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The German Federal Tax Court limits German CFC rules and anti-abuse provisions to wholly artificial arrangements

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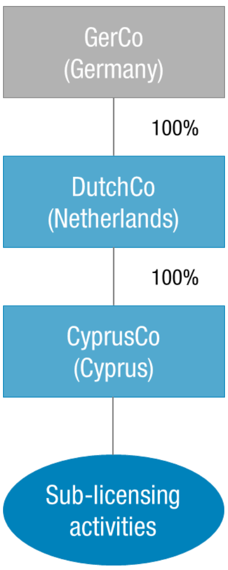
In a decision of the German Federal Tax Court (GFTC) from 13 June 2018 (Decision I R 94/15 published on 17 October 2018), the GFTC ruled, among other things, that the German rules on controlled foreign companies (CFC) are not applicable if a foreign CFC is performing a genuine economic activity. In this regard, the GFTC referred to the decision of the Court of Justice of the European Union (CJEU) in the Cadbury Schweppes case (C-196/04) in which it was ruled that UK CFC rules may only apply to wholly artificial arrangements which do not reflect economic reality and the purpose of which is to unduly obtain a tax advantage.

Background

In the case at hand, a Cypriot company (CyprusCo), indirectly owned by a German corporation (GerCo) through a Dutch corporation (DutchCo), performed activities involving the obtaining and granting of sublicenses to other group companies with regard to the use of intellectual property rights. The license fees paid to CyprusCo exceeded the arm’s length standard. The group structure is depicted in the chart below:



CyprusCo had a fully equipped office that it rented from a bank (monthly rent ca. EUR 220) and employed a Cypriot director with a business administration background for an annual remuneration of ca. EUR 20,000. The director's responsibilities were of a rather administrative nature, in particular, the performance and monitoring of payment transactions, client correspondence, the administration of business records and bookkeeping. The German tax authorities considered CyprusCo's income as passive and low-taxed income since the company did not carry out a genuine economic activity in Cyprus.

The German Federal Tax Court Decision

According to the GFTC, the license fees paid in excess of the arm's length amount have to be considered as deemed distributions from the paying group companies to GerCo, followed by hidden capital contributions in CyprusCo (indirectly through DutchCo). The GFTC ruled that a potential CFC income has to be reduced by the amount of these hidden capital contributions in favour of CyprusCo.

Moreover, referring to the freedom of establishment and the Cadbury Schweppes case, the GFTC ruled that the remaining (arm's length) income may not be subject to German CFC rules since, applying an objective test, CyprusCo undisputedly had an actual establishment in Cyprus with premises, staff and equipment to carry out genuine economic activities, regardless of the administrative nature of CyprusCo's economic activities in Cyprus and potential tax motives which may have been considered when setting up CyprusCo. **In practice, this means that the German tax authorities can only apply anti-abuse legislation, be it CFC rules or other anti-abuse provisions under domestic tax law or tax treaty law, in situations of clear abuse where foreign companies have no economic substance or activity whatsoever (i.e. a letterbox company).**

What the decision means for business

The decision of the GFTC is in line with a series of decisions of the CJEU[1]. It is interesting to note that national courts around Europe have not yet deviated from the wholly artificial arrangement doctrine laid down by the CJEU. Already in the past, the GFTC held that German CFC rules and other anti-abuse provisions when applied in an international context are not consistent with EU Law.

The decision of the GFTC also comes at a time characterised by significant legal uncertainty caused by the way anti-abuse legislation has been applied by the German tax authorities and the implementation of new tax rules as a result of the OECD Base Erosion and Profit Shifting (BEPS) Project. EU Member States have to implement certain BEPS measures as from 1 January 2019 in accordance with the EU anti-tax avoidance directives (ATAD I and II).

In this environment, the decision of the GFTC is positive and contributes to legal certainty as it confirms once again that to be out of reach of German anti-abuse legislation, a company's organisational substance needs to be adequate, rather than excessive, when compared with its business activities.

This GFTC ruling clarifies important points regarding the level of substance required for a company to fall out of the scope of German CFC and anti-abuse rules. Our German desk, led by ATOZ Partner and Head of Transfer Pricing, Oliver R. Hoor, is uniquely placed to provide guidance as to what this may mean for your business.

[1] See more comprehensive publications on some of this case law under: https://www.atoz.lu/media-room/cjeu-german-anti-abuse-legislation-still-incompatible-eu-law, https://www.atoz.lu/media-room/german-anti-abuse-legislation-and-eu-law-incompatible-after-all.

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