Recent Developments in the German Tax Treatment of CFCs

This note describes the tax treatment of controlled foreign companies (CFCs) under German tax legislation and case law. In a recent decision of the German Federal Tax Court, the taxpayer was not required to pay trade tax on CFC income, thus altering the tax consequences of CFC income significantly. This decision has aligned the German tax treatment of CFCs with that of foreign permanent establishments, the income of which is also not subject to trade tax.

1. Introduction

Under German tax law, as is the case for many corporate tax systems worldwide, corporations are taxed separately from their shareholders, while partnerships are treated as tax transparent. Only upon a distribution of profits or the sale of the participation does the shareholder receive taxable income from his subsidiary in the form of income from capital. To mitigate any resulting double taxation at the level of the shareholder, German tax law provides for partial or full exemptions for dividends and capital gains derived from subsidiaries or applies reduced tax rates, depending on the tax status of the shareholder.

The distinction between the shareholder and the corporation has further implications that have bedeviled tax lawmakers for some time and are now also a subject of the BEPS Project at the level of the OECD. For instance, deductions granted for distributions to shareholders in a foreign country are not automatically taken into account for taxation purposes at the level of the shareholder. Without further legislative measures, an exemption for a dividend may be granted in respect of the distribution, leading to a “hybrid mismatch.”

To remedy such situations, German tax law has, for some time, contained a domestic correspondence principle. This principle makes the tax exemption or beneficial treatment at the level of the shareholder dependent on a lack of deduction at the level of the distributing corporation (section 8b(1), sentences 2-4 of the Corporate Income Tax Act (CITA)). The rule has been backed up by a formal correspondence rule that enables changes to the tax assessments of shareholders in such situations even after the expiry of the normal tax assessment period (section 32a of the CITA).

Since 1972, however, the German Foreign Transactions Tax Act (FTTA) has provided for an important exception to this rule. Under sections 7 to 14 of the FTTA, income of a controlled foreign company (CFC) can be attributed to the German shareholder and taxed as income from capital at the shareholder level immediately upon conclusion of the CFC’s tax year. In a later update, section 20(2) was introduced, providing for a treaty override that switches from the exemption to the credit method in respect of income of foreign permanent establishments (PEs).

The taxes triggered by CFC income at the level of a German corporation or trading business as a shareholder used to comprise both corporate tax (15%) and trade tax (ranging from 7% to 18%). In a recent high profile decision, the Federal Tax Court (Bundesfinanzhof – BFH) decided that trade tax is not chargeable on CFC income at the level of the German shareholder. The remaining corporate tax burden is mitigated by a credit mechanism for taxes paid at the level of the CFC. The problem of CFC attribution has thus been mitigated for German shareholders substantially.

This contribution describes the state of the German CFC regime after the recent court decision and highlights implications for taxpayers and investors.

2. The German CFC Regime

2.1. Regime for CFCs

Germany has had a CFC regime since the introduction of the FTTA in 1972. Its basic structure has remained largely static since then. Under the German CFC regime, a CFC is defined as:

(1) A foreign corporation (section 7(1) of the FTTA),

(2) whose share capital or voting rights are majority owned by German residents at the end of its fiscal year (section 7(2) of the FTTA), either directly or indirectly,

(3) insofar as it generates “passive” income, i.e. income that is not covered in an exhaustive list of types of “active income” (section 8(1) of the FTTA), and

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3. DE Corporate Income Tax Act (Körperschaftsteuergesetz), National Legislation IBFD.
5. DE Foreign Transactions Tax Act (Außensteuergesetz), National Legislation IBFD.

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All these requirements must be met simultaneously for the CFC rules to apply. Given that CFCs may pursue different economic activities, some of which may be deemed ‘active’ under German CFC rules and some of which may be regarded as ‘passive’, only part of the income of a CFC may be subject to the CFC rules. If the CFC rules do apply, they supersede any protection of a tax treaty that might exist between Germany and the foreign country of residence of the CFC (section 20(1) of the FTAct).

2.1.1. Foreign corporation

Under the first requirement, the foreign corporation must be substantially similar to a German corporation to qualify as a CFC.9 For German tax purposes, the Federal Ministry of Finance has issued a list of criteria according to which similarity can be determined.8 If an analysis of the articles of association of the foreign entity leads to the conclusion that the foreign entity is more similar to a German partnership, the CFC rules do not apply. As partnerships are flow-through entities under German tax law, in any event, the German partner is taxed on the attributable profit immediately, without any distribution or withdrawal of profits (section 15(1) of the ITA). Hence, the application of the FTAct in this situation is reduced to section 20(2) of the FTAct, which provides for a switch-over from the exemption to the credit method should a tax treaty be applicable.10

The corporation is treated as ‘foreign’ if both its place of management and its statutory seat are located outside Germany (section 7(1) of the FTAct). A dual resident company with a place of management in a foreign country and a statutory seat in Germany is consequently not treated as a CFC.

2.1.2. German majority ownership

Under the second requirement, German residents must hold the majority of either the voting rights or the share capital of the foreign corporation at the end of the tax year (section 7(2) of the FTAct). German residents are natural or juridical persons that are subject to resident taxation in Germany (section 1(1) of the CIT Act, section 1 of the Income Tax Act (ITA)).11 The share ownership of all German residents is added together under this rule. If the sum exceeds 50%, the rule is fulfilled for all German shareholders even if their individual shareholding is lower than 50%.

This condition is relaxed and, in some cases, fully dropped for certain types of capital income of the CFC. In these cases, a 1% ownership or any ownership share, even less than 1%, is sufficient for the CFC rules to apply (section 7(6) of the FTAct).12

The majority ownership in the CFC can be direct or indirect (section 7(2), sentence 2 of the FTAct). If the ownership is direct, the shares in the CFC may be held by a foreign corporation that, in turn, is held by German residents. The CFC income is attributed to the German shareholder through a chain of participations of any length as long as the indirect ownership in the CFC exceeds 50% (section 14 of the FTAct). The interposition of a partnership in the chain also does not prevent the attribution of CFC income (section 7(3) of the FTAct).

2.1.3. Passive income

Section 8(1) of the FTAct provides an exhaustive list of the types of income that are considered “active” under the German CFC rules and hence do not lead to adverse tax consequences thereunder, such as income from agriculture and forestry or, in many instances, trading activities. Any income the taxpayer cannot prove can be allocated to one or more of the income types within the list is regarded as passive.

In many instances, the rules have been tailored to economic circumstances that are supposed to be caught by the CFC rules. For instance, income from services provided by the CFC is generally regarded as active (section 8(1), no. 5 of the FTAct). Insofar as the CFC provides the services to its German majority shareholder, however, the income is treated as passive (section 8(1), no. 5, lit. b of the FTAct). There is a further exception to this rule if the German taxpayer can prove that the CFC has a business organization that is equipped to provide such services, that it participates in a market for such services and that the German shareholder does not assist in providing such services. If these conditions can be shown to be met, the income is regarded as active. The classification of CFC income as active and passive is consequently quite cumbersome and subject to legal uncertainty.

2.1.4. Low effective taxation

Under section 8(1) of the FTAct, the CFC rules only apply if the passive income is taxed at a low rate. The rule for the determination of the low rate for purposes of this rule can be found in section 8(3) of the FTAct. According to this rule, the income is taxed at a low rate if the effective tax rate of the passive CFC income is lower than the threshold of 25%.

The effective tax rate, in turn, is calculated as the ratio between the taxes levied in the residence state on the passive income of the CFC and the tax base of the CFC determined according to German tax rules.13 Hence, the CFC is treated as if it were resident in Germany and its income were subject to resident taxation, and the income
thus calculated is compared to the foreign tax charge. If the resulting ratio is less than 25%, the rule is fulfilled. 14

2.1.5. De minimis rule

Section 9 of the FTAA provides for a de minimis rule that exempts CFC income from attribution to the German shareholder under quite narrow conditions. The CFC income exempted under this rule must not exceed EUR 80,000 for a single CFC or the German taxpayer overall. Additionally, the share of passive income in the overall income of a CFC must not exceed 10% under the de minimis rule. It is consequently rather rarely invoked.

2.1.6. Special situation under EU law

Following the Court of Justice of the European Union (ECJ) decision in Cadbury Schweppes (Case C-196/04), 15 the German legislator introduced section 8(2) of the FTAA, which provides for an exemption from the CFC rules. 16 If the CFC is based inside the European Union or the European Economic Area, the taxpayer can prove to the authorities that it pursues a real economic activity. Insofar as the proof is successful, CFC income is not attributed to the German shareholder. The rules do not allow for an exemption of income generated in third countries, whether by a CFC based in the third country or by a PE of a CFC based in the European Union/European Economic Area (section 8(2), sentences 3 and 4 of the FTAA).

2.2. Consequences at the level of the German shareholder

2.2.1. General consequences

As a legal consequence of the conditions set out herein being fulfilled, a CFC amount 17 is imputed to the German shareholders. The CFC amount is determined according to the provisions of German tax law, i.e. the income determination of the CFC under foreign law is adapted to German tax law via modifications to income (section 10(3) of the FTAA). German tax law gives the shareholder a choice whether to account for the CFC income under normal bookkeeping rules or via cash accounting rules (section 10(2), sentence 2 of the FTAA).

Based on the participation quota of the German shareholder in the CFC, a corresponding share of the income thus determined is attributed to the German shareholder. In the event of a loss of the CFC under German tax rules, no income is attributed to the shareholder (section 10(1), sentence 4 of the FTAA). Instead, the loss is carried forward and can offset future income of the CFC (section 10(3), sentence 5 of the FTAA).

At the level of the German shareholder, the CFC amount is treated as income from capital (section 10(2), sentence 1 of the FTAA). It is deemed to have accrued to the German taxpayer immediately upon the conclusion of the tax year of the CFC. Depending on the tax status of the shares in the CFC, the tax treatment may differ.

For natural persons holding shares in the CFC as private assets, the income is subject to personal income tax at progressive rates ranging from 14% to 45%. If the shares are held by a natural person as business assets for tax purposes, the income is characterized as business income (section 20(8), sentence 1 of the ITA) and also subject to progressive personal income tax rates. If the income is attributed to a corporation, it becomes part of the taxable income of the German corporation that forms the tax basis for the German corporate income tax (section 7(1) of the CIT), and by extension, the trade tax (section 7, sentence 1 of the Trade Tax Act). 18

The CFC amount is treated as a “deemed” dividend. In deviation from the usual practice, however, the measures provided by German tax law to alleviate economic double taxation 19 are not applied to the CFC amount. For instance, the exemption method enshrined in German national tax law (section 8b of the CIT) is not available for German corporations that are recipients of CFC income (section 10(2), sentence 3 of the FTAA). Neither can a German shareholder holding shares in the CFC as private assets for tax purposes avail himself of the German final withholding tax on dividend income (section 32d of the ITA, section 10(2), sentence 3 of the FTAA).

As compensation for the prior attribution of CFC income to the German shareholder, the shareholder is entitled to an exemption for dividends actually paid by the CFC to the German shareholder under section 3, no. 41, lit. a of the ITA. The exemption only applies if income is distributed within seven years of attributing the CFC income to the German shareholder. For corporate shareholders of the CFC, the exemption is not particularly important since dividends are exempt under the national participation exemption enshrined in section 8b of the CIT. 20

In the same vein, if the shares in the CFC are sold, the resulting capital gain is exempt under section 3, no. 41, lit. b of the ITA, subject to the same conditions as for dividends, in particular, the seven-year period.

2.2.2. Duty to file a tax return

Additionally, there is a statutory duty for the German shareholder to file a separate tax return for CFC purposes, setting out the income of the CFC, among other tax attributes. This duty is enshrined in section 18(3) of the FTAA and is binding for all German shareholders regardless of their individual participation quota in the CFC.

14 To catch special provisions in foreign tax codes providing for refunds of taxes, the rules have been amended to take such refunds into account when determining the effective tax rate. See W. Kessler & R. Eicke, Germany Targeting Maltese Holding Companies, 60 Tax Notes Intl. 11, p. 819 (2010).
15 UK: ECJ, 12 Sept. 2006, Case C-196/04, Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, ECJ Case Law IBFD
17 Hinzurechnungsbetrag.
18 DE: Trade Tax Act (Gewerbesteuergesetz).
19 See Weiss, supra n. 1.
20 Id.
2.2.3. Corporate tax

The income derived from the CFC is characterized as income from business activities at the level of the German corporate shareholder (section 10(2), sentence 2 of the FTTA; section 8(2) of the CITA). It is subject to a 15% corporate tax rate (section 23(1) of the CITA) and an additional 5.5% solidarity surcharge thereon.21

For corporate tax purposes, however, a credit mechanism is available. While the CFC amount attributable to the German shareholder is generally defined as net of foreign taxes (section 10(1) of the FTTA), the German shareholder can choose to have the CFC amount increased by the foreign taxes and to have the taxes credited against the corporate tax due on the CFC amount (section 12(1) of the FTTA).

Example 1:

X-GmbH, a German resident corporation, owns 80% of the foreign T-Corp., which is resident outside the European Union and whose articles of association closely resemble the characteristics of a German corporation. The remainder of the shares in T-Corp. are held by persons not resident in Germany. Its income of the equivalent of EUR 1,000,000 in a given fiscal year is subject to a corporate income tax charge of the equivalent of EUR 200,000 in its country of residence. The entire income is regarded as passive under German CFC rules (section 8(1) of the FTTA). Calculated according to German tax rules, however, the passive income of T-Corp. would be EUR 900,000.

T-Corp. is a foreign corporation that is majority owned by a German resident corporation, X-GmbH. Its income is subject to a foreign nominal tax burden of 20%. As mentioned, however, the effective tax burden for purposes of the CFC rules must be calculated according to German rules, yielding an effective tax rate of (200,000/900,000) = 22.22%. Hence, the income is effectively taxed below the 25% threshold stipulated by section 8(3) of the FTTA. Since T-Corp. is not based inside the European Union or the European Economic Area, the Cadbury-Schweppes exception of section 8(2) of the FTTA22 is not available.

Hence, a share of 80% of the income of EUR 900,000 is attributed to X-GmbH upon conclusion of the tax year of T-Corp. The CFC amount of EUR 720,000 is subject to corporate tax at a rate of 15% in Germany. The resulting tax burden is thus EUR 108,000 of German corporate tax.

For corporate tax purposes, upon application, EUR 160,000 (80% of the EUR 200,000 paid in the country of residence) of taxes can be credited against the German tax liability. Since the creditable amount exceeds the German corporate tax liability by EUR 52,000, X-GmbH does not owe any additional corporate tax in Germany, but no credit is given for the excess tax credit. This excess amount is forfeited without any carryforward or carryback under the normal German rules for tax credits (section 34c of the ITA; section 26 of the CITA; section 12(2) of the FTTA). Further, no solidarity surcharge is due since the tax base for the solidarity surcharge is the corporate tax assessed (section 3(1), no. 1 of the SSA), which is zero in the example.

Overall, the corporate tax burden on the CFC income consists of EUR 200,000 in foreign taxes on income determined according to German tax rules of EUR 900,000, leading to a 22.22% tax burden. The higher foreign tax level is thus not compensated for and the tax burden exceeds the normal 15% under the German Corporate Income Tax Act (section 23(1) of the CITA).

2.2.4. Trade tax

The tax rate for the German trade tax is set by each German municipality independently and varies from a legal minimum of 7% to approximately 18%, even though there is no statutory upper ceiling for the rate. The entitlement of a German municipality to a share of trade tax revenue is determined by the presence of a PE for national tax purposes (section 4(1), sentence 1 of the TTA; section 12 of the GFC).23 German trade tax is levied on a special tax base (section 6 of the TTA). The tax base is derived from income calculated for corporate income tax purposes (section 7(1) of the TTA). It is subsequently modified according to sections 8 and 9 of the TTA.

German trade tax is only levied on the income of businesses under the ITA, as defined by section 15(2) of the ITA.24 This restriction on the taxable units, enshrined in section 2(1), sentences 1 and 2 of the TTA, is augmented by a second one, namely that the trade tax must only be levied insofar as a businesses has a German domestic PE (section 2(1), sentence 3 of the TTA). This “territoriality principle” means that only domestically earned income should be subject to trade tax. This principle gives rise to various exemptions in the TAA, for instance, the exemption for income of a foreign PE from trade tax (section 9, no. 3 of the TTA). Income from a foreign partnership is not subjected to trade tax, either (section 9, no. 2 of the TTA), while dividends from foreign subsidiaries are exempted under somewhat more onerous conditions (section 9, no. 7 of the TTA).25

Given that the CFC amount is income for corporate tax purposes, it is included in the tax base for trade tax as well under section 7, sentence 1 of the TTA. There is, however, a dispute in the academic literature as to whether section 9 of the TTA eliminates the CFC amount from the tax base for trade tax purposes.


22. See sec. 2.1.4.

23. Merely transitory differences between the foreign and domestic tax base, such as different depreciation schedules, can be disregarded for purposes of the determination of effective taxation; see German Federal Ministry of Finance. Schreiben betr. Grundsätze zur Anwendung des Außensteuergesetzes, 14 May 2004 – BMF IV B 4 – S 1340 – 11/04, Federal Tax Gazette I, p. 3 (2004), nn. 8.3.1.1.

24. See sec. 2.1.6.


26. Corporations, such as stock corporations (AG) or limited liability companies (GmbH), subject to resident taxation are deemed to have a business under section 8(2) of the CITA, regardless of their economic activity. This carries over to the Trade Tax Act, section 2(2), sentence 1 of the TTA.

27. See Weiss, supra n. 1, at p. 180.
The German tax literature argues, on the one hand, that the inclusion of the CFC amount would subject income that is earned in a foreign country to trade tax, in contrast to the territoriality principle. Trade tax is supposed to be levied only on domestic income, since it provides some compensation to municipalities for the use of public goods by firms operating in their territory. CFC income earned abroad does not fall into this category.

On the other hand, the FTTA includes a couple of provisions that demonstrate quite clearly that the German legislator sees CFC income as part of the trade tax base, as is evident from the statutory rules governing the application of the FTTA (section 21 of the FTTA).

If the CFC amount is included in the trade tax base, the credit mechanism described in section 2.2.3. in respect of corporate tax is not applicable since, according to the prevailing opinion in the German tax literature and the tax administration, there is no credit for foreign taxes under the TTA. Any excess tax credit not used for corporate income tax purposes is thus forfeited since there is no credit for trade tax purposes and no carryforward of tax credits under German tax law.

Example 2:

Extending Example 1 above, imagine that 80% of the CFC amount of EUR 900,000 is subjected to trade tax at the level of X-GmbH. Assuming a (fairly low) trade tax rate of 15%, an additional EUR 108,000 in trade tax is due. A credit for the excess tax credit left over after application of the corporate tax (EUR 52,000) is not available since there is no provision in the Trade Tax Act to grant a credit for foreign taxes.

Hence, following the application of the TTA, the overall tax burden on the CFC income has increased from 22.22% to 37.22% ((EUR 160,000 + EUR 108,000) / EUR 720,000). For higher trade tax burdens, the tax burden climbs even higher since no foreign tax credit is available against trade tax.

The tax burden on the CFC income far exceeds the taxes that would have been due in Germany if X-GmbH had generated the income attributed from the CFC itself. On the EUR 720,000 of income, 15% trade tax and 15% corporate tax would have been due, plus a solidarity surcharge of 5.5% of the corporate tax charge, leading to an overall tax burden of 30.825%. The difference of almost 6.5 percentage points is accounted for by the low German corporate tax rate, which leaves a substantial portion of foreign taxes not creditable. The trade tax is also not reduced by the foreign taxes.

2.3. Regime for foreign PEs

In an update to the rules governing CFCs in 2007, the German legislator inserted a clause dealing with the income of foreign PEs as well (section 20(2) of the FTTA). In situations in which German resident taxpayers have PEs in foreign countries, the rule provides for a test that establishes whether or not the income of the PE would be CFC income if it were generated by a corporation. In other words, for purposes of the test, a corporation is substituted for the PE, and the normal conditions of the German CFC rules are then applied, as described in sections 2.1.1. to 2.1.5. The escape clause for CFCs based in the European Union/European Economic Area is not applicable to PEs (section 20(2), sentence 1 of the FTTA).

The rule constitutes a treaty override since it switches, for income attributable to a foreign PE, from the exemption method provided under most German tax treaties (article 23A of the OECD Model (2010)) to the credit method (article 23B of the OECD Model), insofar as the income of the PE is regarded as passive.

The rule thus offers an additional switch-over mechanism in situations in which the tax treaty itself does not contain an activity clause for the income of PEs. However, the scope of treaty-based activity clauses and section 20(2) of the FTTA differs since the former does not require low taxation according to section 8(3) of the FTTA while the latter does.

3. Planning Techniques for Trade Tax Purposes

Given the prevailing view of the German tax authorities, i.e. that the CFC amount is fully taxable under both the CTA and TTA, various planning techniques were available to reduce the trade tax burden on CFC income. One easily implemented and rather crude measure was to have a German subsidiary that was based in a “trade tax haven”, i.e. a municipality that has a low municipal collection rate, hold the shares in the CFC. This subsidiary could not form a fiscal unity for trade tax purposes with its parent, as the benefit would otherwise have been diluted. In the best case scenario, the municipal collection rate was set at the legal minimum of 200%, leading to an effective trade tax burden of 7%. The trade tax on the CFC amount was thus greatly reduced, but still substantial.

Further trade tax planning could involve the shares in the CFC being held via a foreign partnership or PE. While this technique did not prevent the attribution of CFC income to the German shareholders, as mentioned in section 2.1.2., it did eliminate the trade tax burden on the CFC.

30. Equivalent to a municipal collection rate of approximately 428%.
31. There is no offset for corporations between the corporate tax and trade tax burden, see sec. 4(5b) GTA.
33. See sec. 2.1.6.
34. OECD Model Tax Convention on Income and on Capital (22 July 2010), Model B.
36. See sec. 2.1.4.
37. See sec. 16(4), sent. 2 TTA.
38. See sec. 2.1.2.
income. The CFC income was deemed to have arisen in a foreign partnership or PE. Such income is deducted from the trade tax base under section 9, nos. 2 and 3 of the TTA. There had to be certainty, however, in respect of the attribution of the shares of the CFC to the foreign partnership or PE for the strategy to work.

4. Decision of the German Federal Tax Court

The plaintiff in a recent German high profile court case was a German corporation that, in the 2009 tax year, owned all the shares in a Singaporean corporation A-Ltd. A-Ltd. generated passive income under the German CFC rules to the tune of EUR 110,000, mainly consisting of interest income and foreign exchange gains, which was not disputed by the plaintiff. The CFC income was included in the tax base for corporate tax purposes. For trade tax purposes, however, the plaintiff argued that the CFC income should be deducted such that no trade tax would be due on it. The plaintiff invoked the exception of section 9, no. 3 of the TTA, which exempts income from a foreign PE from trade tax.

The lower court of Düsseldorf ruled against the plaintiff in 2013, stating that CFC income was to be included in both the corporate tax base and the trade tax base. The Court held that none of the subsections of section 9 of the TTA were applicable to the CFC income. Section 9 no. 3 of the TTA requires income from a foreign PE, which the court denied. It argued that the plaintiff did not have a foreign PE. Rather, it was the CFC that had a PE (at the very least due to its place of management) in Singapore. The Court ruled that this was not sufficient for the German plaintiff to be able to invoke the trade tax exemption under section 9, no. 3 of the FTTA.

The plaintiff, however, appealed against the ruling. Under the German two-tier system of tax courts, the appeal went straight to the highest German tax court, the Federal Tax Court in Munich. The Federal Tax Court ruled that the tax base for trade tax purposes should be reduced by the CFC income since the income was derived from a foreign PE.

In its ruling, the Court dismissed the idea that the foreign PE required for the application of section 9, no. 3 of the TTA had to be a PE of the plaintiff itself. Instead, the wording requires income to be subtracted from the trade tax base to be “part of income for trade tax purposes” (section 9, no. 3, sentence 1 of the TTA). It does not specifically mention or deal with the question of whether or not the PE needs to be owned by the taxpayer for German trade tax purposes.

Under German national tax law, a place of management invariably constitutes a PE for national tax purposes (section 12, sentence 2, no. 1 of the GFA). Hence, the PE of Singaporean A-Ltd. constituted by its place of management made the plaintiff eligible for the trade tax exemption, even though the activity of Singaporean A-Ltd. may not have given rise to a physical PE.

The Court also specifically mentioned, as a corollary of its ruling, that there should be a closer alignment of the treatment of foreign PEs and CFCs. Under the special switch-over rule of section 20(2) of the FTTA, income from foreign PEs that is passive under the CFC rules and subject to a low tax rate is not exempted under an applicable tax treaty. Instead, the credit method is used. For trade tax purposes, the income is deducted according to section 9, no. 3 of the TTA, as mentioned in section 2.2.4.

Following this landmark ruling, the CFC amount is no longer subject to trade tax, which comes as a relief to taxpayers. The problem of excess tax credits for corporate tax purposes has not, however, been resolved and may continue to affect taxpayers.

5. Conclusion

Under German tax law, trade tax is supposed to be levied only on income generated in German territory. Consequently, an exemption for CFC income, which is, by its very nature, earned abroad, from trade tax has been demanded in the literature for a considerable amount of time. While the German legislator never budged from its decision to fully tax CFC income for trade tax purposes and the German tax administration regularly included the income in the trade tax base, the German Federal Tax Court has exempted CFC income from trade tax for the time being.

The reaction of the German legislator cannot be anticipated at this point. Further, recent efforts at the OECD level to strengthen CFC rules as an instrument against “base erosion” and “profit shifting” may be hampered by the recent development. They are likely to lose some of their force for German taxpayers due to the alleviation of the tax burden on CFC income. Some form of reaction on the part of the legislator is thus anticipated.

40. Under the German system of tax courts, the lower tier courts are supposed to gather facts and evidence and rule on the dispute. They may also allow an appeal. Upon appeal, the Federal Tax Court cannot gather any additional evidence, but merely rules on disputes regarding the application of the tax law. In the event there is a lack of facts for a final ruling or errors in the fact gathering process, the Federal Tax Court sends the dispute back to the lower tier court for additional fact gathering.
42. See sec. 2.2.4.