An overview of CFC rules in key EU countries and an analysis of cross-border planning structures to avoid the application of CFC rules

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CFC Rules - General

- Altogether nine EU countries have CFC rules, these being:

Germany	Denmark
UK	Finland
Italy	Sweden
France	Portugal
Spain	

Today we will focus on the first five of these countries

CFC Rules - General

- The CFC rules generally apply to apportion a foreign company’s income to the parent company and to subject it to current taxation in the parent company’s country without reference to a dividend distribution

CFC Rules - General

- Some of the CFC rules within the EU include exemptions for EU entities, with the exception of the UK, Danish and German CFC rules which also apply to EU entities
- The EU compatibility of the UK rules is currently before the ECJ (Cadbury's Case) with potential consequences for Denmark and Germany as well

CFC Rules - General

- The CFC rules in European countries often follow a similar pattern of
  - evaluating the nature of activities
  - assessing the shareholder threshold, and
  - ascertaining the existence of a “low” tax
- In calculating the “low” tax rate the CFC rules often require the income to be re-calculated based on their country’s own tax accounting principles

CFC Rules - General

- Some countries work with a “black list” of harmful countries, such as Italy, which includes certain specified EU territories or entities including Malta, Cyprus and Luxembourg
- Some jurisdictions exempt listed countries from the CFC rules

CFC Rules - Germany

- Current CFC rules
  - Income received by a German shareholder from a foreign company is taxed under the German CFC rules if all of the following conditions apply:
    - German-resident shareholders either alone or together own more than 50% of the foreign company, or in the case of passive investment income, any single German-resident shareholder holds at least 1% of the company (or even no reference to a minimum shareholding in some cases)
    - The foreign company realizes passive income
    - The income is subject to “low tax” at a rate of less than 25%
  - There is no exemption for EU companies

CFC Rules - Germany

- Recent changes to German CFC rules
  - Significant changes were made to the German CFC rules from 1991 – 1996 in order to catch the Irish “Dublin Docks“ investments
  - As of 1 January 2001, the “low tax” rate was reduced from 30% to 25%
  - Since 1 January 2002, taxes paid by the foreign company in a third country will be taken into account in ascertaining the 25% tax rate

CFC Rules - Germany

- Recent changes to German CFC rules
  - Since 1 January 2003
    - Treaty protection for CFC income was dropped for all types of income (previously protection was lost for passive investment income only) (full treaty override)
    - Extension of the branch “switch-over” clause to all types of income
  - New comprehensive guidelines issued on 14 May 2004 replaced the old guidelines originally issued in 1994

CFC Rules - UK

- Under UK tax law a CFC is any company
  - Which is resident outside the UK, and
  - which is subject to tax at a lower level, and
  - which is controlled (more than 50%) by UK residents (can be 40% in certain JV structures)

CFC Rules - UK

- A “lower level” tax is given if the amount of tax suffered is less than three-quarters of the “corresponding UK tax”. As the UK tax rate is 30%, this means that the foreign co’s tax rate must amount to at least 22.5%

CFC Rules - UK

Exemptions

1) Excluded countries regulations (i.e. the foreign company is resident in a non-tax haven country)
2) Motive test (UK tax avoidance is not the main motive for the existence of the foreign company)
3) Acceptable distribution policy (at least 90% of net profits are distributed with 18 months)
4) Publicly quoted companies (more than 35%)
5) Nature of primary activity (exemption for trading companies)
6) De minimis exemption (£ 50,000)

CFC Rules - France

- Current French CFC rules render any income realized by a foreign vehicle taxable in France when:
    - Special ownership tests are met; and
    - A low level of taxation applies
    - Unless specific conditions for exemptions are met

CFC Rules - France

- Special ownership tests
  - Holding threshold of more than 50% of the capital or voting rights of the foreign vehicle
  - 50% ownership may be direct or indirect (notably through a “community of interests”)
  - Reduction of the holding threshold to 5% when:
    - the CFC entity is controlled by more than 50% by French entities, acting jointly in the case of a listed company
    - the CFC entity is held by entities that are under control by, or that exercise control over, the French entity

CFC Rules - France

- Definition of a low-tax jurisdiction
  - Tax liability lower than 50% of what would be due in France
  - Exemptions
    - EU exemption: French CFC rules are not applicable to EU entities unless the French tax administration can demonstrate that they are part of an artificial arrangement aimed at circumventing the French tax legislation
    - Safe harbor clause: CFC rules are not applicable to entities deriving income from commercial or industrial operations effectively carried out within the territory of the country where they are established / incorporated

CFC Rules - France

- Exemptions
  - There is an additional requirement for non-EU structures to demonstrate that the activities carried out by the foreign entity do not have tax avoidance as a principal effect, when the foreign entity derives:
    - More than 20% of its profits from tainted passive income (i.e., income derived from the management of financial assets for its account or on behalf of related entities and/or income or gains derived from the management of intangible rights), or
    - More than 50% of its profits from tainted passive income and revenues derived from services provided to related entities

CFC Rules - Spain

- Under the Spanish CFC rules income derived from foreign subsidiaries will be subject to CFC taxation in Spain if:
  - A Spanish taxpayer holds 50% or more of the foreign company
  - The corporate tax effectively paid is less than 75% of the Spanish tax, and
  - The foreign company realizes passive income

CFC Rules - Spain

- The CFC rules do not apply to an EU resident company unless included in the “black list” (e.g. Luxembourg 1929 companies)
- Certain safe harbor rules may exclude the pick up of income under the CFC rules (passive income does not exceed more than 15% of the foreign co’s total net income or 4% of total reserves)

CFC rules - Italy

- CFC rules apply from FY 2002
  - Initially applicable to controlled companies only
    - 50.1% vote
    - Dominant influence
    - De facto control (contracts, BoD, etc.)
  - Extended to "related" companies from FY 2004 (but not yet in force!)
    - 10% profit participation for listed companies
    - 20% profit participation for unlisted companies
    - Notional taxation method possible as an alternative to actual income computation under local accounting rules

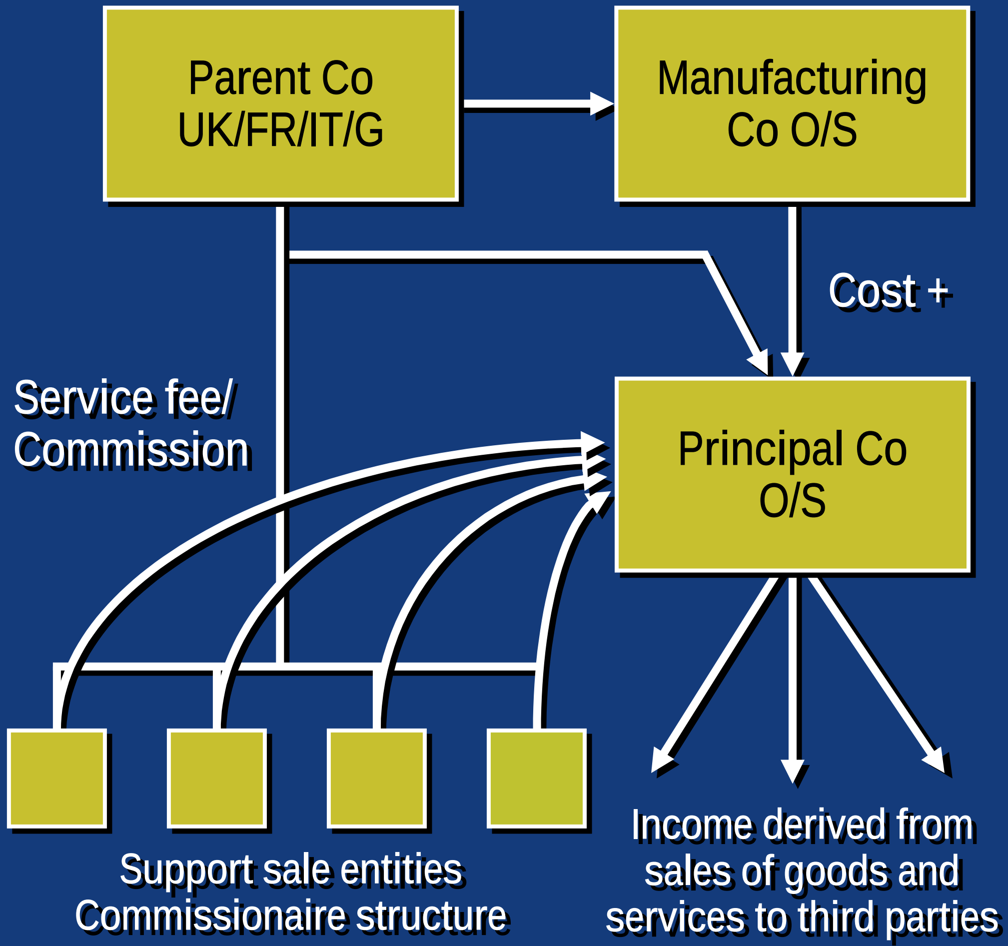
CFC Rules - Italy

- CFC rules based on jurisdictional approach
  - Blacklisted territories
  - Two exceptions – ruling mandatory to qualify
    - Same country
    - High tax in non-tax-haven location

Comparative Analysis of Cross-Border Planning Structures

- Overview:
  - Principal/commissionaire
  - Finance branch of a trading company
  - Belgian notional interest
  - Split ownership
  - Listed Offshore
  - Maltese/Aruban Imputation Credit

Planning Around the Nature of Income – Principal/Commissionaire Structure



United Kingdom

- Structure is difficult, though possible from a UK perspective

Italy

- Subject to CFC if principal is black-listed unless active business exception applies – ruling mandatory

Germany

- The trading income of the principal is out of the scope of the CFC rules assuming the manufacturing company is not taxable in Germany and the goods are sold by the principal direct to the third party customers