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German Tax and Legal News

MOF publishes decree extending application of substance-based exception to German CFC rules

Non-EU/EEA resident companies may qualify for substance-based carve-out, provided certain conditions are met.

The German Ministry of Finance (MOF) published guidance in the form of a decree on 17 March 2021 extending the substance-based carve-out (under section 8 (2) of the current German Foreign Tax Act (FTA)) from the application of the controlled foreign company (CFC) rules to companies that are resident in a non-EU/European Economic Area (EEA) country, provided certain conditions are fulfilled. The guidance, which applies to all open cases, was issued in response to two federal tax court (BFH) decisions (dated 22 May 2019 and 18 December 2019) in which the BFH stated that the German CFC rules must be interpreted in light of the EU principle of the free movement of capital under the Treaty on the Functioning of the European Union and that the substance based carve-out rule also must be applied to companies that are resident in a non-EU/EEA country.

Under the German CFC rules, low-taxed passive income of a German-controlled foreign company generally is subject to German income taxation at the level of the German company, regardless of whether the income is distributed. “Low taxation” under the CFC rules means an effective tax rate of less than 25%, and whether income is passive must be determined based on a list of activities provided by the FTA. Under section 8 (2) of the FTA, an exception from the CFC rules applies in a case where EU/EEA companies have sufficient substance and activities in their jurisdiction of residence. In line with the jurisprudence of the BFH, the MOF decree published on 17 March 2021 extends the application of the substance based carve-out provision under section 8 (2) of the FTA to non-EU/EEA resident companies, provided certain conditions are met.

In addition, the decree provides additional insight into how the tax authorities determine whether there is an actual economic activity, i.e., sufficient substance and activities at the level of the foreign company for purposes of the substance-based carve-out. The substance requirements described in the decree must be fulfilled with regard to the activity that triggers the passive income.

The MOF decree states that the German taxpayer also must prove that its participation in the foreign company is not based on a purely artificial arrangement. A purely artificial arrangement generally is presumed to exist in a structure where the primary objective, or one of the primary objectives, is the artificial transfer of profits generated through activities carried out in an EU/EEA member state to a low-tax jurisdiction outside of the EU/EEA. The MOF, therefore, requires that the taxpayer provide sound business reasons (i.e., non-tax reasons) for the participation in the foreign company. In the MOF’s view, this includes an obligation to provide proof that none of the main purposes of the shareholding in the foreign company is to achieve a tax benefit.

In the case of participations in non-EU/EEA resident companies, the decree states that to benefit from the substance-based carve-out provision, the authorities of the foreign jurisdiction where the company is resident must have an obligation to provide sufficient information to the German tax authorities to allow them to assess whether the conditions of section 8 (2) of the FTA are met. If no such obligation exists, the decree states that EU law does not require the German tax authorities to apply the substance-based carve-out provision to a non-EU/EEA resident company.

The decree lists five different situations where an obligation to provide sufficient information to the German tax authorities is considered to exist, and states that the mere existence of a tax treaty with a given jurisdiction is not sufficient. The situations described in the decree are the following:

- Where article 5 of the EU directive on administrative cooperation in the field of taxation (2011/16/EU) applies;

- Where there is an applicable tax treaty that contains an exchange of information article comparable to article 26 of the 2017 OECD model tax treaty (a comprehensive exchange of information clause);
- Where there is an applicable tax information exchange agreement (TIEA) that provides for rules similar to article 5 of the OECD model TIEA;
- Where articles 4 and following of the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters (as amended in 2010) apply; and
- Where there is an applicable bilateral agreement that includes comparable provisions to those shown in appendix 1 to the MOF decree dated 29 May 2019 (published in the Federal Tax Gazette, part I, page 480).

The existence of a comprehensive obligation to provide information to the German tax authorities also requires the relevant foreign jurisdiction to have properly implemented an agreement mentioned above into its domestic law. The foreign jurisdiction must confirm upon a request from the German tax authorities that the information provided by the taxpayer is true and correct. The MOF decree provides that a statement by the foreign jurisdiction that no conflicting information provided by the taxpayer is available will not be viewed as sufficient.

As noted above, the guidance provided by the MOF in the decree applies to all open cases.

The guidance provided by the MOF should not come as a surprise, as the BFH's jurisprudence (in addition to jurisprudence of the Court of Justice of the European Union) paved the way for the extension of the application of section 8 (2) of the FTA to companies that are resident outside of the EU/EEA. The potential application of the substance-based carve-out provision to US subsidiaries of a German taxpayer is of particular relevance, due to the content of article 26 (exchange of information and administrative assistance) of the Germany-US tax treaty and its comparability with article 26 of the OECD model tax treaty. However, it should be kept in mind that a significant overhaul of the German CFC rules has been proposed (expected to become effective as from 1 January 2022) and the draft law is currently pending in the legislative process.

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