CJEU decision in the X-GmbH case on German CFC rules in light of the Standstill clause

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

On February 26, 2019, the Court of Justice of the European Union (CJEU) rendered its decision 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 CJEU mainly left it to the referring court to assess whether the German rules are in line with EU law, considering first whether they fall within the scope of the Standstill Clause, and secondly whether they are proportionate in light of the pursued objective to prevent tax avoidance.

Background

The case concerned 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 does not apply.

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 comprehensively amended in 2000. However, these amendments were abolished in 2001 before they actually took effect. In addition, the 2001 reform reduced the shareholding threshold for passive

intermediary companies qualifying as CFCs from 10% to 1%. As a consequence, the question arose whether these amendments could affect the applicability of the Standstill Clause.

The CJEU decision

Referring to settled case law on this matter, the CJEU first observed that a restriction on the free movement of capital involving direct investments in a third country, which has continuously existed since December 31, 1993, is covered by the Standstill Clause. This conclusion remains valid even if the scope of that restriction was later extended to cover shareholdings that do not involve direct investments. As a consequence, the German reform reducing the shareholding threshold for passive intermediary companies qualifying as CFCs from 10% to 1% does not in itself affect the applicability of the Standstill Clause.

The Court then addressed whether the applicability of the Standstill Clause to the German CFC regime is affected by substantial modifications to the existing legislation, which although entering into force on January 1, 2001, were repealed before being applied in practice. The Court ruled that amendments that were abolished before they took effect are not in principle likely to limit the applicability of the Standstill Clause. However it is for the referring court to assess whether, in the case at hand, the 2000 reform of the German rules was adopted together with provisions effectively deferring the applicability of that reform, despite its entry into force.

Finally the Court confirmed that the German CFC rules constitute a restriction to the free movement of capital that may be justified by overriding reasons in the public interest, in particular the need to prevent tax evasion. In that respect, the Court noted that the German legislation introduces an irrefutable presumption of abuse, which in principle is not proportionate. However, the obligation for Germany to offer taxpayers an opportunity to provide commercial justifications for their arrangements should be seen in light of the possibility for the German tax authorities to verify the information thus provided. As this case involved a CFC resident in a third country, the Court concluded that it is for the referring court to assess whether a legal framework exists between Germany and Switzerland that provides the German tax authorities with an effective means to verify the accuracy of any information that may be provided about the Swiss CFC.

EU Tax Centre comment

The CJEU sheds some light on the application of the Standstill Clause, in particular regarding whether the German CFC rules have applied continuously since 1993, considering the 2001 amendment of the qualifying shareholding threshold. It remains to be seen how the German Federal Finance Court will rule on this issue. It is also worth noting that the second part of the decision is broadly in line with previous CJEU case law on the restriction of the free movement of capital involving third countries.

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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