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CFC rules considered to be in line with EU law

Following a ruling by the European Court of Justice (ECJ) earlier this year, the Supreme Tax Court held in its decision of 31 October 2019 that the incorporation into the tax base of controlled company income from invested capital from an intermediary company domiciled in Switzerland in the financial year 2006 may restrict the free movement of capital, but it is justified through compelling reasons of public interest and does not therefore contravene EU law.

Background

In the context of these proceedings, the Supreme Tax Court referred the case to the ECJ for a preliminary ruling,, on which the ECJ ruled in its judgment of 26 February 2019 (X, C-135/17) (see our **blog article**).

In the disputed case, a German limited liability company (GmbH) held a 30 percent interest in a Swiss AG and generated income from assigned receivables, which the tax office added back to the tax base of the GmbH as controlled company income from invested capital.

The Court confirmed that in the third country constellation in these proceedings the free movement of capital was not superseded by the freedom of establishment. (To be noted here is that in relation to third states only the free movement of capital is applicable.) The application of the free movement of capital must, however, always be seen in the context of the so-called "stand still clause" of Art. 64 TFEU, whereby certain "old provisions" (i.e. those existing on 31 December 1993) are grandfathered.

The ECJ decided, inter alia, that the CFC rule in Section 7 (6) and (6a) Foreign Taxes Act did constitute a restriction on the free movement of capital but the application of the stand-still clause should be considered by the referring court.

Decision of the Supreme Tax Court

Following on from the decision of the ECJ, the Supreme Tax Court has now issued the following opinion:

Referring to the judgment of the ECJ, the Supreme Tax Court concluded that the stand-still clause in Article 64 (1) TFEU (formerly Article 57 (1) TEC) did not apply in the case of these CFC rules. Whilst the amendments to the CFC rules made by the 2000 Tax Reduction Act were never applied in practice (as they were quickly replaced), the Supreme Tax Court held that the legislation had entered into force and the rules had not been deferred. Accordingly, the rules were not grandfathered and the prohibition (Article 63(1) TFEU) of any restrictions on the free movement of capital was to be applied to them.

The Court then went on to hold that the incorporation into the tax base of the controlled company income from invested capital did constitute a restriction on the free movement of capital but was justified in the case under consideration (Swiss resident CFC in the FY 2006) through compelling reasons of public interest, in particular the requirement to prevent tax evasion and tax avoidance.

Again referring to the judgement of the ECJ, the Court took the view that there was no legal framework, in particular no treaty obligations, in 2006, that empowered the German tax authorities to verify the accuracy of information provided in respect of the Swiss company which could demonstrate that that taxpayer’s shareholding in that company was not the result of an artificial scheme.

Reference

Supreme Tax Court, Judgment of 22 May 2019, (I R 11/19, formerly I R 80/14), published 31 October 2019.

Schlagwörter

CFC provisions, EU Law, free movement of capital, tax avoidance