

# CFC RULES: A GREEK PERSPECTIVE

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## 1. Introduction

Harmful tax competition is a deep-seated problem, mostly achieved through the incorporation of intermediary companies in a state other than the taxpayer's state of residence with the aim of achieving a more favourable tax outcome. There is also a problem known as "treaty shopping" or "Directive shopping", when the taxpayer is trying to take advantage of the benefits of a tax treaty or a Directive as regards mostly royalties, interest and dividends. There is a lack of harmonisation in direct tax matters, other than through the intervention of the CJEU; as a result the Directives between each member state vary considerably. It should be mentioned that the abuse of law phenomenon has its roots in the indirect tax area, in cases like Halifax<sup>2</sup> and RBS Deutschland (RBSD)<sup>3</sup>. In the first case, the Court said that abusive practices exist if the transactions are contrary to the purpose of the VAT Directive<sup>4</sup> and highlighted that

*"It must be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage".*

In RBSD the Court's decision was similar, with the exception that RBSD, contrary to Halifax, was involved in legitimate tax planning by taking advantage of the mismatching in the interpretation given to the VAT Directive by the UK and

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<sup>2</sup> ECJ, 12 Feb.2006, Halifax plc, Leeds Permanent Development Services Ltd and County Wide Property Investments Ltd v Commissioners of Customs & Excise ("Halifax"), [2006] I-1609.

<sup>3</sup> ECJ, 22 Dec. 2010, Case C-277/09, The Commissioners for her Majesty's Revenue & Customs v RBS Deutschland Holdings GmbH (RBD Deutschland), [2010] ECR I-0000.

<sup>4</sup> Council Directive 2006/112/EC of 28 November 2006 on the common system of Value Added Tax.

Germany; the UK regarded the rental payments as services and thus taxable in Germany, while Germany regarded them as supplies of goods taxable in the UK. The Court in that case accepted that this was a completely acceptable tax planning, whereas in *Halifax* it concluded that the transactions were aiming at taking advantage of the VAT Directive.

Going back to the problem of “treaty shopping”, the Organisation of Economic Development and Cooperation (OECD) clarifies in article 1 of the OECD Model Tax Convention that only residents of a Contracting State are entitled to the benefits of the tax treaties, by referring to both legal and natural persons.<sup>5</sup> Therefore, taxpayers who want to take advantage of a specific tax treaty establish a company in a member state party of that specific treaty, which is, in most cases, a shell or a letterbox company, and enjoy the benefits of that treaty; the benefits are usually more beneficial withholding taxes on the income derived. Similarly, as regards “Directive shopping” when a non-resident derives passive income from a EU member state, the taxpayer is going to derive this income more beneficially from the state where he establishes the company than from the state of residence. Countries that want to secure the benefits of their tax treaties concluded with other countries can do so by imposing a limitation on benefits clause (LoB clause) and thus hinder the tax planners from taking advantage of their tax treaty. This clause was examined in detail in *ACT IV GLO* judgment<sup>6</sup> where a tax credit was granted if the ultimate shareholders were residents in the UK or in a member state that had concluded a double tax convention with the UK containing a provision extending the tax credit. The tax credit was denied to companies that were residents of another member state.<sup>7</sup> Therefore, countries can protect their double tax conventions by imposing such a clause and secure their tax treaties.

It should not be overlooked that the base erosion of the resident state by multinational enterprises and the transfer of business profits to countries with preferential tax regimes entails the reduced tax burden of these enterprises and simultaneously and unavoidably the excessive and disproportionate taxation of other categories of taxpayers. This constitutes a disincentive for the last as far as their business activity is concerned and it also distorts competition substantially. There is moreover the danger of major reputational risk of multinational enterprises, especially when after all these arrangements, the tax base is very low

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5 OECD Model Tax Convention Article 1.

6 ECJ, 12 Dec. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*, (“ACT IV GLO”), [2006] ECR I-11673.

7 Tom O’Shea, ‘Limitation on Benefit (LoB) clauses and the EU part I’ [2008] ITR 2,1.

and it is also likely that business enterprises will face comparative disadvantages in a multinational environment.

The OECD 1998 Report on Harmful Tax Competition emphasised that harmful tax competition reduces significantly the global welfare and undermines the taxpayer's confidence in the integrity of tax systems. The OECD is trying to protect and promote a multilateral trade system by taking into account the changing nature of international trade and its relationship with investment and taxation. There is an urgent need for direct measures in order to strengthen an international coordinated action in this field. Furthermore, as this is a global issue, the more countries involved, the greater the effectiveness of the solutions proposed by the OECD. The pace that globalisation moves is extremely speedy and multinational enterprises are continuously developing new global strategies making their links with other countries much stronger. In addition, technological progress has changed the way in which multinational enterprises are managed and the physical location of their business and as a result cross-border capital flow is improved. Therefore, apart from the positive effects globalisation has, there is also this negative aspect because it opens new ways in which companies can avoid or minimise their taxes and countries can exploit new opportunities to develop tax policies aiming at diverting financial and other geographically mobile capital. However, it has proved difficult to obtain information regarding activities related to wholly artificial arrangements due to problems in separating their effects from the total information in countries with normal tax regimes and because such kind of regimes are normally non-transparent.<sup>8</sup>

Harmful tax competition has influenced the majority of countries, which are trying by any means to protect their tax base from artificial transfer of profits to low tax jurisdictions. In this masters dissertation, I will try to analyse the new Greek CFC rules as well as the motives which might urged Greece to adopt them as well as their efficiency given the difficulties of their application.

## **2. The Economic Situation in Greece**

Greece is one of the countries that have been severely affected by the economic crisis. The tax authorities are struggling to collect the taxes due with a result that the majority of taxpayers are being exonerated and overburdened as regards taxation. This unpleasant situation led the Government into taking a series of new tax measures existed in the new income tax code (Law 4172/2013). Up until recently, there were no measures able to combat tax evasion. Greece would be

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<sup>8</sup> OECD, 'Harmful Tax Competition-An emerging global issue' (www.oecd.org 1998) <http://www.oecd.org/tax/transparency/44430243.pdf> accessed 11 July 2014.

unable to survive in the absence of the financial aid granted by other European countries. However Greece is not the only country that has been affected by the economic crisis, neither the only one in which tax avoidance takes place.

The term “offshore” was firstly introduced in Greece in the start of ‘80s and was described as a company that had some exotic and strange constructions in “weird” places. Up until then, it was however, a well-hidden secret of a small business society and was an unknown word for the biggest part of Greece. It was even an unknown word for tax authorities and employees of the Ministry of Economics. Since the beginning of 90’s offshore companies started to come out in the luxurious suburbs of Athens, to cosmopolitan islands and to some other areas of the country. Yet, in most of the places, the responsible tax authorities did not seek to control these kinds of companies; all of a sudden, the tax authorities began to chase those who were well hidden under such structures and this chasing game is continuing until now. Money laundering, manipulation of shares, the distortion of the Greek market with triangular transactions and the overpricing of goods are some of the hallmarks of the offshore companies in Greece.

### 2.1. The New Greek CFC Rules

As mentioned above, the Law 4172/2013 which introduced the new income tax code among other changes contains the introduction of controlled foreign company (CFC) rules in the article 66. It is the first time that Greece introduced such rules aiming at combating tax avoidance and tax evasion by artificially transferring income outside Greece. Controlled foreign companies are legal entities. The conditions for applying the CFC rules vary between countries; for instance some countries apply their CFC rules only to passive income, while some others apply their CFC rules to all income, like Brazil (the former consider the CFC rules as an anti avoidance tool, whereas the latter are concerned with capital export neutrality)<sup>9</sup>, but generally, in order to qualify as a CFC, the company must be owned or controlled by resident shareholders and the taxation that the CFC is subject to in its residence state must be considered too low in comparison with the tax in the shareholder’s residence state.<sup>10</sup> This is why CFC rules might become too complex, when they are accompanied by limitations and exceptions of each country, such as the exception of active income. Normally, passive income such as dividends, interest and royalties is more mobile than active income and therefore more prone to tax planning. Generally, all countries with CFC rules use the same basic taxing mechanism, like the calculation of the income of the CFC, which is

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<sup>9</sup> John Prebble, ‘Controlled Foreign Company Regimes and Double Taxation’ [2006] IBFD 3, 3.

<sup>10</sup> Suzzane Lauritzen Jourdan, Katarina Lif Burren, ‘CFC Legislation in an International Tax Perspective’ [2005] 28,28.

made according to the legislation of the country where the parent company is resident and a tax credit is granted for the tax paid by the CFC. In a EU level there has been some unification due to the cases decided in front of the CJEU.<sup>11</sup> The pro rata share of undistributed income of the CFC is, in whole or in part, attributed to and included in the income of the resident taxpayer who holds an interest in the CFC and since the CFC is an entity based on a jurisdiction other than the state of residence of the shareholder, CFC legislation results in extra-territorial application of the domestic tax legislation (the inclusion of the CFC profit in the tax base of the shareholder is either based on the fiction that the last has earned income of the CFC directly, ie a “look through” approach or on the fiction that he has received that income as dividend, ie a “deemed dividend” approach).<sup>12</sup>

However, conflicts arise when the contracting states interpret the rules in a different way. The US was the first country to introduce CFC rules in 1962, yet their applicability is hampered with the US “check-the-box” rules that enable taxpayers to choose if the foreign entities should be treated as US tax subjects or be disregarded as far as taxation is concerned. CFC legislation exists in many countries and is undoubtedly increasing. It is an indispensable tool for every country in order to tackle tax evasion especially nowadays when the mobility of income enables taxpayers to avoid paying their taxes. It is absolutely essential for the countries to protect the integrity of their tax base. However, they should do so by respecting the International and European Law rules and without breaching the double taxation treaties so as to avoid further conflicts and long-lasting litigation. The OECD 1998 Report on Harmful Tax Competition recommends the adoption of controlled foreign corporations (CFCs) or other equivalent rules.<sup>13</sup> It mentions that under CFC rules, certain income of a CFC is attributed and taxed in the hands of the resident shareholders and generally they function to counter tax avoidance by discouraging the legal migration of certain types of income and thus it is an effective tool to deal with harmful tax practices. Unfortunately, not all countries have such rules and even the rules which exist do not cover all harmful tax practice situations.

There are some conditions that trigger the CFC rules in Greece; therefore, the undistributed income of a foreign legal entity will be considered taxable income of a Greek resident who controls the foreign entity, if all of the following requirements are met cumulatively: a) the taxpayer, on his/her own or jointly with

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11 IFA, *The taxation of foreign passive income for groups of companies*, Vol 98a (1st, Sdu Uitgevers, Netherlands 2013) 19.

12 Luc De Broe, ‘The disregarding of asset transfers to low-tax jurisdictions (Art. 344(2) BITC)’ in (eds), *International Tax Planning and Prevention of Abuse* [2007].

13 OECD (n 7) accessed 6 July 2014.

related persons, holds, directly or indirectly, shares, parts, participations, voting rights or participations in the capital of the foreign company at a percentage exceeding 50% or is entitled to receive a percentage exceeding 50% of the profits of the said legal entity or the other entity, b) the above legal entity or another entity is subject to taxation in a non-cooperative state or a state with a preferential tax regime, namely to a special regime allowing for a substantially lower level of taxation than the general regime, c) a percentage exceeding 30% of the net income before taxes realised by the legal entity or other entity falls into one or more of the following categories:

1. Interest or any other income generated from financial assets,
2. Royalties or any other income generated from intellectual property,
3. Income derived from dividends and the transfer of shares,
4. Income derived from movable assets,
5. Income derived from real estate property, unless the Member State of the taxpayer legal entity or other entity would not be entitled to tax such income according to an agreement concluded with a third country,
6. Income derived from insurance, bank and other financial activities and d) it is a company with non-listed shares. The income is taxed at the tax rate applicable to profits derived from business activities of individuals and legal entities/other legal entities.

In the second paragraph of article 66, which is an exception to paragraph 1, it is said that in case that the legal person or the legal entity is a tax resident of the European Union or resident in a EEA (European Economic Area) country and there is a convention of exchange of information under the Directive 2011/16/EU, the provisions of paragraph 1 regarding CFC rules do not apply, save for the case where the establishment or the economic activity of the legal person or entity aims solely at achieving the avoidance of the tax due. Therefore, in order for the provisions of paragraph 1 to be inactive, in case of a tax resident of the EU or of a country which is member of the EEA, the proof that the CFC is conducting a real activity in the country where it is established is essential, namely to have a proven physical presence in the country of its establishment, either a seat or a permanent establishment, a permanently existing staff there, to be a taxable resident in the foreign country where it has its seat, etc. Next, the paragraph 3 of article 66 defines the categories of income that are taken into account regarding the application of the element c of paragraph 1 (net income before taxes). More specifically, since more than 50% of the income of the foreign legal person or entity is derived from transactions with the taxpayer or with connected with him persons, the following categories of income are taken into account:

- a) Interest or all other income derived from financial assets,

- b) Royalties or all other income derived from intellectual property,
- c) Dividends and income from the transfer of shares,
- d) Income from movable property,
- e) Income from immovable property except if the country of the foreign legal person or entity would not have the right to tax the income based on an agreement concluded with a third country and
- f) Income from insurance, banking and other financial activities.

It should be noted that in order for article 66 paragraph 1 to apply, it suffices one of the above mentioned categories to exist, namely more than 50% of the equivalent category of income of the foreign legal person or entity to be derived from transactions with the taxpayer or with the connected with him persons. Paragraph 4 determines the income tax rate that is imposed to the categories of paragraph c; specifically, the income at issue is calculated according to the taxable year and with the tax rate applicable to business profits of natural or legal persons. From the aforementioned, it is concluded that as taxable income is taken into account the total undistributed income of the CFC for a taxable year as it follows from the balance sheet of the last fiscal year. For example, domestic S.A. corporation whose fiscal year ends in 31.12.2014 and participates with a rate more than 50% in the capital of a foreign legal person whose fiscal year ends in the 30 of June every year, and provided that the rest conditions of the article 66 are satisfied, the undistributed income of that foreign legal person is going to be taken into account as the last follows from the balance sheet of the fiscal year that ended in the 30 of June 2014, for the tax declaration of the year 2014. The income at issue is considered as acquired by the domestic natural or legal person in the end of the fiscal year. Therefore, in cases where the domestic person participates in a foreign company, tax resident in a country which is not into the Eurozone, its taxable income, as it is calculated according to the relevant provisions, is going to be turned into euro by taking into account the exchange rate of the last working date of the fiscal year of the domestic person. When the foreign legal person or entity goes on profit distribution, which has already been taxed, this last sum is exempted from taxation for the part that it has already been taxed, otherwise double taxation would exist.

In sum, there is an important exception to an already existing exception that is when the foreign entity is established in a country solely in order to artificially avoid the payment of the taxes due. The question is how would it be possible to find out that artificiality exists? It is difficult to obtain information for certain “suspicious” taxpayers from countries which they are not willing to cooperate or which have not signed any convention with Greece. The corollary of this is that the taxpayers who were tax evading remained unpunished and Greece was unable to

safeguard its tax base from such kind of artificialities. A further defect is that the Greek CFC rules will not cover controlled foreign companies established inside the EU. There are some countries which offer themselves for tax planning. Therefore, why should they be exempted from the CFC legislation? On the other hand, there are those who claim that the CFC legislation should be extremely restricted to cases of profound tax evasion and should not be broadened because in that way taxpayers would be unduly burdened and hampered to exercise their fundamental freedoms.

Some indications that the income is artificially being sent to controlled foreign companies are the lack of economic or business existence, the lack of real establishment (in terms of staff and premises), disproportionality between the activities undertaken and the degree of the physical presence. A difficulty attached here is to find out the real purpose of the taxpayer. Usually, it is easier to find out the taxpayer's main purpose, yet it is not so easy to discern one of the main purposes. Apart from that, there is nowhere in the Greek legislation, unlike other countries, the meaning of the main or one of the main purposes.

Another way to identify the income which should be taxed under the CFC rules is by a "jurisdictional approach" made via a list of countries with acceptable tax levels ("white list"), countries with unacceptable tax levels ("black-list") and countries with potentially unacceptable tax levels ("grey list").<sup>14</sup> In Greece there are also some black lists, namely some lists that contain all the uncooperative countries and countries with a preferential tax regime. These are mentioned in the article 65 paragraph 3 of the Greek income tax code (Law 4172/2013)<sup>15</sup>. The countries which are uncooperative are the non members of the EU, whose situation regarding the transparency and the exchange of information in tax matters is examined by the OECD and which have not signed any tax convention of administrative assistance with Greece and have not either signed such a convention with twelve at least more countries. These conditions should exist cumulatively. The countries that are considered to have a preferential tax regime are the countries outside Greece which have either zero taxation or a tax rate which is less than the 50% of the Greek one, namely 26% in Greece (up until recently it was the 60% of the Greek taxation but this changed with the new Law 4172/2013).

Uncooperative states are, according to a ministerial decision, which is published in the Official Gazette 2014 the following ones: Andorra, Antigua and Barbuda, the Bahamas, Bahrain, Barbados, Brunei, the Cook Islands, Dominica, Grenada, Guatemala, Jersey, Lebanon, Liberia, Lichtenstein, Malaysia, Marshall Islands, Mauritius, Monaco, Nauru, the Netherland Antilles, the former Yugoslavian

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<sup>14</sup> IFA (n 12) 36.

<sup>15</sup> See article 65 of the Greek income tax code 4172/2013.



Republic of Macedonia (FYROM), Niue, Panama, Philippines, St. Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Samoa, Seychelles, Singapore, US Virgin Islands, Vanuatu, Uruguay and Hong Kong.

The close cross-border cooperation in the field of exchange of information is absolutely necessary, however there is a strong conflict of interests between the countries, an unavoidable consequence of the preservation of their fiscal powers and sovereignty in direct tax matters. As far as the application of the CFC rules in Greece is concerned, there are some practical problems that have to be carefully examined.

First of all, how is the indirect control of the controlled foreign company going to be determined and how will the undistributed income of the controlled foreign company be calculated? Is it going to be received as income of the controlled foreign company? Is the Greek tax legislation going to play any role? Moreover, when should the distribution of profits take place so as not to be considered that there are undistributed profits? If subsequently there is a real distribution of profits, is this income going to be taxed again in Greece? Is there going to be any tax credit that has probably been paid according to article 66 of the income tax code? What is going to happen if the controlled foreign company realises losses? Are the CFC rules going to be applied only to legal entities or to natural entities as well? What is going to happen with the simultaneous application of CFC rules by two or more countries? Finally, is the BEPS Action Plan regarding the empowerment of the CFC rules going to tighten or simplify the rules?<sup>16</sup>

Most countries provide for a tax credit relief so as to avoid the possibility of double taxation if the shareholders are subject to taxation in their state of residence. Some other countries prefer the exemption method instead. Another issue is the deduction of losses in the CFC at the level of the shareholder subject to CFC taxation. In most jurisdictions, the deduction of such losses is denied.<sup>17</sup>

There are some more questions that have to be answered. The likelihood that the new Greek CFC rules could be violated is shown, for instance in the following example: a company seated in a European Union country establishes a subsidiary in a third country with a preferential tax regime in order to artificially transfer its profits there. According to the national law of the member state of the parent company, dividends which come from third countries are not exempted ("participation exemption") and for that reason, in order to avoid the taxation in the form of withholding tax for these dividends, the parent company establishes another subsidiary seated in another EU country to which it transfers its shares in

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<sup>16</sup> Katerina Perrou, E-Themis, Recent Issues of Tax Law, Athens 2014.

<sup>17</sup> IFA (n 12) 40.

order to take advantage of the national tax laws of that state or the double tax convention of that country with the third country which has the preferential tax regime, in which there is also “participation exemption”, as well as to benefit from the Parent-Subsidiary Directive, according to which dividends between parent and subsidiary inside the EU are exempted. The result of the above mentioned tax planning is that both the profits and the dividends derived from that profits go untaxed.

In order to block this loophole the member state of the parent company which was involved in the above mentioned tax planning, could either tax the profits at issue that were taxed at a low tax rate in the third country by making use of the CFC rules, or adopt other criteria such as the switch over-credit system, which are going to tax the dividends derived from the profits of the subsidiary in a third country with a preferential tax regime (controlled foreign company). The two most solid suggestions for the solution of this problem are: a) the adoption of a tool box, which will enumerate the conditions under which a foreign company to which the profits of the parent company are artificially transferred to, will be characterised as controlled foreign company and in that case either the CFC rules or the switch over method are going to be applied and b) the inclusion of some minimum standards which will require the cumulative application of specific criteria with the unanimity of all the member states that should be respected for the application of CFC rules.<sup>18</sup>

The toolbox suggestion is more eligible because it does not require the consensus of all the member states, unlike the suggestion relating to the minimum standards which demands the consensus of all the member states.

As it has already been said, in order for the Greek CFC rules to apply, the cumulative application of the conditions enumerated in paragraph 1 of the article 66 is necessary. It could be suggested that this requirement changes to the disjunctive application instead. Additionally, it should be clarified what is considered to be as passive income; the OECD states that passive income is considered to be interest, royalties and dividends.

As far as the exception from the CFC rules is concerned, it would be preferable if certain OECD countries were not excluded, given the fact that in some of them there might not exist a double tax convention, such as Australia.

I think that Greece in an effort to “survive” and collect all the money lost throughout the previous years, tried to implement the above mentioned rules, not

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<sup>18</sup> Suzanne Lauritzen Jourdan, Katarina Lif Burren, ‘CFC Legislation in an International Tax Perspective’ [2005] 28,28.

only the CFC ones, but generally a series of new severe measures and changes to the tax codes, yet it did not take into account the fact that it is not ready to implement them so easily. I believe so first of all, because up until recently the tax provisions were radically different to the current ones and the taxpayers as well as the tax authorities were used to a different mentality. I am not implying that things should have remained as they were; I am just saying that all these changes should have been implemented gradually and after serious considerations. As far as the new CFC rules are concerned, they will undoubtedly try to restore base taxation and combat artificiality but there are many gaps that have to be carefully examined and possibly solved. For instance, Greece has not signed a convention of administrative assistance with some countries that are considered to be uncooperative and as a result they will not provide their help if needed. I am thus wondering how Greece is going to obtain information from these countries in order to detect an artificial transaction. The fact that the conditions which trigger the CFC rules have to be satisfied cumulatively makes it difficult for the rules to apply. Finally, there are some countries like Switzerland that are famous for their bank secrecy, something that attracts numerous tax planners. These countries might not going to change their policy so easily in order to cooperate and provide information for some taxpayers because in that way they will certainly lose possible “clients” and undoubtedly a lot of investments and bank deposits. Switzerland is also one of the countries that has no CFC rules but may be viewed as a CFC by other countries.

## 2.2. Tax Havens

A classical tax haven may be regarded as a jurisdiction on which actively makes itself available as a tax haven for the avoidance of tax which would otherwise be paid in high-tax countries. The aim of the legislation in such tax havens is to attract income from activities held outside that country, namely to generate passive income.<sup>19</sup> It should be mentioned here, that the UK has been characterised by some as a tax haven, especially as far as its intellectual property rules are concerned. A tax haven may have the following characteristics:

- a) Low or no taxes on all or certain types of income and capital,
- b) Bank and commercial secrecy, ie confidentiality to persons transacting business in or through them combined with the lack of exchange of information with other countries,
- c) Lack of exchange of control or dual currency control systems which distinguishes between residents and non-residents and between local and foreign currency,

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19 Daniel Sandler, “*Pushing The Boundaries*” (1st, IFS, Cambridge 1994) 5.

- d) Relatively importance of banking which encourages offshore banking business and have no requirements,
- e) Excellent communication facilities, both physical and telecommunications,
- f) Their tax treaties are divided into two types: base havens which have a very small treaty network and treaty havens which have a wide network of tax treaties and are good for holding or conduit companies and
- g) Some other aspects like economic stability.<sup>20</sup>

According to the OECD 1998 Report on Harmful Tax Competition, when the tax levied in one country on income from geographically mobile activities is lower than the tax that would have been levied in another country, is due to three reasons: first, the first country is a tax haven and generally imposes no or nominal tax on income, second, the first country collects significant revenues from taxes imposed on income at the individual or corporate level but its tax system has preferential features and third, the first country collects revenues from taxes imposed at the individual or corporate level but the effective tax rate applicable in that country is lower than that applied in the second one.<sup>21</sup>

### 2.3. The OECD 1996 Report “Controlled Foreign Company Legislation”

In 1996 the OECD published a report in order to provide factual information on the CFC legislation. In June 1995 there were rules that concerned controlled foreign companies in fourteen OECD member states. The introduction of CFC rules was examined as a policy for geographically eligible activities. The purpose of this research in 1996 was to find out similarities and differences between the various national rules concerning CFC legislation, to examine the simplification of these rules without affecting their efficiency, to be granted aid relating to the design of relative provisions in the countries that consider the adoption of CFCs, to be examined in what degree it is desired or possible to achieve consistency between the different national rules for CFCs and lastly to detect the difficulties that the tax authorities faced regarding the application of CFC rules as well as the ones that the taxpayers faced in compliance with these rules. It is of utmost importance in view of the lack of harmonised rules in an international level regarding CFC rules, the national rules of each state, which even if not supranational, enjoy a superior status, due to the fact that their goal is the fight against tax avoidance and therefore they are regarded as compatible with the spirit and the aim of the double tax conventions.

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<sup>20</sup> Ibid 5-6.

<sup>21</sup> OECD (n 7) accessed 11 July 2014.

The growing use of international intermediaries and the development of preferential tax regimes have prompted a number of countries to enact legislation in order to reduce the risk of losing domestic tax revenue from international investment.<sup>22</sup> If the CFC rules did not exist, a resident taxpayer could very easily avoid domestic taxation on his foreign income by interposing a foreign corporation in a territory with a lower level of taxation to receive such income instead of remitting it to the home country. For the majority of countries, the legislation fulfills an anti-avoidance objective to prevent the diversion of passive income and certain “base company” income to CFCs. More fundamentally, however, CFC legislation is generally seen as an instrument to guard against the unjustifiable erosion of the domestic tax base by the export of investments to non-resident corporations.<sup>23</sup> It has been the case since a lot of years ago, taxpayers, both individuals and corporations, to shift their profits abroad so as to minimise their taxes and benefit from other more favourable tax regimes. CFC rules, as an anti-avoidance measure, are capable of minimising this unpleasant outcome by taxing the immigrating income back to the home country.

#### 2.4. BEPS Action Plan

In June 2013 the OECD addressed Base Erosion and Profit Shifting, an Action Plan aimed at combating tax avoidance and evasion and protecting the countries' tax base. Globalisation was one of the triggering effects for that action plan because it has enabled the shifting of profits from high cost to low cost locations, the removal of trade barriers and cross-border activities without even physical presence, namely the evolution of digital economy. This evolution led multinational enterprises to minimise their tax burden and gradually led to a harmful result for governments, taxpayers and businesses. Intra-group financing and external debt financing cross-border gave rise to this problem (interest is tax deductible and reduces the tax base, whereas dividends are not tax deductible). However, according to my view, the widespread evolution of digital economy and the ability to take advantage of mismatches in the tax treaties as well as the differences in taxation were the key factors that helped taxpayers to easily evade taxes by artificially moving their profits away. It goes without saying that these were not the only ones, but the ones that contributed mostly in that unpleasant situation. The digital economy relies greatly on intangible assets and the difficulty to determine the jurisdiction in which value occurs.

The Action Plan consists of thirteen chapters, namely thirteen different action plans and its goal is to prevent double non-taxation and cases of low taxation. Therefore, the Action Plan brings about a variety of changes to the current

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22 OECD, ‘controlled foreign company legislation’ [1996] 10,10.

23 Ibid 11,11.

mechanisms in order to prevent and counter base erosion and profit shifting. As mentioned above, BEPS arise from the heavy reliance on digital economy, the exploitation of mismatches, gaps and loopholes, things that have not so far being dealt in double tax treaty provisions. The OECD in Action Plan 3 of the BEPS project addresses the CFC rules and the necessity to be stronger<sup>24</sup>. This is directly related to the excessive deductible payments such as interest and other financial payments that augment double non-taxation by creating excessive interest expense deduction with lending from an entity that benefits from a low-tax regime, something which results in the group having little or no external debt.<sup>25</sup> The expected outcome of this Action Plan and the recommendations relating to their design is expected by September 2015.

Coordination and cooperation between countries is indispensable in order for BEPS Action Plan to be able to achieve its purpose. If every country acts unilaterally, unwilling to cooperate, then this initiative would have no purpose. Therefore, harmonisation is an essential element of this initiative. Unfortunately, as Johanna Hey claims<sup>26</sup>, the ECJ in *Cadbury Schweppes*<sup>27</sup> limited the scope of application of CFC rules by requiring wholly artificial arrangements to exist and not so much the demonstration of genuine financial activities. It follows that the application of CFC rules, as a counteractive measure, should not be delimited because in that way well-advised taxpayers may find the opportunity to exploit some advantageous regimes and avoid their fair share of taxes. Alexander Rust has also said that for a CFC legislation to be effective, it is not enough to fight only letterbox companies because large benefits can also arise from interposing companies with no economic substance and therefore CFC legislations should go beyond what is allowed as a mere fight against wholly artificial arrangements.<sup>28</sup> As far as I am aware, the majority of developed countries have measures to combat tax planning that amounts to tax evasion. Every country has its own CFC rules and its own tax provisions but more or less in all countries the CFC legislation tries to achieve the same purpose, which is to counter tax avoidance and evasion.

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24 OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, <http://dx.doi.org/10.1787/9789264202719-en> accessed 4 July 2014.

25 Ibid.

26 Johanna Hey, 'Base Erosion and Profit Shifting and Interest Expenditure' [2014] *Bulletin of International Taxation* 332,334.

27 ECJ, 12 Sep. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* ("Cadbury Schweppes"), [2006] ECR I-7995.

28 Alexander Rust, 'CFC Legislation and EC Law' [2008] *Intertax* 492,497.

### 3. Compatibility with EU Law

There has been a lot of discussion and litigation regarding the compatibility of CFC rules with EU Law and especially with the freedom of establishment and the free movement of capital, which has also been extended to third countries, as the most important constraints arise in respect of EU Law. It is of utmost importance that the rules be compatible with EU law, as the last is the at the top of the pyramid, therefore every country before considering to adopt them should make sure that this condition is met.

The Treaty of Functioning of the European Union<sup>29</sup> stipulates that obstacles to an internal market shall be abolished in order to guarantee steady expansion, balanced trade and fair competition within the EU and expresses the desire to progressively abolish restrictions on international trade and therefore the fundamental freedoms need to be respected by all EU member states.<sup>30</sup> CFC rules apply not only to a domestic level, but they also attribute undistributed profits of subsidiaries to the parent company and thus they apply internationally. This is why a handful of member states claim that they are contrary to the EU principle of non-discrimination and non-restriction and have made reservations concerning this. Discrimination arises when a member state makes a distinction by treating less favourably foreigners than its own residents. In that situation the host member state imposes barriers to them and makes the exercise of the fundamental freedoms difficult or impossible. Restriction arises when the host member state applies the tax rule to both residents and non-residents, which are in most of the cases foreigners, but still creates an obstacle to both of them as regards the exercise of the fundamental freedoms. Therefore, discrimination appears only in relation to host member states, while restriction can apply to both host and origin member states.

The only way that such discrimination and restriction can be sustained is under a valid written or implied justification that can be accepted by the Court. In the case of direct discrimination on grounds of nationality, only an express derogating provision contained in the Treaty can treat the difference in treatment. In the case of indirect discrimination and restriction, a general reason of public interest can heal the obstacle. So far, there are five acceptable justifications of general interest by the ECJ, namely

- the prevention of tax avoidance
- the balance in the allocation of taxing rights

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29 Consolidated Version of the Treaty of the Functioning of the European Union.

30 Suzanne Lauritzen Jourdan, Katarina Burren, 'CFC Legislation in an International Tax Perspective' [2005] 28,29.

- the cohesion of the tax system,
- the effective recovery of taxes and
- the effectiveness of fiscal supervision.

However, even if the tax measures are covered by a valid and acceptable justification, they still have to pass the proportionality test, ie they should be suitable to attain their objective and they should not go beyond what is necessary to achieve it.<sup>31</sup> This is the so-called rule-of-reason principle, which was for the first time established by the ECJ in *Cassis de Dijon* case.<sup>32</sup>

For example, in the *Schneider* case, the French Supreme Administrative Court considered the CFC legislation to be in breach of the Swiss-French double tax convention and in 2006 the CFC legislation changed so as not to violate the tax treaty obligations.

The CFC rules may not discriminate against non-residents because their scope of application covers only the resident shareholders of foreign companies but this is different from the question of their compatibility with EU law and the Treaty. The fact that they subject the resident shareholders who invest or establish abroad in a less favourable tax position compared to resident shareholders who invest domestically, may be regarded as discriminatory treatment. The CFC rules apply to situations where the shareholders hold shares abroad and not domestically and the first category of shareholders may have to pay taxes on the undistributed profits of the foreign entity, while the second category of shareholders may not. Moreover, the taxpayers who invest abroad might suffer high compliance costs because of the CFC requirements, something that only favours the investment domestically. There is also a difference in treatment between investments or establishments in different member states, as the CFC rules bite only certain member states.<sup>33</sup>

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31 ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v Administration des contributions* [1997] ECR I-2471, Para 26, as confirmed in ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695, Para 26; ECJ, 21 November 2002, Case C-436/00, *X, Y v. Riksskatteverket* [2002] ECR I-10829, Para. 61; and ECJ, 11 March 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie* [2004] ECR I-2409, Para 50.

32 *Cassis de Dijon* case, 120/78, (1979) ECR 649.

33 Marjaana Helminen, 'Is There a Future for CFC-regimes in the EU?' [2005] *Intertax* Vol 33 117, 120.



### 3.1. Cadbury Schweppes, C-196/04

*Cadbury Schweppes* case is a fundamental one in the CFC legislation and its compatibility with EU Law. In that case, the UK's CFC rules were scrutinised and were found to be incompatible with Community Law. Therefore, the UK had to amend them, something which did immediately after the judgment. The Court held that it was for the national UK courts to decide if the "motive test" amounted to "wholly artificial arrangements". In its decision, the Court appears to have been setting out general principles to be applied in determining whether the CFC legislation is compatible with EU Law, so that the decision may have implications for other EU countries where CFC is established in the EU or in the European Economic Area.<sup>34</sup> However, what is the motive test and how is it possible for the Court to determine a specific motive under a transaction? Atkinson says that these kinds of questions were always difficult because it is not an easy task to determine a specific motive behind a transaction. He says that when a transaction reflects good commercial reasons it is regarded as having a good commercial motive, like for example captive insurance companies. Also, what can constitute a bona fide transaction? Even a "money box" company can claim that its directors are investing the funds as better as possible for the benefit of the CFC. A "money box" company is usually a company whose purpose is limited in raising funds derived either from retained profits or disposal proceeds from the sale of assets and normally it will not pass the UK's exempt activities test, as investment companies<sup>35</sup>.

Subsequently to *Cadbury Schweppes*, the UK courts applied the judgment in *Vodafone 2*<sup>36</sup>. In that judgment, the Court of Appeal said that the UK's CFC rules should be interpreted in a way that EU law would be secured and added an additional exception saying that if the CFC is actually established in another member state of the European Economic Area and carries on genuine economic activity there, then it is not caught by the CFC rules.<sup>37</sup> This is what is called "conforming interpretation", which is an obligation for the UK courts that can be summarised as:

*"Where legislation can be reasonably construed as to conform with the United Kingdom's Community obligations, the English Courts must do so,*

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34 Anno Rainer & others, 'ECJ Restricts Scope of CFC Legislation' [2006] Intertax 636,638.

35 Brian Atkinson, *Controlled Foreign Companies* (1st, Tolley Publishing Company Limited, United Kingdom 1984) 27,28,115.

36 *Vodafone 2 v The Commissioners for her Majesty's Revenue and Customs* ("Vodafone 2"), [2010] 2 WLR 288, available at URL: <http://www.bailii.org/ew/cases/EWCA/Civ/2009/446.html>

37 Tom O'Shea, 'CFC Reforms In The UK-Some EU Law Comments' [2012] The EC Tax Journal 66,66.

*even if this involves a departure from the strict and literal interpretation of the words in the legislation”.*<sup>38</sup>

In *Cadbury Schweppes*, the freedom of establishment was at stake and it was necessary that the CFC rules comply with EU Law in order to be sustained. The facts of the case are as follows: Cadbury Schweppes was a UK resident company, the parent company of the Cadbury Schweppes group which owned two subsidiaries in Ireland which were established there and taxed at a rate of 10%. Thus, they were subject to a “lower taxation”, within the meaning of the UK legislation on Controlled Foreign Company legislation. The UK tax authorities argued that the two subsidiaries in Ireland were not caught by the exceptions for the application of the CFC rules and they consequently imposed corporation tax on their profits. As a result, Cadbury Schweppes appealed against the tax authorities and the matter was examined under the preliminary procedure of the Court.

The Court decided that the freedom at issue was the freedom of establishment because there was a holding that gave the resident companies definite influence on the subsidiary’s decisions which allowed them to determine its activities. The Court held that the fact that a company was established in a member state in order to benefit from a more favourable legislation does not in itself suffice to constitute abuse. This was also reiterated in *Centros*<sup>39</sup> judgment. Therefore, the fact that the two subsidiaries were established in Ireland was not necessarily abusive and the Cadbury Schweppes group could rely on the provisions of freedom of establishment, namely articles 49 and 54 of the Treaty of the Function of the European Union. In *Cadbury Schweppes*, the CFC legislation involved a difference in treatment between resident companies and companies which were established abroad. When the resident company has a CFC in a member state with a lower level of taxation, such as Ireland, the CFC’s profits are attributed to the resident company which is in turn taxed for these profits, whereas when the CFC is in the UK or in a state that does not have a lower level of taxation, the CFC rules are not applied. This undoubtedly constituted a tax disadvantage for resident companies, which hindered the exercise of the freedom of establishment, dissuading them from establishing, acquiring or maintaining a subsidiary in a low taxed member state. As a result, the Court held that this difference in treatment amounted to a restriction of the freedom of establishment.

The UK tax authorities claimed that such legislation was intended to counter tax avoidance by means of artificial transfer of profits in low-tax countries. The answer of the Court to this justification was that the advantage resulting from the

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38 See para 18 of *Vodafone 2* case (n 37).

39 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* (Case C-212/97) [2000] Ch 446; [2000] 2 WLR 1048; [2000] All ER (EC) 481; [1999] ECR I-1459, ECJ.

low taxation of a member state where a subsidiary is established, cannot by itself authorise a member state to offset it by applying less favourable tax treatment to the parent company and that the fact that a company establishes a secondary establishment in another member state does not itself mean that it intends to tax evade and therefore cannot justify a restrictive measure which endangers the exercise of the fundamental freedoms. What is important here, is that the Court illustrated that such measures can only be accepted and thus justified when they relate to wholly artificial arrangements aimed at circumventing the legislation of the member state concerned.<sup>40</sup> The existence of wholly artificial arrangement was called by the Court as a fictitious establishment, such as a “letterbox” or “front” subsidiary.<sup>41</sup> The Advocate General confirmed this statement by saying that

*“A hindrance to a freedom can only be justified on the ground of counteraction of tax avoidance if the legislation in question is specifically designed to exclude from a tax advantage wholly artificial arrangements aimed at circumventing national law”.<sup>42</sup>*

The Court found it necessary to look at the objectives of the freedom of establishment and said that this freedom presupposes actual establishment and pursuit of genuine economic activity. So, “the extent to which the CFC exists in terms of premises, staff and equipment”<sup>43</sup> is absolutely essential in order to find out whether the CFC is a real entity or not. That finding must be based on objective factors ascertainable by third parties and if those factors lead to the conclusion that the establishment is a fictitious one and amounts to wholly artificial arrangements, then the CFC rules will apply. The Advocate General holds the same view by saying that the national legislation must not apply “generally to all situations in which the majority of a group’s subsidiaries are established, for whatever reason, outside the United Kingdom”<sup>44</sup>, nor should they concern “generally, any situation in which, for whatever reason, the transfer at undervalue is to a company established under the legislation of another Member State or a branch set up in the United Kingdom of Sweden by such a company”<sup>45</sup>. He also proposed three criteria which should be taken into account when trying to find out if the transactions are genuine or amount to wholly artificial arrangements: a) genuine establishment which requires premises, staff and equipment, b) genuine nature of services such as the skills of the staff working in the subsidiary and the

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40 Cadbury Schweppes (n 28), para 51.

41 Ibid, para 68.

42 See para 87 of the Opinion.

43 Cadbury Schweppes (n 28) para 67.

44 ICI, para 26.

45 Case C-436/00 X and Y C-436.00, para 61.

level of decision making and c) economic value which would look into the true economic substance of the activities.<sup>46</sup> The justification of counteraction of tax avoidance was for the first time given a broader application in the Marks and Spencer judgment<sup>47</sup> where the Court said that in order for this justification to be accepted it should be taken together with the justification of the balance in the allocation of taxing rights, where the legislation is not specifically designed to combat tax avoidance. The Advocate General in Cadbury Schweppes also took the view that the fact that a company centralises a function in another Member State with a lower level of taxation seeking to reduce its overall tax burden does not in itself constitute abuse.<sup>48</sup> The Court finally said that the national authorities could resort to the collaboration and exchange of information so as to obtain the real information of the CFC by making use of the Directive of mutual assistance between states. The answer if the motive test is compatible with the freedom of establishment was a matter for the national court to decide.

According to Jens Schönfeld, the first basic principle of the CFC legislation is the capital export neutrality in that a lower level of taxation abroad should not influence the investors' decision to opt for an inbound or outbound investment.<sup>49</sup> Consequently, the CFC legislation should opt for the neutralisation of cross-border tax differentials by raising the tax burden of investments abroad to the domestic level.<sup>50</sup> The author also doubts the efficiency of the UK CFC rules as a tool able to combat harmful tax competition; one may easily assume that it is an effective tool as it creates an obstacle to those who are artificially trying to transfer their profits abroad, yet the main concern of the rules is to secure the fundamental freedoms and the rules cannot be considered as a means to counter harmful tax competition.<sup>51</sup> Professor Gerard Meussen stated that the question should revolve around what is considered to be "wholly artificial arrangements".<sup>52</sup> The Court has repeatedly said that taxpayers may choose to order their tax affairs in a way that they can limit their tax burden and the fact that a taxpayer wants to profit from a more favourable tax regime is not in itself abusive. In other words, tax mitigation is accepted. According to Baker, it is important to understand the borderlines between tax mitigation and tax avoidance on the one hand, and between tax

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46 Ross Wilkinson, 'Tax Journal' [2006] 1,7.

47 See case C-446/03 Marks and Spencer plc v David Halsey, [2005] ECR I-10837, ('Marks and Spencer').

48 See the opinion of the Advocate General in Cadbury Schweppes, point 109.

49 J Schönfeld, 'The Cadbury Schweppes Case: Are the Days of the United Kingdom's CFC Legislation Numbered?' [2004] European Taxation 441,443.

50 Ibid.

51 Ibid 441, 451.

52 Gerard Meussen, 'European Taxation' [2007] 13,17.

avoidance and tax fraud on the other.<sup>53</sup> Tax fraud is associated with the criminal area, when one is dealing with fraudulent conduct and must absolutely involve an intentional behaviour or actual knowledge of the wrongdoing.<sup>54</sup> Tax mitigation, which belongs somewhere in between tax evasion and tax avoidance, entails the opportunity given to somebody by lawful means and by suffering the tax consequences that the government wanted him to suffer, to minimise his tax burden. Dennis Healy, the former UK Chancellor of Exchequer said some years ago:

*“The difference between tax avoidance and tax evasion is the thickness of a prison wall”.*<sup>55</sup>

The Judge Learned Hand in *Gregory v. Helvering* (1934) said:

*“Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasury; there is not even a patriotic duty to increase one’s taxes”.*<sup>56</sup>

Similarly, Lord Tomlin in *Duke of Westminster* (1936) stated that:

*“Every man if entitled, if he can, to order his affairs so that the tax attaching under the appropriate acts is less than it otherwise would be”.*<sup>57</sup>

After Cadbury Schweppes decision, the UK introduced a new Act, which provides for a reduction in chargeable profits for certain activities of business establishments within the European Economic Area (EEA).<sup>58</sup> The UK government complied with the ruling in the Cadbury Schweppes case and introduced some changes to the CFC rules in order to make them compatible with EU law.

The situation was different in *Columbus Container* case<sup>59</sup> because in Cadbury Schweppes the Court ascertained that the UK’s CFC rules amounted to a

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53 Philip Baker, ‘Tax avoidance, Tax evasion & Tax Mitigation’ [] 2,6.

54 Ibid.

55 The Economist 8152-8163, p. 186 (2000).

56 US: SC, 1934, *Gregory v Helvering*, 69 F.2d 809, 810-11 (2d Cir. 1934).

57 UK: HL, 1936, *Inland Revenue Commissioners v Duke of Westminster*, 19 TC 490, [1936] AC 1.

58 Richard Wellens, ‘Cadbury Schweppes and beyond: the future of the UK CFC Rules’.

59 *Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt* [2005] (ECJ).

restriction of the freedom of establishment <sup>60</sup> whereas in Columbus no such restriction was found to exist in relation to the German CFC rules.<sup>61</sup>

According to Harris and Oliver <sup>62</sup>, *Bricom Holdings* case <sup>63</sup>, which refers to CFC rules, does not breach the tax treaties. The French tax authorities, according to *Bricom*, felt it necessary to change their CFC rules and in 2005 they reformulated the French CFC rules to deem certain foreign subsidiaries that distribute their retained profits as dividends, thus by taking the parent company outside the business profits and dividends articles of the OECD Model and by placing it within the other income article (Article 21 of the OECD Model).

### 3.2. Proportionality Test

The proportionality test consists of two legs and is of utmost importance in the CJEU's jurisprudence. The two legs of the proportionality test are set out in paragraphs 71 and 72 of *SGI* <sup>64</sup> and in paragraphs 82 and 83 of *Thin Cap GLO* <sup>65</sup>. In *Thin Cap GLO* the arm's length principle was enough as regards the wholly artificial arrangements and the test of commercial justification was not required. The important paragraph in this judgment is paragraph 82 where the Court said that

*“ national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents a wholly artificial arrangement, entered into for tax reasons alone, is to be considered as not going beyond what is necessary to prevent abusive practices where, in the first place, on each occasion on which such an arrangement cannot be ruled out the taxpayer is given an opportunity... to provide evidence of any commercial justification that there may have been for that arrangement ”.*

Tom O'Shea points out that two particular phrases in this paragraph should be noted, namely the purely artificial arrangement must be entered into for tax

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<sup>60</sup> Cadbury Schweppes (n 28), paras 44-47.

<sup>61</sup> Tom O'Shea, 'German CFC Rules Held Compatible with EU Law' [2007] Tax Analysts-Tax Notes International 2,4.

<sup>62</sup> Petter Harris, D Oliver, 'Controlled foreign corporations' in (eds), International Commercial Tax (1st, Cambridge University Press, Cambridge 2010).

<sup>63</sup> *Bricom Holdings Ltd v IRC* [1997] STC 1179 (CA).

<sup>64</sup> ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle v Belgian State* ("SGI"), [2010] ECR I-487.

<sup>65</sup> ECJ, 13 Mar.2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* ("Thin Cap GLO"), [2007] ECR I-2107.

reasons alone and whenever the existence of an artificial arrangement is demonstrated by the tax authorities, the taxpayer must be given an opportunity to provide evidence of any commercial justification for the arrangement.<sup>66</sup> The second aspect of the proportionality test, which is mentioned in paragraph 83 of Thin Cap GLO, namely the re-characterisation of the interest payments, is triggered only if the taxpayer fails the first stage, which is to provide evidence of any commercial justification. As O'Shea mentions, it is clear from the wording of the judgment in Thin Cap GLO, that it was first a matter for the tax authorities to demonstrate that a purely artificial arrangement had taken place and this could be achieved through the use of an objective criterion such as the arm's length test and if the transaction did not comply with it, then this constituted evidence that a wholly artificial arrangement entered into for tax reasons alone existed.<sup>67</sup> Therefore, these two judgments and the evolution of the two-prong proportionality test through them gave some kind of leeway to taxpayers who can prove that their transactions are real. Moreover, the burden of proof lies first within the tax authorities to show that artificiality exists. In that way, the taxpayers can rebut this assumption by proving the contrary and even when artificiality exists and the taxpayers are unable to provide any commercial justification, still the re-characterisation of interest payments is confined to what is not at arm's length. What is also important and it has been highlighted in the judgments, is the fact that when the taxpayer is called to provide evidence of any commercial justification he should not be subject to any administrative constraints.

### 3.3. Compatibility with OECD

The Organisation of Economic Cooperation and Development (OECD) encourages all the member states to introduce anti-abuse provisions and has also accepted that the CFC rules are compatible with double tax treaties. Therefore, in paragraph 23 of article 1 of the OECD commentary the counteraction of tax evasion is being addressed and supported by the OECD. In that paragraph the OECD makes it clear that CFC rules do not breach its provisions by stating: “ *Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention*”. Also, in paragraph 14 of the commentary of article 7 it is mentioned that: “*Art. 7(1) does not limit the right of a Contracting State to tax its own residents under CFC rules, even though such tax is computed on the profits of an enterprise in the other state- the tax so levied does not affect the foreign*

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<sup>66</sup> Tom O'Shea, “CFC Reforms in the UK-Some EU Law Comments” [2012-2013] The EC Tax Journal Vol 13 66, 74.

<sup>67</sup> Ibid 75.

resident”.<sup>68</sup> Some countries like Belgium, Luxembourg and Ireland have made a reservation to this by saying that CFC rules are contrary to article 7. Every country that wishes to depart from a specific article or does not fully accept it, is free to make a reservation and say something different or express its disagreement. The OECD in paragraphs 37-39 of the commentary of article 10 says that the taxation of undistributed income is not contrary to article 10(5) because they have a different field of application; with the CFC rules, the one who is taxed is the shareholder while article 10 of the OECD taxes the company which makes the distribution. The 2005 Commentary of the OECD makes it clear in paragraph 37 of article 10 that CFC rules are compatible with the OECD Model as article 10(5) refers to source taxation only, something that has nothing to do with the residence state and the taxation imposed on the shareholder. There are some doubts as far as the application of article 23 is concerned relating to the way in which the income is going to be characterised and how the credit is going to be attributed. According to Sandler, the CFC legislation may be considered contrary to Article 7(business profits) of the OECD and may thus breach any treaty entered into by a state which incorporates its terms. However, the result of this may not be necessarily devastating since many countries, which have CFC rules, may not have entered into double tax treaties with classical tax havens; any country can be considered as a tax haven in particular circumstances though.<sup>69</sup>

The OECD and its commentary must be examined in view of the CFC rules; for example the article 1 that mentions “the Convention shall apply to persons who are residents of one or both of the Contracting States”. In paragraph 23 of the commentary of article 1 it is said that a lot of countries have adopted CFC rules and while there are some differences between them, what is common is the taxation of residents in a contracting state on income attributable to their participation in foreign entities and it is also said that CFC rules are supported by the OECD.<sup>70</sup> Furthermore, in the commentary of article 5 it is written that the fact that a subsidiary is established in another state does not automatically mean that there is a permanent establishment in that other state. However, if we take a look at the commentary of article 7 it is said that the enterprise shall be taxed for its profits which should be taxed only in the residence state, namely a country cannot tax a foreign enterprise unless there is a permanent establishment therein. However, as Sandler wonders, this is not what the CFC rules do? <sup>71</sup> The CFC rules tax the resident shareholder on his pro rata share of profits of a non-resident enterprise; therefore, they tax the profits of the non-resident enterprise and this

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68 OECD commentary para 14 of article 7.

69 Daniel Sandler, “*Pushing the Boundaries*” (n 20) 16.

70 OECD commentary para 23 of article 1.

71 (n 69) 70.



could be regarded as a treaty override. However, the contrary argument derives from what I have already mentioned above, namely that there is a different scope of application between article 7 and the CFC legislation. Next, the article 10 paragraph 5 of the OECD says “ *Where a company which is resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State*”. Therefore, some people argue that according to this article the country of residence cannot tax profits, which have not yet been distributed. Again, as I mentioned above, that paragraph refers to source taxation and has something to do with the taxation of the company, something different from the area of application of the CFCs. Finally, as Sandler supports, it would be difficult to convince a court that the CFC legislation constitutes a breach of the spirit of the treaty, as the treaties are not concluded in order to harmonise competing tax systems, rather they deal with particular aspects of cross-border income flows and they are also aiming at eliminating fiscal evasion. As a result, the CFC legislation may not be considered to breach the spirit of international tax treaties.<sup>72</sup>

Unfortunately, in the absence of an international tax court with competence to settle the disputes deriving from the compatibility between domestic tax rules such as the CFC provisions and tax treaties, domestic courts are responsible for that role. Therefore, it can be concluded that national courts and national tax authorities have not yet reached a consensus regarding the compatibility of CFC rules with international tax rules.<sup>73</sup>

The courts of different countries have reached contrary decisions as far as the compatibility of CFC rules with the tax treaties is concerned, like for example in *Bricom Holdings* case.<sup>74</sup> This case raised fundamental questions as regards the relationship between double tax conventions and CFC rules. More specifically, the agreement at issue was concluded between the United Kingdom and the Netherlands. The facts can be described as simple and are as follows: the taxpayer was incorporated and resident in the United Kingdom and it was an indirect wholly owned subsidiary of the “Bricom Group Limited” and it had a wholly owned

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72 Ibid 117.

73 Renata Fontana, ' The Uncertain Future of CFC Regimes in the Member States of the European Union – Part 1' [2006] *European Taxation* 259, 263.

74 (n 64).

subsidiary incorporated and resident in the Netherlands. The last was an investment company, which was previously conducting business in Singapore. It had surplus which it lent to the UK company after the selling of the branch in Singapore. The last paid interest to the Dutch company, which was taxable in the Netherlands. The tax authorities claimed that the Dutch company was a controlled foreign company and that its income could be attributed to its UK parent company. The taxpayer argued that according to the double tax convention it should be exempted from liability. The appeal was in favour of the Revenue. Therefore, as Baker claims, the operation of domestic anti-avoidance rules is not rendered ineffective by the provisions of a tax treaty. As for the CFC rules, when the subsidiary is resident in a country, which has signed a tax treaty with the residence state of the parent company, it has been argued that the provisions of the tax treaty prevent the application of the CFC rules. When the arrangements have been concluded with a view to rely on the provisions of the tax treaty in order to prevent the anti-avoidance legislation, this may be regarded as improper use of tax treaties.<sup>75</sup>

Unlike Greece, the majority of the CFC rules of the EU member states do not exclude other EU member states from their scope of application. Therefore, the CFC rules apply to EU resident shareholders of an entity which is resident in another EU member state. Thus, even if there were compatibility between the CFC regimes of EU member states and the tax treaties, the EU Parent-Subsidiary Directive may prevent the EU member states from taxing the income of the CFC in intra- EU situations. The state of residence may tax a profit distribution but it is obliged to grant an indirect foreign tax credit. The Directive concerns the taxation of distributed profits and not the undistributed ones and does not therefore concern the taxation of the CFC income, which is actually based on the taxation of undistributed profits. In the article 1(2) of the Directive it is said that the Directive does not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse. The benefits of the Directive do not have to be granted in situations of tax avoidance via directive shopping. As a result, national tax provisions which serve the purpose of combatting tax avoidance through the establishment of intermediary entities do not come into conflict with the Directive. The Directive benefits can be denied in cases where there are artificial arrangements with no real commercial purposes.

#### **4. Recommendations**

In that section I would like to provide my opinion as well as express my concerns relating to the application of the CFC rules in Greece. Although I am a total

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<sup>75</sup> Philip Baker, 'Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion' [2013] *itc* 3,13.

supporter of the new CFC rules as an anti-avoidance tool and I also consider their application absolutely necessary, I still doubt its efficiency in a country like Greece, which is not used to such kind of abrupt changes and measures. I also doubt the effective application of the new CFC rules because of the transfer pricing provisions, which might come into conflict with the CFC ones. To elaborate on that, in the articles 48 and 50 of the income tax code (Law 4172/2013) there are transfer pricing provisions which cater for some exemptions from dividend taxation between connected persons. I am thus wondering how these provisions are going to work in tandem with the CFC rules, when, for instance according to the CFC rules the undistributed income should be taxed in the hands of the parent company and the transfer pricing provisions define something different for associated persons. The CFC rules apply only to connected persons, as a minimum of 50% participation in the foreign company is needed. When the tax authorities are going to tax the parent company based on the CFC provisions, then this company as connected with the controlled foreign one, will invoke the transfer pricing provisions and will claim that the documentation file was correct and the pricing should be different than the one that the tax authorities calculated. The effect of applying the “arm’s length” principle to a transaction with a lower level of taxation will only ensure that the market price is used and it is not an effective measure to track the profits of a transaction. Therefore it cannot be considered as an effective tool against the routing of passive income. The Commission in a communication released said that the scope of the CFC rules should be without prejudice to the application of transfer pricing rules, which can be used more broadly to cover non-commercial pricing arrangements between associated companies. Therefore, the CFC rules can continue to play a vital role regarding corporate residence and transfer pricing insofar as they are able to tackle harmful tax planning.<sup>76</sup>

It is also desirable that measures are devised which would somehow make the uncooperative countries and the countries that are in the s black list of the OECD to cooperate with countries that require information about certain taxpayers. I really doubt the efficiency of the CFC rules if countries like Panama, Luxemburg and many more do not share any kind of information. It is a well-know principle that direct taxation falls into the fiscal sovereignty of each country and nobody could force uncooperative countries and countries with preferential tax regimes to change their policy. Nevertheless, this could be achieved through indirect measures such as fines and penalties whose repercussions would be more than the benefits that such countries obtain through their attractive tax regimes. Undoubtedly, clever taxpayers who want to establish a controlled foreign company and do not want to be caught by the CFC provisions are going to establish that company in a country that does not cooperate with Greece. What is the essence of

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<sup>76</sup> IFA (n 12) 51, 70.

the CFC provisions then? Greece will not be able to check this taxpayer's status and tax the profits of his company in Greece. The OECD has focused on the development of exchange of information agreements and in 2002 issued the model tax information exchange agreement (TIEA) and more and more information agreements have been concluded since then between lower-tax jurisdictions and other countries; under pressure some countries that were unwilling to insert an article of exchange of information did finally accepted to do so.<sup>77</sup> I do not therefore see the reason why some countries are allowed to abstain from such agreements and attract harmful tax planning. These countries are simply not willing to change their regimes as they depend extremely on their tax industries.

Capital export neutrality (CEN) is also an important reason why some countries do not agree to conclude exchange of information agreements because in that way they might lose great part of their investments. Countries that are considered to be tax havens or countries like Switzerland with a very strong banking secrecy base their economy in foreign investments and will undoubtedly do not try to change that. However, Switzerland is under some pressure from the international community to limit its preferential tax regimes but it is its objective to continue to have competitive tax legislation.<sup>78</sup>

As Rosembuj writes, a CFC system entails dangers and conflicts with international fiscal law and the balance between self-limitation principles and the ultra-territoriality of the administrative and legal power of the states. Ultra-territoriality is the exercise of fiscal sovereignty and the CFC systems must be examined according to these elements. Furthermore, what causes tax evasion is the high taxation in the residence state, not the disparities between the tax systems.<sup>79</sup>

According to Kane, CFC rules do not achieve their goal where the residence and the source states determine differently some entity or payment characterisation by creating hybrid mismatch arrangements. One solution to avoid this would be the rationalisation of corporate residency rules and to consider hybridity-based tax benefits as suspicious. Another solution would be the inclusion of a deductibility clause saying that deductible payments in the CFC country shall be included in the shareholders' state.<sup>80</sup>

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77 Ibid 23.

78 Ibid 45.

79 Tulio Rosembuj, 'Controlled Foreign Corporations- Critical Aspects' [1998] *Intertax* Vol 26 333, 351.

80 Mitcell A. Kane, 'The Role of Controlled Foreign Company Legislation in the OECD Base Erosion and Profit Shifting Project' [2014] *Bulletin of International Taxation* 321, 325.

Because of the fact that there is not a common definition of control under the EU umbrella, member states have the competence to define the control threshold as well as some other criteria. In most jurisdictions this control threshold is more than 50%. The Court has a lot of times reiterated that discrepancies stem “from the parallel exercise of tax competences by different Member States”. Nevertheless, EU Law has a certain degree of impact as regards control, since there is the EU Parent- Subsidiary Directive (2011/96)<sup>81</sup> which established a threshold of 10% control. However, this could entail the automatic conflict with the freedom of establishment in any case that member states surpassed the threshold of 10% and undoubtedly something like that cannot be sustained. The purpose of this Directive is to abolish the tax obstacles and disadvantages between companies of different member states by exempting the dividends between associated enterprises inside the European Union. Control must be understood as the ability to dominate and to command. By trying to discern if control has the same meaning in the tax field and inside the European Union, one has to examine the treaties signed between two countries and the role of EU law, which is at the top of the pyramid and it is supreme than domestic law. In *Commission v Germany* case (C-112/05)<sup>82</sup>, the Court established a pattern of looking into the Directive for the meaning of some concepts, such as the “movement of capital”.<sup>83</sup> The requirement of control is essential as it gives a proof that the taxpayer can manipulate the allocation of income within the group and the distribution of CFC profits. It should be highlighted that subjective criteria like the taxpayer’s intention to avoid paying his taxes in the residence state are generally not taken into account for the application of the CFC rules.<sup>84</sup>

The application of the CFC rules raises difficulties as far as the relief mechanisms and possible future losses are concerned. What is going to happen in cases of double taxation? Is the credit mechanism going to solve the problem? Further, if the company realises losses after some period of time, what is going to happen with such losses? Will that company be able to set them off? The main difficulty attached to the credit method is the potential timing mismatching, as the home state taxes deemed distributions whereas the source state taxes future distributions. Therefore, if the home state levies no tax by the time of the actual distribution, the tax levied by the host state may remain unrelieved. The OECD has referred to this

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81 EU Parent-Subsidiary Directive (2011): Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, EU Law IBFD.

82 DE: ECJ, 23 Oct.2007, Case C-112/05, *European Commission v Federal Republic of Germany*, para 18, ECJ Case Law IBFD.

83 Joao Santos Pinto, ‘The Role of the Concept of Control under CFC Legislation within the European Union vis-à-vis Third Countries’ [2013] IBFD 94, 94-95.

84 Renata Fontana (n 74) 261.

problem in paragraphs 38 and 39 of the 2005 Commentary of article 10 and has said that the home country must give the tax credit anyway. Nevertheless, the OECD failed in suggesting a solution to this problem.<sup>85</sup>

It could be very well suggested that the member states follow the French example and amend their domestic taxation; however this would take a substantial amount of time or lead to unexpected results. The new French rules apply to passive income and business profits of foreign permanent establishments arising after 1 January 2005. The minimum threshold was also increased to 50% and the low-tax jurisdiction threshold was reduced to 22.22%. As a result, these amendments limit the application of the French CFC rules, yet they do not provide solutions to the compatibility with the EU Law. What is new is the fact that countries inside the European Union are excluded from the CFC rules, save for the occasion where there is proven artificial behaviour. A further solution could be the harmonisation of the CFC regimes within the European Union by way of secondary law, ie a directive. However, it is unlikely that the member states would agree to this in view of the specificity of the issue. The member states could agree to change the Parent-Subsidiary Directive though so as to apply to CFC rules. Lastly, what could be suggested as a solution to the problem, is the harmonisation by the Treaty Model through the coordination of treaty provisions rather than the substitution of all of the existing tax treaties with a multilateral one. Member states would be obliged to follow the letter of this treaty.<sup>86</sup>

## **5. Conclusion**

All in all, I tried to analyse as much as possible how the CFC rules work and especially how they are going to be applied in Greece. As I said, the economic situation in Greece has reached very unsatisfactory levels and this is what urged the Greek Government to implement a series of new measures and to go on a radical amendment to the income tax code, which includes the insertion of the new CFC rules, which I previously analysed.

Unfortunately and unavoidably, tax havens existed in the past and will continue to exist because a number of countries base their economy exclusively on their low tax regimes. Therefore, these countries attract numerous tax planners and consequently a lot of investments, but this is what leads to base erosion and the artificial transfer of money to such low regimes. The OECD has attempted to address the problem of harmful tax competition in its 1998 report and gave a broad

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<sup>85</sup> Ibid 265.

<sup>86</sup> Renata Fontana, 'The Uncertain Future of CFC Regimes in the Member States of the European Union – Part 2' [2006] *European Taxation* 317, 332-333.

idea of the concept of tax haven. Also, earlier in 1996, it published a report on CFCs and their purpose as an anti-avoidance tool and urged the countries that do not have such a provision to consider adopting one.

BEPS Action Plan 2013 will definitely play a major role in addressing the problem of base erosion and profit shifting. Not only the CFC rules but also all the plans addressed will strengthen the tools of the residence state to fight tax evasion and will hopefully restore taxation and prevent artificial arrangements. This is a smart project in order to tackle the problem and put a strain to harmful tax planners who are by any means trying to avoid their fair share of taxation. This problem is getting worse with the high spread of the digital economy and the difficulty to locate where the actual profits of multinational enterprises arise.

Furthermore, I examined the compatibility of CFC rules with EU Law and especially the landmark decision of *Cadbury Schweppes* and the subsequent *Vodafone 2*. These cases provide a base to countries which implement CFC rules to be able to design them in order not to breach EU Law, which should be respected. The UK was forced to change its CFC rules in lieu of *Cadbury Schweppes* decision and it is very likely that CFC rules of a lot of countries will come in front of the Court in the future because of incompatibility with EU Law. It is of utmost important therefore, before proceeding to such rules to make sure that they comply with EU and *Cadbury Schweppes* decision.

The proportionality test, namely the rules to be able to achieve their purpose and not to go beyond what is necessary to attain it, is fundamental in the Court's jurisprudence and this is the stage where a lot of cases win or lose. The tax authorities are those who first have the burden to prove that the taxpayer is involved into sham transactions and then the taxpayer should be given the opportunity to defend himself by providing evidence of any commercial justification by showing that his transactions are genuine. According to the aforementioned two-prong proportionality test, even if the taxpayer fails in the first stage, namely the proof of any commercial justification, the second stage defines that the corrective tax measure should be confined to what is not at arm's length. Lastly, I examined the compatibility of CFC rules with the OECD and the double tax conventions, a matter which is highly debated in the literature and I said that the OECD supports the CFCs application no matter what certain countries believe.

Finally, I provided some suggestions that could help the Greek CFC rules to succeed but I also expressed my doubts as far as this success is concerned. Greece was extremely quick in proceeding to this implementation without having previously examined and possibly solved certain associated with the new CFC rules problems. As we stand now, nothing is certain. We just have to wait and see how Greece will deal with CFC provisions and if the last would be able to reduce

the long-lasting problem of tax evasion. Until then, taxpayers and tax authorities must re-examine and consider a number of issues.