

Lower tax court rules on pre-2016 taxability of CFC income for trade tax purposes

Lower tax court of Baden-Wuerttemberg considers CFC income exempt from trade tax in years up to and including FY 15, and questions whether subjecting such income to trade tax in subsequent years is compatible with EU law.

In two decisions dated 8 May 2018, the lower tax court of Baden-Wuerttemberg held that passive income of a wholly-owned, low-taxed foreign subsidiary imputed to a German resident taxpayer under the German controlled foreign company (CFC) rules is not subject to German trade tax in fiscal years (FYs) up to and including FY 15. As discussed further below, taxpayers that previously have been assessed trade tax on CFC income may consider challenging their assessments based on these decisions. The decisions are in line with a 2015 decision of the Federal Tax Court (BFH), in which the BFH ruled that CFC income constitutes deemed income of a foreign permanent establishment (PE) for German tax purposes and, thus, is not subject to German trade tax because it is not considered income of a German PE (see GTLN dated [05/19/2015](#)).

The BFH's decision led to a change in the Trade Tax Act in 2016. Under the revised trade tax rules, any such CFC income is deemed to be German-source income, and therefore is subject to trade tax. There had been controversy over whether the new rules were introduced merely for clarification purposes or constituted a fundamental change in German tax law, which would mean that they may be applied only as from FY 16. The German tax authorities took the position that the rules were introduced only for clarification purposes, and therefore may be applied retroactively.

In contrast to the German tax authorities' view, the lower tax court of Baden-Wuerttemberg ruled in the two May 2018 decisions that the 2016 rules constituted a fundamental change in German tax law, and accordingly may not be applied retroactively, but only as from FY 16. As a consequence, the lower tax court of Baden-Wuerttemberg concluded that CFC income is tax exempt for German trade tax purposes in FYs before 2016. The lower tax court also questioned whether subjecting CFC income to trade tax for years after FY 2015 is compatible with the free movement of capital principle under EU law.

The two cases were referred to the BFH, and the appeals are pending. Affected taxpayers that previously have been assessed trade tax on CFC income should review and consider challenging their assessments to potentially benefit from the lower tax court's decision. It should be noted that CFC income and the trade tax exemption are included in different assessments, so taxpayers may need to monitor (and possibly challenge) different assessment notices for a single year to obtain adequate legal protection.

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