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CFC-legislation, the Freedom of  
Establishment and Tax Treaties-  
*A Comparative Study in the  
Light of the Cadbury-Schweppes  
judgement*

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# Summary

Although direct taxation falls under the sovereignty of each individual Member State, that sovereignty must be practiced with respect for community legislation and the EC Treaty. National legislation that in any way hinders the freedoms guaranteed by the Treaty or discourages nationals of a Member State to practice those freedoms is infringing the EC Treaty and is not to be tolerated. The number of cases put before the ECJ regarding direct taxation has increased in the last years and the judgments delivered has helped Member States to understand the relation between national- and community legislation and forced them to adjust the former after the latter.

Up until the much-awaited judgment in the Cadbury Schweppes case there had been no case dealing with the compatibility of national CFC-legislation and the EC Treaty. The matter of dispute was simple. Can we have a unified market and guarantee the freedoms of the Treaty while at the same time applying anti-abuse legislations to corporations established in another Member State? The ECJ answered the question with the classical juridical reply; it depends. On the one hand, CFC-legislation is a clear infringement of the freedom of establishment as it hinders or at least discourages nationals of one Member State to establish themselves in another Member State. On the other hand, the ECJ stated, CFC-legislation can be justified if it is only applied to wholly artificial arrangements that lack real business substance and whose sole purpose is to avoid taxation.

Following this judgment, many Member States changed their CFC-legislations so that they would only apply outside the EU/EEA *unless* the establishment were wholly artificial. It can be argued that the Member States over interpreted the ECJs judgment and that their changes actually changed nothing. What the ECJ meant by wholly artificial arrangement and the abuse of community legislation is still a grey area as the CS case was referred back to the national court to be decided. The ECJ is still to deliver a judgment clarifying how high the demands may be set. In December 2007 the Commission released a communication regarding abusive situations but supplied no further details regarding the definition of wholly artificial arrangement. In late April, the ECJ delivered an order in the CFC and Dividend Group Litigation case repeating its judgment in the CS case. In the order, the Court set out some guidelines concerning the distribution of the burden of proof when it comes to applying anti-abuse legislation within the community, but nothing about defining abusive situations.

There is an immediate need of a clearer definition of wholly artificial arrangement issued at community level. Today, the Member States demands for an establishment to be considered business motivated and therefore Treaty protected and excepted from CFC-legislation varies widely. While some Member States find it sufficient that there is *some* business motivated activity at the establishment, others claim that the effective management and

the majority of personnel must be present. It is the authors view that if an establishment exists, meaning at least one person performing activities that is of essence to the corporation it is genuine. Furthermore, if an establishment falls under the scope of the freedom of establishment, it can never be artificial and hence CFC-legislation not applied.

# Sammanfattning

Trots att direkt beskattning är ett område som faller under varje medlemsstats självständighet så är det ett område som måste praktiseras med yttersta hänsyn för gemenskapsrätten. Nationell lagstiftning som hindrar friheterna som garanteras i fördraget eller som gör det mindre attraktivt för medborgare att praktisera dessa friheter kränker EG-fördraget och är inte accepterade. Antalet mål rörande direkt beskattning som har avgjorts av EG-domstolen har ökat de senaste åren och domarna hjälper medlemsländerna att förstå förhållandet mellan nationell rätt och EG-rätt samt att anpassa den senare efter den förra.

Fram till det uppmärksammade Cadbury Schweppes målet hade EG-domstolen aldrig tidigare beslutat i ett mål gällande förhållandet mellan CFC-lagstiftning och EG-fördraget. Problematiken är enkel. Går det att ha en gemensam marknad och garantera fördragsfriheterna samtidigt som vi applicerar skatteflyktsregler på företag etablerade inom unionen? EG-domstolen besvarade frågan på klassiskt juridiskt maner; det beror på. Å ena sidan utgör CFC-lagstiftning en klar kränkning av etableringsfriheten då den hindrar, eller i minsta fall försvårar, etableringar i andra medlemsländer. Å andra sidan, som domstolen uttryckte det, kan CFC-lagstiftning vara befogad om det bara appliceras på artificiella upplägg som saknar affärsmässig substans och vars primära syfte är att undandra sig beskattning.

Efter domslutet ändrade flertalet medlemsländer sin CFC-lagstiftning så att den bara är applicerbar på länder utanför EU/EES *om inte* etableringen är artificiell, då gäller den även inom EU/EES. Det kan argumenteras att medlemsländerna övertolkade EG-domstolens dom och att förändringarna inte förändrade något i verkligheten. Vad domstolen menade med helt artificiellt upplägg är fortfarande oklart då CS målet skickades tillbaka till den nationella domstolen för prövning där. EG-domstolen har alltså fortfarande inte uttalat sig i var gränsen bör gå för en etablering ska vara genuin. I december 2007 släppte kommissionen en kommunikation gällande missbruk av friheterna, dock utan att ge en tydlig vägledning gällande definitionen av artificiell etablering. I slutet av april kom ett åläggande från EG-domstolen i CFC and Dividend Group Litigation målet där CS domen i princip upprepades. I åläggandet gav domstolen några riktlinjer gällande fördelning av bevisbördan i fall gällande missbruk av gemenskapsrätten, men inget om vilka trösklar som gäller vid definitionen av helt artificiellt arrangemang.

Det finns ett omedelbart behov av en definition av helt artificiellt arrangemang utfärdad på gemenskapsnivå. Idag är definitionerna i de olika medlemsländerna vitt spridda och sprider sig från att det räcker med *någon* form av affärsrelaterad verksamhet till att kräva att ledning och större delen av personalen skall befinna sig på etableringen. Det är författarens åsikt att om en etablering existerar, det vill säga att där finns minst en person som

utför affärsmotiverad verksamhet, så är etableringen äkta. Om en etablering faller under etableringsfriheten kan den därför aldrig vara artificiell och som en följd av detta, CFC-lagstiftning kan inte appliceras på den.

# Preface

Jag vill främst tacka Cécile Brokelind för hennes stöd och utmärkta handledning under arbetet med uppsatsen. Ett varmt tack också till Magnus Brokelind på Deloitte Malmö för hjälp vid val av uppsatsämne samt synpunkter på det färdiga arbetet. Ett stort tack till alla mina vänner och min familj för att ni finns och har funnits där under mina år i Lund.

# Abbreviations

AG	Advocate General
AStG	Aussensteuergesetz
BMF	Bundesfinanzministerium
CIN	Capital Import Neutrality
CEN	Capital Export Neutrality
CFC	Controlled Foreign Company
CS	Cadbury Schweppes
CSO	Cadbury Schweppes Overseas Limited
CSTI	Cadbury Schweppes Treasury International
CSTS	Cadbury Schweppes Treasury Services
EC	European Community
ECJ	European Court of Justice
EEA	European Economic Area
EU	European Union
FTC	French Tax Code
HMRC	Her Majesty's Revenue and Customs
IL	Inkomstskattelagen
MC	Model Convention
OECD	Organisation for Economic Co-operation and Development
Prop	Proposition (Swedish)
TA	Income and Corporate Taxes Act
UK	United Kingdom

# 1 Introduction

## 1.1 Background

CFC-legislation was first introduced in the US as early as 1937. It was then known as Foreign Personal Holding Company rules and had as its main objective to tax passive income derived from foreign corporations that were US controlled. Through the 1962 Revenue Act CFC-rules were introduced that applied US taxation on passive income of foreign entities if a US resident shareholder were holding at least 10 per cent of the shares or voting rights in the foreign corporation of which at least 50 per cent were US owned.<sup>1</sup> During the mid-20<sup>th</sup> century, the US faced the problem of a deficit of payments that the government felt were a direct result of the deferral of taxation on profits arising in foreign investments. The Kennedy-administration considered this in combination with the privileged treatment that US investors received abroad to lead to an unequal treatment, tax wise, of investors investing in the US and outside the US. The government identified two ways that the US tax system were being taken advantage of. The first was through tax deferral as the taxation of profits on foreign investments were postponed or not realised at all. The second way was through tax haven deferral through which the foreign investment was of a passive sort and had as its main purpose to avoid US taxation. To remedy this, CFC-legislation was introduced as a way of taxing profits of foreign investments at shareholder level in the US and to bring back the funds invested abroad to the US. This was done through a deemed dividend equal to the profit of the CFC.<sup>2</sup>

Starting with Germany in 1972, many European countries introduced CFC-legislation and today almost every Member State of the European Union has CFC-rules in one way or another.<sup>3</sup> The various CFC-legislations in the Member States have as its main objective to stop the erosion of the national tax base by taxing the profits of a CFC through extending their taxation right cross borders. What was once introduced in the US as a way of bringing back the funds that were invested abroad to the US is today a way of countering what is seen as harmful tax competition and to limit the erosion of the national tax base that is a result of this. The fact that the field of direct taxation falls under the sovereignty of each individual Member State and that the EC Treaty does not regulate it is a qualified truth. This becomes evident when examining the ECJs case law. In countless decisions, the court concludes that it is not in conformity with the Treaty for a Member State to enforce national legislation in the field of direct taxation that in any way may conflict with the freedoms guaranteed by the Treaty.

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<sup>1</sup> Malherbe (2007), pg. 608.

<sup>2</sup> Wenehed (2000), pg. 257f..

<sup>3</sup> Belgium, Luxembourg and the Netherlands do not.

“although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law”<sup>4</sup>

As a result, the Member States have the sovereignty regarding direct taxation as long as they exercise that sovereignty in accordance with the EC Treaty. At the same time the national courts are bound by the decisions of the ECJ and the Treaty and the Member States are obliged to revise their legislation regarding direct taxation in accordance.<sup>5</sup> The discussion of whether or not CFC-rules are compatible with community legislation has been an ongoing debate with little or no guidelines. Up until the much-awaited Cadbury Schweppes judgment in 2006, the ECJ had never analyzed CFC-legislation as a possible infringement of EC law. After that judgment, the Court delivered an order in the CFC and Dividend Group Litigation case<sup>6</sup> in late April, strengthening its statement in the CS case.

Furthermore, the standing of CFC-legislation against tax treaties has not been, and is not of this day, clear. Some countries claim that CFC-legislation precedes tax treaties whilst other claims that this is not case. The uncertainty regarding the relation between the two provides for an unclear application of tax treaties and an uncertainty concerning the possibility for the individual taxpayer to foresee the tax consequences of an establishment.

## 1.2 Purpose and Problem

The CS case was the first to ever be decided by the ECJ regarding the compatibility of national CFC-legislation and the EC Treaty. Since then the CFC and Dividend Group Litigation case has been decided and the Vodafone2 case is awaiting judgment, both regarding CFC-rules. In the two former cases the ECJ stated that when applying CFC-rules to an establishment within the EU/EEA the rules may not be imposed on an actual establishment, but only to wholly artificial arrangements. If this is not the case, CFC-legislation hinders the freedom of establishment that is guaranteed to all citizens of the EU and furthermore, conflicts with Member States responsibility to guarantee that freedom. From the ECJs decision in the CS case as well as in the CFC and Dividend Group Litigation case<sup>7</sup> it is obvious that applying CFC-legislation against a company established in another Member State is a clear infringement of the freedom of establishment. The Court on the other hand claims that this infringement can be justified if only applied to artificial arrangements. However, it has not been made clear how the determining of what constitutes an artificial arrangement should be carried out or how far-reaching it may be. Regardless of this many Member States have amended their CFC-legislation according to their interpretation of the judgment. The field of EC tax law is a changing area that is still in an early stage and over the coming years we will probably

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<sup>4</sup> C-311/97 Royal Bank of Scotland, para. 19. C-279/93 Schumacker, para. 21. C-251/98. Baars, para. 17. C-319/02 Manninen, para.

<sup>5</sup> Dahlberg (2005), pg. 45f. Terra & Wattel (2005), pg. 37.

<sup>6</sup> C-201/05.

<sup>7</sup> C-201/05.

see it change and develop. Pending before the ECJ are the Vodafone2 case<sup>8</sup>, dealing with the compatibility of CFC-legislation and the EC Treaty. The question is if the changes imposed by the Member States are in line with the ECJs opinion or if the Member States have over-simplified the judgment in the CS case and changed their national legislations in a way that is not EC-concordant. The first, and foremost, purpose of my thesis is therefore to examine if the recent changes to national CFC-legislations following the CS case are compatible with EC law and the freedom of establishment. To describe CFC-regimes in the EU I will use the rules in France, Germany, Sweden and in the UK as examples and as the objects of my analysis. As my guiding light in this analysis I will, of course, use the ECJs decision in the CS case.

Although it will not be as thoroughly examined as the former, the second purpose of my thesis is to examine the relation between CFC-legislation and tax treaties. Regarding this, the problematic are that it is yet not clear which of the two that precedes the other. The case-law in the Member States is thin and the ECJ will not deal with the application of tax treaties in relation to national legislation as it falls outside their competence. Again, I will use the national legislations in France, Germany, Sweden and in the UK as examples and as the objects of my analysis.

### **1.3 Method and Material**

I will apply a legal dogmatic method by examining the relevant books, legal articles from journals specialized in international tax law and, of course, case law. As a result of the less-than-extensive case law concerning CFC-legislation this thesis is a result of an analysis of the different opinions of scholars and the authors own conclusion from this in combination with relevant case law from the ECJ concerning direct taxation. The outcome in the pending cases will show if the result of the analysis are the same as the one of the ECJ.

### **1.4 Delimitation**

My thesis will only consider the effect of CFC-legislation between Member States of the EU. In some scenarios, when the prerequisites call upon it or it would make for an unnatural account, I will touch upon third state relations or widen the scope to also consider members of the European Economic Area.

One might argue that the free movement of capital may very well be of interest when examining CFC-legislation in the EU. The scope of this thesis is limited to the freedom of establishment as this is the relevant freedom in the authors' eyes as well as the ECJs in the CS case.

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<sup>8</sup> C-203/05.

Much of this thesis is based on the ECJs case-law. I will however only make a more profound analysis of the Cadbury Schweppes and, to some extent, the CFC and Dividend Group Litigation. Furthermore, I will touch upon the recently decided Columbus Container case but not linger on it as it, in my view, falls outside the scope of this thesis as the case does not concern “pure” CFC-rules.

It could be argued that I should leave the relationship between CFC-legislation and tax treaties outside the scope of this thesis altogether as I will not examine this as in depth as the relationship between CFC-legislation and the freedom of establishment. However, I am of the opinion that it is a closely linked area that is too relevant to completely leave outside this thesis and that an account and analysis of the subject, independently of how petite it may be, can help the clarification and understanding of the main problem of the thesis.

## 2 Theoretical background

### 2.1 Controlled Foreign Company

A controlled foreign company (CFC) is a company residing in a state other than the home state of the taxpayer that controls it. In this other state, the company is subject to low- or non-taxation when compared to the level of taxation in the home state. The income from the CFC is only subject to taxation in the home state of the shareholder *if* the profits are distributed. To circumvent this loss of tax revenue and discourage nationals to set up CFCs many Member States have implemented CFC-legislation as a mean to tax the income of CFCs even when not distributed. For a company to be regarded as a CFC and for CFC-legislation to apply there are a few criteria that are to be met.<sup>9</sup>

For CFC-legislation to apply, a resident taxpayer in the home state must have a certain amount of control of the corporation. Shareholding in the company in question often constitutes this control. The thresholds vary in different Member States but generally 50 percent of the voting shares or of the value of the CFC are set out as a limit.<sup>10</sup>

The goal of CFC-legislation is to avoid the loss of tax revenue because of domestic companies allocating their profits to companies residing in tax havens.<sup>11</sup> A CFC is, as a rule, a corporation recognized as a separate taxable entity in a state other than the home state. Furthermore, the CFC is not per automatic subject to taxation in the home state.<sup>12</sup>

### 2.2 CFC-Legislation

CFC-legislation in general is set out to eliminate the deferral of taxation of the income of CFCs and to make the income subject to tax as it arises rather than when it is distributed. There are different approaches used when determining what constitutes a CFC and which income that should fall under the CFC-legislation. I will briefly account for the two main approaches in the following. This account, however, is at a theoretical level and the reader should note that when applied in reality the different approaches may, and most likely will, vary from how they are described here.<sup>13</sup>

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<sup>9</sup> Fontana (2006), pg. 259f.. Malherb (Ed) (2007), pg. 607f.

<sup>10</sup> Fontana (2006), pg. 260.. Malherb (Ed) (2007), pg. 609.

<sup>11</sup> Lang (Ed) (2004) pg. 18.

<sup>12</sup> Fontana (2006), pg. 260.. Malherb (Ed) (2007), pg. 609.

<sup>13</sup> Lang (Ed) (2004) pg. 21.

## 2.2.1 Jurisdictional Approach

When applying CFC-legislation according to the jurisdictional approach all the income of a foreign corporation is taxed at the level of the shareholder if the company is established in a low-tax country. Which countries that fall under this definition can be determined through compiling lists of low-tax countries (black list) or non-low-tax countries (white list). It can also be determined by reference to the nominal or effective tax rate or by comparing the percentage of effective tax rates. Another way of determining if a country constitutes a low-tax country is by comparing the tax actually paid in the source state with the tax that would have been levied in the home state. While the jurisdictional approach is easy to administer it is rather skewed as it assumes that the shareholder have shares in the foreign corporation to achieve a tax benefit or to avoid taxation in the home state. The jurisdictional approach can also be seen as a way of making sure that national corporations does not establish subsidiaries outside the home state.<sup>14</sup>

## 2.2.2 Transactional Approach

The Transactional approach on the other hand aims at the nature of the income at the CFC or at the transaction behind the income.<sup>15</sup> When applying the transactional approach only the income that should have been taxed at the level of the shareholder if the CFC had not existed is taxed. A distinction is made between active and passive income. Passive income is typically dividends, royalties, rents and such alike. Passive income is attributed to the shareholders in the home state and taxed immediately while active income still enjoys the deferral. Generally, the tax level in the source state is not taken into consideration.<sup>16</sup>

## 2.2.3 Determining the Taxable Amount

Even if a Member State applies the Jurisdictional or the transactional approach the question of what constitutes the taxable amount still arise. First it must be determined if the profit computation should be done using the taxation system in the home state or the one in the source state. Secondly, two main ways of taxing income derived from the CFC can apply. One way is to treat the income as a fictitious dividend paid to the resident shareholder according to the transactional approach. Another way is to tax the profits of the CFC at shareholder level according to a see-through approach according to the jurisdictional approach.<sup>17</sup>

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<sup>14</sup> Wenehed (2000), pg. 71f..Pinto (2003), pg. 325.

<sup>15</sup> Fontana (2006), pg. 260.. Malherb (Ed) (2007), pg. 609

<sup>16</sup> Lang (Ed) (2004) pg. 20.

<sup>17</sup> Lang (Ed) (2004) pg. 23.

## 2.3 CFC-Legislation and the EU

Regarding the conformity of CFC-legislation to the EC Treaty both the freedom of establishment and the free movement of capital can be of relevance. Which freedom that is applied to a specific situation is of lesser interest within the EU, but when a situation involves a third state it becomes of greater interest as the free movement of capital applies outside the union as well, contrary to the scope of the freedom of establishment.<sup>18</sup> According to the doctrine, the general point of view is that the free movement of capital would be applied in a situation involving portfolio investments and alike whereas the setting up of or investing in a business abroad would fall within the freedom of establishment.<sup>19</sup> This standpoint is also found in the ECJs case law.<sup>20</sup> In the *Cadbury Schweppes*<sup>21</sup> case, the ECJ examined CFC-legislation in the light of the EC Treaty for the first time and came to the same conclusion, which is that CFC-legislation should be examined in the light of the freedom of establishment<sup>22</sup>. The free movement of capital will not be discussed further, unless necessary, in this thesis as it falls outside the scope of it.

## 2.4 CFC-Legislation and the Freedom of Establishment

The freedom of establishment<sup>23</sup> guarantees all nationals of a Member State the right to set up an establishment in another Member State and to do so under the same conditions as the nationals of that Member State.

Furthermore, the home state may not impose any conditions regarding direct taxation that would make such an establishment less favourable compared to an establishment in the home state. For a company to enjoy the protection of the Treaty there must be a certain economic link to the other Member State. Companies that are set up with the sole purpose to acquire a more favourable tax regime than the one in the home state is not necessarily included in the scope of article 43 of the Treaty.<sup>24</sup>

To conclude if CFC-legislation infringes the EC Treaty it has to be decided if the legislation constitutes a restriction, and if so, there are any grounds for justifying that restriction.

### 2.4.1 Restriction

Dealing with direct taxation, a restriction often constitutes a non-national not getting the same treatment or benefits as a national. When it comes to CFC-legislation, the restriction usually aims against a resident taxpayer

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<sup>18</sup> Terra & Wattel (2005), pg. 49.

<sup>19</sup> Terra & Wattel (2005), pg. 49. Fontana (2006), ps. 321.

<sup>20</sup> C-200/98 X AB & Y AB, para. 26 & 30. C-251/98 Baars, para. 22, 23 & 42.

<sup>21</sup> C-196/04

<sup>22</sup> C-196/04 *Cadbury Schweppes*, para. 32.

<sup>23</sup> Art. 43 EC Treaty.

<sup>24</sup> Lang (Ed) (2004), pg. 39. Schön (2001), pg. 252. Fontana (2006), pg 322f.

owning a CFC that is receiving a different tax treatment than a national owning a domestic company/subsidiary. The restriction may vary, as there are many ways to impose tax to the income of a CFC<sup>25</sup>. However, taxing a resident shareholder on the profits of its CFC (i) as they arise in the source state, regardless if the profits have been distributed or (ii) if the profits are deemed to have been distributed may lead to the loss of interest, to making the shareholders investment less profitable or to lead to economical or jurisdictional double taxation. All of these are factors that make CFC-legislation an infringement of the EC Treaty.<sup>26</sup> Furthermore, CFC-legislation in general determines the level of taxation according to the tax law in the home state. This may require the shareholder to keep two accounting systems, one for the home state and one for the source state. This is a clear infringement of the EC Treaty according to the ECJs decision in the Futura-Singer case. Although not about foreign subsidiaries, I believe that an analogy can be made as the Futura-Singer case dealt with the increased compliance costs for a foreign PE and CFC-legislation sometimes also call upon the parent company being forced to keep two accounting systems.<sup>27</sup> Lastly, many CFC-legislations do not apply if the shareholder can prove that the level of taxation in the source state does not qualify for low-taxation. This shift of the burden of proof can be contrary to the Treaty and therefore constitute an infringement depending on how it is designed.<sup>28</sup>

## 2.4.2 Justification

Once a restriction is established, it must be analyzed if there are any grounds for justification of the restriction. Most Member States that enforce CFC-legislation claim to do so as a mean of fighting fraud and abuse. Although the ECJ has recognized this as a possible ground for justification of an infringement, the court nevertheless always deemed the restriction as being intrusive and failing to meet the demands of the proportionality test. This means that the legislation in question has to be the least invasive way of preventing fraud and abuse. Furthermore, the ECJ has stated that the restriction can never be justified if imposed to all arrangements and not only the ones that are wholly artificial.<sup>29</sup> For the prevention of abuse to be a justified ground the legislation in question must have the sole purpose of preventing wholly artificial arrangements and the arrangement in question must have the sole purpose of tax abuse. In the argumentation of the ECJ one can see that it is not sufficient that the arrangement in question consist of an individual or company taking advantage of a lower tax regime in another Member State as this is a freedom granted within the European Union.<sup>30</sup> Therefore, it will probably be difficult for a Member State to claim the prevention of abuse and fraud as grounds of justification of CFC-legislation.

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<sup>25</sup> See 2.3.

<sup>26</sup> Lang (Ed) (2004), pg. 41f. Schön (2001), pg. 254.

<sup>27</sup> C-250/95 Futura-Singer, para 26.

<sup>28</sup> Lang (Ed) (2004), pg. 43.

<sup>29</sup> Lang (Ed) (2004), pg 44. Fontana (2006), pg 323f.

<sup>30</sup> Dahlberg (2005), pg. 132f.

Another possible justification ground discussed is if CEN could be seen as justifying CFC-legislation as it is in the very nature of CEN to tax worldwide income. When examining the ECJs decision in the Gilly case<sup>31</sup> it appears as though CEN is compatible with community legislation although the court stresses the fact that the levels of taxation in other Member States must be considered. Using CEN as a ground for justification of CFC-legislation would most likely not be permitted by the ECJ, as there is still a differentiated treatment between shareholders owning a company in another member State and shareholders owning one in the home state. It is only the former that is subject to taxation regarding the income of the company.<sup>32</sup>

An additional argument for justifying CFC-legislation through CEN may be fiscal cohesion. The principle of fiscal cohesion is when a national measure that in fact is restricting a fundamental freedom is considered by the ECJ not to infringe EC Law because of greater cause. In short, it can be used when there is a direct link between a discriminatory national tax rule and a compensatory tax advantage. For a direct link to exist the discriminatory rule and the compensating rule must be within the same national system. Furthermore, the two must concern the same taxpayer and the same tax. Only twice has the ECJ accepted the argument of fiscal cohesion, in the *Bachman* and *Commission vs. Belgium* cases.<sup>33</sup> It is not likely that the ECJ will find CFC-legislation justified because the Member State impose CEN as the discriminatory rule and the compensatory act is not connected by a direct link. Furthermore, it is settled case law of the ECJ<sup>34</sup> that the direct link also means that it must be the same person that is affected by both the discrimination and the compensation. In the case of CFC-legislation, the low taxation of the CFC is to be seen as discrimination which is compensated with higher taxation of the shareholder. Firstly, there is no direct link existing and secondly, enjoying a more favourable tax regime is not contrary to EC law.<sup>35</sup>

Another possible ground for justification of a CFC-legislation is the prevention of loss of tax revenue. This would not stand up in court however; as the ECJ has made it clear that the loss of tax revenue does not constitute a valid ground for justification of a restriction. The level of taxation falls within the sovereignty of each Member State and there is no tax evasion if the profits are taxed in the source state regardless of what rate that is applied.<sup>36</sup>

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<sup>31</sup> C-336/96 Gilly.

<sup>32</sup> Lang (Ed) (2004), pg 46f. Fontana (2006), pg. 320f, 324f.

<sup>33</sup> Lupo (2000), pg 272. Englisch (2004), pg 355f.

<sup>34</sup> C-294/97 Eurowings.

<sup>35</sup> Lang (Ed) (2004), pg 45f.

<sup>36</sup> Lang (Ed) (2004), pg. 45.

## 2.5 CFC-Legislation and Tax Treaties

The possibility for a country that has signed a double tax treaty with another state to impose CFC-legislation on a CFC established in that same state is a question that has been disputed by scholars for many years. The problem lies in that the underlying thought when signing a tax treaty is to eliminate double taxation and that the basic idea of CFC-legislation is re-tax already (low) taxed profits. An argument for the application of CFC legislation even though a tax treaty exists is that the scope of the tax treaty is limited to the avoidance of international double taxation of the same person regarding the same income. When applying CFC-legislation and taxing a national shareholder for the profits of a CFC that is a different person and a different income, created by the country imposing the CFC-legislation that is being taxed.<sup>37</sup>

If a national provision, such as the CFC-legislation, is applied to a situation where a tax treaty also is applicable and sets aside the terms of the tax treaty, it constitutes treaty override. Many countries claim that the taxation of CFC profits are not equal to taxing the profits of a CFC, which would fall under the tax treaty, but it is the taxation of a different fictitious income that does not enjoy treaty protection.<sup>38</sup>

The OECD has a long going battle against harmful tax competition and tax avoidance and is of the view that tax treaties do not conflict with the application of CFC-legislation. Since the changes to the commentaries to the OECD MC in 2003, the OECD explicitly states that CFC-legislation can be used “as a legitimate instrument to protect the domestic tax base”<sup>39</sup>. They also preclude the possible argument that article 7 and/or 10 would preclude the application of CFC-legislation by stating that that is not the case<sup>40</sup>. Today many countries entering into tax treaties specifically include a paragraph that gives them the right to apply CFC-legislation regardless of the tax treaty, an action that OECD claim to be useless since CFC-legislation, in their view, is not contrary to tax treaties.<sup>41</sup>

## 2.6 C-196/04 Cadbury Schweppes

As mentioned before, the Cadbury Schweppes case was the first case dealing with the compatibility of CFC-legislation and community law. I will give a presentation of the case as well as the opinion of the Advocate General and the decision of the ECJ. Furthermore, I will examine what conclusions that can be drawn from the case.

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<sup>37</sup> Lang (Ed) (2004), pg. 37. Malherbe (2007), pg. 612.

<sup>38</sup> Lang(Ed) (2005), pg. 31f.

<sup>39</sup> Commentary to the OECD MC 2005, article 1 para 23.

<sup>40</sup> Commentary to the OECD MC 2005, article 1 para. 23, article 7 para. 10:1 and article 10 para. 37.

<sup>41</sup> Commentary to the OECD MC 2005, article 1 para 23

## 2.6.1 Facts of the Case

Cadbury Schweppes (CS) is a UK resident company and the parent company to a group of subsidiaries residing both in the UK and outside. The subsidiaries residing outside the UK are established both in other Member States as well as in third countries. The head subsidiary is Cadbury Schweppes Overseas Limited (CSO), established in the UK. Two of the subsidiaries are Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI). Both CSTS and CSTI are established in the International Financial Service Centre in Dublin, Ireland where they enjoy a tax rate of 10 percent. The purpose of CSTI and CSTS is to raise finance and to supply that finance to other companies within the CS group. CSTS were established to replace an earlier structure involving a Jersey-based company. This would firstly remedy a Canadian tax problem for preferential Canadian resident shareholders in CS. Secondly; it would avoid the need for consent from the UK treasury for overseas lending. Thirdly, it would benefit from the Parent-Subsidiary directive, which would reduce the withholding tax on dividends distributed. All this would have been fulfilled if CSTS were established in the UK as well. CSTI was established to circumvent a UK foreign exchange regulation on transactions carried out in US dollars.

As both subsidiaries enjoyed the low-tax regime of 10 per cent, the profits of both CSTI and CSTS fell under the UK CFC-legislation stating that a company is a CFC if the level of taxation is less than three-quarters of the amount of UK tax that would have been paid. Consequently, the UK tax authorities claimed CSO, which was the first UK resident company in the chain, corporation tax on the profits of CSTI for the financial year of 1996. CSTS made a loss that year and was therefore not included. CS and CSO appealed this decision claiming that the UK CFC-legislation was contrary to the freedom of establishment.

The national court was uncertain of how they should apply community legislation and posted the following uncertainties:

- Is CS by establishing CSTI and CSTS in Ireland for the sole purpose of enjoying the lower tax regime exercising the freedom of establishment or abusing the same freedom?
- If CS is exercising the freedom of establishment, should the UK CFC-legislation be examined as a possible restriction or a discrimination?
- If the answer to the former question is as a restriction, does it mean that there is no restriction as CS would not pay more tax than CSTI and CSTS would have paid if they were established in the UK? Moreover, does it matter that there is a difference in calculating the profits of CSTI and CSTS from calculating the profits of a UK subsidiary and that there were no loss relief granted between the profits of CSTI and the losses of CSTS?

- Was the correct way of determining the discrimination through a comparison with establishing a subsidiary in the UK or should it be done through comparison with another, non-low-tax Member State?
- If there was a restriction or discrimination, could this be justified as a means to prevent tax avoidance? Specially by giving CS the opportunity to prove that it did not have a tax-avoiding motive by the motive-test.

In conclusion, the question referred to the ECJ was if article 43, 49 and 56 of the EC Treaty preclude national legislation such as the UK CFC-legislation, which provides in specified circumstances for the imposition of a charge upon a company resident in another Member State and subject to a lower taxation.

## 2.6.2 AGs Opinion

AG Léger delivered the opinion on the 2 of May 2006. Firstly, he stated that it was the freedom of establishment that was of relevance for the proceedings and limited the examination to article 43 and 48<sup>42</sup>. Three principal questions were made to shed light on the situation, if the establishing of CSTS and CSTI in a low-tax Member State constituted an abuse of the freedom of establishment, if UK CFC-legislation hindered the freedom of establishment and if such a hinder could be justified.

When examining the supposed abuse the AG stressed the fact that as long as an establishment reflects a genuine situation, i.e. that business is actually carried out, the underlying reasons for that establishment is not of relevance<sup>43</sup>. This applies even if these underlying reasons are to take advantage of a more favourable tax regime<sup>44</sup>. Moreover, Léger stated that since the levels of taxation has not been harmonized one Member State may not hinder a domestic company of establishing a subsidiary in another Member State by using the loss of tax revenue since some tax-competition is unavoidable.<sup>45</sup> Hence, there was no abuse of the freedom of establishment.

The AG then moved on to examine if the UK CFC-legislation constituted a restriction of the freedom of establishment. He concluded that the differentiating treatment between a UK parent that establishes a subsidiary in the UK and one that establishes a subsidiary in another Member State is not permitted.<sup>46</sup> As a response to the UK claims that, the tax paid by CS was no more than what should have been paid if CSTS and CSTI had been established in the UK the AG simply disregarded this claim. He referred to the ECJs decision in the Eurowings and the Barbier cases<sup>47</sup> and stated that:

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<sup>42</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 31 & 37.

<sup>43</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 49.

<sup>44</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 51.

<sup>45</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 52-54.

<sup>46</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 74-78.

<sup>47</sup> C-294/97 Eurowings. C-364/01 Barbier.

“low taxation applicable in a Member State cannot justify unfavorable tax treatment by another Member State and a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence.”<sup>48</sup>

As it had been established, the UK CFC-legislation constituted a restriction to the freedom of establishment, and the remaining question for the AG was to examine where if there were any grounds for justifying that restriction.

The UK claimed that the CFC-legislation was adopted as a mean to fight tax avoidance. Although AG Léger accepted this as an overriding reason in the public interest that could be used as justifying a restriction to a fundamental freedom he also stated that this was applied extremely narrowly by the court. For the court to accept such a restriction it could not be too general in its wording and the application of the legislation should be decided on a case-by-case basis, examining the specific circumstances of each individual situation.<sup>49</sup>

AG Léger stated that as long as the subsidiary is carrying out actual economic activity in the host state the tax allocation is not affected and the loss of tax revenue in the home state of the shareholder is merely a result of that economic activity.<sup>50</sup> The AG extracted two general points from the Marks and Spencer case<sup>51</sup>, through which he examined this and stressed the fact that the conclusion that a wholly artificial arrangement exists must be drawn on a case-by-case basis by the use of objective factors.<sup>52</sup>

The AG moves on to examining if the legislation goes beyond what is necessary for countering tax avoidance. He states that for this purpose it can be acceptable for the UK CFC-legislation to have a presumption that tax avoidance is at hand unless the CFC can show that that is not the case and that actual economic activity is carried out. If this can be shown, the CFC-legislation cannot be applied.<sup>53</sup>

To conclude, AG Léger did not find the UK CFC-legislation to be incompatible with the freedom of establishment if they are only applied to wholly artificial arrangements that are designed to circumvent national legislation.<sup>54</sup>

### 2.6.3 The Courts Decision

The Court firstly concluded that the question referred were to be examined in the light of the freedom of establishment<sup>55</sup>. It then moved on to examine

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<sup>48</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 82.

<sup>49</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 86-92.

<sup>50</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 109.

<sup>51</sup> C-446/03 Marks and Spencer.

<sup>52</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 110, 117 & 119.

<sup>53</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para.140-144.

<sup>54</sup> AGs opinion in case C-196/04 Cadbury Schweppes, para. 154.

<sup>55</sup> C-196/04 Cadbury Schweppes, para. 32-

if CS were abusing this right by establishing CSTS and CSTI in Ireland. The Court referred to its earlier case law where it was made clear that the fact that a company is established in a Member State with a more favourable tax regime does not constitute an abuse of the freedoms.<sup>56</sup>

Just like AG Léger, the Court concluded that the UK CFC-legislation is a restriction of the freedom of establishment as there is a difference in treatment between a shareholder establishing a subsidiary in the UK or if one that establishes a subsidiary in another Member State.<sup>57</sup>

The Court responded to the UKs claim that the aim of the CFC-legislation was to prevent tax avoidance by stating that the loss of tax revenue is not a justification ground that is recognized by the Court<sup>58</sup> but that the application of CFC rules only to wholly artificial arrangements may be<sup>59</sup>. “It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be 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.”<sup>60</sup>

When it examined if the UK CFC-legislation meets the objective of only preventing wholly artificial arrangements with the sole purpose of avoiding national tax rules the Court found that that was the case and moved on to see if the measure were proportionate.<sup>61</sup> This was done using the motive test which consists of one objective and one subjective part. The subjective part examines if there was an intention to obtain a tax advantage and the objective part examines if the objectives of the freedom of establishment has not been fulfilled.<sup>62</sup> If this is the case, a CFC may exist and the CFC-legislation may be compatible with the EC Treaty. The Court, however, stresses the fact that if the shareholder is able to produce evidence that the activities of the CFC are genuine CFC-legislation is contrary to the EC Treaty.<sup>63</sup>

The Court came to the conclusion that CFC-legislation is precluded by the freedom of establishment *unless it only* is applicable to wholly artificial arrangements that are intended to escape national tax. CFC-legislation may never be enforced if it can be shown, on objective grounds that regardless of the tax motive there is actual economic activity in the other Member State.<sup>64</sup>

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<sup>56</sup> C-212/97 Centros, para. 27. C-167/01 Inspire Art, para. 96.

<sup>57</sup> C-196/04 Cadbury Schweppes, para. 45.

<sup>58</sup> C-196/04 Cadbury Schweppes, para. 49.

<sup>59</sup> C-196/04 Cadbury Schweppes, para. 51.

<sup>60</sup> C-196/04 Cadbury Schweppes, para. 55.

<sup>61</sup> C-196/04 Cadbury Schweppes, para. 59 & 60.

<sup>62</sup> C-196/04 Cadbury Schweppes, para. 64.

<sup>63</sup> C-196/04 Cadbury Schweppes, para. 70.

<sup>64</sup> C-196/04 Cadbury Schweppes, para. 75.

## 2.6.4 Conclusion of the Judgement

In the Cadbury Schweppes judgement, the conclusion can be drawn that as long as there is no harmonization of the level of corporation tax in the Member States or a minimum rate agreed upon, Member States will have to accept that the level of taxation can be used for attracting companies and as a mean of competition between Member States. The ECJ makes it clear that it is acceptable to establish a company in another Member State because of the lower level of taxation alone. In other words, the Court approves of certain forms of tax planning within the community. The judgement further supports the Courts earlier stand that one Member State cannot treat a receiver of a service less favourably because the performer of the service is subject to low taxation in the Member State where the service is carried out. To allow such a conduct would go against the very foundation of the inner market.<sup>65</sup>

The final implications of the case remains to be seen, however as the Court referred the case back to the UK national court to decide if the Motive test can be applied in a way that makes sure that CFC-rules only affect wholly artificial arrangements. A problem that may arise is that the motive test considers the motive behind the establishment and that the ECJ clearly stated that even though the possibility to enjoy a lower tax regime may be a reason for establishing a subsidiary in another Member State this does not constitute abuse. According to the ECJ, Member States must examine the actual economic activity that is being carried out by a CFC when applying CFC-legislation. This should be done in the light of the objective pursued by the freedom of establishment, which is to allow nationals of a Member State to set up a secondary establishment in another member State and to maintain that establishment. Doing so involves the resident to contribute to the economic life in that other Member State as well as to enjoy advantages from it.<sup>66</sup> Furthermore, the Court stresses that Member States must make this examination based on “objective factors which are ascertainable by third parties<sup>67</sup>”.

## 2.7 C-201/05 CFC and Dividend Group Litigation Case

I will only account for the ECJs statement in this case and not give a thorough account for it as I did with the CS case. The case, that was joined with others, were put on hold awaiting judgments in cases such as the CS case and the Thin Cap Group Case<sup>68</sup>. The part of the joined case that dealt with CFC-legislation also regarded the UK rules and its compatibility with the EC treaty. The Court hastily answered by a near-replica of its answer in the CS case regarding the relation between CFC-legislation and the freedom

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<sup>65</sup> C-294/97 Eurowings, para. 44 & 45.

<sup>66</sup> C-196/04 Cadbury Schweppes, para. 52-54.

<sup>67</sup> C-196/04 Cadbury Schweppes, para. 67.

<sup>68</sup> C-524/04.

of establishment as well as the grounds for justification.<sup>69</sup> The only news, in my view, was a definition of how the burden of proof could be divided when determining if a genuine establishment exists. The Court first repeats its statement in the CS case, that it is the individual tax payer that has the best prerequisites to prove that a genuine establishment exists at the lowest cost and effort. The clarification comes via analogy from the Thin Cap Group Litigation case<sup>70</sup> where the Court concluded that it is a reasonable measure for a Member State to claim evidence regarding the factual circumstances of an establishment in another Member State from the taxpayer himself.<sup>71</sup>

Even though this case did not bring any new conclusions from the ECJ, it strengthens the decision in the CS case, giving Member States clearer guidelines regarding the relationship between CFC-legislation and community legislation. The clarification of the distributing of the burden of proof may also lead to more homogenous rules in the EU and a better ability to foresee the tax consequences of an establishment in another Member State for the individual taxpayer, as he knows what is going to be expected of him.

## **2.8 C-203/05 Vodafone2**

The Vodafone2 case that is pending before the ECJ regards the obligation for a UK company, Vodafone2, to pay taxes according to the UK CFC-rules for the profits of its Luxembourgian holding company. Vodafone2 claimed from the get go that the UK CFC-legislation was incompatible with the EC Treaty and HMRC therefore referred the case to the ECJ for an opinion. As the case was pending, however, the judgment in the CS case was delivered and the special commissioners in the UK decided not to maintain the reference to the ECJ. To support for their decision they claimed that the judgment in the CS case could be read down to the UK legislation. To decide the Vodafone2 case, they argued, it was sufficient to apply the motive test to see if the holding company constituted a genuine establishment. Vodafone2 appealed this decision arguing that the order for reference to the ECJ should be maintained. The appeal is as of this date not decided but the hearing at the high court is scheduled to the 22<sup>nd</sup> of May.

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<sup>69</sup> C-201/05 CFC and Dividend Group Litigation, para. 70-81.

<sup>70</sup> C-524/04.

<sup>71</sup> C-201/05 CFC and Dividend Group Litigation, para 84 and C-524/04 Thin Cap Group Litigation, para. 82.

# 3 National Legislations

## 3.1 CFC-legislation in the UK

The UK CFC-legislation was introduced through the 1984 Finance Act. The scope where to counter the tax avoidance the government saw arising when companies established subsidiaries in low-tax countries. The primary purpose was to impose UK tax on profits derived from companies in low-tax jurisdictions that were UK controlled.<sup>72</sup> A company is a CFC within the meaning of the TA section 747 (1) if it is resident outside the UK, is controlled by persons resident in the UK and is subject to a lower level of taxation in the territory in which it is established<sup>73</sup>.

### 3.1.1 CFC-Rules and the Taxable Event

At shareholder level, the UK CFC-legislation applies only to companies, and more specifically, companies established within the UK. Individuals and partnerships are thus not affected by the legislation. Regarding the foreign entity, the legislation also only applies to a company as it is defined in the TA: “any body corporate or unincorporated association but does not include a partnership, a local authority, or a local authority association”.<sup>74</sup>

#### 3.1.1.1 Low-Tax Countries

For a country to be a low-tax country, the level of taxation in the foreign country must be less than half of the tax that should have been paid in the UK<sup>75</sup>. This means that a comparison is carried out based on the assumption that the profits that arisen in the CFC had arisen in the UK instead and the levels of taxation compared. The reader should note that it is not the nominal tax rate that is being compared, but the effective tax rate when the profits are computed on a UK basis.

#### 3.1.1.2 Control

The general definition of control is to have the power to make sure that the CFC functions in the way that the shareholder wishes. To attribute the profits of a CFC to the shareholder, he must have a controlling interest of more than 40 per cent in the company<sup>76</sup>. The provisions of the meaning of control was widened in 2000 and now also include two persons owning at least 40 per cent each even if one of these persons is not a resident in the UK.<sup>77</sup>

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<sup>72</sup> Lang (Ed) (2004), pg. 609. Malherbe (2007), pg 646.

<sup>73</sup> Section 747 TA 1988, para. (1), (2).

<sup>74</sup> Section 832 TA 1988, para. (1).

<sup>75</sup> Section 750 TA 1988, para. (1).

<sup>76</sup> Section 747 TA 1988, para. (1A).

<sup>77</sup> Section 755 D TA 1988, para. (2).

### 3.1.1.3 Profits

If a company constitutes a CFC, the profits deriving from it are taxable at the level of the shareholders by means of apportionment<sup>78</sup>. This is done by taxing the shareholder for a deemed dividend that respond to the profits made by the CFC.

### 3.1.1.4 Credits

If the CFC has been subject to any taxes in its state of residence this tax is credited against the tax that is to be paid by the shareholders in the UK<sup>79</sup>. A credit is also granted if later, there is an actual distribution of dividends from the CFC. The taxes imposed on the apportioned profit are then credited.

## 3.1.2 Exceptions

There are situations when the CFC-legislation is not applicable:

- If the CFC engages in an acceptable distribution policy as specified in the TA<sup>80</sup>. This means distributing a specified percentage of the profits as dividends, which are taxed at shareholder level according to UK tax law.
- If the country in which the CFC is established is on the list in the *Excluded Countries Regulation*. This list excludes companies in high-tax countries from CFC-legislation. The requirement is that the majority of income must have arisen in this country.
- If the activity of the CFC is exempt. The reason for this exception is to discard automatically businesses that because of their very nature is located in another territory and whose purpose cannot be assumed to circumvent UK tax.
- If the *public quotation* test is fulfilled. This means that the shares of the company must be dealt on a recognized stock exchange and that the public holds at least 35 per cent of the voting power.
- If the *Motive Test* is passed. The test requires the shareholder to prove that if there is a loss in UK tax revenue this was not the main objective when establishing the CFC. The shareholder also has to prove that the allocation of profits away from the UK was neither one of the main objectives of the establishment.
- If the profits of the CFC is less than £ 50, 000.

## 3.1.3 Impact of EC-Law and the CS Case

Even though it was the UK CFC-legislation that was under examination in the CS case, the practical outcome of the ECJs decision is still to come as the Court referred the case back to the national court. However, that the UK CFC-rules, as they were applied in the CS case, was not compatible with the freedom of establishment was made clear by the ECJ. This was recognized

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<sup>78</sup> Section 747 TA 1988, para. (3).

<sup>79</sup> Section 751 TA 1988, para.(6).

<sup>80</sup> Part 1 of schedule 25 of TA 1988.

by HMRC and parts of the CFC rules were amended through the 2007 Finance Act. The introduced changes principally dealt with the possibility for a shareholder to have a reduction of the deemed dividend if he could prove that the income of the CFC actually reflected an economic value created in the country in which the CFC is established.

### 3.1.3.1 Discussion Document

In June 2007, HM Treasury and HMRC released a discussion document on the taxation of the foreign profits of companies. The document discusses an exemption system for dividends, a way to allocate interest and a new modified CFC-regime, the last of course being of interest for this thesis. The new, proposed, CFC-regime is called the CC-rules, as in Controlled Company rules. When discussing the CS case the Government clarifies that, the new CC-rules will apply both to UK and non-UK subsidiaries and should therefore not pose a problem regarding community legislation<sup>81</sup>. The scope of the new rules is to prevent the artificial location of profits.

According to the document, a large problem with the current CFC-legislation is that it gives the UK no possibility to tax passive income that has originated within an active company<sup>82</sup>. The new rules will change this giving the UK a wider scope and by taxing the passive foreign income each accounting period. To make the new rules more accessible it is also proposed that the level of control will be reduced to 10 per cent and that the meaning of control will be widened.<sup>83</sup>

### 3.1.4 Tax Treaties

During the 1997 Bricom case the debate about the relation between tax treaties and CFC-legislation in the UK where at its height. The case concerned a UK shareholder owning a Netherlands CFC and who were taxed on the income of the CFC. This, even though the income originated from interest payments and the fact that the tax treaty between the UK and the Netherlands clearly stated that income derived from interest payments should only be taxed in the state where they had arisen. Bricom of course appealed this decision but the UK Court of Appeal rejected their claim stating that the nature of the CFC-legislation led to the result that the incomes of the CFC had to be computed on the notion that the CFC was a resident in the UK. Furthermore, the income taxed by the UK was not the interest itself, but an artificial income equal to it and therefore, the tax treaty did not protect the CFC.<sup>84</sup> The judgment has been criticised for being too far-reaching and for applying a to arbitrary label on the income of the CFC.<sup>85</sup>

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<sup>81</sup> "Taxation of the foreign profits of companies: a discussion document", pg. 19, para. 4.11.

<sup>82</sup> That is when the company itself is active and not artificial but some of the income is passive. Today all of the income passes as active.

<sup>83</sup> "Taxation of the foreign profits of companies: a discussion document", pg 19f.

<sup>84</sup> Berner (1997), pg. 47. Lang (Ed) (2004), pg. 625f.

<sup>85</sup> Lang (Ed) (2004), pg. 627.

However, the right to apply CFC-legislation regardless of the presence of a tax treaty is incorporated in most of the UKs tax treaties and should therefore not pose as a problem. If it were to be contested the UK would simply claim the conclusion in the Bricom case, that they are in fact not taxing the profits of the CFC but a deemed dividend which is not protected by the tax treaty.<sup>86</sup>

### 3.1.5 Analysis

The changes made to the UK CFC-legislation through the 2007 Finance Act does, in my view not address the problems concerning the compatibility between CFC-legislations and community legislation. The changes were addressing circumstances that take place *after* a foreign company has been deemed a CFC. The possibility to have the apportioned profit reduced by providing proof that part of or all of the profits have its origin in actual economic activity does not change the fact that UK shareholders that own a foreign company are always seen as trying to circumvent UK tax legislation. For a change to comply with what the ECJ concluded in the CS case it would have to be a change that tackles this problems firstly. The ECJ made it clear, in my opinion that the UK CFC-legislation as it is today is not compatible whit the freedom of establishment as the legislation targets both artificial and non-artificial arrangements<sup>87</sup>. The Court left it to the national Court to determine if the motive test could be applied in a way so that the CFC-legislation only would target wholly artificial arrangements. The changes imposed trough the 2007 Finance Bill does not fulfil this but rather burdens shareholders in the UK that set up subsidiaries in low-tax countries with a heavier burden of proof and limits their legal certainty. A shareholder now is always presumed to have a CFC and that the reason behind the establishment was to avoid UK taxation. The shareholder is only given a possibility to clear himself in the second stage so to say. In my view, a clearer and more efficient way would be to have shareholders who are establishing subsidiaries in a low-tax country the possibility to show that their establishment was made with the intention to carry out actual economic activity in the first stage. This opportunity should therefore be given *before* the UK Government decides that the company constitutes a CFC, which would save time and money as well as being in line with the ECJs reasoning. The fact that the shareholder will have to provide proof as to the objectives behind his establishment, this is not an unjust demand as the ECJ also points out in its judgement.

The 2007 discussion document suggests that the new CC-rules main focus will be to include passive income of a CFC in the taxable income of the UK shareholder. The general spirit of the discussion document is that the CC-rules will be stricter, cover more types of income and do so while demanding a lower level of control by the shareholder. In my view, these are not changes in line with the ECJs decision in the CS case. Sure, there are

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<sup>86</sup> Malherbe (2007), pg. 647.

<sup>87</sup> C-196/04 Cadbury Schweppes, para. 72.

certain activities that are exempt from the rules such as genuine active finance business and certain intra-group interests. Still this is not enough, as I have opined in the paragraph above, as the CC-rules would not only target wholly artificial arrangements. For the new rules to be in line with the ECJs reasoning there would have to be a clearer and more selective system of targeting which establishments that should fall under the CC-rules and which should not as the real problem with the current CFC-regime is its non-selective character.

Regarding the discussion document of 2007, it will have a serious impact on companies regarding costs of examining what type of income different sources of profits constitute. The Government recognizes these costs as a problem and states that a further discussion on the costs for companies to comply with the new CC-rules are welcome. At the same time, however, the Government claims that even though the costs may be large, it believes that many companies already have the tools and competence to do so.<sup>88</sup>

A point of interest in the CS case that the ECJ does not comment on at all but that Whitehead<sup>89</sup> recognize is that the circumstances in the CS case involved CS moving their treasury services from Jersey to Ireland, not from the UK to Ireland. The result of this being that there is no loss of UK tax revenue but rather a status quo concerning CSs taxable income in the UK. If the scope of the UK CFC-legislation is to prevent erosion of the UK tax base caused by domestic companies moving their subsidiaries to tax havens how does the CS case fit into that scope. Perhaps this is one of the questions that the national court will have to consider when making their final decision in the CS case.

What was done by the UK in the Bricom case was to simply “re-label” the taxed income of the corporation in question so that it will fall outside the scope of a tax treaty. This, in my view, is a clear case of treaty override as it means that the UK can choose to set aside a tax treaty as they please by simply re-naming the deemed dividend from the original name and by doing so “acquire” the taxation right according to domestic tax legislation.

## **3.2 CFC-legislation in Germany**

The German CFC-legislation was introduced for the first time in 1972 and has since then been amended several times. The scope of the legislation is to counter harmful tax schemes set up to avoid German taxation. For a company to constitute a CFC and fall within the CFC-legislation the income of the CFC must be passive and taxed at a low rate in the country of establishment.

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<sup>88</sup> “Taxation of the foreign profits of companies: a discussion document”, pg. 23.

<sup>89</sup> Whitehead (2007), pg. 181.

## 3.2.1 CFC-Rules and the Taxable Event

Just like the UK CFC-legislation the German CFC-rules does not apply to partnerships or branches. This is because the scope of the legislation is corporations and the definition of corporations follows that of basic German tax principles. Thus, if an entity would have constituted a taxable entity under German tax law, the CFC-legislation is applicable.<sup>90</sup> The aim of the legislation is passive income of foreign corporations that is attributed to the German shareholder as a deemed dividend. For this to apply, the shareholder must have a qualified interest in the foreign corporation and the profits must be subject to low taxation in the source state.<sup>91</sup>

### 3.2.1.1 Low-Tax Countries

According to the AStG, a corporation is subject to low taxation if the effective tax rate is less than 25 per cent.<sup>92</sup> Conveniently enough, the tax rate in Germany is exactly 25 per cent and thus, all countries applying a lower level of taxation than Germany constitute a low tax state. Just like in the UK, the effective tax rate is calculated according to domestic principles.<sup>93</sup>

### 3.2.1.2 Control

For a foreign corporation to constitute a CFC according to German legislation the domestic shareholder must control 50 per cent of the corporation alone or together with other German citizens. Notable is that the German citizens that own the shares together must not in any way be connected or even aware of each other's existence.<sup>94</sup>

Regarding passive capital investments, the ownership threshold for a company to constitute a CFC is only 1 per cent of the corporation.<sup>95</sup> When applying this rule, the analysis is made regarding each individual shareholder.

### 3.2.1.3 Profits

The German CFC-legislation only targets passive income. In the AStG article 8 (1) there is a list of activities that are considered to be active and therefore not covered by the CFC-legislation. If the activities of a foreign company are not on the list, income from its activities is deemed passive and falls under the CFC-rules.<sup>96</sup>

When a foreign company is decided to constitute a CFC according to German law, the incomes deduced from it are taxed at the level of the shareholder. Normally, a distribution of dividends is subject to a tax

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<sup>90</sup> AStG, para 7 (1).

<sup>91</sup> Lang (Ed) (2004), pg. 257f.

<sup>92</sup> AStG, para. 8 (3).

<sup>93</sup> AStG, para. 10 (3).

<sup>94</sup> AStG, para. 7 (2) & (3).

<sup>95</sup> AStG, para. 7 (6).

<sup>96</sup> Lang (Ed) (2004), pg. 259. Malherbe (2007), pg. 623f.

exemption of 50 per cent for individuals and 95 per cent for corporations. This exemption is motivated by the presumption that the dividend has already been subject to tax at the level of the corporation. This exemption does not, however, apply to deemed dividends from CFCs.<sup>97</sup>

#### **3.2.1.4 Credits**

Generally, the deemed dividend attributed to the shareholder is done so at the after-tax value, that is after taxes has been deducted in the other country.<sup>98</sup> However, if the shareholder does not experience that this has been done he may demand a credit of the taxes already paid against the German taxes claimed.<sup>99</sup>

The profits of the CFC are allowed to be reduced by the losses of the same CFC. Losses can also be carried forward but it is not allowed to attribute only losses to a German shareholder.<sup>100</sup> However, the shareholder is allowed to set off losses relating to other incomes against the deemed dividend from the CFC.

### **3.2.2 Exceptions**

As mentioned above, there is a breakdown between passive and active income in German CFC-legislation. If the profits of a CFC derived from passive activities does not constitute more than 10 per cent of its total income *and* if the income that is to be attributed to the shareholder is less than €62 000 the profits are not attributed to the shareholder. Notable is that both criteria must be met for the exemption to apply.<sup>101</sup>

### **3.2.3 Impact of EC-Law and the CS Case**

As shown in the description of the German CFC-legislation above, it has many similarities with the UK ones. Therefore, it did not come as a surprise when the German Ministry of Finance (BMF) issued a circular limiting the scope of the German CFC-rules barely four months after the CS judgement. The limitation was to be applied during modification of the German CFC-legislation to conform to the ECJs decision in the CS case.

#### **3.2.3.1 Limitation of the CFC-Legislation**

The general conclusion in the BMF-circular of January 8, 2007 is that the German CFC-rules were to continue to apply but that under certain circumstances profits of a CFC would not be attributed to the German shareholder. That was if the passive income of the CFC actually reflected a situation where the company had its place of effective management and

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<sup>97</sup> Lang (Ed) (2004), pg. 258. Malherbe (2007), pg. 624.

<sup>98</sup> AStG 10 (1).

<sup>99</sup> AStG 12 (3).

<sup>100</sup> AStG 10 (3).

<sup>101</sup> AStG 9.

control in the foreign country. Furthermore, the foreign company had to be a member of the EU or the EEA and fulfil certain additional requirements.<sup>102</sup>

- The company had to, through its normal business participate in the market development in the country of establishment in an active and lasting manner.
- The management and other personnel required to operate the company had to be permanently employed in the foreign country.
- These personnel also had to be competent to perform the functions of the company on a day-to-day basis and to do so without outside assistance.
- The company's income should be generated by its own activities.
- If the foreign company performed services to a related person, the services had to create an additional value and the equity value of the company should reflect this.<sup>103</sup>

Even if all these requirements were met, the CFC-legislation still applied in its original form if the income of the company came from passive capital investments, if the income was derived by low-tier foreign companies or if the passive income had arisen in a permanent establishment outside the EU or EEA.<sup>104</sup>

### **3.2.3.2 New CFC-Legislation**

In August 2007 a draft legislation for 2008 was published by the German government and was later passed by both the upper and lower house of parliament and taking effect starting the assessment period of 2008. A pronounced aim of the new legislation is to adjust the German CFC-legislation to the ECJs decision in the CS case. Doing so, the government changed article 8 (2) of the AStG so that CFC-legislation is not applied if a company actually has its management in the other country and that this country is an EU or an EEA state. This is expressed that the foreign corporation must pursue a genuine economic activity in the foreign country. The new legislation largely follows the BMF-circular regarding the provisions that are to be met and the three exceptions to its application, as mentioned in the last paragraph in section 3.2.3.1, are incorporated.<sup>105</sup>

### **3.2.4 Tax Treaties**

Unlike the UK, Germany has not incorporated, in their tax treaties, a paragraph giving it the right to apply CFC-legislation when there is a tax treaty. However, in 1992 article 20 (1) of the AStG was introduced and in 2003 strengthened, stipulating the precedence of CFC-rules before tax treaties regarding passive income from an offshore corporation. In the doctrine, there is an ongoing discussion regarding whether or not this provision constitutes treaty override.<sup>106</sup>

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<sup>102</sup> Malherbe (2007), pg. 626.

<sup>103</sup> Malherbe (2007), pg. 626.

<sup>104</sup> Malherbe (2007), pg. 627.

<sup>105</sup> Malherbe (2007), pg. 627f. KPMG, German Tax Monthly, September 2007.

<sup>106</sup> Lang (Ed) (2004), pg. 265. Malherbe (2007), pg. 625.

The most current controversy regarding German CFC-legislation and tax treaties are the switchover rules in article 20 (2) of the AStG. This rule means that if there is passive income of a permanent establishment belonging to a German shareholder in a foreign country and that permanent establishment would have constituted a CFC if it were a subsidiary belonging to a German shareholder double-taxation should not be avoided according to the exemption method, but the credit method. The recently decided Columbus Container Services case (CC)<sup>107</sup> addressed article 20 (2) of the AStG. The case concerned a Belgian Coordination Centre, which is subject to low tax in Belgium, controlled by German shareholders. Under German law, CC is seen as a partnership that is transparent for tax purposes and its profits are taxed at shareholder level according to article 20 (2) AStG. This is however, contrary to the German-Belgian tax treaty. CC appealed this decision to the fiscal court of Münster who referred the question to the ECJ. The question asked was whether the German legislation was infringing article 43 and 56 of the EC Treaty. The ECJ decided that this was not case since the provisions in German law did not lead to CC being treated less favourably than a partnership residing in Germany.<sup>108</sup> The Court touched upon the subject of the possible infringement of the bilateral tax treaty between Germany and Belgium but simply clarified that it did not fall within the Courts competence to examine that question.<sup>109</sup>

### 3.2.5 Analysis

The scope and aim of both the BMF-circular as well as the amended German CFC-rules were to adjust the German CFC-legislation so it would stand a possible future examination from the ECJ regarding its compatibility with the freedom of establishment. In my view, the new rules go beyond the opinions expressed by the ECJ in the CS case. First and foremost, and I cannot stress this enough, the point made clear by the ECJ was that a CFC-legislation is an infringement to the freedom of establishment if it targets all foreign establishments made by nationals without regard to the nature of the establishment. The Court defines wholly artificial arrangement very narrow in the judgement as it states, “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”<sup>110</sup>. In my view the ECJ by this mean that for a company to constitute a fictitious entity there must be next to no activity at all performed by the company. One could interpret this that a rule of thumb could be that if there are employees carrying out *some* business, an actual establishment does exist<sup>111</sup>. I would say that the newly imposed German demands regarding the activity in the foreign country still are too farfetched and would not stand up in front of the

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<sup>107</sup> C-298/05 Columbus Container Services.

<sup>108</sup> C-298/05 Columbus Container services, para. 40.

<sup>109</sup> C-298/05 Columbus Container Services, para. 45-47.

<sup>110</sup> C-196/04 Cadbury Schweppes, para. 68, *Italic by me.*

<sup>111</sup> See also C-196/04 Cadbury Schweppes, para. 67.

ECJ. I am convinced that the use of the words letterbox and front by the ECJ strengthens this argument as they indicate that for a company to clearly be fictitious there is no activity carried out at all.

Although it is not entirely clear yet how the German government will interpret the new legislation stating that the foreign corporation must pursue a genuine economic activity it is likely that the requirements from the BMF-circulation will be used as a guideline. Amongst the requirements is the demand that the company must have its management permanently employed in the foreign country as well as other personnel. Again, I would claim that this is to go far beyond the provisions set out by the ECJ in the CS case.

The comprehensive problem with the amended German CFC-legislation, in my opinion, is that after the CS judgment the German government, with right, felt the need to act quick and harsh to make the CFC-legislation compatible with the judgment. By doing so they did not actually change the rules or made them more differentiated but rather made them more exhaustive and demanded more of the individual shareholder. I am not opining that I think it is too burdensome for the shareholder to produce evidence that the establishment actually pursue genuine economic activity in the foreign country but rather that the demands that are to be proven are to far-reaching. That it is the shareholder that is to produce the evidence regarding the establishment is a view that is supported by the ECJ in the CS judgment.<sup>112</sup>

Regarding the German CFC-legislation in relation to the bilateral tax treaties entered by Germany there is little doubt to me that the CFC-rules constitute an infringement of the treaties. If they do not constitute a violation, they are at least a serious restriction that makes the tax treaties entered with Germany barely worth the paper they are written on. If Germany can override the content of the tax treaties by a wink of a hand then who would dare to rely on them. And who would want to do so as it brings no legal certainty whatsoever for the individual tax payer. In the EU of today, a shareholder investing or establishing a subsidiary in another Member State must be able to rely on, not only the EC Treaty for protection, but also the domestic tax legislation as well as bilateral tax treaties for planning the tax consequences of that establishment or investment.

### **3.3 CFC-legislation in France**

The primary intention of the French CFC-legislation was to avoid the double exemption that could arise when French shareholders invested abroad. This was to be done by gaining the legal possibility to tax French shareholders advantaging from a more favourable tax regime. The CFC-legislation was first introduced through the Finance Act of 1980 as mean for taxing French shareholders on the profits of their foreign controlled companies. The legislation was later amended in 1992 to cover a wider

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<sup>112</sup> C-196/04 Cadbury Schweppes, para. 70.

scope. The French Administrative Supreme Court in the 2002 Schneider Electric case, regarding the relation between the CFC-rules and tax treaties dismissed these modified rules and the old CFC-legislation was completely overhauled and replaced by a new system, which entered into force starting 2006. Through the changes, the French CFC-rules have maintained under article 209 B in the FTC.<sup>113</sup>

### **3.3.1 CFC-Rules and the Taxable Event**

Before the changes imposed in 1992, the French CFC-legislation only covered entities that had legal autonomy. This made it easy to circumvent the rules and thereby avoiding taxation in France. As a result, the changes in 1992 included a widening of the scope of the CFC-legislation to cover branches as well. If the widened scope also covered other forms of entities such as partnerships and trusts were unclear, but through the 2006 changes it is clear that the CFC-legislation in France now cover all foreign legal entities, regardless of their legal personality.<sup>114</sup>

#### **3.3.1.1 Low-Tax Countries**

Just like the UK and the German provisions, the French CFC-rules base the notion of what constitutes a favourable tax regime on the percentage of the effective tax rate in the foreign state rather than on a blacklist. For a corporation to fall within the French CFC-legislation, the effective tax rate must be 50 per cent or less of the corresponding French tax rate that should have been applied if the computation of taxes had been done according to French tax law.<sup>115</sup>

So far, the similarities between the UK, the German and the French CFC-legislation regarding tax rates are the same. Noteworthy though, is the fact that the French assessment is done on a case-by-case basis each fiscal year meaning that a corporation that constitutes a CFC one year may very well not do so the next.<sup>116</sup>

#### **3.3.1.2 Control**

For a shareholder to have control over a foreign corporation according to the French CFC-rules he must directly or indirectly control more than 50 per cent of the shares, voting rights or financial rights in the corporation. Before the changes to article 209 B of the FTC the ownership threshold was as low as 10 per cent. Simultaneously as the threshold was heightened, an anti-abuse provision was introduced that lowers the ownership threshold and

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<sup>113</sup> Lang (Ed) (2004), pg. 223f.. Malherbe (2007), pg. 618.

<sup>114</sup> Lang (Ed) (2004), pg. 225f.. Malherbe (2007), pg. 618.

<sup>115</sup> EY EU Tax News Sept/Okt 2005, pg. 3. International Tax Review, World Tax 2005-France. Malherbe (2007), pg. 619.

<sup>116</sup> EY EU Tax News Sept/Okt 2005, pg. 3. International Tax Review, World Tax 2005-France. Malherbe (2007), pg. 619.

triggers the application of article 209 B of the FTC if 50 per cent of the shares in the foreign corporation is controlled by French tax residents.<sup>117</sup>

### **3.3.1.3 Profits**

The profits of the foreign corporation is taxed at shareholder level as a deemed dividend. This is done at the end of each fiscal year and without any differentiated treatment of passive or active income.

### **3.3.1.4 Credits**

An extensive change incorporated by the 2006 changes is that the deemed dividend from the CFC is no longer taxed as a separate entity and can therefore be used to set off losses that has occurred in France against the profits made by the CFC. Losses relating to the CFC may not be used against French profits but are still allowed to be carried forward to set off against profits of the CFC in coming years.<sup>118</sup>

If there are taxes levied in the foreign country, these taxes are allowed to be deducted from the taxes that are due in France. A condition for this is, however, that the taxes paid by the CFC in the foreign country must correspond or be deemed as doing so to the taxes in France. Furthermore, if a real distribution of profits takes place and a withholding tax is being levied in the foreign country, relief is also provided in France.<sup>119</sup>

## **3.3.2 Exceptions**

Under the French CFC-legislation, there are two safe harbour clauses. The first is EU related and states that if the foreign corporation is located within the EU the corporation is not included in the scope of the legislation. For this to apply it must be proven that the activities of the corporation is genuine and does not constitute a wholly artificial arrangement set up to circumvent national tax. The second safe harbour is when it can be proved that the foreign corporation carries out real industrial or commercial activities in the country of establishment.<sup>120</sup>

## **3.3.3 Impact of EC-Law and the CS Case**

Even though it was the applicability of the CFC-legislation to tax treaties that brought upon the 2006 changes of article 209 B, they also helped to make the provision more EC-concordant. Since neither the judgment nor the AGs opinion had been delivered in the CS case the French legislators seems to have had the ability to foresee the future. Alternatively, and more likely,

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<sup>117</sup> EY EU Tax News Sept/Okt 2005, pg. 3. International Tax Review, World Tax 2005-France. Malherbe (2007), pg. 619.

<sup>118</sup> EY EU Tax News Sept/Okt 2005, pg. 3. International Tax Review, World Tax 2005-France.

<sup>119</sup> EY EU Tax News Sept/Okt 2005, pg. 3. Malherbe (2007), pg. 620.

<sup>120</sup> EY EU Tax News Sept/Okt 2005, pg. 3. International Tax Review, World Tax 2005-France. Malherbe (2007), pg. 619.

they took the ECJs reasoning from previous case law into consideration when drawing up the amendments that an establishment within the EU does not constitute a CFC unless it is wholly artificial. As early as the ICI case the Court established its reasoning that an establishment outside the home state does not constitute tax avoidance even though a lower tax regime is one of the underlying reasons for that establishment. For the establishment to constitute a wholly artificial arrangement its sole purpose must be to circumvent national legislation and be fictitious.<sup>121</sup>

On the surface, the French CFC-legislation seems to be compatible with the freedom of establishment. A future trial of the rules will have to be awaited to see how the tax authorities will apply the test of what constitutes a wholly artificial arrangement. Today, the burden of proof is on the tax authorities to prove that the foreign corporation constitutes a CFC regarding the shareholding threshold and the favourable tax regime. If this can be proven, the shareholder must show that the corporation actually is carrying out genuine economic activity in the other Member State and that it has an actual establishment there regarding personnel and equipment. This breakdown of the burden of proof is in line with the ECJs reasoning in the CS case<sup>122</sup> and does not constitute a too heavy burden of proof for the shareholder. The fact that there are guidelines for the division of the proof strengthens the legal certainty for the shareholder and makes it foreseeable that they will have to provide proof.<sup>123</sup> The problem that may arise is if the French tax authorities determine the definition of wholly artificial too narrow as discussed above under 3.2.4.

### 3.3.4 Tax Treaties

In 2002, the French Administrative Supreme Court found the CFC-legislation in France to be inconsistent with tax treaties. This was in the Schneider Electric case which regarded a French company (Schneider) with a CFC in Switzerland. The French tax authorities claimed taxing rights concerning the profits of the controlled foreign corporation. Schneider appealed this and referred to the tax treaty between France and Switzerland stating that profits were only taxable in the state in which they had arisen. The tax treaty in question followed the OECD MC and the decision therefore had far-reaching implications. Because of the judgment, the changes regarding the CFC-rules took place making them more in line with France's bilateral tax treaties.<sup>124</sup> In the Schneider case, the profits of its subsidiary were taxed as profits of the parent. This has now been amended and profits arising in offshore subsidiaries are instead taxed as a deemed dividend to the parent.<sup>125</sup>

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<sup>121</sup> C-264/96 ICI, para. 26.

<sup>122</sup> See C-196/04 Cadbury Schweppes, para. 70.

<sup>123</sup> See AG's opinion in case C-196/04 Cadbury Schweppes, para. 141.

<sup>124</sup> Lang (Ed) (2004), pg. 223f.

<sup>125</sup> Malherbe (2007), pg. 620.

That the new article 209 B does not precede a double tax treaty entered by France has been recognized by the French tax authorities who have actually stated that for that to be the case, it must be expressly stated in the tax treaty or implied.<sup>126</sup>

### 3.3.5 Analysis

As mentioned above, the only real and foreseeable problem with the French CFC-legislation and its compatibility with the freedom of establishment is how the French tax authorities choose to define wholly artificial arrangement. It is my believe that the ECJ by its reasoning in the CS case clarified that for an infringement of the freedom of establishment to be justified the fictitious corporation must not be more than a mere mailbox-company or a front.

To say that the French CFC-legislation is in line with the ECJs decision in the CS case is a bit far-reaching in my taste. Like pointed out in the paragraph above, the consequences of the current CFC-legislation will have to wait until the French tax authorities applies the free harbour exemption regarding CFCs in the EU. A misunderstanding that is drawn from the CS case is that the ECJ said that CFC-legislation is allowed as long as it is only applied to wholly artificial situations and that member States have cleared their back by citing that in their legislations and/or guidelines. I believe, that what the ECJ said when referring the CS case back to the national court in the UK was that we approve of the legislation if you can show us that the motive test can make a fair and just decision of when to apply the CFC-legislation, and more importantly, when to not do so. If the French CFC-legislation passes this test is yet to see.

A unique and remarkable feature of the new French CFC-rules is the allowance of setting of losses in France against profits of the CFC. This gives the French shareholder at least one benefit when being subject to CFC-taxation. This may not be referred to as a benefit that up weighs the disadvantage that CFC-taxation may impose as the ECJ has made it obvious in its case law that this is not a valid ground for justification.

Regarding the relationship between the French CFC-legislation and tax treaties the French position may be seen as clear after the Schneider case as well as the clarification from French tax authorities that if CFC-rules should be applicable on a CFC in a specific state it must be stated in the tax treaty with that country that it is allowed. In my view, this is a just interpretation that provides for strengthening the reliability of tax treaties as well as giving the individual taxpayer the possibility to plan the tax consequences of his establishment in a foreseeable way.

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<sup>126</sup> Malherbe (2007), pg. 620.

## 3.4 CFC-legislation in Sweden

Up until 1992, Sweden had restrictions against cross-border capital movements. When these restrictions were removed, a need arose for new legislation that could prevent tax avoidance and erosion of the Swedish tax base. Thus, in 1993 CFC-legislation was introduced in Sweden. The rules were amended in 2003 to better comply with tax treaties and community law and then again in 2007 following the CS judgment.<sup>127</sup>

### 3.4.1 CFC-Rules and the Taxable Event

Swedish CFC-legislation is applied to domestic shareholders holding an interest in a foreign, low taxed legal entity. To qualify as a foreign legal entity according to Swedish national law the entity must be able to, under the national laws in the country of establishment, acquire rights and assume obligations, to be able to plead its case in front of a national court and to other public authorities. Furthermore, the individual owners may not have the right to freely dispose of the entity's assets.<sup>128</sup>

#### 3.4.1.1 Low-Tax Countries

According to Swedish CFC-legislation, there are two ways of determining if the income of a foreign company is subject to low taxation. There is a main rule in chapter 39a section 5 and a supplementary rule in section 7, same chapter. The main rule stipulates that a foreign entity is subject to low taxation if its profits are not taxed at all or taxed at a level that is lower than if 55 per cent of the profits had been subject to corporate taxation in Sweden.<sup>129</sup> Currently, the level of corporate taxation in Sweden is 28 percent and hence, the threshold for low taxation according to the main rule is 15,4 per cent<sup>130</sup>. When calculating the level of taxation, this should be done according to the rules in the Swedish tax legislation.<sup>131</sup> The supplementary rule states that even if a foreign entity is subject to low taxation according to the main rule CFC-legislation should not be applied if the foreign country is listed on a white list that is supplemented to the law. There are, however, activities that is not included in the exception of the white list and therefore always constitute low taxed activities if the main rule is applicable. These activities are insurance, banking and financial activities that are not aimed at a corporation with in the same grouping.<sup>132</sup>

#### 3.4.1.2 Control

Before the changes in 2003, the threshold regarding ownership in a CFC was 10 per cent for an individual shareholder and 50 per cent for a group of shareholders (in which case the 10 per cent threshold did not have to be

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<sup>127</sup> Lang (Ed) (2004), pg. 583f..

<sup>128</sup> Chapter 6 section 8 IL.

<sup>129</sup> Chapter 39a, section 5 IL.

<sup>130</sup>  $55 * 0,28 = 15,4$ .

<sup>131</sup> Chapter 39a section 10 IL

<sup>132</sup> Chapter 39a section 7 IL.

met). Since the changes, the threshold is that a shareholder must control at least 25 per cent of the shares, votes or capital alone or in an interest grouping with other Swedish shareholders.<sup>133</sup> For an interest grouping to be at hand the persons involved must be a parent and a subsidiary *or* under joint control *or* one person is an individual person that controls the legal entity which is the other part *or* if the persons in question are related.<sup>134</sup>

### 3.4.1.3 Profits

If the control threshold is met and the income of the foreign legal entity is deemed to be subject to low taxation, it constitutes a CFC according to Swedish CFC-legislation. The income of the CFC is then taxed at the level of the Swedish shareholder corresponding his share of the CFCs profits.<sup>135</sup>

### 3.4.1.4 Credits

If the CFC has been subject to corporate taxation in the foreign state, the amount paid is allowed to be deducted against the taxes levied in Sweden. Public taxes are not allowed to be deducted against the Swedish taxes.<sup>136</sup>

The result of the CFC is only attributed to the Swedish shareholder if it makes a profit. If the CFC suffers losses during a taxation year, the losses may be carried forward for three years and deducted from the CFCs profits. The carrying forward of losses is only allowed if the shareholder in question was also the shareholder when the losses occurred.<sup>137</sup>

## 3.4.2 Exceptions

As mentioned above, there is a supplementary rule that excepts a corporation from the CFC-legislation if the foreign country is listed on a white list.

Since the 2007 changes, a general exception excludes all CFCs that are situated within the EEA if the establishment is genuine and carries out an activity that is business motivated. When determining if this is the case the Swedish tax authorities examines if

- The foreign entity has resources that are necessary to carry out the business of the corporation such as its own premises and equipment in the foreign country.
- The foreign entity has personnel employed and that these personnel have the competence necessary to carry out the business of the corporation.
- That the personnel have the authority to make independent decisions regarding the business of the corporation.<sup>138</sup>

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<sup>133</sup> Chapter 39a section 2 IL.

<sup>134</sup> Chapter 39a section 3 IL.

<sup>135</sup> Chapter 39a section 13 IL.

<sup>136</sup> Chapter 16 section 19 IL.

<sup>137</sup> Chapter 39a section 6 IL.

<sup>138</sup> Chapter 39a section 7a IL.

### 3.4.3 Impact of EC-Law and the CS Case

As the Swedish CFC-rules of 2003 applied to corporations set up in several Member States and members of the EEA<sup>139</sup> the Swedish government decided to change the range of the legislation as a response to the ECJs judgment in the CS case. In the government bill of 2007 proposing the adding of the above mentioned section 7a in chapter 39a of the IL the government clarifies that the changes are brought upon by the CS judgment and the realisation that the Swedish CFC-legislation were infringing the freedom of establishment.<sup>140</sup> The wording of the new addition to the CFC-legislation is that CFCs that are established in a member State of the EEA should not be subject to the CFC-rules if the establishment is genuine and carries out an activity that is business motivated. I have already given account for the criteria for this to be applied in 3.4.2.

In the government bill, there is an extensive discussion about the interpretation of the new section 7a in relation to the ECJs statements in the CS case. The government and the several bodies to which the proposition was sent for referral debate over the burden of proof, exceptions from the main rule and the circumstances that should be specifically considered when deciding if a CFC constitute a genuine establishment.

Regarding the burden of proof, the shareholder has to prove that the establishment is genuine and carries out a business-motivated activity. Many of the organizations that the proposal was referred to claim that the placement of the burden of proof entirely on the shareholder was too far-reaching and goes against the ECJs decision. The government contradicted this and in the new CFC-rules, the burden of proof is on the shareholder.<sup>141</sup>

How the term, genuine establishment that carries out an activity that is business motivated should be phrased was also a very hot topic. Many of the organizations claimed that the Swedish government was interpreting the CS judgment too narrowly and that the term genuine establishment that carries out an activity that is business motivated was more far-reaching than the ECJ intended in the judgment.

### 3.4.4 Tax Treaties

When the CFC-legislation first was introduced in Sweden, all countries with which Sweden had a tax treaty were excluded from the rules as the Swedish legislator found that the application of CFC-rules where a tax treaty existed where against the OECD MC. When the OECD changed their guidelines in the mid-90s so did Sweden and since then CFC-legislation has not been seen as contradictory to tax treaties. When the amendments were made to the CFC-legislation in 2003 their compatibility with tax treaties were taken

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<sup>139</sup> Belgium, Ireland, Luxembourg, Netherlands, Portugal, Spain, Iceland and Lichtenstein

<sup>140</sup> Prop. 2007/08:16, pg. 16f.

<sup>141</sup> Prop. 2007/08:16, pg. 17f.

into consideration. The Swedish government found that the rules were in line with the tax treaties based on the commentaries to the OECD MC, on which most Swedish tax treaties are based.<sup>142</sup>

In the 2003 proposition, the French Schneider case is mentioned and the Swedish government considers the French court to have done a very narrow interpretation of the tax treaty between France and Switzerland. However, in chapter 39a section 7, subparagraph 3 there is an exception that exempt countries, which Sweden has concluded a tax treaty with from the application of the supplementary rule in chapter 39a section 7 regarding incomes that are included in the taxation rights of that treaty.<sup>143</sup>

### 3.4.5 Analysis

The new CFC-legislation that entered into force starting 2008 has as its main purpose to be EC concordant. The underlying reason for the changes was the ECJs decision in the CS case. As the Swedish CFC-legislation before the changes did not provide for neither an EC-exception regarding the application of the rules, nor a section that excluded genuine businesses from it was clear that something had to be done.

The specified EEA exclusion from the application of the Swedish CFC-rules is comparable to its French and German alike as it specifically targets EEA Member States. This leaves the conclusion that the Swedish CFC-legislation provides for no exception other than the white list regarding third states. Therefore, it does not differentiate between genuine or artificial business activities unless the establishment is in an EEA Member State. Concerning the requirement that a business must be genuine, this is, as discussed before, a wording that if applied in a not too narrow and not in a generally applicable way is EC approved and does not stand in the way of the freedom of establishment. However, I have discussed this earlier in the thesis and will develop my arguments further in the discussion part of the thesis and therefore I will leave the subject for now.

In a decision from the Supreme Administrative Court in Sweden that was delivered in April this year the Court found that the Swedish CFC-rules precedes the tax treaty between Sweden and Switzerland.<sup>144</sup> In Sweden, a tax treaty must be incorporated as a law to be valid and the court stated that the law regarding the tax treaty between Sweden and Switzerland does not enjoy a more prominent position than the CFC-rules and that the latter therefore are applicable. The same conclusion was met by the court in a different case regarding the tax treaty between Sweden and Luxembourg<sup>145</sup>. That the court gives the same answer in two cases can be seen as the general opinion in Swedish tax law today is that CFC-legislation precedes tax treaties. This is, in my view, a clear treaty override as it sets aside the aim of

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<sup>142</sup> Prop 2003/04:10, pg. 97f..

<sup>143</sup> Prop. 2003/04:10, pg. 98.

<sup>144</sup> RegR 2655-2005

<sup>145</sup> RegR 2472-2005

the tax treaties and provides for a very low legal certainty and a limited possibility to anticipate the tax consequences of an establishment for a corporation. The decision in the latter case were however eliminated, not because of the courts attitude towards the tax treaty/CFC-legislation question, but for EC law reasons that will be examined in the paragraph below.

In RegR 2472-2005 the Swedish Administrative Courts analyzed if the Swedish CFC-legislation infringes the freedom of establishment and if so, that infringement can be justified. The Swedish Tax Board had found in an advanced tax notice to a Swedish corporation with a subsidiary in Luxembourg that the freedom of establishment did restrict the use of CFC-legislation regarding such a scheme. The board recognized that the Swedish CFC-legislation was in fact restricting the freedom of establishment and that this restriction could not be justified. The Swedish Tax Administration appealed the decision to the Supreme Administrative Court who actually eliminated the decision. The reason behind the elimination was the ECJs decision in the CS case in combination with the 2008 amendments to the Swedish CFC-legislation. When the Tax Board delivered its decision the CS case had not yet been decided and section 7a not been incorporated into chapter 39a. Noteworthy in this case is the fact that the Tax Board actually came to the same decision as the ECJ did in the CS case. Their analysis first concluded that the CF-legislation did infringe the freedom of establishment and then moved on to analyzing if this restriction could be justified. The tax board discussed the grounds for justification in relation to already decided cases from the ECJ, and discarded both cohesion of the tax system as well as the aim of avoiding tax evasion as the rules are to generally applied. The board actually mentioned that if there had been a section, such as the 7a section that is existing today, they could have made a distinction between an artificial and a genuine establishment to decide the case at hand. Nevertheless, since there was no such section the restriction could not be justified. As mentioned above, the advanced tax notice has been eliminated and only time will tell if the case will come back to the board. If it were to do so, it would be an interesting test of the new CFC-rules in Sweden regarding EC/EEA establishments and the definition of wholly artificial arrangement.

# 4 Discussion

## 4.1 Freedom of Establishment

After the ECJ delivered its judgment in the CS case, many of the Member States revised their CFC-legislation to concur with the EC Treaty in general and the freedom of establishment in specific. However, did anything actually change? As shown by the examples in this thesis, the major change imposed by the Member States were to include a sentence stating that the CFC-legislation in question does not apply if there is a genuine business activity being carried out through the CFC. In addition to this, there are little or no changes made. The question is if the Member States that changed their CFC-legislation because of the judgment in the CS case acted to hastily and if there actually were any real changes made. In Sweden, the legal counsel, tried to draw the government's attention to the dangers of revising the legislation based on one single case from the ECJ, but were unsuccessful. As I have pointed out time and again, the mere act of excluding "genuine business activities" from CFC-rules are not, in my view, sufficient nor is it in line with the ECJs decision. On the other hand, it may be sufficient, depending how these new rules are actually interpreted and applied to a real situation. According to me, for this to happen, *(i) the definition of genuine establishment must be reasonable, (ii) it must be clear and foreseeable and (iii) the burden of proof must be determined.*

*(i) The definition of genuine establishment must be reasonable.*

In the CS judgment, the ECJ uses the terms letterbox or front subsidiary to illustrate what constitute a fictitious establishment that does not enjoy treaty protection. It is my view that for a genuine establishment to exist in another Member State, it is sufficient for that entity to carry out *some* activity, i.e. it is enough to have one or two employees present as long as they are carrying out actual activity that is relevant to for the business. Therefore, it is not likely that the German rules for example will stand up in front of the ECJ as they demand that for an establishment to be considered genuine, it must not only carry out economic activity relating to the business but it must also have its place of effective management in the foreign state. On the other hand, it cannot at all be seen as certain that the Swedish or the French rules for example are legitimate from an EC perspective even though they only apply CFC-legislation to establishments within the EU if it is a wholly artificial arrangement. The assessment of what is a fictitious and what is a genuine establishment is to be carried out on a case-to-case basis and depending on how harshly this appraisal is done the CFC-rules may or may not be EC concordant.

*(ii) The definition must be clear and foreseeable.*

Member States are free to set up demands or standards that are to be met for a national to enjoy a community freedom as long as these demands are foreseeable and not to far reaching for the individual. This can be supported

by an analogy drawn from the Courts decision in the Teleos<sup>146</sup> case were the ECJ stated that when setting up demands for the application of community legislation, in that case the sixth directive, the Member States must always take the principle of proportionality and legal certainty into consideration.<sup>147</sup> According to the principle of proportionality, the Member States must, when enforcing their domestic legislation and its means do so in the least harmful way in relation to relevant community legislation, in this case the freedom of establishment.<sup>148</sup> Regarding legal certainty, it is even more of essence that the application of community legislation, or in this case the justification of a restriction of community legislation, is clear when it concerns a possible financial consequence. In those cases, it is of utter importance that the individual is aware of exactly what is expected of him.<sup>149</sup> Both these fundamental principles of community legislation endorse a clear and objectively verifiable definition of what constitutes genuine business activity. I am most certainly aware of the difficulties that lie in applying a general and fixed definition of the term and that by doing so the Member State would in some way differentiate from the ECJs statement in the CS case that the assessment of what constitutes an actual establishment should be done on a case-to-case basis. I am on the other hand of the belief that the two can be combined. To have a fixed definition of a genuine establishment in the national legislation does not only guarantee legal certainty for the individual but also respects the freedom of establishment. The definition does not, of course, have to be written in stone but serve as a general definition that can be adjusted under certain specific circumstances. Furthermore, the Court states that the assessment should be based on objectively verifiable factors that can be ascertained by a third party.

*(iii) The burden of proof*

In the very recently decided CFC and Dividend group litigation<sup>150</sup> the ECJ points out in its order that when determining when to apply CFC-legislation and when not to it is acceptable to demand that the taxpayer provide evidence that an establishment reflects an economic reality. In the order, the Court refers to its statement in the CS case that it is the taxpayer that has the best prerequisites to prove a genuine establishment. The Court develops its argument by mentioning its judgement in the Thin Cap Group litigation<sup>151</sup> where it was concluded that:

“national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement, entered into for tax reasons alone, is to be considered as not going beyond what is necessary to prevent abusive practices where, on each occasion on which the existence of such an arrangement cannot be ruled out, the taxpayer is given an opportunity,

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<sup>146</sup> C-409/04.

<sup>147</sup> C-409/04 Teleos, para. 45.

<sup>148</sup> C401/95 Molenheide, para. 46.

<sup>149</sup> C-326/85 Netherlands vs Commission, para. 24.

<sup>150</sup> C-201/05.

<sup>151</sup> C- 524/04.

without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that arrangement “<sup>152</sup>

The conclusion that can be drawn from this is that it is acceptable for the national legislators to set up a demand that the individual taxpayer must provide the tax administration with proof regarding if the CFC is fictitious or genuine establishment. Again, this strengthens the legal certainty as well as provide for an EC concordant application of national legislation.

To sum it up, the changes made by Member States to their CFC-legislations after the judgment in the CS case have, in my opinion, not changed anything in reality. The Member States still face an imminent risk of getting their national legislations rejected by the ECJ if the interpretation of wholly artificial is made too narrow. As mentioned in the introduction to this thesis, the field of EC tax law is still at an early stage and develops and changes as new cases are presented by the ECJ. In the minutes of the Swedish legal council from the implementation of the new CFC-rules<sup>153</sup>, the council points out the same thing. The council further stress the fact that even though the ECJ had delivered its judgment in the CS case, the procedural rules following this were likely to be clarified by the Court in later judgments. This development has already started as could be seen in the CFC and Dividend Group Litigation case where a clarification of how the burden of proof could be divided was provided. My hope for a future decision from the ECJ would be a clearer definition of what constitutes abusive behaviour in general, and wholly artificial arrangement regarding CFCs in specific.

Regarding other areas of taxation where the concordance with the Treaty were unclear the Court have through its judgments given Member States the tools to interpret and apply their national legislations without infringing their community obligations. One example of this is, in my view, the area of cross-border dividends in which the Court through its case-law<sup>154</sup> have constructed a framework of does and don'ts which it is now leaving up to the Member States to interpret. Stressing that there must be an individual assessment in each case and making sure that there is no disadvantages for individuals investing in other Member States. This is much alike the reasoning and development that can be seen in the CS case as well as in the CFC and Dividend Group Litigation case. Perhaps the Court in the Vodafone2 case that is pending before it will provide further clarification.

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<sup>152</sup> C-524/04 Thin Cap Group Litigation, para 82.

<sup>153</sup> Protokoll från lagrådet 2007-10-03.

<sup>154</sup> C-319/02 Manninen, C-265/04 Bouanich, C-513/04 Kerckhaert-Morres, C-292/04 Meilicke.

## 4.2 Tax Competition, Abuse and Wholly Artificial Arrangements in the EU

In my view, there is a need for a clearer definition of what constitutes tax avoidance and is a wholly artificial arrangement. This definition is not only highly needed regarding CFC-legislation but in numerous fields of EC tax law. The discussion on fictitious arrangements and the abuse of community freedoms have arisen in the past years and have probably not reached its peak. Because of the recent years discussion the Commission released a communication regarding anti-abuse measures in direct taxation within the community in December 2007<sup>155</sup>. The goal of the communication was to analyze and, hopefully, outline ways for Member States to find a balance between combating abuse and protecting their national tax base while at the same time observing their obligation to respect the EC Treaty. The lack of a common level of taxation in the EU has led to Member States using their levels of taxation as a way of attracting companies and investors. Of course, this leads to a loss of tax revenue in other Member States as investors and companies turn to the Member States with a lower level of taxation. As a way of compensating for this loss, many Member States have anti-abuse rules such as CFC-legislation. The ECJ have however stated that the mere fact that a national of one member State choose to establish himself in another Member State simply because that Member State have a more preferential legislation does not, in itself constitute abusive behaviour.<sup>156</sup> The Court have in the same way concluded that even though the underlying reason behind an establishment in another Member State is to achieve a lower level of taxation, this does not constitute abuse. Abuse of community legislation or, as this thesis concerns, the freedom of establishment only exists if the establishment is fictitious. In my view, this would mean that for an establishment *not* to enjoy treaty protection and therefore be regarded as artificial, it cannot exist at all. This meaning that since there are not fixed limits or guidance to be found in community legislation regarding what constitute an establishment it would be sufficient to have at least one or two employees or other function in the low-tax Member State for an establishment to exist. This view is supported by the ECJ in the CS case where it is pointed out that it must be an actual establishment carrying out economic activity and that this must be objectively verifiable by a third party. The Court also mentions the terms letterbox or front subsidiary<sup>157</sup> indicating, I believe, that the only way for an establishment not to enjoy treaty protection is if it have not been covered by it in the first place, i.e. if it is a fictitious establishment that only exist on paper. I believe this conclusion also can be drawn from the Commissions communication when it states that “for anti-abuse rules to be justified, they must be confined to situations in which there is a *further* element of abuse”<sup>158</sup>.

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<sup>155</sup> COM (2007) 785 final.

<sup>156</sup> See for example C-212/97 Centros, para. 27.

<sup>157</sup> C-196-04 Cadbury Schweppes, para. 67 & 68.

<sup>158</sup> COM (2007) 785 final, pg. 4. Italic by me.

## 4.3 Tax Treaties

The conflict between tax treaties and CFC-legislation becomes evident when a Member State imposes CFC-rules on the profits of a CFC established in another Member State with whom they have a tax treaty. Normally a tax treaty that is drawn up according to the OECD MC stipulates that incomes should be taxed where it arise. By taxing the profits of a CFC in the home state of the shareholder, the tax treaty is being pushed aside and there is a treaty override. In this thesis it has been shown that the four Member States used as examples have all, more or less explicitly, claimed that their national CFC-legislation precedes tax treaties. The only example of the contrary is the French Schneider case, but since that, the French legislation has changed. The re-defining of the profits of a CFC to a deemed dividend, as the UK does it or to simply claim the superiority of CFC-legislation over tax treaties as Sweden go about it is, in my view, a clear case of treaty override. This as (i) *the purpose of entering a tax treaty is to avoid double- or non-taxation and (ii) the purpose of CFC-legislation is to fight tax avoidance and combat abuse.*

*(i) The purpose of a tax treaty is to avoid double- or non-taxation.*

When CFC-legislation is applied to the profits of a CFC it does not override a tax treaty in such a way that the right of taxation for the other contracting state is eliminated, but rather a form of double taxation is at hand. The home state of the CFC still has the right to taxation, and applies this right to the profits of the CFC. In addition to this, the deemed dividend, which is equal to the profits of the CFC is taxed at shareholder level in the other contracting state. The UK, for example justifies this by re-defining the profit of the CFC to a deemed dividend which is taxable under British rules as the dividend is an income of the British shareholder. Quite similar, but a bit more subtle are the French CFC-rules as they tax the income of subsidiaries<sup>159</sup> as income of the parent company which has as the result that the deemed dividend falls outside the scope of tax treaties<sup>160</sup> and is taxable at the level of the beneficiary, that is the parent company. This goes against the sole purpose of entering a tax treaty and double taxation is at hand as well as, in my view, a treaty override. If a mere re-labelling of the profits arisen in a CFC is enough for a tax treaty to be set aside and a double taxation to take place. What is then the use of tax treaties as an instrument for avoiding just this and to allocate the taxation rights? Furthermore, this treaty overriding behaviour leads to little or no legal certainty for the individual taxpayer as there is no possibility to foresee the tax consequences of an establishment in another Member State.

I believe that it is the “extra-ordinary” situations such as the use of low-tax regimes or set-ups that call upon a tax treaty to conclude the right of taxation, not the more common and non-complicated situations that usually is regulated in domestic tax legislations anyway. If tax treaties are

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<sup>159</sup> PEs are not included.

<sup>160</sup> It becomes “other income” according to the OECD MC article 20.

overridden by anti-abuse legislations such as CFC-rules then there is no use for them as they provide little more than basic guidance, which would have been found anyway, and they provide no ability to foresee tax consequences nor do they provide legal certainty.

*(ii) The purpose of CFC-legislation is to fight tax-avoidance and combat abuse.*

The sole purpose of CFC-legislation is to fight tax-avoidance. The question is how there can ever be any tax-avoidance if there is an existing tax treaty between two Member States that allocate the right of taxation. Sure, there is a loss in tax revenue if taxpayers chose to establish themselves in other Member States, but then there is an increase in tax revenue in that Member State instead. I do not believe that this is a valid reason for overriding a tax treaty and apply CFC-legislation. If Member States are to set aside the entire application of tax treaties and claim the right of taxation according to their CFC-legislation the entire purpose of concluding a tax treaty is in vain.

The big question mark is, however, how to solve these treaty-overriding situations. Of course, the best solution would be to conclude the presidency of tax treaties over national legislation, or the other way around, so there is a clear hierarchy. The outlook for this being done is slim however as there is no court or other instance that can lay down the law, so to speak. The ECJ will not give an answer as how to interpret or apply a tax treaty, as the Court does not believe it falls within their competence<sup>161</sup>. As we have seen in the *Bricom* and the recently decided *Swedish* cases<sup>162</sup>, national courts are bound to look out for their own interests and opt for an application of CFC-legislation over tax treaties.

## 4.4 Conclusion

A classic answer to legal questions is “it depends”, an answer that is highly relevant when it comes to the amended CFC-legislations compatibility with the freedom of establishment. For while I have my doubts to whether the amended rules would pass an examination by the ECJ this is highly dependent of how the rules are applied to an intra-community establishment. As pointed out throughout this thesis, the changes imposed by the Member States are changes that can be interpreted and applied in numerous different ways depending on the context of the situation. I have opined for the laying down of a clearer and more static definition of what constitutes abuse or a wholly artificial situation as a way of strengthening the legal certainty. A clarification of what demands that are to be met for an establishment to enjoy treaty-protection issued at community level would be extremely valuable in the drawing up of future CFC-rules as well as for companies thinking about an establishment in another Member State. That the commission did not try to do this in their communication of December last year is incomprehensible to me. A clarification at community-level would

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<sup>161</sup> C-298/05 *Columbus Container*, para. 47.

<sup>162</sup> RegR 2655-2005 and RegR 2472-2005

serve as a foundation for the various national legislations and give guidelines as to what constitutes a reasonable level of demands on an establishment for it to enjoy treaty-protection. As I have stated earlier in this thesis I am of the firm believe that if an establishment is defined as an establishment within the EU and enjoys treaty-protection it can never constitute an artificial establishment. In such a case, the application of CFC-legislation would be infringing the EC Treaty and therefore not be allowed.

Within the EU, Member States have agreed upon creating a unified market and as long as that market is not harmonized tax-wise, there will be competition between Member States when it comes to attracting businesses and the levels of corporate taxation will be used as a mean in that competition. In my view, CFC-legislation, when applied to an actual establishment, is always infringing the freedom of establishment as well as overriding an applicable tax treaty. It is not possible to give residents in the EU the freedom to establish themselves in either Member State of their choice and then punish them as they exercise that right. If CFC-legislation is not abolished altogether it has to be redefined and adjusted to the more mobile EU that presents itself before the Member States today. The solution to the problem, in my opinion, can be found in the laying down of a clearer and more static definition of the term “genuine establishment”, and the burden of proof regarding these demands. Such a definition would give the corporations involved in establishments in other Member States a comprehensible apprehension of what is expected of them and would lead to lower administrative costs for the national tax administrations, as it would provide for a more generic way of defining an actual CFC.

As an attempt to answer my own question, that is if the changes made by the Member States to their national CFC-legislations as a reaction to the CS judgment serve their purpose to be more concordant with the freedom of establishment, the answer would have to be, it depends. The relationship between anti-abuse legislation such as CFC-rules and the EC Treaty is a constant balance act between the Member States obligation to follow the EC Treaty and their unwillingness to accept a loss of tax revenue. I opt for a clearer guidance regarding what constitutes an establishment issued at community level followed by a definition and rules regarding the burden of proof at a national level in the respective CFC-legislations. This would lead to high level of legal certainty as well as lowering the administrative costs and, I believe, minimise the situations classified as abuse of community legislation. Nevertheless, as I have pointed out, it depends.

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