ARTICLE

The *De Minimis* Exclusions in the ATAD's CFC Rules: A Normative Analysis

Monique T. Malan*

This study undertakes a normative analysis of the four de minimis *exclusions in the controlled foreign company (CFC) rules of Article 7 of the European Union's (EU's) Anti-Tax Avoidance Directive (ATAD). In the EU, CFC legislation inherently restricts either the freedom of establishment or the free movement of capital. Case law from the Court of Justice of the European Union (CJEU) confirms that, for this restriction to be permissible, the scope of application of CFC legislation must be limited to only capture income from wholly artificial arrangements. First, this study evaluates the design of the four different* de minimis *exclusions in Article 7 against their stated objective to limit the administrative burden and compliance costs in order to ascertain their (relative) effectiveness. Second, the normative coherence of these provisions is evaluated in the context of the limited application – only to cases of abuse – of the CFC rules in the EU. The study finds that the* de minimis *exclusions pertaining to Model A (in Article 7(3)) are only effective to a limited extent in achieving their objective and could be redesigned to improve their effectiveness. Further, those pertaining to Model B (in Article 7(4)) are not normatively coherent in an EU context. Therefore, their inclusion cannot be justified, and it is recommended that they be deleted.*

Keywords: De minimis exclusion, controlled foreign company, CFC rules, anti-tax avoidance directive, ATAD, Article 7(3) and (4), EU law, tax law, Cadbury Schweppes, anti-abuse.

1 Introduction

Controlled foreign company (CFC) legislation has existed for decades both outside and within the European Union (EU).[1] CFC rules are a specific anti-abuse/avoidance rule (SAAR). They aim to deter and counteract the tax avoidance practice whereby resident taxpayers erode their country's tax base by shifting profits to a foreign entity in which they hold a controlling interest located in a low-tax jurisdiction.[2] Within the EU, however, the question regarding the compatibility of a Member State's CFC legislation with EU primary law surfaced in the *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* (*Cadbury Schweppes*)[3] case referred to the European Court of Justice (ECJ or the Court)[4] in 2004. In 2015, one of the outcomes of the OECD/G20's Base Erosion and Profit Shifting (BEPS) Project, specifically, the BEPS Action 3 Final Report,[5] provided recommendations regarding the design of CFC rules to ensure that they effectively address BEPS. While the report considered the unique context of EU Member States in having to comply with the EU's supranational law in its recommendations,[6] its target audience was far more global than merely EU Member States.[7]

The Anti-Tax Avoidance Directive (ATAD) of 12 July 2016[8] is the EU instrument used to implement some of the recommendations of the 15 OECD/G20 BEPS Action Final Reports (2015). Its objective is to set a

Notes

* Research and teaching associate and doctoral candidate in the Doctoral Program in International Business Taxation (DIBT) at the Institute for Austrian and International Tax Law, WU Vienna University of Economics and Business. This research is supported by the Austrian Science Fund (FWF): Doc 92–G. Email: monique.malan@wu.ac.at.

1 The United States was the first country to adopt CFC legislation by including 'Subpart F' in the US Internal Revenue Code in 1962.

2 OECD, *Designing Effective Controlled Foreign Company Rules, Action 3–2015 Final Report* (2015), para. 7.

3 CJEU, Judgment of 12 Sep. 2006, *Cadbury-Schweppes and Cadbury Schweppes Overseas* (C–196/04, ECR2006, at I–7995) ECLI:EU:C:2006:544.

4 Formally named the Court of Justice. In this article, ECJ is used to refer to the Court of Justice prior to the *Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community (The Treaty of Lisbon)* that entered into force on 1 Dec. 2009. Court of Justice of the European Union (CJEU) is used to refer to this court post the Treaty of Lisbon. Both therefore refer to the supreme court of the EU's judicial institution and can be regarded as being used synonymously.

5 OECD, *supra* n. 2, at 9.

6 *Ibid.*, paras 19–22.

7 *Ibid.*, para. 21.

8 Council Directive (EU) 2016/1164 of 12 Jul. 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 (19 Jul. 2016).

common minimum level of protection against the erosion of tax bases in the internal market and the shifting of profits out of it that results from cross-border tax avoidance practices.[9] Member States may therefore adopt rules that offer a higher level of protection than those stipulated in the ATAD[10] provided they do not infringe EU primary law. The ATAD mandated Member States to introduce (or adapt their) domestic CFC legislation to meet the minimum standards set out in Articles 7 and 8 to be applicable from 1 January 2019.[11]

There is already an abundance of literature on both the ATAD in general[12] and the CFC rules contained in it.[13] This article endeavours neither to rehash the discussion regarding the compatibility of the CFC rules contained in the ATAD with EU primary law nor to, more specifically, assess the extent to which these rules are congruent with the principles established in the *Cadbury Schweppes* ruling.[14] Further, this study does not intend to provide a comprehensive critical review of the CFC rules in the ATAD.[15]

Instead, this article aims to evaluate the relative effectiveness and normative coherence of the four *de minimis* exclusions contained in paragraphs 3 and 4 of Article 7 of the ATAD. *Prima facie*, these provisions may not warrant careful scrutiny precisely because of the seeming insignificance of what they intend to cover. Recent research, however, suggests that, counterintuitively, *de minimis* rules may, in fact, 'have a profound, but largely unexamined, effect on the tax system' and cautions that 'the notion that *de minimis* tax rules are relatively insignificant serves only to perpetuate their proliferation'.[16]

As the *de minimis* exclusions in Article 7 may lead to the non-application of the CFC rules, these provisions establish the bottom threshold for determining the scope of the application of the rules. Furthermore, while the rationale for their inclusion may appear sensible and obvious, the provisions' effectiveness in fulfilling their stated purpose has not yet been systematically considered in the existing literature. Incoherent and poorly designed *de minimis* rules may undermine the integrity of the tax system in which they appear.[17]

Scholarly commentary on Article 7(3) and (4) is, unsurprisingly, sparse and perfunctory. When these provisions are discussed in the literature, however, there appears to be consensus, contrary to this article's findings, that these (optional) provisions are appropriate, and their adoption is recommended.[18] *De minimis* provisions commonly appear in the national CFC legislation of EU Member States.[19] As this article demonstrates, upon a more comprehensive examination, the effectiveness of three of the *de minimis* provisions in Article 7 is very limited or ambivalent. Further, those in Article 7(4) are unjustifiable within the specific context of CFC legislation in the EU.

This article commences with a discussion of CFC legislation in the EU in §2 that provides the necessary context for evaluating the *de minimis* exclusions. It discusses the compatibility of CFC legislation with EU primary law and provides an overview of the ATAD's CFC rules (EU secondary law). Next, §3 considers the purpose of *de minimis* exclusions in CFC legislation generally, in the EU context, and then contrasts this with non-EU jurisdictions. The core of this article, §4, evaluates the *de minimis* provisions contained in Article 7(3) and (4) of the ATAD. It begins with an analysis of the provisions' design in order to evaluate their effectiveness and subsequently considers other measures that can be used to achieve the same objective. It evaluates their normative coherence in the EU context and summarizes the findings of the evaluation. Finally, §5 concludes the article.

Notes

9 *Ibid.*, Recital 3 and 5.

10 *Ibid.*, at Art. 3.

11 *Ibid.*, at Art. 11(1).

12 *See* e.g., *A Guide to the Anti-Tax Avoidance Directive* (Werner C. Haslehner et al. eds, Edward Elgar 2020); *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (Pasquale Pistone & Dennis M. Weber eds, IBFD 2018).

13 *See* e.g., Christiana H. J. I. Panayi, *The ATAD's CFC Rule and Its Impact on the Existing Regimes of EU Member States*, in *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (Pasquale Pistone & Dennis M. Weber eds, IBFD Apr. 2018); Isabella de Groot & Barry Larking, *Implementation of Controlled Foreign Company Rules under the EU Anti-Tax Avoidance Directive (2016/1164)*, 59 Eur. Tax'n (2019), doi: 10.59403/gz1xvh; Alexander Rust, *Controlled Foreign Company Rule (Articles 7 and 8 ATAD)*, in *A Guide to the Anti-Tax Avoidance Directive* (Werner C. Haslehner et al. eds, Edward Elgar 2020).

14 For a discussion on the compatibility of the ATAD CFC rules with the EU fundamental freedoms, *see* Wilhelm Nyström, *Saving the ATAD CFC Regime Through Abuse of Law or the Rule of Reason*, 49 Intertax (2021), doi: 10.54648/TAXI2021021; *see also* Panayi, *supra* n. 13, §16.2.

15 For a comprehensive critical review of the ATAD CFC rules, *see* Till Moser & Sven Hentschel, *The Provisions of the EU Anti-Tax Avoidance Directive Regarding Controlled Foreign Company Rules: A Critical Review Based on the Experience With the German CFC Legislation*, 45 Intertax (2017), doi: 10.54648/TAXI2017052.

16 Leigh Osofsky & Kathleen DeLaney Thomas, *The Surprising Significance of De Minimis Tax Rules*, 78 Wash. & Lee L. Rev. 780 (2021).

17 *Ibid.*, at 774.

18 Moser & Hentschel, *supra* n. 15, at 619 and 620.

19 The following EU Member States have *de minimis* provisions in their CFC legislation: Austria, Croatia, Cyprus, Denmark, Germany, Hungary, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Spain, and Sweden. Information obtained from De Groot & Larking, *supra* n. 13 and *Controlled Foreign Company Legislation* (Georg Kofler et al. eds, IBFD 2020).

2 CFC LEGISLATION IN THE EU

2.1 *EU Primary Law: Prior to the ATAD*

In designing their direct tax legislation, and in particular, any anti-avoidance provisions, EU Member States face the difficult challenge of complying with EU primary law and respecting the fundamental freedoms while simultaneously protecting their tax revenues. Before adopting the ATAD, each EU Member State had the competence to decide whether to include CFC rules in their domestic tax legislation. The only limitation that they faced concerning the design of their CFC legislation was that such national legislation would need to be compatible with EU primary law.[20]

The landmark *Cadbury Schweppes* case,[21] decided on 12 September 2006, was the first case in which a Member State's CFC legislation was tested for compatibility with EU primary law. The national legislation at issue was the CFC legislation of the United Kingdom of Great Britain and Northern Ireland (UK), the parent entity's jurisdiction. Consistent with the anti-avoidance objective of CFC regimes in general, its purpose was to counteract tax avoidance.[22]

In both the *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes) (ICI)*[23] and the *Lankhorst-Hohorst GmbH (Lankhorst)*[24] judgments decided on 16 July 1998 and 12 December 2002, respectively, the ECJ had considered the permissibility of national measures that had as their object or purpose to prevent, counter, or reduce the risk of tax avoidance or evasion.[25] In both of these cases, national legislation that 'does not have the specific purpose of preventing wholly artificial arrangements'[26] and applies generally – thus also encompassing within its scope situations that may not necessarily involve tax avoidance – was found to constitute an unjustifiable restriction to the freedom of establishment.[27]

Referring to various prior judgments of the ECJ,[28] the *Cadbury Schweppes* judgment states: 'It is also apparent from case-law that the mere fact that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty'.[29]

In the *Cadbury Schweppes* case, the relevant CFCs were wholly-owned subsidiaries located in Ireland.[30] Since both of the resident states of the parent and the subsidiaries were EU Member States, the case dealt with an intra-EU situation. To be applicable, the UK's CFC legislation required the domestic parent company to hold more than 50% of the foreign company's capital.[31]

The ECJ held that this legislation restricted the freedom of establishment.[32] The subsequent questions that needed to be considered were whether it could be justified by pressing reasons of public interest and, if so, whether the measure was proportionate in relation to its objective and did not exceed what was necessary to achieve that.[33] The ECJ held as follows:

(1) Such a restriction can, however, be justified if the inclusion relates only to wholly artificial arrangements intended to escape taxation in the first state that would normally be payable.[34]
(2) To ensure that the measure is proportional, such legislation must not be applied to a CFC that, based on objective factors, is actually established in the host Member State and carries on genuine economic activities there even in the presence of tax motives.[35]

The *Cadbury Schweppes* judgment therefore makes it clear that, when the CFC is resident in another EU Member State and the parent entity has definite influence over the CFC's decisions, for national CFC legislation in an EU Member State to constitute a justifiable

Notes

20 *See* Case C-311/97, *Royal Bank of Scotland*, [1999] ECR I-2651 para. 19; Case C-319/02, *Manninen* [2004] ECRI-7477 para. 19; Case C446/03, *Marks and Spencer* [2005] ECR I-10837 para. 29.

21 Cadbury-Schweppes, *supra* n. 3.

22 Opinion of AG Léger in Case C–196/04, ECR2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, ECLI:EU:C:2006:278, para. 2.

23 Case C-264/96, *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)*, ECLI:EU:C:1998:370.

24 Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, ECLI:EU:C:2002:749.

25 ICI, *supra* n. 23, para. 25; Lankhorst, *supra* n. 23, paras 15 and 34.

26 ICI, *supra* n. 23, para. 26; Lankhorst, *supra* n. 23, para. 37.

27 ICI, *supra* n. 23 paras 26 and 30; Lankhorst, *supra* n. 23, paras 32, 37 and 45.

28 *See* e.g., Case C-436/00, *X and Y v. Riksskatteverket*, ECLI:EU:C:2002:704, para. 62.

29 Cadbury-Schweppes, *supra* n. 3, para. 50.

30 *Ibid.*, para. 13.

31 *Ibid.*, para. 6.

32 *Ibid.*, para. 46.

33 *Ibid.*, paras 47, 57 and 60.

34 *Ibid.*, paras 51, 55 and 75.

35 *Ibid.*, paras 65 and 75.

restriction to the freedom of establishment, its scope must be restricted to only capturing income from wholly artificial arrangements.[36] Consequently, its application became limited to functioning as a remedy. With this judgment, CFC legislation in the EU lost its bite.

The freedom of establishment only applies to intra-EU situations and does not offer protection to EU nationals when establishing themselves in countries that are not EU Member States (hereinafter referred to as 'non-EU jurisdictions').[37] The question that remained unanswered was whether the *Cadbury Schweppes* ruling could be applied by analogy in cases when CFC legislation restricts the free movement of capital. The free movement of capital would be the relevant fundamental freedom in the following two situations. The first is when the foreign entity is located within the European Economic Area (EEA) and the national legislation encompasses both cases of when there is and is not definite influence, and the factual situation is that no definite influence exists.[38] The second is when the foreign entity is located outside of the EEA and the national legislation does not apply exclusively to situations in which the parent entity exercises definite influence over the foreign entity.[39] In this case, the factual situation is irrelevant.[40]

2.2 *EU Secondary Law: The ATAD*

It is understood that the CFC rules in the ATAD needed to be designed and drafted in a way that encapsulated as many of the recommendations of the BEPS Action 3 Final Report as possible within the confines of compatibility with EU primary law. This is especially relevant given the interpretation provided by the Court of Justice of the European Union (CJEU) in cases in which CFC legislation was the contested matter. As a SAAR, the CFC rules in the ATAD would meet their objective of changing taxpayers' behaviour if they never have to apply. When they do apply, they serve merely to remedy the consequences of the specific undesirable practice.

2.2.1 *Article 1(1): Scope of Application of the ATAD*

The scope of application of the ATAD (relevant to the CFC rules) needs to be established before a more comprehensive analysis of the CFC rules contained in Articles 7 and 8 of the ATAD can ensue. Article 1(1) of the ATAD sets out its scope as follows: 'This Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments (PEs) in one or more Member States of entities resident for tax purposes in a third country'.

While the interpretation of this paragraph raises many questions,[41] what is clear from it is that the ATAD does not apply to natural persons. Consequently, the CFC rules as contained in the ATAD do not apply to resident taxpayers who are natural persons.[42] This is not necessarily true for CFC regimes in non-EU jurisdictions. Applying the CFC rules to taxpayers subject to corporate tax is the minimum standard in the EU and Member States are, therefore, free to extend the personal scope to other types of taxpayers.[43]

2.2.2 *Article 7(1): The Requirements to be Treated as a CFC*

As a SAAR, CFC rules are targeted rules. Since they aim to counteract a particular anti-avoidance technique or strategy, they target the specific taxpayers, transactions, and jurisdictions that present the greatest risk for employing this strategy. Article 7(1) stipulates two main thresholds (inclusion criteria) that must be crossed to fall within the scope of the CFC rules. When these are met, an entity or a PE (hereinafter referred to as the 'foreign entity' or 'foreign PE' respectively) of which the profits are not subject to or are exempt from tax in the taxpayer's Member State[44] (hereinafter referred to as the 'parent') will be regarded as a CFC in relation to the parent. First, the actual corporate tax paid on the profits of the foreign entity or the foreign PE must be less than half (50%) of that which would have been charged if the tax liability was computed using the corporate tax rules of the parent's Member State (the 'low-tax threshold').[45] Second, in the case of a foreign entity, the parent must by itself or together with its 'associated

Notes

36 This interpretation was confirmed in Case C-201/05, *The Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue*, ECLI:EU:C:2008:239.

37 Case C-35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue and The Commissioners for Her Majesty's Revenue & Customs*, ECLI:EU:C:2012:707, para. 97.

38 *Ibid.*, paras 93 and 94; Case C-47/12, *Kronos International Inc. v. Finanzamt Leverkusen*, ECLI:EU:C:2014:2200, para. 37.

39 FII Group Litigation, *supra* n. 37, para. 99.

40 *Ibid.*, paras 96 and 101.

41 *See* Martha Caziero & Ivan Lazarov, *The Substantive Scope of the Anti-Tax-Avoidance Directive: The Remaining Leeway for National Tax Sovereignty*, 58 Common Mkt. L. Rev. (2021), doi: 10.54648/COLA2021112.

42 Richard Krever, *Controlled Foreign Company Legislation: General Report*, *in Controlled Foreign Company Legislation* 9 (Georg Kofler et al. eds, IBFD 2020).

43 Council Directive (EU) 2016/1164, *supra* n. 8, Art. 3.

44 *Ibid.*, Art. 1 requires that the taxpayer be subject to corporate tax.

45 Council Directive (EU) 2016/1164, *supra* n. 8, Art. 7(1) subpara. (b). The second sentence of Art. 7(1) further states that, for a foreign entity, the PE of the CFC that is not subject to or is exempt from tax in the jurisdiction of the CFC shall not be taken into account.

enterprises'[46] (wherever located or resident) have an interest in the foreign entity in any one of three ways: (1) hold a direct or indirect participation of more than 50% of the voting rights, (2) own directly or indirectly more than 50% of capital, or (3) be entitled to receive more than 50% of the profits of the foreign entity (the 'control threshold').[47]

Since the ATAD specifies the minimum standard that must be met, Member States may broaden the scope of their CFC rules for either the first criterion, the second criterion, or both. Regarding the low-tax threshold: this could be done by increasing the ratio of tax paid by the foreign entity or foreign PE in relation to the tax that would have been paid in the parent's Member State to, for example, 60%.[48] In respect of the control threshold: the scope could be broadened by decreasing the percentage of voting rights, capital ownership, or profit entitlement that the parent alone or together with its 'associated enterprises' is required to hold or receive to, for example, 40%.[49]

2.2.3 *The Two Models Presented*

Article 7 provides Member States with two options regarding the type of CFC regime to be implemented. The rules pertaining to one of the models are contained in paragraphs 2(a) and 3 (hereinafter referred to as 'Model A'). The rules pertaining to the alternative one are contained in paragraphs 2(b) and 4 (hereinafter referred to as 'Model B').[50] Model A follows what is referred to as the 'categorical approach' that requires certain categories of the CFC's non-distributed income to be included in the parent's tax base. The inclusion only applies to CFCs that do not carry on a substantive economic activity to ensure that only income from wholly artificial arrangements is captured.[51] Model B comprises what is known as the 'transactional approach' that requires the CFC's non-distributed income arising from non-genuine arrangements to be included in the parent's tax base. Both are designed to only capture income from wholly artificial arrangements (when the foreign entity or foreign PE is located within the EU) – before the optional *de minimis* exclusions in paragraphs 3 and 4 of Article 7 are considered – to ensure compliance with the fundamental freedoms. Member States may adopt one, both, or a combination of the models. Under both, the income to be included in the parent's tax base shall only be included in proportion to the parent's participation in the foreign entity as defined in Article 7(1)(a).[52]

Article 7 of the ATAD contains four optional *de minimis* exclusions: two applicable to Model A and two to Model B. They provide that foreign entities or foreign PEs that would otherwise be treated as CFCs can be disregarded if any of these exclusions apply. These are *de minimis* exclusions since they aim to exclude entities with a low percentage of 'tainted income', those with low accounting profits and non-trading income, or those with a low percentage of profits to operating costs. Although they are optional, many EU Member States have adopted them.[53]

2.2.3.1 Model A: The Categorical Approach

Paragraph 2(a) lists six types of a CFC's income (hereinafter referred to as the 'tainted income') that must be included in the parent's tax base (unless the CFC is excluded under a *de minimis* exclusion in paragraph 3). The income primarily consists of that from financial or intangible assets such as interest, dividends, royalties, as well as certain income from transactions between 'associated enterprises', as this income represents the greatest BEPS risk. This income must be calculated in accordance with the rules stipulated in the corporate tax laws of the parent's Member State.[54]

CFCs are specifically excluded from the scope of paragraph 2(a) when there is evidence that they carry on 'a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances' (hereinafter referred to as the 'substance carve-out'). This carve-out was evidently included to ensure adherence with point (2) of the ECJ's ruling in the *Cadbury Schweppes* case discussed in §2.1 *supra* – to limit the scope to capturing the tainted income of letter-box or shell companies.[55] It is important to note that the

Notes

[46] As defined in *ibid.*, Art. 2(4).

[47] *Ibid.*, Art. 7(1)(a).

[48] Council Directive (EU) 2016/1164, *supra* n. 8, Recital 12.

[49] *Ibid.*, Recital 12.

[50] Terminology derived from Krever, *supra* n. 43, at 6.

[51] Council Directive (EU) 2016/1164, *supra* n. 8, Recital 12.

[52] Council Directive (EU) 2016/1164, *supra* n. 8, Art. 8(3).

[53] *Supra* n. 19.

[54] Council Directive (EU) 2016/1164, *supra* n. 8, Art. 8(1).

[55] *Ibid.*, Recital 12 provides the reason for this provision: 'To comply with the fundamental freedoms, the income categories should be combined with a substance carve-out aimed to limit, within the Union, the impact of the rules to cases where the CFC does not carry on a substantive economic activity'.

substance carve-out is an entity-based exclusion exempting the entire foreign controlled entity from the CFC regime when the entity has sufficient substance.[56] The *Cadbury Schweppes* judgment, however, only applies to holdings conferring definite influence over an entity located within the EU and does not extend to CFCs located outside the EU. The ATAD therefore gives EU Member States the option to not apply the substance carve-out to CFCs located in third countries[57] (hereinafter referred to as the 'third country exclusion'). The third country (states not party to the Agreement of the EEA, hereinafter referred to as a 'non-EEA Member States' or 'third countries') exclusion thus has the effect that the proportionate share of the undistributed tainted income will need to be included in the parent's tax base even if CFCs in third countries have sufficient substance. Notably, this is the only instance in either model where a distinction is made between CFCs in the EEA and those in third countries.

Paragraph 3 provides Member States with two options to exclude certain CFCs from the application of paragraph 2(a). They may opt to use one, both, or neither. These exclusions make no distinction between CFCs in the EEA and those in third countries. The first is an entity-based exemption that applies if the tainted income represents one third or less of the CFC's total income. The second relates specifically to CFCs that are 'financial undertakings'.[58] If one third or less of such CFC's tainted income arises from transactions with the parent or its 'associated enterprises', Member States may opt to exclude the CFC from the application of paragraph 2(a). As these are minimum standards, Member States may use values less than a third, such as a quarter.

Table 1 below summarizes the two optional *de minimis* exclusions in Article 7(3) pertaining to Model A.

2.2.3.2 Model B: The Transactional Approach

Paragraph 2(b) requires the following income of a CFC to be included in the parent's tax base (unless the CFC is excluded under a *de minimis* exclusion in paragraph 4): 'the non-distributed income of the entity or permanent establishment arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage'. Stated differently, two requirements must be met before such income is required to be included in the parent's tax base. First, the income must arise from non-genuine arrangements and, second, these arrangements must have been put in place for the essential purpose of obtaining a tax advantage. This determination of CFC income evidently aims to adhere to point (1) of the ECJ's ruling in the *Cadbury Schweppes* case discussed in §2.1 *supra*. In making no distinction between CFCs located in the EEA or in third countries, Model B applies *mutatis mutandis* irrespective of the CFC's location. Consequently, concerning Model B, the ATAD has, as a minimum standard, extended the *Cadbury Schweppes* ruling to apply when the CFC is resident in a third country.

Paragraph 2(b) further explains what a non-genuine arrangement is for the purposes of that paragraph:

> [A]n arrangement or a series thereof shall be regarded as non-genuine to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.[59]

Table 1 Summary of the De Minimis Exclusions in Article 7(3) of the ATAD

	Paragraph	*Description*	*De Minimis Rule*
Model A	Para. 3, first sentence	Low percentage of tainted income	CFC's tainted income ≤ ⅓ CFC's total income
	Para. 3, second sentence	'Financial undertakings': low percentage of tainted income from intra-group transactions	CFCs that are 'financial undertakings': tainted income arising from transactions with the parent or its 'associated enterprises' ≤ ⅓ tainted income

Notes

56 Stefanie Geringer, *Substance Carve-Out and Function-Risk Analysis in the ATAD's CFC Rule as Two Sides of the Same Coin: Strengths and Limits of a Uniform Concept of Abuse*, 60 Common Mkt. L. Rev. 154 (2023), doi: 10.54648/COLA2023006.

57 Council Directive (EU) 2016/1164, *supra* n. 8, at Art. 7(2).

58 As defined in *ibid.*, Art. 2(5) which broadly includes credit institutions, investment firms, alternative investment fund managers (AIFM), an undertaking for collective investment in transferable securities (UCITS) management companies, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provisions, pensions institutions, alternative investment funds (AIF), UCITS, central counterparties, and central securities depositories.

59 *Ibid.*, Art. 7(2)(b).

Article 8 contains the provisions that provide further detail for computing CFC income. Article 8(2) provides additional clarification regarding what is meant by 'non-genuine arrangement[s]', specifically that 'the income to be included in the tax base of the taxpayer shall be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company'.[60] It further specifies that the CFC's income that is required to be included in the parent's tax base must be calculated in accordance with the arm's length principle.[61]

Article 7(4) provides Member States with two options to exclude certain CFCs from the application of paragraph 2(b). They may opt to use one, both, or neither. These are either a fixed monetary *de minimis* threshold (subparagraph (a)) or a percentage of profits to operating costs *de minimis* threshold (subparagraph (b)). As these are minimum standards, Member States may use a lower monetary amount or a lower percentage. These exclusions would apply *mutatis mutandis* irrespective of the CFC's location.

The optional entity-based exemptions from the application of paragraph 2(b) contained in paragraph 4 read as follows:

> Member States may exclude from the scope of point (b) of paragraph 2 an entity or a permanent establishment:
>
> (a) with accounting profits of no more than EUR 750 000, and non-trading income of no more than EUR 75 000[62]; or
> (b) of which the accounting profits amount to no more than 10 percent of its operating costs for the tax period.
>
> For the purposes of point (b) of the first subparagraph, the operating costs may not include the cost of goods sold outside the country where the entity is resident, or the permanent establishment is situated for tax purposes and payments to associated enterprises.

Table 2 below summarizes the two optional *de minimis* exclusions in Article 7(4) pertaining to Model B.

2.3 *EU Primary Law: Post the ATAD*

In March 2017, a request for a preliminary ruling in *X GmbH v. Finanzamt Stuttgart – Körperschaften* (*X GmbH*)[63] was referred to the CJEU. On 26 February 2019, it delivered its judgment on this case dealing with the compatibility of the German CFC legislation with EU primary law.[64] This case differs from the *Cadbury Schweppes* case in two ways. First, it involves the situation in which the CFC is resident in a non-EEA Member State, specifically Switzerland, as opposed to dealing with an intra-EU situation.[65] Second, the national legislation at issue automatically attributes income from a CFC to all resident shareholders that hold at least 1% in it,[66] thus applying both to holdings that confer definite influence ('direct investments') and those that do not ('portfolio investments'). Therefore, the fundamental freedom at issue in this case is the free movement of capital.[67]

Table 2 Summary of the De Minimis Exclusions in Article 7(4) of the ATAD

	Paragraph	*Description*	*De Minimis Rule*
Model B	Para. 4(a)	Low monetary amounts of accounting profits and non-trading income	CFC's accounting profits ≤ EUR 750,000, and CFC's non-trading income ≤ EUR 75,000
	Para. 4(b)	Low percentage of accounting profits to operating costs	CFC's accounting profits ≤ 10% of its operating costs (excluding from extra-territorial trade and payments to 'associated enterprises') for the tax period

Notes

60 *Ibid.*, Art. 8(2). *See also* Recital 12 which states: '[I]n order to ensure that CFC rules are a proportionate response to BEPS concerns, it is critical that Member States that limit their CFC rules to income which has been artificially diverted to the subsidiary precisely target situations where most of the decision-making functions which generated diverted income at the level of the controlled subsidiary are carried out in the Member State of the taxpayer'.

61 *Ibid.*

62 *Ibid.*, Art. 11(3) that deals with the transposition of the directive requires that '[w]here this Directive mentions a monetary amount in euros (EUR), Member States whose currency is not the euro may opt to calculate the corresponding value in the national currency on 12 July 2016'.

63 Case C-135/17, *X GmbH v. Finanzamt Stuttgart – Körperschaften*, ECLI:EU:C:2019:136.

64 *Ibid.*

65 *Ibid.*, para. 9.

66 *Ibid.*, paras 5 and 85.

67 *Ibid.*, paras 15 and 21.

One of the questions that the national court put before the CJEU was, in essence, whether the German CFC rules would constitute an unjustifiable restriction on the free movement of capital in respect of a CFC resident in a third country subject to a low level of tax and in which a German shareholder held at least a 1% interest.[68] By applying the reasoning of the *Cadbury Schweppes* judgment analogously,[69] the Court concluded that such legislation does indeed constitute a restriction on the free movement of capital.[70] However, it accepted the justification of such a restriction on the grounds of the prevention of tax evasion and avoidance.[71] Referring to the *Cadbury Schweppes* judgment, the Court reiterated the principle that the aforementioned justification may be used when the national measure only targets wholly artificial arrangements.[72] Within the context of the free movement of capital, the concept of 'wholly artificial arrangements' is broader than in the context of the freedom of establishment (which only applies in intra-EU situations). It is capable of covering: '[A]ny 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'.[73]

The Court held that the legislation at issue was 'suitable for ensuring the attainment of the objective which it pursues'[74] and continued by considering whether it was proportional in achieving its objective. Consistent with its prior judgments, the Court again made the point that national legislation with an anti-tax avoidance objective may not be so broad that it creates a 'general presumption'[75] or 'irrebuttable presumption'[76] of tax evasion and avoidance. It must be 'designed specifically to prevent conduct that consists of creating wholly artificial arrangements'.[77] The Court held that the legislation at issue is disproportionate since it does not afford the taxpayer the opportunity to demonstrate that their holding in the CFC is not the result of an artificial scheme.[78] To the extent that there is a legal framework in place allowing the Member State to verify the information provided by the shareholder in demonstrating its commercial justification for its investment in the CFC, national legislation such as that at issue would create an impermissible restriction to the free movement of capital.[79]

The *X GmbH* judgment confirms that the two points emanating from the *Cadbury Schweppes* judgment (discussed in §2.1 *supra*) also apply to CFC legislation that restricts the free movement of capital.[80] This would be the case when it applies to both situations when there is and is not 'definite influence' – such as the ATAD's CFC rules.[81] The effect of this judgment is that the substance carve-out in Model A[82] needs to be extended to also include CFCs located in third countries when there is an agreement allowing for the exchange of tax information between the parent's Member State and the (third country) state in which the CFC is located.[83] Accordingly, to be compatible with EU primary law as interpreted in the *X GmbH* judgment, the option granted to Member States in Article 7(2)(a) of the ATAD to refrain from applying the substance carve-out to CFCs located in third countries may only be exercised when they are located in a country that does not have an exchange of information agreement with the parent's Member State.[84] This exclusion would thus likely only apply in exceptional cases given the enormous strides made in the international exchange of tax information.

In the context of the free movement of capital, the *X GmbH* judgment can be applied by analogy to an intra-EU situation. As the exchange of tax information between EU Member States has been regulated by EU secondary law through the Directive on Administrative

Notes

[68] *Ibid.*, para. 53.

[69] *Ibid.*, para. 57.

[70] *Ibid.*, para. 58.

[71] *Ibid.*, para. 75.

[72] *Ibid.*, paras 73 and 80.

[73] *Ibid.*, para. 84.

[74] *Ibid.*, para. 78.

[75] *Ibid.*, para. 80.

[76] *Ibid.*, para. 86.

[77] *Ibid.*, para. 80.

[78] *Ibid.*, para. 88.

[79] *Ibid.*, paras 95 and 96.

[80] *See also* Case C-464/14, *SECIL – Companhia Geral de Cal e Cimento SA v. Fazenda Públic*, ECLI:EU:C:2016:896, para. 59.

[81] Robert J. Danon, *EU Fiscal Protectionism Versus Free Movement of Capital: The Case of the ATAD CFC Categorical Model*, *in European Tax Integration: Law, Policy and Politics* (Pasquale Pistone ed., IBFD 2018).

[82] Council Directive (EU) 2016/1164, *supra* n. 8, at Art. 7(2)(a).

[83] Rust, *supra* n. 13, at 7.45.

[84] *Ibid.*, at 7.14 and 7.60.

Cooperation[85] (the DAC) (as amended), the requirement in the X *GmbH* case regarding the exchange of information agreements can be regarded as having been satisfied. Therefore, CFC legislation in the EU will only be compatible with EU primary law if it is limited to applying solely to income from wholly artificial arrangements. The only exception to this is when the CFC is located in a third country and there is no agreement for the exchange of tax information between the parent's EU Member State and the CFC's state (third country). This would be achieved when a Member State implements CFC legislation equivalent to Model B or equivalent to Model A without the third country exclusion or when that exclusion only applies in situations when the CFC is located in a country that does not have an exchange of information agreement with the parent's Member State. When a Member State has implemented such CFC legislation, the only scenario in which non-artificial income could be captured by the CFC rules are when the CFC is located in a country that does not have an exchange of information agreement with the parent's Member State. Such scenarios would likely be rare occurrences. CFC legislation in the EU thus not only has no bite but also no bark.

3 The purpose of *de minimis* exclusions in CFC legislation

3.1 *In General*

De minimis provisions are a useful tool that can be and often are used to reduce administrative burdens and compliance costs. The BEPS Action 3 Final Report acknowledges the same in the context of CFC rules;[86] however, it does not make a general recommendation for or against using *de minimis* thresholds.[87] *De minimis* provisions also serve the function of preventing unsophisticated taxpayers from unwittingly being subject to a complex tax regime.[88]

3.2 *In An EU Context*

Article 7 of the ATAD includes four optional *de minimis* exclusions (discussed in §2.2.3 *supra*). The rationale provided for them is as follows: 'With a view to limiting the administrative burden and compliance costs, it should also be acceptable that those Member States exempt certain entities with low profits or a low profit percentage that give rise to lower risks of tax avoidance'.[89]

It is interesting to note that the proposal for the ATAD on 28 January 2016[90] did not contain any *de minimis* provisions in the proposed CFC rules. Since unanimity is required to issue directives on direct tax measures in the EU,[91] these directives are a product of negotiation. Various Member States' specific interests are thus taken into account in order to achieve unanimity. Perhaps the *de minimis* provisions were therefore included to obtain this.

3.3 *In Non-EU Jurisdictions*

As non-EU jurisdictions do not have to consider the freedom of establishment and the free movement of capital when designing their CFC legislation, it can be and often is much broader in scope than would be permissible in the EU. Non-EU jurisdictions can therefore design it in such a way as to create an irrebuttable presumption of tax avoidance and cover situations in which there is not necessarily tax avoidance. The legislation is also not limited to capturing only wholly artificial arrangements in its scope. In some jurisdictions, it is also broader than the rules of the ATAD in that, to determine control, it considers the interests in the foreign entity held by all (even unrelated) residents of that jurisdiction. Due to the broad reach of the CFC rules of many non-EU jurisdictions, *de minimis* exclusions may serve an additional purpose other than just reducing the administrative and compliance burden of applying the legislation. The exclusion may serve to provide a measure of relief for income captured that may not be the result of artificial arrangements.

4 Evaluating the *de minimis* exclusions in Article 7 of the ATAD

4.1 *The Relative Effectiveness of the De Minimis Exclusions*

To determine the relative effectiveness of the four different *de minimis* exclusions, this section evaluates them against their stated objective, viz., to reduce the administrative and compliance burden.

Notes

85 Council Directive (EU) 2011/16/EU of 15 Feb. 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ 1–12.

86 OECD, *supra* n. 2, at s. 3.2.1.

87 *Ibid.*, para. 59.

88 Osofsky & DeLaney Thomas, *supra* n. 16, at 792.

89 Council Directive (EU) 2016/1164, *supra* n. 8, Recital 12.

90 European Commission, *Proposal for a Council Directive Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market*, COM(2016) 26 final, Art. 8 (28 Jan. 2016).

91 *Treaty on the Functioning of the European Union*, 26 Oct. 2012, OJ L. 326/47-326/390 (26 Oct. 2012), Art. 115.

4.1.1 *De Minimis Exclusions: Model A*

When the foreign entity or foreign PE is located within the EU or the parent's Member State has opted not to include the third country exclusion in its CFC legislation, at least one of two tests needs to be satisfied to disregard the foreign entity or foreign PE for the purposes of Article 7(1) and 2(a) (first subparagraph). These tests are the substance carve-out and the *de minimis* exclusion in paragraph 3, first sentence (the foreign entity or foreign PE's tainted income is one third or less of its total income). If it fails the one test, the other test must be considered. If it fails both and the inclusion criteria of paragraph 1 are met, the parent's proportionate share of the CFC's tainted income must be included in its tax base in accordance with paragraph 2(a). If there is clear evidence that the foreign entity or foreign PE carries on a substantive economic activity, the substance carve-out would apply, and this would be the end of the enquiry. The foreign entity or foreign PE can be disregarded. In such a case, there would be minimal, if any, compliance costs involved as no special calculations or additional information would be required to perform the test. When there is uncertainty as to whether the foreign entity or foreign PE is carrying on a substantive economic activity or there is little evidence to support that assertion, the bright line *de minimis* rule serves as a safe harbour. It provides some certainty when there is no clear evidence that the foreign entity or foreign PE is carrying on a substantive economic activity. In effect, the *de minimis* test uses a minimum percentage of non-tainted income as the proxy for sufficient substance. When the foreign entity or foreign PE is located outside the EEA and the third country exclusion applies,[92] the substance carve-out exclusion falls aways, and only the *de minimis* test remains to exclude it. Only if the foreign entity or foreign PE's non-tainted income exceeds two thirds of its total income, may it be disregarded for the purposes of Article 7(1) and 2(a). Performing this *de minimis* test requires calculating the tainted income of the foreign entity or foreign PE (in accordance with the corporate tax rules of the parent's Member State) – the same calculation that would be required to apply paragraph 2(a). Costs would be incurred to perform this additional work. As this *de minimis* test requires the same calculation that would be required in applying paragraph 2(a), its design limits its effectiveness in reducing the administrative and compliance burden of adhering to the requirements of Article 7 under Model A.

For the *de minimis* exclusion in paragraph 3, second sentence, the analysis is the same as the above analysis with the following additions: the parent would need to determine whether the foreign entity or foreign PE meets the definition of a 'financial undertaking' (defined in Article 2(5)).[93] An additional calculation is required only for the purpose of performing this *de minimis* test, i.e., the amount of tainted income that arises from transactions with the parent or its 'associated enterprises'. The percentage of this tainted income to the total tainted income of the foreign 'financial undertaking' can then be calculated and tested against the one-third threshold. If the *de minimis* test is satisfied, the foreign 'financial undertaking' can be disregarded for the purposes of Article 7(1) and 2(a) (first subparagraph). When the test fails and the foreign 'financial undertaking' meets the inclusion criteria in Article 7(1), the parent's proportionate share of the CFC's tainted income must be included in the parent's tax base in compliance with paragraph (2)(a). As this *de minimis* test requires a further calculation, it is even less effective in reducing the administrative and compliance burden of adhering to the requirements of Article 7 under Model A than the *de minimis* exclusion in paragraph 3, first sentence.

The objective of these *de minimis* exclusions to limit the administrative burden and compliance costs is thus only met to a limited extent. This is because much of the work that needs to be performed to comply with the provisions of Article 7 pertaining to Model A is required in order to determine whether the *de minimis* exclusions apply. Osofsky and Thomas state it succinctly:

> If taxpayers have to incur costs to monitor their compliance with a *de minimis* threshold, this runs directly counter to the benefits conferred by *de minimis* rules. *De minimis* thresholds like these, which do little to alleviate compliance costs and may even increase them, should be viewed as suspect and subject to particularly careful cost-benefit analysis.[94]

4.1.2 *De Minimis Exclusions: Model B*

Determining whether the *de minimis* exclusion in paragraph 4(a) applies should not require any calculations to be performed, as it merely requires determining whether two amounts contained in the financial records of the foreign entity or foreign PE are below a specified fixed monetary amount. Should it be determined that this *de minimis* exclusion applies, the result is that the foreign entity or foreign PE may be disregarded for the purposes

Notes

[92] To be proportionate, such an exclusion is only permissible when the CFC is located in a third country that does not have an exchange of information agreement with the parent's Member State.

[93] This determination is also required for the purposes of applying Art. 4(7) of ATAD that sets out the interest limitation rule.

[94] Osofsky & DeLaney Thomas, *supra* n. 16, at 833.

of Article 7(1) and 2(b). Only if it is not met do the provisions of paragraphs 1 and 2(b) need to be applied. Therefore, this *de minimis* exclusion is indeed effective in reducing the administrative and compliance burden of adhering to the requirements of Article 7 under Model B.

For the *de minimis* exclusion in paragraph 4(b), the operating costs of the foreign entity or foreign PE need to be determined to establish whether this exclusion applies. The cost of goods sold outside of the country where the foreign entity is resident or the foreign PE is situated as well as payments to 'associated enterprises' are required to be excluded from the operating costs. These determinations would require transactional level detail of the foreign entity or foreign PE. In the case of a foreign entity, access to and verification of this information may prove to be challenging for the tax administration of the parent entity's jurisdiction.[95] The percentage of accounting profits to the operating costs of the foreign entity or foreign PE can then be calculated and evaluated against the threshold of 10%. Should it be determined that this *de minimis* exclusion applies, the result is that the foreign entity or foreign PE may be disregarded for the purposes of Article 7(1) and 2(b). Only if it is not met do the provisions of paragraphs 1 and 2(b) need to be applied. Therefore, while this exclusion may spare the taxpayer from making the determinations under paragraphs 1 and 2(b), the design of the exclusion does require additional work to be performed (requiring transactional level detail of the foreign entity or foreign PE). The extent to which this *de minimis* exclusion is effective in reducing the administrative and compliance burden of adhering to the requirements of Article 7 is ambivalent.

4.2 *Other Measures*

Even if *de minimis* exclusions are effective for achieving the objective of reducing the administrative burden and compliance costs, consideration should be given to whether they are the most appropriate instrument for doing so. Two other ways in which the ATAD has limited the administrative burden and compliance costs of CFC legislation are discussed in §4.2.1 and §4.2.2 *infra.* In §4.2.3, a further measure that could be used to achieve this objective is considered.

4.2.1 *The Type of Taxpayer to Which the CFC Rules Apply*

The ATAD only applies to taxpayers that are subject to corporate tax in a Member State,[96] and the CFC rules further only apply to multinational enterprises (MNEs).[97] Consequently, individuals and stand-alone domestic corporations do not fall within the scope of the CFC rules in the ATAD. Therefore, the administrative burden and compliance costs of adhering to CFC legislation are limited to MNEs. MNEs operate at an economically more sophisticated level than individuals and stand-alone domestic enterprises. It could reasonably be accepted that, as the level of sophistication of a taxpayer's economic activities increases, so do the regulatory and compliance obligations (to be able to commensurately deal with the increased level of sophistication). It is, in fact, the complex and sophisticated tax planning practices of MNEs exacerbating the BEPS problem that in part led to the BEPS Project and, in turn, the ATAD.[98]

Unsophisticated parties are therefore adequately protected from this complex tax regime – even without the *de minimis* provisions. Given the type of taxpayer that is included within the scope of the CFC rules as contemplated in Article 7(1), the risk of an unsophisticated party unwittingly stumbling into the ambit of the CFC rules is highly unlikely.

4.2.2 *The Low-Tax and Control Thresholds*

The criteria in Article 7(1) determine which entities are included in the CFC rules' scope of application, and the *de minimis* exclusions in Article 7(3) and (4) determine which entities are excluded. The inclusion criteria stipulated in Article 7(1) thus also reduce the administrative and compliance burden by narrowing the scope of these rules. The population of foreign entities, which may be CFCs, is reduced by exempting entities that are not subject to low taxation.[99] The operative provisions of Articles 7 and 8 only apply when the foreign entity or foreign PE pays less than half of the corporate tax that it would have paid in the parent jurisdiction. The scope of Article 7 is therefore restricted to foreign investee companies or PEs that pay low amounts of

Notes

[95] Interestingly, in De Groot & Larking, *supra* n. 13, at 271, the authors suggest that the reason why Belgium has opted not to include the *de minimis* exclusions of Art. 7(4) is 'to avoid administrative complexity'.

[96] Council Directive (EU) 2016/1164, *supra* n. 8, Art. 1(1).

[97] The term 'multinational enterprise' is defined in the IBFD International Tax Glossary (Julie Rogers-Glabush ed., IBFD 7. rev. ed. 2015) as a '[c]ompany or group of companies with business establishments in two or more countries. A multinational structure may consist of a company established in one country with sales outlets, production facilities, joint-venture projects, etc., in other countries, or a number of companies in various countries that are connected by shareholdings in each other'.

[98] OECD, *Action Plan on Base Erosion and Profit Shifting* 7 and 8 (OECD 19 Jul. 2013).

[99] OECD, *supra* n. 2, para. 10.

tax relative to that which would have been paid in the parent jurisdiction.[100]

Further, in respect of a foreign entity, the control threshold (as discussed in §2.2.2 *supra*) must be met. Control in Article 7 of the ATAD is determined by aggregating the interests of the taxpayer and its 'associated enterprises'. Given the high percentage of 25% in the definition of 'associated enterprises',[101] MNEs should easily be able to determine and monitor who their 'associated enterprises' are and thus when they (collectively) control a foreign entity. CFC legislation equivalent to Article 7(1) of the ATAD does not apply to independent investor corporations with interests of less than 50% in a foreign entity. These investors are thus protected from inadvertent non-compliance with the CFC legislation. This is not the case, for example, in CFC legislation that establishes control by aggregating interests held by all residents of a particular country (whether or not associated enterprises) to assess whether it exceeds the specified percentage.[102]

4.2.3 *The Level of Interest Required for Income Inclusion*

The ATAD does not set a minimum level of interest (or participation) in the CFC that is necessary before income is required to be included in the parent's tax base. Another way that the ATAD's CFC rules could have been designed to limit compliance and administration costs would have been to set a *de minimis* holding before the income of a CFC is included in the parent's tax base. For example, a minimum interest of 1% (as is the case in the German CFC rules) or 10% (as is the case in the CFC rules of the US and South Africa) in the foreign entity could be required. These small interests would likely represent portfolio investment and not confer definite influence. Ascertaining a shareholder's interest in an entity is easier to administer than a provision that requires information about the income or profits of the foreign entity.

4.3 *The Normative Coherence of the De Minimis Exclusions*

4.3.1 *The ATAD's CFC Rules: A Remedy*

The question that remains unanswered is whether the *de minimis* exclusions in Article 7 of the ATAD can be normatively justified in the context of the narrow scope of application of the CFC legislation in the EU (necessitated by the requirement to ensure compatibility with EU primary law). Unlike many of the CFC regimes of non-EU jurisdictions, EU Member States' CFC legislation may only apply to income from wholly artificial arrangements to be justifiable on the grounds of prevention of abusive practices.[103] Accordingly, the ATAD's CFC rules are designed to only capture income that has been artificially diverted to CFCs.[104] This is narrower than the objective of CFC legislation in many non-EU jurisdictions and the recommendations in the BEPS Action 3 Final Report for which the objective can more broadly be to deter and counteract BEPS whether or not such BEPS actually occurs. In non-EU jurisdictions, CFC rules can operate merely to remove the incentive for groups to engage in profit shifting and thus have a purely preventative objective. This is not so within the EU.

The two models presented in Article 7 of the ATAD accordingly only apply to CFCs that either do not carry on a substantive economic activity (Model A)[105] or that have derived income from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage (Model B). Therefore, the normative coherence of the *de minimis* exclusions in paragraphs 3 and 4 of Article 7 should be evaluated in the context of this narrower scope of the CFC rules in the ATAD. The presence of these exclusions raises the following questions. How much is a *de minimis* amount of artificially diverted income? What amount of artificially diverted income should be exempted from the CFC regimes in the EU?

In the context of Article 7's limited scope of application and its purpose as a SAAR, it seems incoherent that a substantive tax provision allows for any amount of income to be artificially diverted. Further, are *de minimis* considerations not inherent in tax administration and more appropriately considered in adjudication and sanctioning? Further, a statutory exclusion from a SAAR targeted at sophisticated parties on the grounds of compliance costs seems nonsensical. When sophisticated taxpayers set up structures for abusive purposes, should they be spared the compliance burden of adhering to anti-abuse rules specifically targeting these practices – even if the amounts are potentially small?

Notes

100 Council Directive (EU) 2016/1164, *supra* n. 8, Recital 12 provides for the following: 'It should be acceptable that, in transposing CFC rules into their national law, Member States use white, grey or black lists of third countries, which are compiled on the basis of certain criteria set out in this Directive and may include the corporate tax rate level, or use white lists of Member States compiled on that basis'.

101 *Ibid.*, Art. 2(4).

102 For example, South Africa's CFC legislation. *See* s. 9D(1) of the Income Tax Act 58 of 1962 (as amended).

103 Cadbury-Schweppes, *supra* n. 3, para. 55; X GmbH, *supra* n. 65, para. 73.

104 Council Directive (EU) 2016/1164, *supra* n. 8, Recital 12.

105 With the only exception being when the CFC is located in a third country that does not have a legal framework for the exchange of information with the parent's Member State.

4.3.2 *De Minimis Exclusions: Model A*

If the *de minimis* exclusion in paragraph 3, first sentence is regarded as a bright line safe harbour to determine whether the CFC is carrying on a substantive economic activity, then it does not raise a coherence concern in the context of the limited scope of application of Article 7. In the exceptional case when the parent's Member State has opted to include the third party exclusion (in respect of jurisdictions that it does not have an exchange of information agreement with), the *de minimis* exclusion would operate to disregard the CFC from the application of the CFC rules in the parent's Member State where the CFC's tainted income is less than a third of its total income. This would then equally provide relief to both non-abusive and artificially diverted tainted income. In respect of the *de minimis* exclusion in paragraph 3, second sentence, again, it does not raise any particular coherence concern if it is regarded as a bright line safe harbour for determining whether the 'financial undertaking' carries on a substantive economic activity.

A point of concern regarding both above provisions is that, since the threshold is provided as a percentage (or ratio), the absolute value of the amounts escaping the application of the CFC rules can be significant. Some countries have addressed this concern by including a monetary threshold that may not be exceeded in addition to the percentage threshold.[106]

4.3.3 *De Minimis Exclusions: Model B*

Accounting profits and non-trading income up to the fixed monetary thresholds set out in the *de minimis* exclusion in paragraph 4(a) may not be quantitatively significant amounts. However, these monetary thresholds essentially set the maximum acceptable level of profits and non-trading income that may be earned from non-genuine arrangements that have been established for the essential purpose of obtaining a tax advantage and do not need to be included in the parent's tax base. The *de minimis* exclusion in paragraph 4(b) may also have the effect of providing an exclusion for income from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage. These exclusions therefore essentially allow for a quantifiable amount of acceptable abuse – a result incompatible with the rules' objective. Provided that such arrangements are not captured by the general anti-abuse rule (GAAR) in Article 6 (discussed in §4.3.4 *infra*), Member States may feel compelled to include the *de minimis* exclusions to prevent being at a competitive disadvantage to those Member States who have decided to include them in their national CFC legislation.[107]

In addition, while using accounting profits reduces tax compliance costs, accounting profits may be manipulated through, for example, depreciation and amortization deductions. This is especially a concern when there is no regulatory requirement for the entity's financial statements to be independently audited.

4.3.4 *The General Anti-Abuse Rule: A Coda*

When a Member State opts to use the *de minimis* provisions in Article 7(4) of the ATAD in their CFC legislation, a subsequent question arises. To what extent are the artificial arrangements that escaped the application of the CFC rules by meeting the requirements of one of the *de minimis* exclusions captured by the GAAR in Article 6 which does not contain a *de minimis* threshold? This may very well be a case of jumping out of the frying pan of Article 7's CFC rules and into the fire of Article 6's GAAR.

It is beyond the scope of this article to answer the above question. However, should the arrangements contemplated in Article 7 that escape the application of those rules as a result of meeting the requirements of a *de minimis* provision under paragraph 4 fall within the scope of the GAAR, this would support the findings of the normative analysis that the *de minimis* provisions in paragraph 4 are incoherent in the context of Article 7's already limited application.

4.4 *Summary of Findings*

The findings of the evaluation are summarized in Table 3 below.

5 Conclusion

This article analysed the (optional) *de minimis* exclusions contained in Article 7(3) and (4) of the ATAD's CFC rules. It demonstrated that the *de minimis* exclusions pertaining to Model A (contained in Article 7(3)) are designed in such a way that their effectiveness in reducing the administrative burden and compliance costs of the CFC rules is limited. The design of these *de minimis* exclusions – using a percentage or ratio – is such that they may provide the opportunity for significant amounts of artificially diverted income to escape the application of the CFC rules. Future empirical research could investigate this concern.

The analysis further showed that the *de minimis* exclusions pertaining to Model B (those in Article 7(4)) are incoherent with the anti-abuse objective of the rules given

Notes

[106] Germany, for example, requires that, in order to be exempt, the foreign entity's passive income should not exceed 10% of its total gross income and that the amounts to be disregarded may not exceed EUR 80,000 for both the company and for the taxpayer; *see* Jochen Gerbracht, *Controlled Foreign Company Legislation in Germany*, in *Controlled Foreign Company Legislation*, (Georg Kofler et al. eds, IBFD 2020), §17.1.4.3.

[107] Gilles van Hulle & Jean-Philippe Van West, *Controlled Foreign Company Legislationin Belgium*, in *Controlled Foreign Company Legislation* (Georg Kofler et al. eds, IBFD 2020), §6.7.3.

Table 3 Summary of Findings

	Paragraph	*Description*	*Effectiveness*	*Coherent*
Model A	Para. 3, first sentence	Low percentage of tainted income	Limited (*see* §4.1.1)	Yes (*see* §4.3.2)
	Para. 3, second sentence	'Financial undertakings': Low percentage of tainted income from intra-group transactions	Less effective than the exclusion in para. 3, first sentence (*see* §4.1.1)	Yes (*see* §4.3.2)
Model B	Para. 4(a)	Low monetary amounts of accounting profits and non-trading income	Effective (*see* §4.1.2)	No (*see* §4.3.3)
	Para. 4(b)	Low percentage of accounting profits to operating costs	Ambivalent (*see* §4.1.2)	No (*see* §4.3.3)

the limited scope of CFC rules in the EU. EU primary law restricts their scope in the EU – for both CFCs located within and outside of the EEA – to instances of actual abuse. Article 7(4) provides EU Member States with the option to include a statutory provision allowing a *de minimis* amount of artificiality in the context of CFC legislation.

The EU Council should consider amending Article 7 of the ATAD by redesigning the *de minimis* exclusions in paragraph 3 to improve their effectiveness, deleting paragraph 4 to remove normatively incoherent *de minimis* exclusions, and possibly introducing a *de minimis* participation threshold for the attribution of CFC income. EU Member States should similarly also re-evaluate the design or consider the deletion of the *de minimis* exclusions in their CFC legislation.

The somewhat unexpected results of this study indicate that a more careful scrutiny of *de minimis* provisions in other pieces of tax legislation or international tax agreements is warranted. In addition, the design of *de minimis* provisions in future tax legislation or agreements can benefit from the findings of this study.