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Germany's CFC taxation reform:
New control concept leads to increased compliance requirements

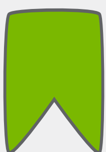
December 20, 2019

On December 10, 2019, the German Ministry of Finance published a first draft of a reform of its controlled foreign corporation (CFC) taxation. Even though Germany had already implemented CFC taxation in 1972, a reform was necessary because the existing legislation is not in line with the requirements of the Anti-Tax-Avoidance Directive (ATAD) of the European Union in every aspect. At first glance, the proposed amendments look rather minor, but after a closer look it becomes evident that the reform has the potential to significantly increase compliance requirements, in particular for German investors in investment funds.

Because of the Anti-Tax-Avoidance Directive (ATAD), Member States of the European Union were obligated to implement CFC taxation or, as in the case of Germany, to amend their CFC taxation in order to meet the ATAD standard. The major difference between the CFC taxation under ATAD and the existing law in Germany is the control concept. The implementation of the ATAD standard looks to ease requirements at first glance, but it has some key features, which indeed have the potential to increase compliance requirements.

Individual controlling instead of German controlling, but hidden stumbling blocks

Under current law, the control requirement for a CFC taxation is met if shareholders, who are subject to unlimited tax liability in Germany, directly or indirectly hold more than 50 per cent of the shares in a foreign corporation, i.e. under this concept, the "German control" may rest solely with German tax payers. It is not relevant if those shareholders are related to or affiliated with each other. Contrary to the current German control concept, the reform draft implements an individual control concept. According to this individual control concept, the participation requirement is met if only one individual German shareholder holds, together with its related or affiliated parties, directly or indirectly more than 50 per cent of the shares of the foreign corporation (as opposed to several German shareholder holding more than 50 per cent in the aggregate). This deceptively easing amendment has its disadvantages. Persons are deemed to be related or affiliated persons if such persons hold at least a 25 per cent of each others shares (i.e. "related persons"). This would also cause non-German persons to be subject to this new individual control concept.



Documents to beinformed:

- Proposed draft of German CFC reform (in German)

Example: A German investor holds 25 per cent in a fund in corporate form. As the more than 50 per cent threshold is not met, the control requirement will not be satisfied under the proposed legislation or under existing law. However, the German shareholder and the foreign fund will in the future – in contrast to existing law – be deemed to be related persons . Thus, when the fund in turn holds at least 51 per cent of the shares in a low-taxed corporate subsidiary, the German investor will be deemed to control the low-taxed corporate subsidiary of the fund. Consequently, the German CFC taxation rules will apply.

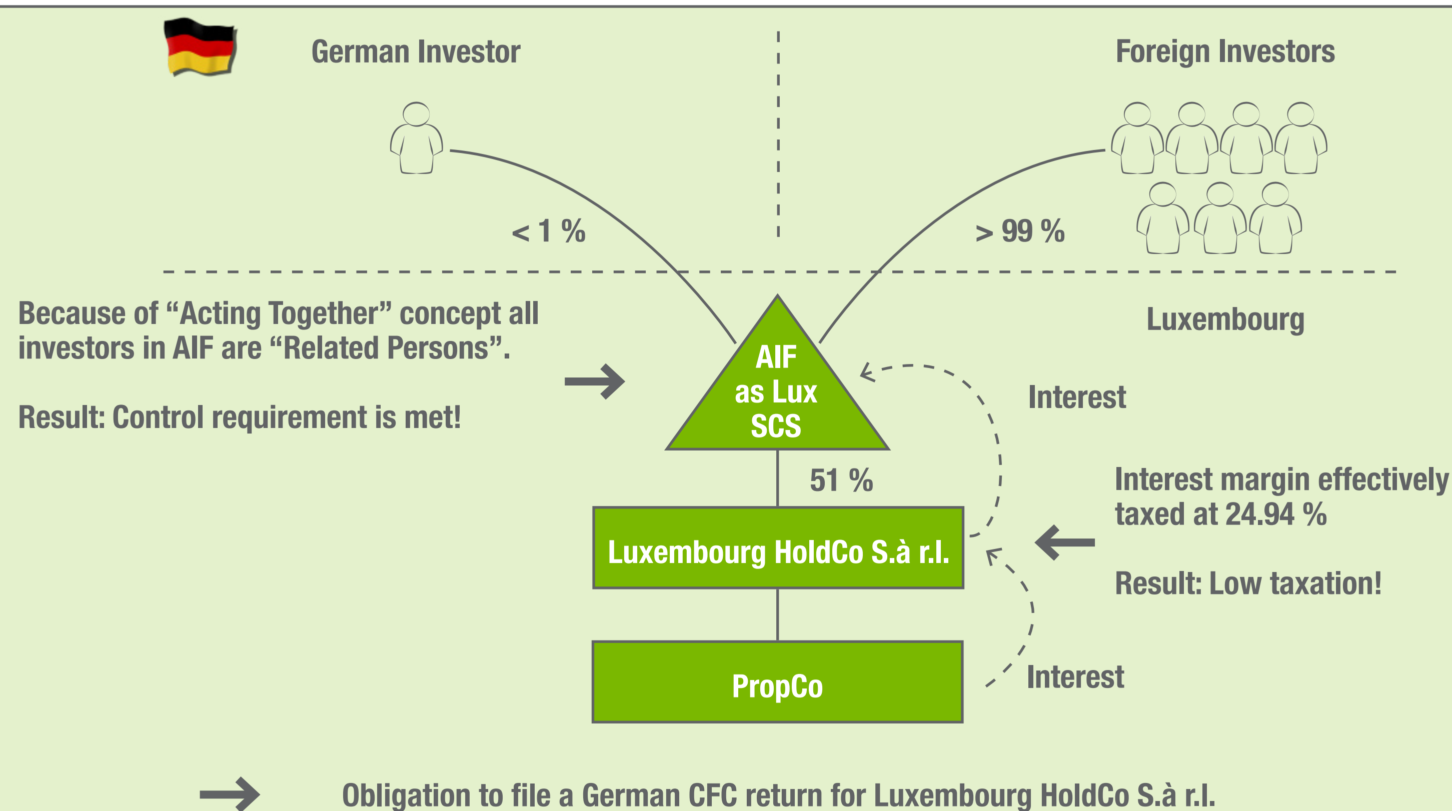
Unfortunately, the new individual control concept also is accompanied by two further proposed amendments: Firstly, the proposed reform revokes the primacy of application of the German Investment Tax Act. Thus, CFC taxation will apply in addition to the deemed dividend taxation of the German Investment Tax Act. Secondly, dividends, which are not included as CFC income under the current concept, will be caught under the new rules if dividends stem from minority shareholdings (less than 10 per cent). Putting these separate restrictions together, it becomes evident that the proposed reform might result in equity funds becoming subject to German CFC taxation.

German Investor
Foreign Investors
German investor and fund vehicle are “Related Persons” → 25 %
75 %
No blocking of German CFC taxation by German Investment Tax Act →
Fund Vehicle as Corporation
Luxembourg
51 %
Luxembourg Master HoldCo
Minority dividends now passive income!
← Effective taxation at 24.94 % results in low taxation!
< 10 %
< 10 %
< 10 %
< 10 %
Target Companies
Target Companies
Target Companies
Target Companies
→ Obligation to file a German CFC return for Luxembourg Master HoldCo

New concept of “acting together” with unexpected consequences for alternative investment funds (AIF)

Another amendment to the German CFC legislation is the proposed concept of “acting together”. According to this, persons are deemed to be “related persons” if they act together with regard to their investment in a foreign corporation. In this context, the legislative text does not allow for much interpretation as it explicitly points out that all partners in a partnership are deemed to be “acting together”. This has far-reaching consequences.

Example: One German investor has a stake of less than 1 per cent in an alternative investment fund (AIF) in the form of a partnership, while more than 99 per cent are held by unrelated (German or non-German) investors. In such a case, the German CFC taxation will always apply if the partnership itself has a minimum participation of more than 50 per cent in a foreign low-taxed corporation, because the stake of the German investor will be aggregated with all other investors in the AIF. As low taxation already applies for rates less than 25 per cent, it becomes evident that the CFC legislation will apply regularly. For instance, as of 2019, a Luxembourg S.à r.l. will often be effectively taxed at a rate below 25 per cent (depending on the municipal trade tax burden of the S.à r.l. within Luxembourg). Even though the effective taxable income at the level of the low-taxed corporate subsidiary might be substantially reduced by debt financing, and thus additional CFC tax will only be due on the resulting margin, the German taxpayer must ensure that the CFC Act tax return is filed with the German tax authorities.



Extended CFC taxation for capital investment type income remains in force

Nothing has changed in relation to the extended CFC taxation on capital investment type income ("Zwischeneinkünfte mit Kapitalanlagecharakter"). Under current law, the CFC taxation applies if a German shareholder holds at least 1 per cent of the shares in a low-taxed foreign corporation, which generates capital investment type income. This is defined as income sourced from bonds, securities, receivables or participations (except for qualifying dividends or capital gains). So far, any hopes that this strict regulation could be relaxed by the reform have been disappointed. On the contrary, because of the deemed passive income of minority dividends and the parallel application of investment fund and CFC taxation, German 1 per cent investors in widely held equity funds might become subject to the German CFC taxation.

First assessment of the proposed legislation and practical implications

Expectations and hopes that the German CFC reform will have only a minor effect, or might even ease certain requirements, have been disappointed. Indeed, key parts of the reform will certainly lead to a significantly broader scope of the German CFC Act, such as the new participation concept, including "acting together", and the parallel application of investment fund and CFC taxation. However, we expect that with prudent tax compliance measures, adverse tax effects of the new CFC rules can be mitigated.

Please contact us: We have more than twenty years of experience in German CFC and investment fund taxation.

be in touch: Any questions? Please do not hesitate to contact us!

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