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## Foreseeing the Impact of X GmbH (Case C-135/17), III: The Importance of the Genuine Exchange of Tax Information with Third Countries

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***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 third and final part part discusses point (2) and tries to foresee the German Federal Finance Court's judgement in respect of the possibility to justify the restriction of free movement of capital by ensuring the need for effective fiscal supervision of German tax authorities.

### 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

After deciding about the standstill clause in Article 64(1) of the Treaty on the Functioning of the European Union (TFEU),[1] the CJEU moved to the examination of the compatibility of German CFC rules with the fundamental freedoms. In that respect, the CJEU first focused on the justification by the need to prevent unacceptable tax avoidance (the standard of abuse under EU law in direct taxation), which was analysed in parts I and II of this piece. Before diving in the relevant passages of the analysed judgment on the exchange of tax information, it is wise to briefly look into the CJEU's previous case law in that area.

### CJEU's case law regarding the need to ensure the effectiveness of fiscal supervision

Up until the judgment in *X GmbH* (Case C-135/17), one of the most significant differences between Member States and third countries in a legal context is caused by the fact that Directive 2011/16/EU on administrative cooperation in the field of taxation applies only between the EU Member States.[2] In consequence, CJEU case law regarding restrictions on fundamental freedoms within the EU cannot be applied *in its entirety* to cases involving Member States and third states. For instance, an application of CFC rules to a CFC established in a third state may be justified for other reasons than the prevention of wholly artificial arrangements (WAAs), as applied in *Cadbury Schweppes*. In fact, the CJEU's case law indicates that domestic tax law provisions of a Member State resulting in a restriction of fundamental freedoms may be justified by the need to ensure the effectiveness of fiscal supervision. This justification has been rejected by the CJEU only when the tax authorities of a Member State could rely, in a concrete case, precisely on Directive 2011/16/EU.[3] In such cases as these, it would not be suitable to rely on the justification, since tax authorities are entitled to exchange of tax-related information in order to ensure effective fiscal supervision.

Moreover, the CJEU's case law[4] indicates that safeguarding the effectiveness of fiscal supervision may be achieved by other means than Directive 2011/16/EU, i.e., other international legal instruments, such as tax treaties, Tax Information Exchange Agreements (TIEAs) or the Convention on Mutual Administrative Assistance in Tax Matters (MAATM). What should matter is whether the legal instrument in question is suitable for obtaining the information required for the effective application of the domestic tax law provisions.[5] The important thing is not nature of the legal instrument enabling the exchange of tax information but its capacity to enable tax authorities to verify the information provided by a CFC and/or its participants in order to apply CFC rules.[6]

**The emphasis on genuine exchange of tax information in *X GmbH* (Case C-135/17)**

Since the legal measures facilitating an effective exchange of tax information are required in order to prevent tax evasion and tax avoidance by Member States, there is a link between the effective exchange of tax information to enable:

1. effective fiscal supervision; and
2. the effective application of anti-avoidance provisions, such as the German CFC rules, required for preventing tax avoidance.

When the tax authorities are unable to verify whether a taxpayer is exploiting a WAA for tax avoidance purposes in a third state or not, they may justify the restriction of the free movement of capital by invoking the need to ensure effective fiscal supervision rather than the prevention of tax avoidance via WAAs. This was the main difference in justifying the restrictive effect of CFC rules within and outside the EU until the CJEU's judgement in *X GmbH* (Case C-135/17).

Nevertheless, the CJEU in its previous case law, for example in paras. 94–96 of *ELISA* (Case C-451/05), implied that *the fact that it may be impossible to request that cooperation cannot justify refusal of a tax benefit*, because there is no reason why the tax authorities should not request from the taxpayer the evidence that they consider they need to apply their domestic tax law and, where appropriate, refuse the tax advantage applied for (e.g. no taxation under CFC rules) if that evidence is not supplied.

In *X GmbH* (Case C-135/17), the CJEU has taken the view that what matters is a legal framework

of cooperation and procedures for the exchange of information between the national authorities concerned, *which are genuinely such as to empower the German tax authorities to verify, if necessary, the accuracy of the information provided on the company* established in Switzerland in order to demonstrate that that taxable person's shareholding in that company is not the result of an artificial scheme. This shows that the approach of the CJEU, as expressed in *ELISA* (Case C-451/05) is nowadays obsolete. What matters now is an existence of legal basis for a genuine exchange of tax information.

The reasoning of the CJEU reveals an interesting correlation between the scope of the German CFC rules and exchange of tax information. In paragraph 85, the CJEU stated that it is apparent that the German CFC rules are not designed solely to prevent artificial schemes. Then the question is why in paragraph 94 the CJEU examined the possibility to justify the German CFC rules by the need to verify the accuracy of the information provided on Y (Swiss CFC) in order to demonstrate that that X's shareholding in Y is not the result of an artificial scheme? Perhaps, the fact that the legislation was not proportional due to its wording could be sanctioned by its application only to artificial schemes and therefore the verification of such schemes should be decisive?

Going back to the core analysis, in this author's opinion, the CJEU's position in *X GmbH* (Case C-135/17) is correct and consistent with its previous case law which implies that what matters for ensuring effective fiscal supervision is the suitability of the legal basis for exchanging tax information. This legal basis must be functional in the sense that such exchanges actually take place and are not merely illusory, i.e. a legal basis exists without its effective application. Moreover, I dare to say, *de lege ferenda*, that without actually obtaining information from foreign tax authorities, irrespective of their location (inside or outside the EU), the tax authorities of the Member States cannot effectively supervise their tax residents in respect of their foreign activities. Nor can they apply their anti-avoidance legislation effectively. Consequently, the effective (genuine) exchange of tax information, i.e. the way that is suitable and necessary for the application of national tax regulations such as the CFC rules, are decisive to ensure effective fiscal supervision, not just the existence of such opportunities based on tax treaties, TIEAs or other legal facilities, without an actual possibility to enforce such opportunities. The effective exchange of tax information allows to effectively verify the taxpayer's documentation by the foreign tax authorities. This cancels the necessity of providing a justification of the restriction of free movement of capital with reference to the need to ensure the effective fiscal supervision.

This proposal should improve consistency and symmetry of CJEU case law in relation to the need to ensure effective fiscal supervision – the effective (functional) exchange of tax information matters enabling efficient fiscal supervision as much as between Member States as between Member States and third countries, including tax havens. This approach also fits the purposes of the ATAD and the BEPS Project insofar as the effective exchange of tax information is indispensable for the effective application of anti-avoidance measures, including CFC rules. Perhaps in the light of the ATAD and the BEPS Project, the CJEU will modify its position in the near future in light of these proposals and emphasise very clearly the significance of the effective exchange of tax information not only between Member States and third countries, but also among Member States only.

**Conclusions and a foresight of the German Federal Finance Court's judgement**

I would say that the German Federal Finance Court will find out, consistently to the opinion of AG Mengozzi delivered on 5 June 2018 in *X GmbH* (Case C-135/17), that Article 4 of MAATM, as

applicable between Germany and Switzerland, could not be applied to the scheme under examination, because the case concerned 2005 and 2006 tax years, while, in accordance with Article 30 of that MAATM, it does not provide assistance in respect of tax claims which are in existence at the date of entry into force of MAATM, that is to say before 1 January 2017.

Another legal basis worth to look at is Article 27(1)a) of the German-Switzerland tax treaty (1971), as it was applicable to the facts in 2005 and 2006. It permits the competent authorities of the Contracting States to exchange information for carrying out the provisions of this treaty concerning taxes covered by the treaty. The German CFC rules are provisions, which lead to taxation of corporate income, i.e. tax covered by the treaty. The questionable is, however, whether the information necessary to apply the German CFC rules equals to the information necessary for carrying out the provisions of the German-Swiss tax treaty. Perhaps not, because such information is rather necessary for applying the German domestic tax law. If so, it *almost* falls within the scope of Article 27(1)b) rather than Article 27(1)a), since the former provisions stipulates that administrative assistance shall also be provided for *the implementation of national law in cases of acts of fraud*. Point 3 of the 2002 Protocol to the treaty clarifies that the term “acts of fraud” under Article 27 means fraudulent conduct which is deemed to be an offence under the laws of both States, and is punishable by imprisonment. Since situations covered by the German CFC rules are not linked with such conducts, it seems that Article 27 of the treaty is not suitable to obtain information necessary to verify the accuracy of the information provided on the company established in Switzerland in order to demonstrate that that taxable person’s shareholding in that company is not the result of an artificial scheme.

Consequently, it appears that the German Federal Finance Court will conclude that the German tax authorities, under given actual and legal circumstances, were not in a position to verify whether or not the scheme involving the Swiss company Y was artificial or genuine. The German CFC rules should thus be considered to be compatible with free movement of capital due to the need to ensure the effectiveness of fiscal supervision. This conclusion could be challenged only if the German taxpayer proves the existence of legal basis allowing for an effective exchange of tax information between German and Swiss authorities in 2004 and 2005 in order to verify the existence or absence of artificiality of the Swiss company Y and the transactions between X, Y, and Z.

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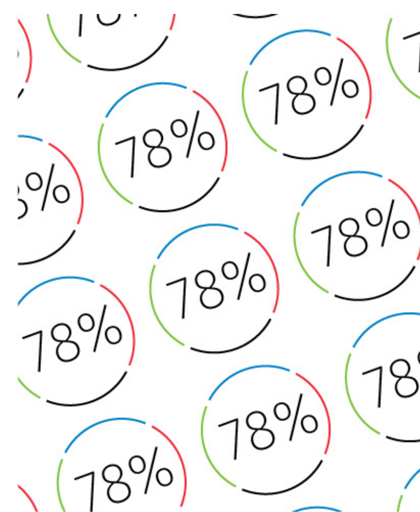

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