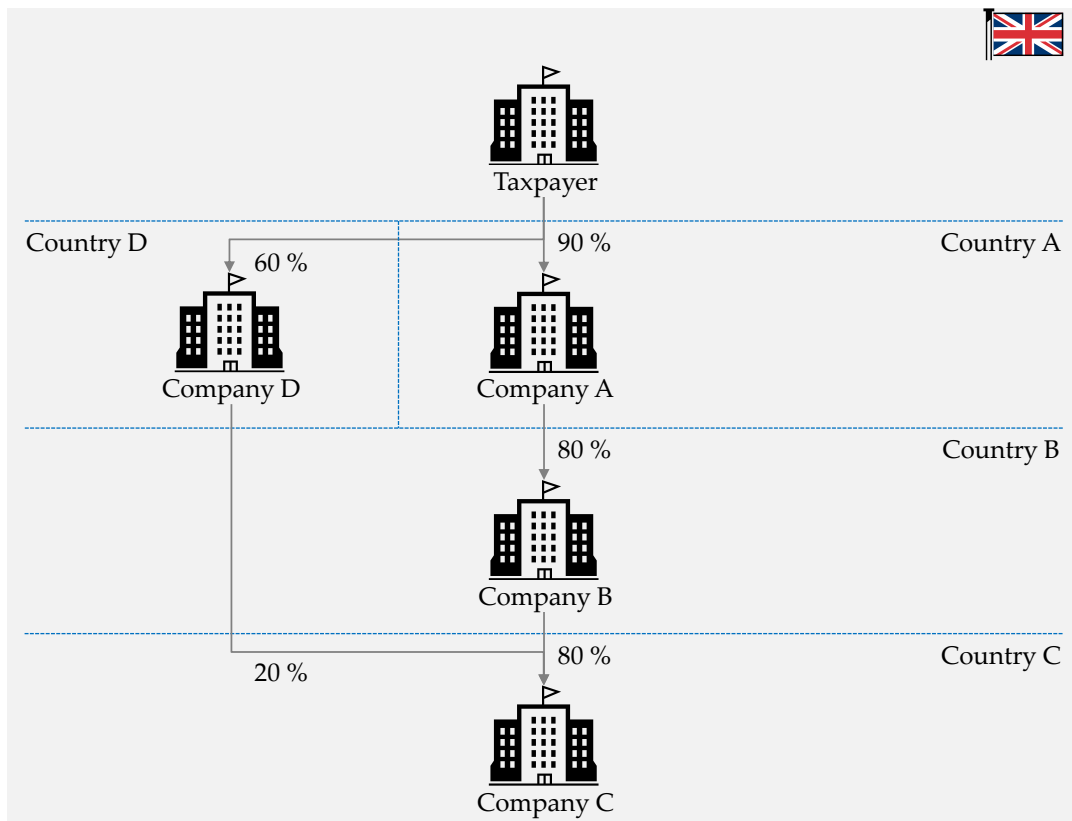


Figure 68. Illustration of the case at hand.

The calculation is shown in Table 8.

Table 8. Calculation.

	P		S		P * S
Indirect holding 1	90 % * 80 %	*	80 %	=	57.6 %
Indirect holding 2	60 %	*	20 %	=	12.0 %
Total					72.3 %

However, if at any time an arrangement is entered into with at least one of the main purposes being to obtain for any person a tax advantage in relation to the relevant (and possibly more) accounting periods, the CFC's chargeable profits for the accounting period are to be apportioned on a just and reasonable basis, counteracting, so far as practicable, the effects of this arrangement so far as they are referable to the aforementioned purpose, Sections 371QG and 371QC(2) of the TIOPA.

Are the above conditions not met, the percentage of the chargeable profits to be apportioned to each relevant person is also to be determined on a just and reasonable basis, Section 371QC(2) of the TIOPA.

3.2.5.1.3 Chargeable company

A company meeting the UK residence condition is a chargeable company, if the total of the percentage of the CFC's chargeable profits apportioned to it and the percentages (if any) of those profits which are apportioned to relevant persons who, at any time during the accounting period, are connected or associated with it, is at least 25 percent, Section 371BD(1) of the TIOPA.

The following example is based on Whiting and Gunn (2019, Binder 5, para. D4.439).

Example

The resident taxpayer R1 holds 80 percent, the resident taxpayer R2 20 percent of the ownership interests in company A, resident in country A, a low tax jurisdiction. The resident taxpayers R1 and R2 are members of the same group. 80 percent of company A's chargeable profits are apportioned to the resident taxpayer R1, further 20 percent to the Resident taxpayer R2. Figure 69 illustrates the case at hand.

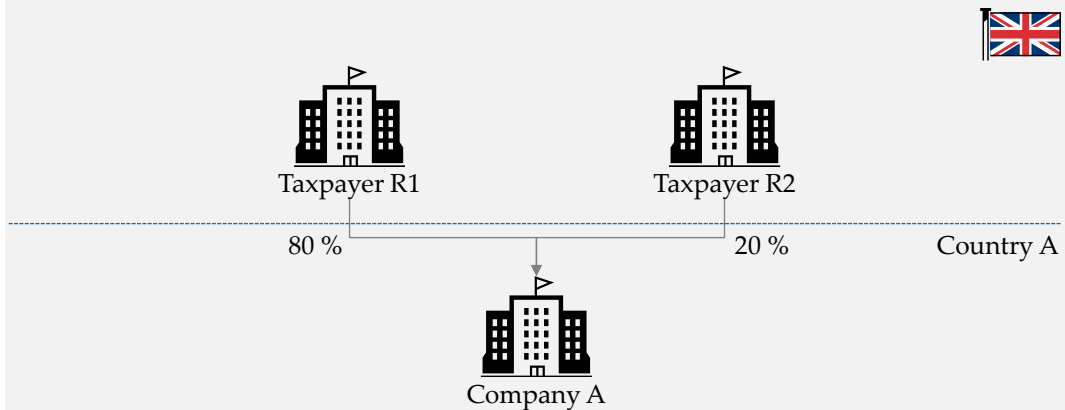


Figure 69. Illustration of the case at hand.

According to Section 371DB(1) of the TIOPA, both of them are chargeable companies.

However, from the above definition, the following companies are excluded:

- ▶ Companies which are managers of offshore funds etc. under the conditions provided in Section 371BE of the TIOPA;
- ▶ Companies which are participants in offshore funds under the conditions provided in Section 371BF of the TIOPA; and
- ▶ Companies holding shares as trading assets etc., Section 371BG of the TIOPA.

Section 371BH of the TIOPA provides special rules for companies carrying on a basic life insurance and general annuity business.

3.2.5.1.4 Tax rate

The UK tax rate is applied to the attributed CFC income, Section 371BC(1) and (3) of the TIOPA. Should there be more than one rate, the average rate is used (Harper, & Walton, 2017, para. 22.23).

3.2.5.2. *Issues*

In practice the apportionment of chargeable profits/creditable tax may be difficult, as the following example shows.

Example

Due to different types of shares, a resident taxpayer holds 90 percent of the voting rights, but only 60 percent of the economic rights in company A, resident in country A, a low tax jurisdiction. Figure 70 illustrates the case at hand.

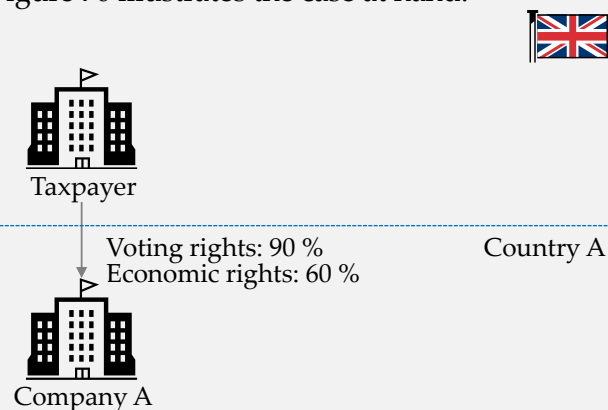


Figure 70. Illustration of the case at hand.

According to Step 3 of Section 371BC(1) of the TIOPA company A's chargeable profits/creditable tax have to be apportioned to the resident taxpayer. The apportionment has to be made on a just and reasonable basis, Section 371QC(2) of the TIOPA (see "3.2.5.1.2 Apportionment"). However, the wording of the latter section leaves a high degree of uncertainty.

On the other hand the just and reasonable approach may avoid that a hierarchy between various proxies for the income attribution is exploited.

3.2.5.3. *ATAD compliance*

To make the UK rules for attributing CFC income ATAD compliant, Step 4 of Section 371BC(1) of the TIOPA has to be amended. According to the latter the CFC charge is only charged to chargeable companies. As detailed above a chargeable company is, broadly, a UK resident relevant person, if the total of the percentages of the CFC's chargeable profits apportioned to it and to certain persons connected/associated with it, is at least 25 percent, Section 371BD(1) of the TIOPA. However, Article 8(3) of the ATAD, requires that the income to be included in the tax base shall be calculated in proportion to the taxpayer's participation in the entity as defined in Article 7(1)(a) of the ATAD. In other words, a 25 percent threshold is not allowed in the future.

3.2.6. **Recommendation**

Under the German rules, the CFC income is currently taxable for each of the resident taxpayers so far as it is attributable to the respective resident taxpayer's direct ownership interest in the CFC's nominal capital, Paragraph 7(1) of the AStG. Are the profits of a CFC not distributed in accordance with the ownership interests in its nominal capital, or does a CFC not have a nominal capital, the income is attributed based on the proxy which is relevant for the distribution of profits, Paragraph 7(5) of the AStG. The Spanish rules for attributing income, Articles 91(1)(a) of the IRPF and 100(1)(a) of the LIS, look as well at the resident taxpayer's participation in the result, however, subsidiarily, also to the resident taxpayer's participation in the capital, equity or voting rights of a CFC. The Spanish approach seems preferable, as it avoids structurings. However, not ideal seems that no hierarchy exists between latter three criteria. Considering always the highest

criteria for determining the taxpayer's participation would lead in many cases to a double taxation (see "3.2.4.2 Issues"). A solution, instead of a hierarchy that might also be exploited, could be the just and reasonable approach employed by UK CFC rules (see "3.2.5.2 Issues").

In any case, in light of the ATAD, the CFC taxation will have to be realized, as under the Spanish CFC rules, in the tax period which comprises the day on which the CFC's business year ends, Article 100(8) of the LIS (see "3.2.3.3 ATAD compliance").

4. RULES TO PREVENT OR ELIMINATE DOUBLE TAXATION

4.1. BEPS

According to the OECD/G20 double taxation may arise especially, where (OECD, 2015c, paras. 122, 125):

- ▶ Attributed CFC income is also subject to foreign corporate taxes;
- ▶ Attributed CFC income is subject to CFC taxation in multiple jurisdictions; and
- ▶ Dividends and capital gains are paid out of income formerly attributed under CFC rules to its resident shareholders.

For the first two situations the OECD/G20 recommend to credit foreign taxes on income actually paid (limited to the lesser of the domestic tax or the foreign tax actually paid), including CFC tax paid in an intermediate country (hierarchy: priority of the shareholder's jurisdiction, which is closer to the CFC in the shareholder chain). For the third situation dividends and capital gains should be exempted, unless the regular participation exemption is applicable. As it may be difficult to determine whether dividends are paid out of income formerly attributed under CFC rules to its resident shareholders, the dividend exemption might be limited to profits generated by the CFC throughout tax years when CFC rules applied (OECD, 2015c, paras. 123, 126, 131, 132).

4.2. ATAD

To prevent double taxation, the ATAD allows the following:

- ▶ Where a CFC distributes profits to a taxpayer that are included in the latter's taxable income, the amounts of income previously included in the tax base according to Article 7 of the ATAD are deducted from the tax base when determining the amount of tax due on the distributed profits, Article 8(5) of the ATAD;
- ▶ Where a taxpayer disposes of its participation in a CFC or of the business carried out by a PE, the amounts of disposal proceeds previously

included in the tax base according to Article 7 of the ATAD are deducted from the tax base when determining the amount of tax due on the disposal proceeds, Article 8(6) of the ATAD (Rieß, & Herbst, 2017, p. 987); and

- ▶ Where the CFC paid tax, the member state of the taxpayer allows a deduction of this tax (calculated in accordance with national law) from the taxpayer's tax liability in its state of tax residence or location, Article 8(7) of the ATAD.

According to the wording of Article 8(7) of the ATAD the tax payment of a CFC is a condition for the deduction. Consequently, a deduction of CFC tax paid in another member state appears not to be allowed. However, such deduction should be possible for systematic reasons or considering objective fairness (Schnitger et al, 2016, p. 973).

4.3. GERMANY

4.3.1. Rules

The German rules to prevent or eliminate double taxation comprise a relief for subsequent dividends, for subsequent capital gains and for foreign income taxes.

4.3.1.1. *Relief for subsequent dividends*

Does a CFC distribute profits, a double taxation is prevented as follows:

- ▶ For natural persons as recipients Paragraph 3(41)(a) of the EStG provides that profit distributions are tax-exempt, so far as the taxpayer proves that attributed income in terms of Paragraph 10(2) of the AStG from an ownership interest in the same CFC was subject to income tax in the calendar or business year in which they are derived, or in the previous seven calendar or business years. Paragraph 3c(2) of the EStG (deduction prohibition) applies accordingly.

Taxes on profit distributions exempted under Paragraph 3(41)(a) of the EStG are, upon request, credited or deducted according to Paragraph 12(3) of the AStG in the tax assessment period in which the underlying

CFC income was attributed, even if the tax assessment notice for this assessment period has become final. Paragraph 34c(1) and (2) of the EStG and Paragraph 26(1) and (6) of the KStG apply accordingly;

- ▶ For corporations as recipients Paragraph 8b(1) and (4) of the KStG applies. Broadly, this Paragraph provides that profit distributions are excluded when determining income, if the taxpayer holds a share of at least 10 percent in the CFC. However, according to Paragraph 8b(5) of the KStG 5 percent of these profit distributions are deemed to constitute a non-deductible business expense (Kahlenberg, 2018b, p. 630). As a result an economic double burden arises, as held by the BFH in its decision as of 26 April 2017 (I R 84/15).

4.3.1.2. *Relief for subsequent capital gains*

Does a taxpayer sell a share in a CFC, liquidate it or reduce its capital, a double taxation is prevented as follows:

- ▶ For natural persons as recipients Paragraph 3(41)(b) of the EStG provides that gains resulting therefrom are tax-exempt, so far as the taxpayer proves that attributed income in terms of Paragraph 10(2) of the AStG from an ownership interest in the same CFC was subject to income tax in the calendar or fiscal year in which the gain is derived or in the previous seven calendar or fiscal years, and that the taxpayer has not received the attributed income as a profit share;
- ▶ For corporations as recipients Paragraph 8b(2) of the KStG applies. Broadly, this Paragraph provides that gains on the sale of a share in a CFC are excluded when determining income. However, according to Paragraph 8b(3) of the KStG 5 percent of these gains are deemed to constitute a non-deductible business expense. As a result an economic double burden arises.

4.3.1.3. *Relief for foreign income taxes*

Paragraph 10(1) of the AStG determines that the income taxable according to Paragraph 7(1) of the AStG is taxed to the resident taxpayer in the amount that results after deduction of the taxes levied against the CFC on this income and on the property underlying the latter. Deducted are only taxes that have not been

deducted as a business expense in computing income according to Paragraph 10(3) and (4) of the AStG (Heuermann, & Brandis, 2018, Chapter § 10, para. 22). Paragraph 10(1) of the AStG applies to all direct taxes levied by the states involved, i.e. taxes of the CFC's state of residence, taxes of other foreign states (especially of states where the passive income comes from) and German taxes levied on the CFC's domestic income due to the latter's limited tax liability (Heuermann, & Brandis, 2018, Chapter § 10, para. 23). Voluntarily paid taxes may not be deducted (BMF, 2004b, para. 8.1.3.2). However, the prevailing view in German tax literature trusts that a voluntary payment may only be given, where the respective tax is not assessed (Flick et al, 2018, Chapter § 8 para. 731; Strunk et al, 2018, Chapter § 8, para. 186). Non-deductible are also taxes, which the CFC withholds and pays for someone else (Heuermann, & Brandis, 2018, Chapter § 10, para. 25). So far as the taxes to be deducted have not yet been paid at the time at which the income is deemed to have been received according to Paragraph 10(2) of the AStG, they are deducted from the income taxable according to Paragraph 7(1) of the AStG only in the years in which they are paid, Paragraph 10(1) sentence 2 of the AStG.

Upon the taxpayer's request, the taxes that are deductible according to Paragraph 10(1) of the AStG are credited against the income tax or corporate tax owing with respect to the attributed income, Paragraph 12(1) of the AStG. In the latter case, the attributed income is increased by the amount of these taxes. Paragraph 34c(1) of the EStG and Paragraph 26(1) and (6) of the KStG apply accordingly, Paragraph 12(2) of the AStG.

4.3.2. Issues

4.3.2.1. Relief for subsequent dividends

Does a CFC distribute profits, a double taxation is prevented for natural persons as recipients by exempting profit distributions from tax, so far as the taxpayer proves that attributed income in terms of Paragraph 10(2) of the AStG from an ownership interest in the same CFC was subject to income tax in the calendar or business year in which they are derived, or in the previous seven calendar or business years, Paragraph 3(41)(a) of the EStG. The latter seven year period is fix (Heuermann, & Brandis, 2018, Chapter § 3 number 41, para. 8) and actually forces the CFC to distribute its profits, which infringes EU law (Schönfeld,

2017b, p. 728) and is questionable in terms of constitutional law (Heuermann, & Brandis, 2018, Chapter Vor §§ 7-14, para. 62).

If a CFC distributes profits, a double taxation, generally, is prevented for corporations as recipients by Paragraph 8b(1) of the KStG. However, according to Paragraph 8b(4) of the KStG the taxpayer has to hold a share of at least 10 percent in the CFC (Watrin, & Eberhardt, 2013, p. 2607). Does a taxpayer hold a share of less than 10 percent in the CFC, double taxation is neither prevented, nor eliminated.

4.3.2.2. *Relief for foreign income taxes*

Paragraph 10(1) sentence 2 of the AStG provides that so far as the taxes to be deducted according to Paragraph 10(1) sentence 1 of the AStG have not yet been paid at the time at which the income is deemed to have been received according to Paragraph 10(2) of the AStG, they are deducted from the income taxable according to Paragraph 7(1) of the AStG only in the years in which they are paid. However, in the years in which the taxes are paid there does not necessarily have to be income taxable according to Paragraph 7(1) of the AStG.

According to Paragraph 7 sentence 7 of the GewStG attributed income in terms of Paragraph 10(1) of the AStG is income arising in a PE, i.e. it is subject to trade tax (Adrian, Rautenstrauch, & Sterner, 2017, pp. 1458-1460; Köhler, 2018a, p. 387).¹⁷ However, as determined in Paragraph 12(1) of the AStG, the taxes that are deductible under Paragraph 10(1) of the AStG are credited only against the income tax or corporate tax owing with respect to the attributed income. Compared to a similar purely domestic case, in certain constellations, the tax burden may be significantly higher, thus resulting in an infringement of the free movement of capital (Kahlenberg, & Prusko, 2017, p. 309). Where a CFC, wholly owned by a resident corporate entity, is subject to a taxation of less than 25 percent, but more than 15 percent, always an excess foreign tax credit remains after applying Paragraph 12 of the AStG, Paragraph 26(1) of the KStG and Paragraph 34c(1) of the EStG, which cannot be credited against trade tax (Zieglmaier, 2017, p. 150).

¹⁷ Issues raised by this fiction are discussed in Adrian and Tigges (2017, pp. 477, 478), Kahlenberg (2018a, pp. 183, 184) and Kollruss (2017b).

4.3.3. ATAD compliance

The German rules to prevent or eliminate double taxation are ATAD compliant.

4.4. SPAIN

4.4.1. Rules

As the German rules to prevent or eliminate double taxation, the Spanish rules comprise a relief for subsequent dividends, for subsequent capital gains and for foreign income taxes.

4.4.1.1. *Relief for subsequent dividends*

According to Article 91(9) of the IRPF and Article 100(10) of the LIS dividends or shares in profits are not included in the tax base, so far as they relate to a positive income, which has previously been included in the tax base. The same holds true for interim dividends. Are reserves distributed, the provisions of the articles of association are decisive. The last amounts paid to the reserves are deemed to be distributed first. Furthermore, Article 91(9) of the IRPF and Article 100(10) of the LIS provide specifically that the same positive income may only be taxed once, regardless of the form and entity in which it is manifested.

Pursuant to Article 91(10) of the IRPF and Article 100(11)(b) of the LIS a tax or levy actually paid because of a distribution of dividends or shares in profits, either according to a DTT or to the internal legislation of the country/territory in question, is deductible from the tax liability, so far as it corresponds to the positive income previously included in the tax base. If the participation in the CFC is held indirectly through one or more non-resident entities, the tax or levy of an identical or similar nature to the Spanish (corporate) income tax actually paid by the non-resident entity or entities is deducted so far as it corresponds to a positive income previously included in the tax base. The foregoing deduction and the deduction in Article 100(11)(a) of the LIS (see below) are even made, if the taxes correspond to tax periods other than the one in which the taxation occurred. However, in no case taxes paid in countries or territories classified as tax havens may be deducted.

4.4.1.2. *Relief for subsequent capital gains*

Article 91(11) of the IRPF and Article 100(12) of the LIS provide a special provision to calculate the income derived from the direct or indirect disposal of a shareholding. According to the foregoing provision the acquisition costs are increased by the amount of the social benefits that, without actual distribution, correspond to income that was taxed at the level of the shareholders as income from their shares or participations between the acquisition and the disposal. Thereby, the capital gain, if any, is lowered.

4.4.1.3. *Relief for foreign income taxes*

Pursuant to Article 100(11)(a) of the LIS actually paid taxes or levies of an identical or similar nature to the Spanish corporate tax are deductible from the tax liability, so far as they correspond to a positive income previously included in the tax base. Taxes paid by the CFC and its subsidiaries, are deemed to have been actually paid, provided that the CFC has the percentage of ownership established under Article 32(3) of the LIS, i.e. at least 5 percent. The sum of the deductions in Article 100(11)(a) and (b) of the LIS may not exceed the total tax payable in Spain on the positive income included in the tax base.

4.4.2. **Issues**

The tax reliefs for subsequent dividends and for foreign income taxes are only granted, so far as the subsequent dividend/foreign income tax corresponds to a positive income previously included in the tax base. In practice, this correspondence may be difficult to prove.

4.4.3. **ATAD compliance**

The Spanish rules to prevent or eliminate double taxation are ATAD compliant.

4.5. UK

Also the UK rules to prevent or eliminate double taxation comprise a relief for subsequent dividends, for subsequent capital gains and for foreign income taxes.

4.5.1. Rules

4.5.1.1. *Relief for subsequent dividends*

Does a CFC distribute a dividend to a resident taxpayer, such dividend is taxable as overseas income. Is such dividend distributed out of profits which have been previously subject to CFC taxation, a double taxation occurs. However, the double taxation is mitigated, broadly, by deeming the CFC tax as underlying tax creditable against the liability on the dividend. HMRC provides under INTM 254300 that this does not hold true, so far as the CFC tax has been relieved otherwise.

4.5.1.2. *Relief for subsequent capital gains*

A resident taxpayer which was previously subject to a CFC charge may dispose its shareholding in the CFC, which gave rise to the charge, wholly or in part. In such cases, the CFC tax, or a proportionate part of it, may be deducted in computing the taxable capital gain. However, HMRC indicates under INTM 254290 that the aforesaid does not hold true, if the CFC tax has been relieved by certain set offs.

4.5.1.3. *Relief for foreign income taxes*

According to Section 371PA of the TIOPA a CFC's creditable tax for an accounting period is the total of:

- ▶ the amount of any double taxation relief which, applying the corporation tax assumptions, would be available in respect of any income included or represented in the CFC's chargeable profits for the accounting period. This is tax paid in the country of residence and in third party countries (Harper, & Walton, 2017, para. 22.25);

- ▶ any UK income tax deducted at source (and not repaid/repayable), e.g. of interest (as provided by HMRC under INTM 230100), from a payment to the CFC which, applying the corporation tax assumptions, would be set off against corporation tax on the CFC's chargeable profits (MacLachlan, 2012, para. 5.207);
- ▶ any amount of income/corporation tax actually charged (and not repaid/repayable) in respect of any income included or represented in the CFC's chargeable profits; and
- ▶ any amount of a foreign CFC charge paid (and not repaid/repayable) in respect of any income included or represented in the CFC's chargeable profits.

Example

The resident taxpayer holds all ownership interest in company A, resident in country A. The latter, in turn, hold all ownership interest in company B, resident in country B, a low tax jurisdiction. Company B is subject to both, the CFC rules of country A and the UK CFC rules. The CFC charge in country A is paid and not repaid/repayable. The underlying income is included/represented in the company B's chargeable profits. Figure 71 illustrates the case at hand.

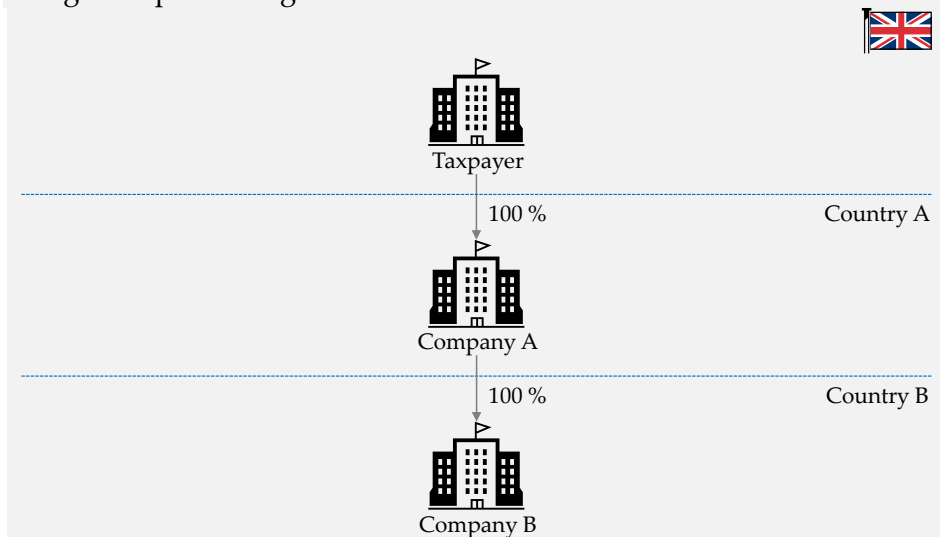


Figure 71. Illustration of the case at hand.

According to Section 371PA(1)(d) of the TIOPA company B's creditable tax for the accounting period includes the amount of CFC charge paid in country A.

4.5.2. Issues

Regarding the foregoing example might be argued that it may be more appropriate to prioritize the UK CFC rules to the CFC rules of country A. For most countries the goal of CFC rules is to prevent the shifting of income from the parent jurisdiction. However, such income is more likely to have been created in the jurisdiction of the ultimate shareholder, than in the jurisdiction of an intermediate holding.

4.5.3. ATAD compliance

The UK rules to prevent or eliminate double taxation are ATAD compliant.

4.6. RECOMMENDATION

As detailed above, the German rules to prevent or eliminate double taxation provide for natural persons as recipients, under certain conditions, a relief for subsequent dividends, Paragraph 3(41)(a) of the EStG, and for subsequent capital gains, Paragraph 3(41)(b) of the EStG. One of the conditions is that the subsequent dividend/capital gain has been subject to CFC tax in the previous 7 calendar or business years. In light of the issues described under "4.3.2.1 Relief for subsequent dividends" the recommendation is to delete the 7 year limit.

For corporations as recipients of subsequent dividends Paragraph 8b(1), (4) and (5) of the KStG applies, i.e., does the resident taxpayer hold a share of less than 10 percent in the CFC, a subsequent dividend is not exempt at all, otherwise 5 percent of the subsequent dividend are taxed. Also 5 percent of a capital gain from the sale of a share in a CFC are subject tax, Paragraph 8b(2) and (3) of the KStG. Nevertheless, the recommendation is to stick with these rules, as they are in line with the national tax system, and a modification would have a material impact on the national tax system.

Regarding the relief for foreign taxes I recommend to allow in light of the issues raised under “4.3.2.2 Relief for foreign income taxes” to credit taxes that are deductible under Paragraph 10(1) of the AStG also against trade tax (Kahlenberg, & Prusko, 2017, p. 304).

A further recommendation is to state in the German rules to prevent or eliminate double taxation specifically that the same positive income may only be taxed once, regardless of the form and entity in which it is manifested, as under Articles 91(9) of the IRPF and 100(10) of the LIS. This would give legal certainty to resident taxpayers in cases where a double taxation is impending.

5. CONCLUSIONS, LIMITATIONS AND FUTURE LINES OF RESEARCH

5.1. CONCLUSIONS

In order to find the best ATAD compliant approaches provided in the OECD/G20's CFC report to make Germany's CFC rules effective again, I undertook a comparative analysis to Spain's and UK's CFC rules. More specifically, I presented first under each building block elaborated by the OECD/G20 in its CFC Report the outcome of the report. The report prove to comprise numerous design alternatives without specifying how these alternatives shall work in detail and together (see "2.1.1 BEPS", "2.2.1 BEPS", "2.3.1 BEPS", "3.1.1 BEPS", "3.2.1 BEPS", and "4.1 BEPS"). Moreover, it does not consider the minimum standards set out by the ATAD, which I addressed afterwards, again, for each building block (see "2.1.2 ATAD", "2.2.2 ATAD", "2.3.2 ATAD", "3.1.2 ATAD", "3.2.2 ATAD" and "4.2 ATAD"). Now, to identify from the numerous and not very specific design alternatives provided by the OECD/G20 those which work in practice, I looked at the Spanish and UK CFC rules. I described each set of rules, identified issues, indicated structurings and checked the ATAD compliance. Although the Spanish CFC rules were amended lately in light of the work of the OECD/G20 and also the UK CFC rules are rather up-to-date, I found the issues, structurings and ATAD incompliances referenced in Table 9.

Table 9. Issues, structurings, ATAD incompliances.

Building block	Issues		Structurings		ATAD incompliances	
	Spain	UK	Spain	UK	Spain	UK
1	2.1.4.2	2.1.5.2	2.1.4.3	2.1.5.3	2.1.4.4	2.1.5.4
2	2.2.4.2	2.2.5.2	2.2.4.3	2.2.5.3	-	2.2.5.4
3	2.3.4.2	2.3.5.2	2.3.4.3	2.3.5.3	2.3.4.4	-
4	3.1.4.2	3.1.5.2	-	-	-	-
5	3.2.4.2	3.2.5.2	-	-	-	3.2.5.3
6	4.4.2	4.5.2	-	-	-	-

The foregoing analysis enabled me to provide at the end of each building block a recommendation how to make Germany's CFC rules effective again. These recommendations are summarized below for each building block, followed by an outlook.

5.1.1. Rules for defining a CFC

5.1.1.1. Entities

The German CFC rules provide for transparent entities and PEs a switch over from the exemption to the credit method, where income would be taxable as CFC income if the transparent entity or PE was a foreign company, Paragraph 20(2) of the AStG. I suggest the following amendments:

- ▶ Where an individual holds ownership interests in a foreign partnership or PE, Paragraph 20(2) of the AStG should provide that for the tax rate exemption the individual's actual income tax rate is decisive and not the corporate tax rate of the CFC jurisdiction (see "2.1.3.2.1 Entities"); and
- ▶ As shown above, a resident taxpayer may currently shift passive income into a PE, in a low tax jurisdiction, which the resident taxpayer holds indirectly through a foreign company, resident in a high tax jurisdiction, without triggering CFC taxation (see "2.1.3.3.1 Entities – Indirect PE"). Paragraph 20(2) of the AStG should be amended to capture also such structurings.

Furthermore, as under the UK CFC rules (see "2.1.5.1.1 Entities"), cell companies might be included in the German CFC definition, considering that such structures replicate the effect of each shareholder controlling its own separate entity.

5.1.1.2. Control

5.1.1.2.1 Type

Regarding the type of control the minimum standard set out in Article 7(1)(a) of the ATAD is to look at the holding of voting rights, capital (legal control) and at the entitlement to receive profits (economic control). This requires two amendments to Paragraph 7(2) of the AStG:

- ▶ Economic control will also have to look at the entitlement to receive profits, not only at the relative ownership interests in the CFC's property [Vermögen];
- ▶ The entitlement to receive profits has to be considered in any case, not only where share capital and voting rights (legal control) do not exist. This would also avoid structurings (see “2.1.3.3.2 Disproportionate profit distribution” and “2.1.3.3.2.1 Trust/profit participation right”).

To avoid structurings with call option rights (see “2.1.3.3.2.3 Call option right”) a Paragraph similar to Section 371RD(3) of the TIOPA should be included in the AStG, which provides that control may be established also through rights and powers which a person is or will become entitled to acquire at a future date and through similar cases.

To address structurings with joint ventures (see “2.1.3.3.2.5 Joint venture”), the AStG might include a Paragraph based on Section 371RC of the TIOPA. The latter section provides, that control may also be established through a resident and a non-resident shareholder having each interests, rights and powers representing at least 40 percent, but in the case of the non-resident shareholder no more than 55 percent, of the holdings, rights and powers in respect of which they fall to be taken to have control over the foreign company. However, where both, the resident and the non-resident shareholder, are associated parties, their ownership interests should always be aggregated, to avoid structurings as the one mentioned under “2.1.5.3 Structurings”).

To avoid structurings where the taxpayer sells all ownership interests before the end of the fiscal year (see “2.1.3.3.2.6 Timing of the sale”), the fulfillment of the control requirement should not be checked at the end of the year. Instead, control at any point throughout the year should be sufficient.

5.1.1.2.2 Level

Paragraph 7(1) of the AStG requires resident taxpayers to hold ownership interests of more than 50 percent in the foreign company, i.e. neither an individual ownership interest is required, nor do the resident taxpayers have to be related, acting together, etc. This makes it often difficult for minority ownership interest holders to determine whether the control level is actually met and control is also presumed where resident taxpayers hold accidentally more than 50 percent of the

ownership interests in the foreign company. Thus, I recommend to include in the German CFC rules a relatedness requirement. As under Article 91(1)(a) of the IRPF and Article 100(1)(a) of the LIS ownership interests of the resident taxpayer itself, or together with related persons or entities, should be considered in calculating the level of control. This would not be complex to apply and capture most structurings raising BEPS concerns. However, the relatedness definition should not be too broad. The latter might lead to over-inclusive results as shown under “2.1.4.2.2.1 Non-resident related persons and entities”. In my opinion the current German relatedness definition should only be extended to ownership interests held by sister- and parent companies of the taxpayer, as required by Articles 7(1) and 2(4) of the ATAD.

For ownership interests in foreign companies with passive investment income the level of control is lowered to at least 1 percent or even to any level of control, where the CFC earns (almost) exclusively passive investment income, Paragraph 7(6) sentences 1 and 3 of the AStG, to avoid structurings as shown under “2.1.4.3.3 Passive investment companies”. However, the foregoing paragraph leads often to over-inclusive results. A solution might be to apply to companies with a high level of investment income an acting-in-concert test, i.e. a fact-based analysis to determine whether shareholders are in fact acting together to influence the foreign company. If that is the case, the shareholders’ ownership interests are aggregated to determine the level of control.

Finally, to avoid structurings as shown under “2.1.3.2.2.2.3 Indirect ownership interests”, the German rules should require a resident taxpayer to have the power to secure that the affairs of a foreign company are conducted in accordance with its wishes, as set out by Sections 371AA(3) and (6) and 371RB(1) of the TIOPA, instead of multiplying the taxpayer’s ownership interest in a foreign company with the foreign company’s ownership interest in the lower tier foreign company, as provided under Paragraph 7(2) of the AStG.

5.1.2. CFC exemptions and threshold requirements

5.1.2.1. De minimis threshold

Under Paragraph 9 of the AStG passive income is disregarded if:

- ▶ the CFC's gross revenue underlying the passive income amounts to no more than 10 percent of the CFC's total gross revenue (threshold I);
- ▶ the total amount to be disregarded by a CFC under Paragraph 9 of the AStG does not exceed 80,000 € (threshold II); and
- ▶ the total amount to be disregarded by a resident taxpayer under Paragraph 9 of the AStG does not exceed 80,000 € (threshold III).

Now, to increase the practical relevance of the German de minimis threshold, which shall ensure that entities posing low BEPS concerns are excluded from CFC taxation, threshold I should be increased, as under the Spanish CFC rules to 15 percent, Article 91(5) of the IRPF and Article 100(5) of the LIS, whereas thresholds II and III might be set at 100,000 € for geographically mobile income (dividends, interests, insurance income, royalties, IP income and sales and service income). Where the foregoing condition is met, the fix amount for all passive income might be set at 600,000 €, as inspired by Section 371LB of the TIOPA. In both countries the aforementioned thresholds do not seem to be exploited for structurings.

5.1.2.2. *Tax rate exemption*

The German CFC rules fix the low level of taxation at less than 25 percent of the tax base as computed according to the German rules, Paragraph 8(3) of the AStG. This is at least not adequate, if the resident taxpayer is a corporate entity, as the tax burden of a resident corporate entity may be lower, equal or at least not significantly higher than the low level of taxation, depending on the applicable trade tax rate (see "2.2.3.2.2.1 Low level of taxation"). The gap between the statutory corporate tax rate of 15 percent, Paragraph 23(1) of the KStG, and the low level of taxation of less than 25 percent, may result in an overtaxation, see "2.2.3.2.2.1 Low level of taxation". Instead, the low level of taxation should be defined as a percentage of the income/corporate tax as computed according to the parent country's rules (including the trade tax rate). This would allow to consider progressive tax rates for individuals as well as the various trade tax rates. Please note that in case of individuals the percentage of the tax as computed according to the parent country's rules should not look at the corporate tax as under the current Spanish CFC rules (see "2.2.4.3.2 Tax rate exemption"), but at the income tax.

The minimum percentage of the tax as computed according to the respective parent country's rules required for the tax rate exemption to apply, should be fixed

as under the Spanish and the UK CFC rules at 75 percent, Article 91(1)(b) of the IRPF, Article 100(1)(b) of the LIS and Section 371NB(1) of the TIOPA. In both countries the tax rate exemption does not seem to be exploited for structurings.

5.1.3. Definition of CFC income

5.1.3.1. *Positive list*

5.1.3.1.1 Positive list instead of negative list

Parts of the German tax literature would prefer to define CFC income – as in Spain (see “2.3.4.1.2 Negative list”) – in a negative list, to do not put a brake on new business models. However, considering that the German resident taxpayers are familiar with the positive list, there is literature, administrative guidance and jurisprudence, the recommendation is to stick with the positive list. However, it should be updated more frequently.

5.1.3.1.2 Production

Active income in terms of Paragraph 8(1) number 2 of the AStG should also be given, if the CFC does not manufacture the property itself, but subcontracts the manufacturing to either third parties or to other group companies (see “2.3.3.2.1.2 Production”). The latter should not be harmful as long as the CFC controls the manufacturing process and bears the manufacturing risk. This would allow to employ common manufacturing models such as toll manufacturing and contract manufacturing. Thereunder, the toll/contract manufacturer only assumes routine functions, which are usually remunerated on a cost plus 5 to 10 percent basis, i.e. the possibility to shift income to a toll/contract manufacturer is very limited. Such amendment of Paragraph 8(1) number 2 of the AStG would allow to centralize routine production functions in a cost efficient region.

5.1.3.1.3 Banks and insurance companies

Broadly, Paragraph 8(1) number 3 of the AStG provides that, under certain conditions, income from the operation of banks (including financial lease) and insurance companies is not considered CFC income. However, Article 7(2)(a)(v) of the ATAD, deems non-distributed income from insurance and banking activities to

Conclusions, limitations and future lines of research be passive. Paragraph 8(1) number 3 of the AStG will have to be amended accordingly.

5.1.3.1.4 Trade and services

Looking at Paragraph 8(1) numbers 4 and 5 of the AStG, income from trade/services should become always active, if the arm's length principle is observed, as in such cases the profit shifting risk is very remote (see "2.3.3.2.1.4 Trade" and "2.3.3.2.1.5 Services"). Structurings as indicated under "2.3.3.3.2 Trade" and "2.3.3.3.3 Services" would then no longer be necessary. The foregoing would allow to employ:

- ▶ limited risk distributors, commission agents, commercial agents, sales support service providers or representative offices to better satisfy the customer requirements and customer relationships; and
- ▶ control or coordination centers to benefit from cost savings and synergy effects. Thereby a duplication of costs in areas that do not form part of the local enterprises' operative business may be avoided, without giving up market proximity and in particular responsiveness to changing conditions.

However, in light of Article 7(2)(a)(vi) of the ATAD income of invoicing companies that earn service income from goods/services purchased from and sold to associated enterprises, without adding more than little economic value, may no longer be excluded from CFC income under Paragraph 8(1) numbers 4 and 5 of the AStG.

5.1.3.1.5 Letting and leasing

Under the current Paragraph 8(1) number 6(a) of the AStG income from licensing the use of rights, plans, samples, procedures, experience, and knowledge is active, if the CFC is exploiting the results of its own research and development work, which was carried out without the involvement of certain resident taxpayers/related persons. However, according to Article 7(2)(a)(ii) of the ATAD all royalties or any other income generated from IP has to be deemed CFC income in the future. Paragraph 8(1) number 6(a) of the AStG will have to be amended accordingly.

Paragraph 8(1) number 6(b) of the AStG provides that income from letting and leasing of land is only excluded from CFC income, if the taxpayer proves that it would have been exempt under the terms of a DTT, had the resident taxpayer holding ownership interests in the CFC in terms of Paragraph 7 of the AStG earned it directly. The recommendation is to exclude – beyond the foregoing rule – income from the letting and leasing of land situated in Germany without further requirements (see “2.3.3.3.4 Letting and leasing”).

5.1.3.1.6 Financing

The current Paragraph 8(1) number 7 of the AStG provides that, under certain conditions, raising and lending of capital is active. However, under Article 7(2)(a)(i) of the ATAD any income generated by financial assets has to be passive. Thus, the mandatory recommendation is to amend Paragraph 8(1) number 7 of the AStG accordingly. The issues raised under “2.3.3.2.1.7 Financing” would disappear thereby.

5.1.3.1.7 Profit distributions, sale of a share in another company etc.

Pursuant to Paragraph 8(1) numbers 8 and 9 of the AStG dividends are always excluded from CFC income (see “2.3.3.1.1.8 Profit distributions”) and income from the disposal of shares is generally deemed active income (see “2.3.3.1.1.9 Sale of a share in another company etc.”). However, according to Article 7(2)(a)(iii) of the ATAD dividends and income from the disposal of shares have to be deemed CFC income. Thus, the mandatory recommendation is to amend Paragraph 8(1) numbers 8 and 9 of the AStG accordingly. Thereby, the issues raised under “2.3.3.2.1.8 Sale of a share in another company etc.” would disappear. The same holds true for the structurings presented under “2.3.3.3.6 Sale of assets” and “2.3.3.3.5 Sale of a share in another company etc.”.

Please note that after the mandatory amendment of Paragraph 8(1) numbers 8 and 9 of the AStG the tax rate exemption is likely to exclude most dividends and income from the disposal of shares, as under the German tax rules dividends and income from the disposal of shares are often fully tax exempt, partially tax exempt or taxed at a preferential tax rate (see “2.3.3.4 ATAD compliance”).

5.1.3.1.8 Reorganizations

As the sale of a share in another company etc. will have to be deemed CFC income in the future, Article 7(2)(a)(iii) of the ATAD, resident taxpayers might consider a reorganization instead. Broadly, income from reorganizations that, disregarding Paragraph 1(2) and (4) of the UmwStG, could take place at book value, is excluded from CFC income, Paragraph 8(1) number 10 of the AStG. However, considering that under the German tax rules income from the disposal of shares is often fully tax exempt, partially tax exempt or taxed at a preferential tax rate, the tax rate exemption is likely to exclude also most income from the disposal of shares in the future (see “2.3.3.4 ATAD compliance”). Consequently, the cases where a reorganization may be preferential to a sale of shares will be limited. Therefore, the recommendation is to stick with the current Paragraph 8(1) number 10 of the AStG to do not avoid economically reasonable foreign restructurings. Only the reference to Paragraph 8(1) number 9 of the AStG will have to be deleted.

5.1.3.2. *Substance test*

The recommendation is further to include a substance test. A substance test is a more qualitative measure than a categorical analyses and may be more accurate than the latter. The Spanish substance test (see “2.3.4.1.1 Substance test”) may serve as a model. However, as a substance test also leads to an increased administrative and compliance burden, substance should only be tested where income is earned from the activities set forth under Paragraph 8(1) numbers 4 (trade) and 5 (services) of the AStG, as these are geographically mobile. The latter holds also true for dividends, interests, insurance income, royalties and IP income. However, irrespective of substance, income from the foregoing categories will have to be deemed passive in the future (see “2.3.3.4 ATAD compliance”). The substance test should be applied as a proportionate test (see “2.3.4.2.1 Substance test”).

5.1.3.3. *Proof to the contrary*

Paragraph 8(2) of the AStG provides, broadly, that a company resident in an EU/EEA member state is not a CFC with respect to income for which the resident taxpayer demonstrates that insofar the company carries out a genuine economic activity in the state in question. However, according to Paragraph 20(2) of the AStG the proof to the contrary is not available for foreign partnerships/PEs. The

difference in treatment between partnerships/PEs on the one hand, and corporate entities on the other hand is difficult to justify, considering that income earned by a CFC from a genuine economic activity in the state in question raises only limited profit shifting concerns. The same holds true for the difference in treatment between CFCs resident in an EU/EEA member state and those resident in other states. Therefore, the recommendation is to extend the proof to the contrary to partnerships/PEs and to CFCs resident or situated in a third country that is not party to the EEA Agreement, as allowed by Article 7(2)(a) of the ATAD. The foregoing would allow banks, insurance companies, the software industry etc., resident in non-EU/EEA member states, to evidence that they carry out with respect to their “passive” income a genuine economic activity in the state in question and thereby to avoid a CFC taxation.

5.1.4. Rules for computing and attributing income/Double taxation

The German rules for computing income have proven effective in practice. Broadly, as under the Spanish and UK CFC rules (see “3.1.4.1 Rules” and “3.1.5.1 Rules”), the CFC income is computed by applying the provisions of the German tax law analogously. The only recommendation is to delete from Paragraph 10(3) sentence 4 of the AStG the exclusion of Paragraph 8b(1) and (2) of the KStG (see “3.1.3.2 Issues”), moreover now, that dividends and gains from the sale of a share in another company etc. will have to become passive according to Article 7(2)(a)(iii) of the ATAD.

According to the German rules for attributing income, the CFC income is currently taxable for each of the resident taxpayers so far as it is attributable to the respective resident taxpayer’s direct ownership interest in the CFC’s nominal capital, Paragraph 7(1) of the AStG. Only if the profits of a CFC are not distributed in accordance with the ownership interests in its nominal capital, or if a CFC does not have a nominal capital, the income is attributed based on the proxy which is relevant for the distribution of profits, Paragraph 7(5) of the AStG. Also the Spanish rules for attributing income, Articles 91(1)(a) of the IRPF and 100(1)(a) of the LIS, look at the resident taxpayer’s participation in the result, however, subsidiarily, as well to the resident taxpayer’s participation in the capital, equity or voting rights of a CFC. The Spanish approach seems preferable, as it avoids structurings. However,

a hierarchy between the latter three criteria should be included to avoid double taxation (see “3.2.4.2 Issues”). An alternative to a hierarchy, which might also be exploited, could be the just and reasonable approach employed by UK CFC rules (see “3.2.5.2 Issues”). In any case, in light of the ATAD, the CFC taxation will have to be realized, as under the Spanish CFC rules, in the tax period which comprises the day on which the CFC’s business year ends, Article 91(7) of the IRPF and Article 100(8) of the LIS (see “3.2.3.3 ATAD compliance”).

As detailed above, the German rules to prevent or eliminate double taxation provide for natural persons as recipients, under certain conditions, a relief for subsequent dividends, Paragraph 3(41)(a) of the EStG, and for subsequent capital gains, Paragraph 3(41)(b) of the EStG. One of the conditions is that the subsequent dividend/capital gain has been subject to CFC tax in the previous 7 calendar or business years. In light of the issues described under “4.3.2.1 Relief for subsequent dividends” the recommendation is to delete the 7 year limit. Regarding the relief for foreign taxes I recommend to allow – considering the issues raised under “4.3.2.2 Relief for foreign income taxes” – to credit taxes that are deductible under Paragraph 10(1) of the AStG also against trade tax. A further recommendation is to state in the German rules to prevent or eliminate double taxation for the sake of legal certainty that the same positive income may only be taxed once, regardless of the form and entity in which it is manifested, as under Articles 91(9) of the IRPF and 100(10) of the LIS.

5.2. LIMITATIONS

As indicated above, the research goal of the present thesis is to find the best ATAD compliant approaches provided in the OECD/G20’s CFC report to make Germany’s CFC rules effective again, more specifically through a comparative analysis to Spain’s and UK’s CFC rules. Considering the complexity of CFC rules and that the CFC report, the ATAD and three jurisdictions had to be analyzed, not all rules could be explained in detail, not all issues could be discussed and not all structurings could be indicated. Instead, a selection was necessary. This leaves room for more in-depth investigations.

5.3. FUTURE LINES OF RESEARCH

According to Article 11(1) of the ATAD the member states have to make their CFC rules, if necessary, until 31 December 2018 ATAD compliant and apply them from 1 January 2019 onwards. As of today Germany has not amended its CFC rules. As shown above, the ATAD incompliances are few. Instead, the German rules often go far beyond the minimum standard. In light of the foregoing, the German legislator does not have to act immediately.

In the meantime researchers might review carefully further CFC rules, preferably of other EU member states, which have been amended lately in light of the CFC Report and the ATAD (e.g. the Austrian (Raab, 2018) and Hungarian CFC rules (Juhasz, 2018)), in order to gather more best practices. Once, the BMF publishes the first draft of the new German CFC rules, it will be interesting to analyze their impact.

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