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AG Opinion in the X-GmbH case on German CFC rules in the light of the Standstill clause

Free Movement of Capital – Third Countries - Standstill clause – CFC provisions – Direct Investments

On June 5, 2018, Advocate General (AG) Paolo Mengozzi of the Court of Justice of the European Union (CJEU) published his opinion in the X-GmbH case (C-135/17). The case concerns the derogation from the prohibition on restrictions to the free movement of capital with non-EU countries (also referred to as the 'Standstill Clause'), and its application to the German controlled foreign company (CFC) rules. The AG considered that the German rules are in line with EU law, as they fall within the scope of the Standstill Clause and that the restriction to the free movement of capital may in any case be justified by the need to guarantee the balanced allocation of powers to tax and the effectiveness of fiscal supervision.

Background

The case concerns a German parent company holding a 30% participation in a subsidiary located in Switzerland. The Swiss subsidiary, having mainly passive income, qualified as a CFC according to the German Foreign Tax Act. The tax authorities therefore increased the parent company's profits in 2005 and 2006 with the passive income derived by the Swiss entity. The taxpayer challenged this assessment arguing that the German provisions are contrary to the free movement of capital and that the Standstill Clause is not applicable.

Article 64(1) TFEU (the Standstill Clause) allows a derogation from the prohibition on all restrictions existing on December 31, 1993 to the free movement of capital between Member States and third countries, where such capital movements involve direct investment, establishment, the provision of financial services or the admission of securities to capital markets. In the case at hand, the German provisions under review were amended comprehensively in 2000. However, these amendments were abolished in 2001 before they actually became applicable. In addition, the 2001 reform reduced the shareholding threshold

for passive intermediary companies qualifying as CFC from 10% to 1%. As a consequence, the question arose whether this series of amendments was liable to affect the applicability of the Standstill Clause.

The AG opinion

The AG first examines the German CFC provisions in light of a possible restriction to the free movement of capital. Relying on settled case law, he initially observes that any restriction to the fundamental freedoms must be assessed in light of the free movement of capital. As the German CFC rules do not apply exclusively to situations in which the parent company exercises decisive influence over its subsidiary, there is no need to assess whether this is effectively the case in the circumstances at hand. The German company may therefore rely on the free movement of capital, which is applicable to dealings with non-EU countries, contrary to the freedom of establishment. As the German CFC rules only apply to cross-border situations by definition, the AG further concludes that the German provision in question clearly constitutes a restriction to the free movement of capital.

The AG then examines whether the Standstill Clause is applicable, arguing that its scope does not depend on the specific purpose of the German rules, but on its effect on the movements of capital in scope of the Standstill Clause (i.e. time and materiality requirements). Considering that the time-related requirement is fulfilled (i.e. the restriction already existed on December 31, 1993), the AG recalls that although formally amended, the limitations provided for by the German CFC rules have been applicable without interruption to qualifying non-EU resident companies since 1993. As regards materiality (i.e. the restriction applies to direct investments), the AG considers whether the 2001 amendment to the qualifying shareholding threshold, which extends the scope of the German CFC rules to portfolio investments, is liable to result in the non-applicability of the Standstill Clause. In line with previous case law, the AG concludes that the Standstill Clause is applicable to cases involving a direct investment, irrespective of the fact that the German legislation applies to both direct and portfolio investments. As the case at hand involves a 30% shareholding, which would allow the German company to participate effectively in the management of its Swiss subsidiary, the AG suggests that the Standstill Clause should be applicable. However, it is for the referring court to confirm in each individual case whether a direct investment is concerned.

If the CJEU considers that the standstill clause is not applicable, the AG turns to examining possible justifications of the restriction to the free movement of capital. He first observes that the situation of a German parent company having a subsidiary in a third country and the situation of a German company with a domestic subsidiary are objectively comparable. The AG then assesses possible justifications by overriding reasons of the public interest. He first rejects the need to prevent tax evasion as a possible justification, arguing that the German CFC rules do not target purely artificial arrangements, but apply generally, on the basis of an irrefutable presumption of tax evasion. As regards the aim to preserve the balanced allocation of powers to tax and the effectiveness of fiscal supervision, the AG argues that the application of CFC rules in the present case may be justified, unless a bilateral framework exists between Germany and Switzerland that provides for the exchange of information in tax matters. However, it is for the referring Court to determine whether such a framework exists.

EU Tax Centre Comment

The AG opinion sheds some light on the application of the Standstill Clause, which seems to

be largely in line with recent CJEU case law. However, it remains to be seen whether the CJEU will follow his assessment that the limitations provided for by the German CFC rules have been applicable without interruption since 1993, considering the 2001 amendment to the qualifying shareholding threshold.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre or, as appropriate, your local KPMG tax advisor.

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