Foreseeing the Impact of X GmbH (Case C-135/17), I: Understanding the PPT Standard under CJEU Case Law

Kluwer International Tax Blog
March 18, 2019

Błażej Kuźniacki (Ministry of Finance (Poland))

Please refer to this post as: Błażej Kuźniacki, 'Foreseeing the Impact of X GmbH (Case C-135/17), I: Understanding the PPT Standard under CJEU Case Law', Kluwer International Tax Blog, March 18 2019, http://kluwertaxblog.com/2019/03/18/foreseeing-the-impact-of-x-gmbh-case-c-13517-i-understanding-the-ppt-standard-under-cjeu-case-law/

The text represents the personal views of the author, which do not purport to represent the view of Poland's Ministry of Finance.
In the judgement in *X GmbH* (Case C-135/17), on 26 February 2019, the CJEU for the first time examined a compatibility of CFC rules with the EU primary law to the extent of their application to companies established in third countries. Although the judgment addressed several interesting issues, including stand still clause, this three part piece primarily focuses on the two fundamental findings of the Court:

1. Lowering an abuse standard from wholly artificial arrangements (WAA) used for tax avoidance purposes to arrangements with primary objective or one of their primary objectives (PPT) to artificially transfer of the profits made by way of activities carried out in the territory of a Member State to third countries with a low tax rate;
2. The importance of the genuine exchange of tax information with third countries for justifying a restrictive effect of CFC rules on free movement of capital to third countries.

This first part deals with the issue indicated in point (1) above in respect of the CJEU's case law. The second part also pertains to point (1), but from the perspective of the usefulness of OECD and foreign case law guidelines on the PPT standard in respect of understanding of this standard under EU law. Finally, the third part will address point (2). In part II and III, the author will take an attempt to foresee the judgment of the referring court (*Bundesfinanzhof*, later also as: the German Federal Finance Court) based on the particular findings as provided by the CJEU as well as other interpretative sources, including the OECD's Commentary to the Article 29(9) of the 2017 Model Convention (MC) and US case law in tax avoidance cases.

Legal background

The German CFC rules in question stipulated that German taxpayers are chargeable to tax in the proportion corresponding to their shareholding attributable to them in the share capital of a controlled foreign company (CFC). A company established in a third country is to be regarded as a CFC with respect to income that is liable to low taxation (i.e. less than 25%). In such cases, a German taxpayer was subject to tax if they hold at least 1% of the shares in that company and that company derives income from invested capital, i.e. the income which is derived from the holding, administering or maintenance or increasing the value of means of payment, debts, securities, shares and similar assets.

The German Federal Finance Court explained that the objective of the German CFC rules at issue in the main proceedings is *to prevent or offset the transfer of (passive) income of persons with unlimited tax liability to States with a low tax rate*. The German Government said that legislation is also designed *to prevent tax avoidance by the artificial transfer of income to third countries which have a low tax rate*. The German Federal Finance Court pointed out that the German CFC rules would apply irrespective of the economic function of the CFC and its controlling German shareholder would not be afforded the opportunity to establish and demonstrate to the German tax authorities that their investment in a third country has an economic basis. It means that the German CFC rules would neither apply only to prevent WAA aimed at circumventing the application of national tax provisions within the meaning of the judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas* (Case C-196/04) nor their application requires to analyse information relating, in particular, to the nature of the activities of the CFC that is established in a third country.

Factual background

According to the factual background, as submitted by the referring court, X, a German LLC, held 30% of the shares in Y, a company having tax residence in Switzerland with a portion of income from invested capital (income from passive activity). In June 2005 Y concluded *a debt assignment contract* with Z GmbH, a sports rights management company established in Germany. The debts assigned to Y were owed under contracts pursuant to which Z granted non-repayable subsidies to sports clubs, thereby making liquid assets available to those clubs, and received *profit participation rights* in return. At the minimum, those returns corresponded to the amount paid in subsidies by Z. However, that amount could be larger depending, among the others, on the sports performance of the club concerned and its income from broadcasting rights or other sources of income. The Y's passive income, in the proportion of 30%, was incorporated into the tax base of X under the German CFC rules.

Interestingly the CJEU stated that although there is no enough factual information to determine the abuse, it cannot be rule out that the transactions at issue were not artificial and that they have no valid commercial justification. Nor it can be rule out that X's primary objective or one of its primary objectives was to avoid the tax normally due on the profits generated by activities carried out in Germany by using Y as a controlled company for that purpose. I will back to the determination of abusiveness of these transactions later on in the conclusions to Part II of this contribution.

Lowering the EU abuse standard in direct taxation between Member States and third countries

After deciding about the standstill clause in Article 64(1) of the Treaty on the Functioning of the European Union (TFEU),[fn]The CJEU concluded that the standstill clause cannot be applied to the German CFC rules in question, because they were substantially amended after 31 December 1993. Its applicability, however, would be permissible if an application of these CFC rules was deferred in accordance with national law, so that, despite their entry into force, they were not applicable to cross-border movements of capital that are covered by Article 64(1) TFEU.[/fn] the CJEU moved to the examination of the compatibility of German CFC rules with the fundamental freedoms. In that respect, the CJEU first stated that the objective of the German CFC rules corresponds, *in essence*, to the overriding reasons in the public interest, in particular, to the prevention of an unacceptable tax avoidance. The next step was thus to analyse the proportionality of such rules in achieving that purpose, i.e. whether the German rules are suitable for securing the attainment of the objective which it pursues – the prevention of an unacceptable tax avoidance, and does not go beyond what is necessary in order to attain it. This is where the most important part of the judgment starts.

Different understandings of the concept of WAA under various fundamental freedoms

Up until now, the CJEU has never explicitly admitted that one can differentiate between freedom of establishment and free movement of capital for understanding the concept of abuse (WAA) under these freedoms in direct taxation. That is to say, under both freedoms the abuse has been considered as the use of WAA aimed at circumventing the application of national tax provisions alike.[fn]See C-282/12, paragraph 37; C-524/04, paragraph 82; C-318/10, paragraph 50; C-264/96, paragraphs 24 and 26; C-324/00, paragraphs 32 and 37; C-9/02, paragraphs 48 and 50; C-446/03, paragraphs 34 and 57 and C-196/04, paragraphs 46 and 57.[/fn] The same was confirmed by EFTA Court in *Olsen* (Case E-3/13 and E-20/13). But in the analysed case, the Court stated somewhat differently, and the reason for that was that *the free movement of capital between Member States and third countries is intended not to frame the conditions under which companies can establish themselves within the internal market*. Therefore:

- In the context of the free movement of capital, the concept of 'wholly artificial arrangement' cannot necessarily be limited to merely the indications, referred to in paragraphs 67 and 68 of the judgment of 12 September 2006 in the *Cadbury Schweppes* case, that the establishment of a company does not reflect economic reality (…);
- That concept is also capable of covering, in the context of the free movement of capital, any scheme which has as its primary objective or one of its primary objectives the artificial transfer of the profits made by way of activities carried out in the territory of a Member State to third countries with a low tax rate.

These findings of the CJEU imply that for the purpose of examining the proportionality of the domestic legislation, *which restricts free movement of capital between Member States and third countries*, the understanding of the WAA, reflecting the standard of abuse of EU law in direct taxation cases, should be different from the situation of a restriction of free movement of capital or freedom of establishment between Member States. In the former case, the standard of abuse is lower and amounts to any scheme which has as its primary objective or one of its primary objectives the artificial transfer of the profits made by way of activities carried out in the territory of a Member State to third countries with a low tax rate. By contrast, between the Member States the standard of abuse is higher and corresponds to WAAs with a view to escaping payment of national tax, where WAAs are to be understood, in particular, as fictitious establishments which do not carry out any genuine economic activities in the territory of the their establishment.

An attempt to understand the PPT standard under CJEU's case law and AG's opinion

Although the CJEU seemingly lowered the EU abuse standard in respect of abuse in direct taxation between Member States and third countries – PPT standard, in comparison to situations between Member States only – WAA standard, almost no guideline has been provided by the CJEU how to approach to this new, lower standard. The Court merely stated the text as mentioned in the above bullet points.

In my perception, it means that PPT standard under EU law consists, as a kind of bottom line or a starting point, the features for WAA, as indicated by AG P. Léger in his opinion on the *Cadbury Schweppes* case and the CJEU in that case. First and foremost, the existence of WAA implies a fictitious establishment which does not carry out any genuine economic activity in the territory of the host Member State, such as a 'letterbox' or 'front' subsidiary. The first time the CJEU used these terms was in its judgement in *Eurofood* (Case C-341-04), when it explained that a letterbox or front subsidiary is *a company not carrying out any business in the territory of the Member State in which its registered office is situated*. This corresponds to the lack physical existence in terms of premises, staff and equipment or the existence of thereof in the scale which does not commensurate to the size and the nature of the activity of an entity (e.g. a CFC), and to the genuine nature of the activity provided by a CFC and the economic value of that activity with regard to the parent company and the entire group. In general, the above-mentioned features of WAA pertain to the existence (or the absence of) a genuine economic activity carried out by a foreign company.

The features different than those indicated in the judgment in *Cadbury Schweppes* case and the AG's opinion on it can be relevant, but the CJEU has been silent on them and therefore they must be found beyond the analysed judgment on the German CFC rules in a careful manner. In that regard, of particular importance can be the recent judgments of the CJEU in *N Luxembourg 1* (Case C-115/16) and other joined cases (C-118/16, C-119/16, C-299/16), on 26 February 2019 regarding the abuse of EU directives, in which the CJEU provided with several features of a group of companies which may be regarded as being an artificial arrangement where it is not set up for reasons that reflect economic reality, its structure is purely one of form and its *principal objective or one of its principal objectives is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law*. Those features broadly refer to the setting up of complex financial transactions which include the grant of intragroup loans. In that respect, of high importance is *the existence a conduit entity interposed in the structure of the group between the company that pays interest (or other payments) and the entity which is its beneficial owner in order to avoid taxation on the payment*. If all or almost all of the aforesaid payment is, very soon after its receipt, passed on by the conduit company that has received it to entities which do not fulfil the conditions for the application of tax exemption under EU law (here: Interest & Royalties Directive), this implies the abuse. By contrast, *if the payment would have been exempt had it been paid directly to the company having its seat in a third State, that the aim of the group's structure could be considered as being unconnected with any abuse* – this resembles the Derivative Benefits Test under the LOB clause in Article 7(11) of the MLI.[fn]See B. Kuźniacki, "The Limitation on the Benefits

(LOB) Rule in BEPS Action 6/MLI: Ineffective Overreaction of Mind–Numbing Complexity – Part 2", 46 *Intertax* 2018, Issue 2, sec. 2.2.[/fn] It is noteworthy that those features of WAA focus not only on the existence (or the absence of) a genuine economic activity carried out by a foreign company, but also on the artificiality (or the absence of it) of the transactions between domestic and foreign company (or any other entity).

Interim conclusions

It seems that the CJEU effectively brings the PPT as incorporated in Art. 7(1) MLI and in Art. 29(9) 2017 OECD MC[fn]The phrase "one of its primary objectives" used by the CJEU could be used interchangeably with the phrase "one of the principal purposes" used under the PPT.[/fn] within the domain of prevention of tax avoidance under the primary EU law in respect of relations between Member States and third countries, while still keeping its WAA's mantra to be valid only among Members States. This poses a question whether the CJEU has introduced a new algorithm of an unacceptable tax avoidance with the use of companies from third countries. The new algorithm seemingly allows to prevent not only WAAs aimed solely to avoid taxation, but also arrangements with one of their primary purposes to avoid taxation. Consequently, the significance of the PPT standard in prevention of tax avoidance becomes huge: it does not only encompass 87 countries and jurisdictions under the MLI (treaty abuse standard), but also all Member States in respect of their relations to third countries, as covered by free movement of capital (the EU abuse standard towards third countries). One may pose the question whether the PPT standard will soon effectively replace the WAA standard in respect of direct taxation cases between Member States under the concept of abuse of EU primary law (it is quite evident that it has already taken place under the EU secondary law, e.g. *N Luxembourg 1* (Case C-115/16) and other joined cases (C-118/16, C-119/16, C-299/16), on 26 February 2019).

The closer look at the CJEU's case law in tax avoidance cases shows that the most important overall future determining the existence of abuse of EU law under the PPT standard is the absence of or the insufficient degree of economic substance. Importantly, the degree of substance matters in respect of the entities in question and the transactions conducted by them. If, under given circumstances, the economic substance is very low and the tax advantage is significant, one may assume the existence of abuse according to the PPT standard. This is linked to the magnitude of the anticipated tax advantage which may arise from a taxpayer's arrangement or transaction in comparison to their anticipated non-tax advantage – a feature typical for tax avoidance.[fn]See Ch. Evans, "Containing Tax Avoidance: Anti-Avoidance Strategies", in G.J. Head & R. Krever eds., *Reform in the 21st Century: A Volume in Memory of Richard Musgrave* (Tax Series on International Taxation 34; Kluwer Law International, 2009), pp. 536-537.[/fn] Still, how to understand the phrase "principal purpose" and "one of its principal purposes" under the CJEU's case law is not clear. In order to make it more clear, the OECD and foreign case law guideline may be of assistance. This will be the topic of the next part of this contribution.