

By PwC Deutschland | 12. März 2019

ECJ: Passive income attribution from controlled companies resident in third countries

The European Court of Justice has held that the German provision for the taxation of controlled company income from invested capital from outside the EU might fall under the “grandfather” clause of Art 64 TFEU, provided the German legislation has remained substantially unchanged since that date. It is now for the Supreme Tax Court to decide finally whether this is the case.

For some decades the Foreign Transactions Tax Act (FTTA) has acted as a brake on the transfer of profits to controlled companies with passive income in low tax regimes by adding the amount sheltered to the taxable income of the shareholder. If a company is a *controlled company with income from invested capital*, and if certain other conditions of Sec. 7 FTTA are fulfilled, that controlled company income is added to taxable income for both corporate and trade income tax purposes (the “attributed amounts”).

A German parent company held a 30% participation in a subsidiary located in Switzerland that mainly had passive income and the tax office claimed the add-back of *controlled company income from invested capital*. The ensuing request for a preliminary ECJ-ruling by the Supreme Tax Court concerns the interpretation of Articles 63 TFEU (Free Movement of Capital) and 64 TFEU (“grandfather” clause / standstill clause). One of the key questions to be answered in the case at dispute is if the German passive income attribution rules (i.e. Sec. 7, 7a of the 2005 version of the FTTA applicable for the year in dispute) fall under the “grandfather” provisions of Art 64 of the TFEU, allowing the continued application of restrictions on the free movement of capital in force on December 31, 1993. This is the case if the present German legislation remained substantially unchanged since that date.

The referring Supreme Tax Court therefore asked the ECJ: **First**, whether Article 64(1) TFEU allows a restriction on free movements of capital between a Member State and a third country relating to direct investment, even though the scope of the FTTA-legislation in question has been extended after 31 December 1993 to also cover other types of investments, including ‘portfolio’ investments. Of major importance to the decision is also (**second question**) that the relevant provision in the FTTA in force on December 31, 1993 was in fact substantially amended in 2000 (with effect from January 1, 2001). The adoption of this regulation, however, was replaced in 2001 (i. e. before ever being applied in practice) by legislation essentially identical to that applicable on 31 December 1993.

German CFC rules may comply with EU law due to “grandfather” clause - The ECJ answered the two questions as follows:

First question: Article 64(1) TFEU allows a restriction to be applied on movements of capital between a Member State and a third country relating to direct investment, even though the substantive scope of the legislation at issue was extended after 31 December 1993 to also cover other types of investments, including ‘portfolio’ investments. The ECJ also held that the German tax amendment reducing the shareholding threshold for passive intermediary companies from 10% to 1% does not in itself affect the applicability of the “grandfather” clause.

Second question: In general, the ECJ sees the legislation in the FTTA as identical to that of 31 December, 1993 even if was substantially amended after 31 December 1993 but never came into force. Nevertheless, the referring Supreme Tax Court still has to determine whether, in the case at hand, the 2000 reform of the German CFC rules was adopted together with provisions effectively deferring the applicability of that reform, despite its entry into force.

Alternative scenario - ECJ gives a third answer

Finally – and in the event the Supreme Tax Court should conclude that the relevant provisions in the FTTA do not fall under the standstill clause – the ECJ then further examined whether an infringement of the free movement of capital is justified. According to the ECJ the German attribution rules in question could constitute a restriction of the free movement of capital that may be justified by overriding reasons in the public interest. A justification would be based on the need to prevent tax evasion or to counter merely artificial arrangements with the primary objective or one of its primary objectives to avoid paying the tax normally due on the profits generated by activities carried out in Germany. The ECJ went on to point out that the attribution of the controlled company income takes place automatically without providing the taxpayer with an opportunity to show to the tax authorities that his shareholding is not the result of an artificial scheme. On the contrary, the taxpayer should be able to provide commercial justification for the chosen arrangement and / or to prove the genuine nature of the intermediary company's economic activities.

Therefore, as the case in dispute involved a third country, it would be for the Supreme Tax Court to assess whether a legal framework existed between Germany and Switzerland which provided the German tax authorities with a suitable tool to verify that the taxable person's shareholding in the Swiss company is not the result of an artificial scheme. Only in the absence of such an agreement would the German FTTA-rules be appropriate and not constitute an infringement to the fundamental freedom of the movement of capital.

Source: The ECJ case reference is C-135/17 X judgment of February 26, 2019.

Schlagwörter

controlled company, foreign passive income, grandfather clause, standstill clause