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ARE CONTROLLED FOREIGN COMPANY RULES COMPATIBLE WITH THE PRINCIPLE OF FREEDOM OF MOVEMENT OF CAPITAL WITHIN THE EU?

Sascha Steingen[1]

I. Introduction

In December 1997, the ECOFIN Council reached agreement on the so called 'tax package' including, amongst other measures, the Code of Conduct on harmful tax practices. The Code applies to all business tax measures in the EU that affect or might affect in a significant way the location of business activity in the Community.[2]

According to the timetable, Member States are to adapt their national legislation to fulfil the requirements of the Code of Conduct with the result that the legislation of the Member States would not contain any harmful tax features as defined by the aforementioned resolution. The reality nowadays appears to be different - enterprises have traditionally used a variety of techniques to relocate income-generating activities from high-tax countries to low-tax countries. High-tax countries have reacted through the application of a variety of measures, such as transfer-pricing rules, thin capitalisation rules and controlled foreign company ('CFC') rules.

CFC rules can be characterised as specific anti-avoidance measures which can be found in internal national tax law and in certain double tax treaties. The principal aim of CFC rules is to counter a transaction which is not satisfactorily subject to existing statutory provisions or regulations.

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1 Sascha Steingen, Tax Consultant (Luxembourg) and Lawyer (Germany); 6, Rue des Girondins; L-1626 Luxembourg; Tel: (+352) 091 644 270; E-mail: steingen@web.de

2 Code of Conduct for Business Taxation, OJEC C2 of January 6th, 1998.

Nowadays it is doubtful how far the CFC rules still meet this initial objective. Indeed it often seems that CFC rules are used as an instrument of national economic policy, for instance, to protect their national markets.

In an EU context the question arises to what extent CFC rules hinder the freedom of capital movement between Member States enshrined in Article 56 EC Treaty and it is this question which is analysed below in more detail.

II. Code of Conduct on Harmful Tax Competition

The EU Ministers of Finance have adopted the Code of Conduct designed to eliminate preferential tax regimes that are harmful to other Member States.[3]

The Code of Conduct for business taxation is not a legally binding instrument, however it has political force. According to the Code, the Member States should undertake to roll-back existing tax measures that constitute harmful tax competition and refrain from introducing any such new measures. The Council, when adopting the Code, acknowledged the positive effects of fair competition therefore the Code was designed to detect only such measures which unduly affect the location of business activity in the Community, for example, if non-residents benefited from a more favourable tax treatment than that generally available in Member States concerned.[4]

Another approach to combating harmful tax competition was taken by the Committee on Fiscal Affairs of the OECD which in 1998 published the results of their examinations in their report on 'Harmful Tax Competition'.[5] The report included three categories of recommendation: in relation to domestic legislation, tax treaties and the intensification of international co-operation. In addition to these recommendations, there were proposed guidelines for dealing with harmful preferential tax regimes. Those guidelines included, inter alia, the recommendation that countries refrain from adopting or extending harmful tax practices and remove measures identified as harmful within five years. Moreover, the OECD Council at that time recommended that countries that did not have CFC rules consider adopting

3 See 'Harmful Tax Competition; The EU and OECD Responses Compared' Alex Easson ECTJ 3/1 [1998] 1 and 'State Aid and the Primarolo List' Alex Easson ECTJ 5/2 [2001] p. 109.

4 European Commission, The Taxation Package.

5 Harmful Tax Competition, An Emerging Global Issue, OECD, 1998.

such rules as one way of countering harmful tax competition.[6]

Meanwhile, the OECD Council issued the 2001 progress report.[7] In contrast to the 1998 report, the OECD had by now come to approve of tax competition 'that will achieve the overall aims of the OECD to enhance economic growth and development world-wide'. The OECD did not seek to dictate to any country what its tax rate should be, or how its tax system should be structured. It sought to encourage an environment in which free and fair tax competition could take place. The Head of the Financial, Fiscal and Enterprise Affairs Directorate of the OECD, Mr Jeffrey Owens, stated that tax competition in itself was not bad and that fair competition could even have positive effects. He stressed that every country had the right to choose and define its own tax system in the way best suited to its domestic, social, economic and political situation. Countries should be free to apply zero-rates of taxes or no taxes at all, but be required to comply with the international standards on transparency and exchange of information.[8]

In contrast to the OECD approach, the EU Code of Conduct considers tax measures which provide for a significantly lower level of taxation than the levels which apply generally in the Member States in question as 'potentially harmful'.[9]

In March 1998, a High Level Working Group, made up of representatives of the Member States, the Commission, and chaired by the U.K. Paymaster General, Dawn Primarolo, was set up to discuss the need for co-ordinated action at EU level to tackle harmful tax competition. The aim was to help achieve certain objectives, such as: reducing the continuing distortions in the single market, preventing excessive losses of tax revenue or getting tax structures to develop in a more employment-friendly way.[10]

The report of the Primarolo Group as released by ECOFIN in November 1999 identified 66 'harmful measures'. The November 2000 ECOFIN Council proposed

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6 Harmful Tax Competition, An Emerging Global Issue, OECD, 1998, p.41.

7 On 14th November 2001.

8 Gyongyi Vegh, OECD, Tax Haven and Harmful Tax Regime List Published, IBFD 2000, Volume 40, p.391.

9 Conclusions of the ECOFIN Council Meeting on 1st December 1997 (98/C2/01). See also Malherbe, 'Harmful Tax Competition and the European Code of Conduct', *Tax Notes International*, 10th July 2000, p.151.

10 Conclusions of the ECOFIN Council Meeting on 1st December 1997 (98/C2/01).

a detailed timetable for a comprehensive roll-back of harmful measures, including the implementation of legal changes at national level, this roll-back being however conditional on also reaching agreement on the global tax package. This first timetable suggested that certain harmful financing structures implemented after 31st December 2000 and before 31st December 2001 would only exist until 31st December 2002. This timetable also indicated that no new harmful financing structures should be entered into after 31st December 2001.

In July 2001, the ECOFIN Council agreed to a timetable of work. According to the same document the 15 Member States were to determine which measures could extend their benefits beyond 2005. As the July 2001 document is in conflict with the November 2000 consensus paper, the conclusion could be drawn that the deadlines agreed in November 2000 were implicitly put back until the end of 2002 and/or the end of 2005. As a matter of fact, most Member States have not yet put in place the necessary measures to roll-back harmful tax provisions.

The ECOFIN papers are far from clear, and the timetable for the roll-back of the harmful tax measures is subject to many uncertainties. It cannot be beyond the bounds of possibility that a future ECOFIN meeting will produce a new agenda with a different timetable. As these discussions are by nature very political, progress remains impossible to predict even up to the very last step of the process.

III. Controlled Foreign Company Rules

CFC rules seek to apportion the income of connected companies based in low tax regimes to the tax jurisdiction of the parent based in a higher tax jurisdiction. If certain conditions are fulfilled, the low tax foreign source income is subject to taxation in the country of the parent even if no dividend is paid (taxation on a 'deemed income basis').

The spread of CFC rules over the past 30 years is remarkable. The United States were the first country to adopt CFC rules in 1962, although those rules (subpart F of the Internal Revenue Code) were based on foreign personal holding company rules enacted in 1937. In 1972 Canada and Germany followed with their own CFC rules. By 1986 there were still only 6 countries with CFC rules. By the 1990's, however, there were over 15 countries that implemented CFC rules in their national law. Individual countries have been improving and extending the legal tools available to them to avoid the erosion of their ability to collect tax revenue.[11]

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11 Arnold, Dibout, Cahiers de Droit Fiscal International, IFA Report 2001, p. 38.

In the EU, Member States like the United Kingdom, Spain, Portugal, Sweden, Germany, Finland, France, Denmark and Italy now have CFC rules in their tax legislation.

IV. Infringement of freedom of capital movement - Article 56 EC Treaty

The EU Commissioner for the Internal Market, Taxation and the Customs Union, Frits Bolkestein, declared that his intention is not to have a definitive EU tax system, but to make the national tax systems of the Member States more compatible with each other. Tax systems must enable enterprises to flourish and take advantage of the benefits offered by increasingly open markets.[12] This objective would be hampered if Member States mainly used CFC rules for political reasons - to protect their national fiscal regimes. In such a situation national tax authorities would not take measures against tax arbitrage, avoidance or fraud, but would take measures purely to attract (or capture) the maximum taxable profit.

This raises the question of whether maintaining CFC rules after the roll-back of harmful measures predicated by the Primarolo Report would infringe the right to freedom of movement of capital. This question has become relevant since 1993 when free movement of capital became real for residents of the Member States as a result of the Treaty of Maastricht.

Before 1993 the right to freedom of movement of capital was limited, so that additional legislation was needed to liberalise the movement of capital. The first step in this direction was taken with a Directive adopted in 1960[13] which distinguished between four categories of capital movement, each of which was subject to a different degree of liberalisation. This Directive was repealed in 1988 and replaced by Directive 88/361.[14]

The European Court was not yet concerned with this question of compatibility of CFC rules with the right of freedom of movement of capital. However there have been indications in recent judgments of an incompatibility of the Treaty with existing CFC rules before the roll-back of harmful measures required by the Primarolo

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12 Bolkestein, 'The future of European Tax Policy', 18th October 2001. Bolkestein, 'Current Priorities for Tax Issues', 29th May 2001. Bolkestein, Taxation and Competition: The Realization of the Internal Market, IBFD 2000, Volume 40, p.401.

13 Directive of 11th May 1960 (OJ 1960 p. 921).

14 Article 9, Directive 88/361/EEC, OJ 1988 L178/5. Landsmeer, Movement of Capital and other freedoms, Legal Issues of Economic Integration 2001, p.57 (58).

Report. Doubts can also be found in the jurisprudence and the literature of some Member States.[15]

1. The Scope of Article 56 EC Treaty

According to Article 56 EC all restrictions on movement of capital and on payments within the Community and between the Member States and third countries are prohibited, save as far as the specific exceptions are concerned.

Although the Treaty does not define the expression 'capital movements' in Article 56 EC, the European Court, when determining whether the Treaty regime on capital movements applies, still refers to the Directive 88/361 and makes use of the nomenclature which it contains.[16] This means that the Court has still not formulated a general definition which will allow it to answer the question whether a transaction falls within Article 56.[17] However it is broadly the case that the Court interprets Article 56 EC in a very liberal and extensive way. Freedom of capital movement covers every placement of capital which involves a cross-frontier movement. The Court has stated in many judgments that although direct taxation falls within the competence of the Member States, the Member States must nonetheless exercise that competence consistently with Community law.[18]

It can be concluded that CFC rules of Member States fall in general within the scope of Article 56 EC.

2. Infringement of Article 56 EC

CFC rules may represent an infringement of the freedom of capital movement, insofar as domestic investors might be put off making investments in foreign companies as a result of the substantial additional financial and administrative

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15 E.g. Bundesfinanzhof, 21st June 2001 (I B 141/00). Werra, Reformbedarf beim Außensteuergesetz, IStR 2001, p. 438.

16 E.g. Case C-35/98, *Verkooijen* [2000] at para 27.

17 Landsmeer, Movement of Capital and other freedoms, Legal Issues of Economic Integration 2001, p. 57 (58).

18 Case C-80/94 *Wielockx* [1995] ECR I-2493, at para. 16.
Case C-264/96 *ICI v Colmer* (HMIT) [1998] ECR I-4695, at para. 19.
Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, at para. 19.
Case C-35/98 *Verkooijen* [2000] at para 32.

charges arising from the CFC taxation. Capital markets may suffer a higher segmentation, since investors will be discouraged from investing their capital abroad. Obstacles to the realisation of cross-border mergers could be the consequence. In addition, there is an indirect infringement in that the domestic investor is forced to arrange for the foreign company to pay dividends in order to reduce the effect of CFC rules.

3. Justification of the infringement

Article 58 EC sets out the grounds on which Member States can restrict free movement of capital. Article 58Ib EC sets out a general basis for Member States to restrict free movement of capital within the Community. Member States have the right to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and for the prudent supervision of financial institutions, or to lay down procedures for the declaration of capital movements for the purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.

In this context, the European Court has used the fiscal cohesion principle to decide that certain domestic measures did not infringe EU law. The fiscal cohesion principle provides that a restrictive measure can be justified whenever it is strictly connected to another measure that usually operates in the opposite direction.

(a) Jurisdiction of the European Court

Recent judgments of the European Court show that the cohesion principle cannot be invoked to justify a national measure aimed at avoiding or reducing economic double taxation from a purely domestic point of view.[19]

Since the *Bachmann* case in 1992 the Court has not accepted arguments based on the fiscal cohesion principle which does not mean however that the Court has given up the cohesion principle altogether.[20] The cohesion principle is the only one which could be used to justify the existence of restrictive measures such as CFC rules.

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19 Case C-35/98 *Verkooijen* [2000] 56-62. Case C-251/98 *Baars* [2000] at para. 40. Case C-478/98 *Commission v Belgium* [2000] at para 45. See also Lupo, Reliefs from Economic Double Taxation on EU dividends, IBFD July 2000, p.270, (274).

20 Case C-204/90 *Bachmann* [1992] ECR I-249. Lupo, Reliefs from Economic Double Taxation on EU dividends, IBFD July 2000, p.270, (272).

The *Verkooijen* case concerned Dutch legislation which partially exempted dividends in respect of shares of companies established in the Netherlands from income tax. Mr Verkooijen was unable to qualify for this exemption because the dividend in question had been distributed by a public limited company established in Belgium. The Dutch government argued that their decision not to give the exemption was justified by the fiscal cohesion principle - the Dutch exemption was given to mitigate the effects of double taxation and was given only for dividends distributed by Dutch companies since only they were taxed in the Netherlands. The European Court clarified the fiscal cohesion principle, arguing that the principle was not applicable if two different taxes (in the *Verkooijen* case, personal income tax and corporate tax) were levied on different taxpayers (shareholder and company).[21] The judgment shows that the Court accepted the cohesion principle only in a very restrictive way. Possible losses of taxable income in the Member States should not be the only reason for a restriction of the freedom of movement of capital.

Protectionist interests must be disregarded because they are contrary to the realisation of a Single Market. As indicated above, Member States decided in favour of competition between national tax systems. Consequently it is not permissible to discriminate by setting-up CFC rules purely to counter participation in the competition.

A Member State is not free to decide if and to what extent it wants not to hinder the freedom of capital movement within the EU. The practice of the Member States which have CFC rules in deciding which tax practices are considered to be potentially harmful and which not, is contrary to the complete liberalisation of the movement of capital within the EU as companies in states with CFC legislation are prevented from exploiting the tax differences between Member States. Freedom of movement of capital would be useless if capital investors were only allowed to invest in countries that are disadvantageous from a tax point of view.

(b) Further aspects in the Member States

(aa) Germany

Recently, German courts had doubts about the compatibility of German CFC rules and the EU Treaty.[22] Moreover, in the German tax literature authors have queried

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21 See also Case C-251/98 *Baars* [2000], at para. 40.

22 Decision of the Bundesfinanzhof of 21st June 2001 – I B 141/00 concerning 1 I Aussensteuergesetz.

the existing German CFC rules on the basis that, as they are intended to tax all activities in Germany as well as in foreign countries, they contradict the right of freedom of movement in the EU.[23]

The most important German CFC rule is the so-called 'Hinzurechnungsbesteuerung' provided for by §§ 7-14 Außensteuergesetz. If the pre-tax burden of foreign dividends is below the German corporate tax burden, the passive income subject to a lower burden of tax will be subject to the 'Hinzurechnungsbesteuerung'. This is always applicable, if the tax burden on the foreign company is below 25 per cent. By this measure also, low tax profits of foreign companies will be taxable in Germany. This rule is not applicable if the income is 'active income' or if the tax allowances set out in § 9 Außensteuergesetz are not exceeded. This means that if the conditions of § 9 Außensteuergesetz are not fulfilled, profits from countries that would not be considered as typical low-tax countries, but that have a tax burden of, for example, 24 per cent are subject to the 'Hinzurechnungsbesteuerung'. It is doubtful that this result corresponds to the original aim of the CFC rules and gives the impression that the German government pays more attention to national protectionism than to an effective control and regulation of harmful tax competition.

The aim of the 'Hinzurechnungsbesteuerung' was to avoid unjustified tax advantages, resulting from passive income arising in foreign companies when a deemed distribution by the foreign company to the German company was assumed. The validity of this taxation method has become questionable after the *Verkooijen* judgment. The whole mechanism of the 'Hinzurechnungsbesteuerung' is based on the fact that a lower tax burden of a foreign company is equalized by a higher tax burden of the shareholder in the domestic country. This is exactly the situation that the European Court did not tolerate in the *Verkooijen* case.

Moreover it should be noted that the *Verkooijen* judgment could have implications also for shareholdings in non-Member States, because the right to freedom of movement of capital set out in Article 56 EC guarantees also the right to invest outside the EU.[24]

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[23] Dautzenberg, Annotation to Verkooijen case in Finanzrundschau 2000, p. 725 (727). Wassermeyer, Die Fortentwicklung der Besteuerung von Auslandsbeziehungen, Internationales Steuerrecht 2001, p. 113, (114). Thömmes, EG-rechtliche Anmerkungen, Internationales Steuerrecht 2001, p. 441, (441). Werra, Zum Reformbedarf beim Außensteuergesetz unter besonderer Berücksichtigung des Verhaltenskodex, Internationales Steuerrecht 2001, p. 438, (438).

[24] Wassermeyer, Die Fortentwicklung der Besteuerung von Auslandsbeziehungen, Internationales Steuerrecht 2001, p. 113, (114).

(bb) Other low-tax jurisdiction

Other questions arise. For instance if the Irish government were to declare a 12.5 per cent general rate of corporation tax for trading income to apply from 1st January 2003, why should this trigger the application of CFC rules in other Member States? No other Member State nor the EU can force Ireland to increase its taxes; leaving aside the fact that the Irish budget is balanced so that there is no need to increase the taxes.

Another example arises in relation to the EU applicant Estonia. According to Estonia's new income tax act, corporate taxpayers are not subject to corporate income tax. Instead, they are subject to a distribution tax on distributed profits, but no tax is levied on any retained earnings. Estonia could not be forced as a future Member State to tax at a minimum level. It is more important to prevent specific cases of artificial tax planning, i.e. cases where Estonia is used only to benefit from the zero rate of taxation on retained earnings.

(cc) France

The existing French CFC rules, in particular, Article 209 B CGI, give rise to problems of incompatibility with the right to freedom of movement of capital.

Any French legal entity subject to corporate income tax which has a business activity abroad or owns, directly or indirectly, a financial or voting participation of 10 per cent or higher, or with a cost of at least 150 million French francs (equivalent to around 22,87 million Euro) in a company or a partnership that is subject to a beneficial tax regime abroad, is subject to Article 209 B CGI.[25] The profit of that entity taxed at the beneficial rate is considered a profit of the French company, taxable under a separate schedule. The French resident company is taxed on the profits realised in the low-tax country as if that French company had realised them itself.

It is questionable if this result accords with EU law as it provides an obstacle for a French company that wants to invest in low tax areas. Article 209 B CGI assumes that there is an abuse only because the French company has a participation in a company that profits from a privileged tax regime. The French tax authorities do not have to prove an actual abuse. Therefore it seems that Article 209 B CGI has protectionist effects that infringe the right to freedom of movement of capital.

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25 Article 209 B CGI, Instructions April 17th, 1998, 4 H-3-98, no. 12-14. Douvier, Cahiers de Droit Fiscal International, IFA Report 2001, p. 518.

(dd) Italy

The Italian Senate approved definitive CFC rules on 9th November 2000. After a number of revisions the CFC rules have been inserted as Article 127 bis of the Income Tax Code and are to enter into force as of the tax year following the year in which a black list is published in the Official Gazette by the Italian Ministry of Finance. This black list appeared in November 2001 and includes a number of low tax jurisdictions.[26] It was expected that the black list would contain a number of low tax countries and regimes, including all those listed in the Primarolo Report, but this was not the case as the only EU regime listed was the 1929 Holding Regime in Luxembourg.[27]

The Italian Government published a very restrained black list. One reason for this could be that the Italian Ministry of Finance has realised that CFC rules can conflict with the right to freedom of movement of capital.

4. Tax Competition or Tax Harmonisation?

It is questionable to what extent we need CFC rules today and – on the other hand – to what extent we need competition between national tax regimes in the EU. It helps to see the situation as an EU-wide issue and not just one arising between Member States. Larger Member States seek to avoid emigration of capital, whereas smaller ones try to induce capital immigration. Therefore the pro and contra arguments of tax competition have to be analysed.

A positive argument in favour of tax competition is that it regulates the relationship of cost and services provided by a state – a taxpayer balances the cost - in the form of the taxes to be paid - against the service or supplies provided by a state, i.e. the quality of the infrastructure. In this regard, tax competition is a necessary regulatory instrument. Furthermore tax competition exerts a positive pressure on public expenditure.

A negative aspect of tax competition is the danger of it resulting in a 'race to the bottom', i.e. that the tax competition between the states may end in a zero rate of

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26 Valente/Magenta, New CFC Legislation, Intertax 2001, p. 52 (52, 54).

27 This holding regime is a special tax status which gives full exemption from income taxation in Luxembourg. The companies are also excluded from all Double Tax Treaties concluded from Luxembourg with other Member States. The very special tax status explains the inclusion in the list.

taxation on corporate income among all Member States. In order to avoid this situation, more and more Member States implement or enforce their CFC rules. Nevertheless it has to be said that the percentage of corporate income tax in the Member States compared to other taxes is only about 8 per cent. Therefore the race to the bottom has not got such drastic consequences as might be feared.

Member States should have the option to use their right to tax otherwise this would result in a de facto harmonisation of direct taxes. This is wanted neither by the EU nor by the Member States. As long as the Commission does not undertake further steps to harmonise corporate tax in the EU, the Member States can form their corporate tax rules themselves without being influenced from outside. If the Commission considers that European tax harmonisation is necessary and takes as its basis the Primarolo Report without focussing on corporate tax rates in the Member States, then only the EU Treaty and the jurisdiction of the European Court can have an effect on the harmonisation of corporate taxes.

It follows that the differing corporate tax rates in the EU are not unfair but are the result of national fiscal sovereignty. If the Member States feel that this situation is no longer acceptable, they have to find together a solution for harmonisation.

One open question remains - in what way should corporate tax laws in the EU be harmonised (assuming that in the future the Member States feel the need for a harmonisation)? On this point there are interesting parallels in Switzerland, which recently took a step towards harmonising its 26 different cantonal tax laws.

Swiss income taxes are levied at three levels: the Federation, the 26 cantons and about 3000 municipalities levy income taxes in their territories.[28] The reason why there are 26 different cantonal laws is that the main power of 'state sovereignty' lies in the hands of the cantons and the situation is to that extent comparable with the position of the Member States in the EU. Moreover there was strong inter-cantonal tax competition.

The future will show if and to what extent the tax harmonisation in Switzerland will serve as a model for the further harmonisation process in the EU. However it seems evident that an enlargement of the scope of the CFC rules is not the right way to deal with the different levels of corporate taxation in the EU.

28 Amonn, Swiss Tax Harmonisation, IBFD Bulletin, 2001, p.132 (132).

V. Conclusion

Over recent years Member States have introduced CFC rules and added further refinements to their tax legislation based on their national tax system. Nowadays however the EU is committed to guaranteeing the freedom of capital movement within the EU. CFC rules by their very nature have an impact on the cross border flow of investments and can therefore be in conflict with the freedom of capital transfer.

After the roll-back of harmful tax measures identified by the Primarolo Report at the latest, there will be a case for the argument that certain CFC rules are no longer acceptable in the EU.