

# Are the Danish CFC Rules in Conflict with the Freedom of Establishment? – An Analysis of the Danish CFC Regime for Companies in Light of ECJ Case Law

**Unlike other Member States, Denmark reacted to *Cadbury Schweppes* (C-196/04) by widening the scope of application of its CFC legislation for companies to purely domestic situations. Inspired by the BEPS Report recommendation on strengthening CFC legislation – and in light of the lack of certainty under existing ECJ case law – this article analyses whether or not the Danish CFC rules applicable to companies should be considered in line with the freedom of establishment.**

## 1. Introduction

In the OECD report entitled Addressing Base Erosion and Profit Shifting (BEPS),<sup>1</sup> the effectiveness of anti-avoidance measures, such as CFC regimes, is listed as a key pressure area that should be included in a comprehensive action plan launched to counter BEPS. Moreover, in the subsequently published Action Plan on BEPS it is stated that the CFC rules of many countries do not always counter BEPS in a comprehensive manner. Accordingly, the OECD now intends to develop recommendations regarding the design of CFC rules.<sup>2</sup>

However, when EU Member States introduce or re-draft CFC legislation, the limits imposed by EU law obviously have to be taken into account.<sup>3</sup> With respect to these limits, it has been argued that the European Court of Justice's (ECJ) landmark decision in *Cadbury Schweppes* (C-196/04)<sup>4</sup> implies that there is little room for the application of CFC rules in an EU context,<sup>5</sup> as the ECJ stated that, in order for the CFC legislation to comply with EU law, the taxation provided for by that legislation must not apply

where, despite the existence of tax motives, the incorporation of a subsidiary reflects economic reality. In other words, CFC legislation can only be used to counter wholly artificial arrangements.<sup>6</sup>

The *Cadbury Schweppes* decision concerned the UK CFC rules as they applied at the time, however, several Member States have found it necessary to amend their CFC rules following the decision,<sup>7</sup> despite a lack of clear guidance in the existing case law.<sup>8</sup> It seems that a solution often used by Member States has been to limit the applicability of CFC rules by introducing an exception for subsidiaries resident in other Member States that actually do reflect economic reality.<sup>9</sup>

However, unlike other Member States, Denmark reacted to the decision by widening the scope of application of its CFC legislation for companies. Accordingly, the condition that the subsidiary should be a foreign company subject to low taxation was abolished, as the amended rules now also apply domestically. In the view of the legislator, this amendment implies that: “[...] there is no different treatment, regardless of whether the parent company owns a subsidiary resident in Denmark, a foreign subsidiary resident in the EU/EEA or a foreign subsidiary resident outside the EEA.”<sup>10</sup> Thus, by also applying the CFC rules to Danish subsidiaries, the rules have been brought into line with EU law without undermining the scope of the legislation – at least according to the Danish legislator.

Against this background, this article explores whether or not the Danish approach could serve as an inspiration for other Member States concerned with the limits imposed by EU law. More precisely, the article analyses – on the basis of *Cadbury Schweppes*, as well as more recent ECJ case law – whether or not the Danish CFC rules applicable to companies should be considered to be in line with the freedom of establishment.<sup>11</sup>

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1. OECD, *Addressing Base Erosion and Profit Shifting*, pp. 47-53 (OECD 2013), International Organizations' Documentation IBFD.  
 2. OECD, *Action Plan on Base Erosion and Profit Shifting*, p. 16 (OECD 2013), International Organizations' Documentation IBFD.  
 3. See also, for example, Commission Recommendation, C(2012) 8806 final of 6 December 2009 on aggressive tax planning.  
 4. 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.  
 5. See, for example, M. Lang & S. Heidenbauer, *Wholly Artificial Arrangements, in A Vision of Taxes Within and Outside European Borders, Festschrift in Honour of Prof. Dr Frans Vanistendael*, p. 615 (L. Hinnekens & P. Hinnekens eds., Kluwer 2008); and G.T.K. Meussen, *Cadbury Schweppes: The ECJ Significantly Limits the Application of CFC Rules in the Member States*, 47 Eur. Taxn. 1, pp. 13-18 (2007), Journals IBFD.

6. See UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, paras. 65-68, ECJ Case Law IBFD.  
 7. See C. Möller, *Die Hinzurechnungsbesteuerung ausgewählter EU-Mitgliedstaaten – Reaktionen auf "Cadbury Schweppes"*, IstR 5, pp. 166-170 (2010).  
 8. See W. Schön, *Taxing Multinationals in Europe* (Working Paper 11), p. 25 (Max Planck Institute for Tax Law and Public Finance 2012).  
 9. See M. Dahlberg & B. Wiman, *General Report – The taxation of foreign passive income for groups of companies*, in *IFA Cahiers de droit fiscal international*, vol. 98a, pp. 44-45 (Sdu 2013), Online Books IBFD.  
 10. See DK: Bill L 213 of 18 April 2007.  
 11. This article does not consider the Danish CFC rules in light of secondary EU law. Moreover, the Danish CFC rules concerning foreign PEs and

## 2. Overview of the Danish CFC Regime

Traditionally, Danish tax law applies the worldwide taxation principle. However, for resident companies a (limited) territoriality principle now applies. Accordingly, income from permanent establishments (PEs) and real estate located abroad should, generally, be excluded from taxable income. Moreover, a participation exemption applies to dividends. All companies within a group that are liable to full, Danish taxation – as well as PEs and real estate located in Denmark – are subject to mandatory, national tax consolidation. Furthermore, it is possible to opt for voluntary, international tax consolidation. Currently, the corporate tax rate is 25% but is being gradually reduced to 22% (by 2016).

Denmark introduced CFC rules for companies in 1995 under section 32 of the Corporate Tax Act.<sup>12</sup> The objective was to prevent erosion of the Danish tax base caused by the increasing openness of borders to flows of capital. More specifically, the aim of the CFC rules was to prevent Danish companies from establishing subsidiaries in low-tax countries and moving income and assets to such entities.

The CFC legislation has been amended several times since its introduction, including significant changes made in 2007 in response to *Cadbury Schweppes*. First, the area of application of the CFC rules was widened such that the current CFC rules also apply with respect to subsidiaries resident in Denmark if the conditions for CFC taxation are fulfilled. Moreover, the 2007 reform entailed a shift from a transactional approach towards an entity approach.

The CFC rules apply if (1) a parent company directly or indirectly is a shareholder in the subsidiary and the group has “deciding influence” over the subsidiary; (2) the tainted income – known as the CFC income – of the subsidiary amounts to more than 50% of the subsidiary’s total taxable income in a given year; and (3) the financial assets of the subsidiary exceed 10% of total assets. However, CFC taxation shall, inter alia, not be imposed if the group has opted for voluntary, international tax consolidation.

CFC income consists of types of income that are perceived as easy to place abroad, such as interest income, taxable gains and deductible losses on securities, taxable dividends, certain royalties and capital gains on intangible assets and income from financial leasing. The Danish CFC rules may also target active business activities of subsidiaries within the financial sector such as, inter alia, insurance activities and activities of a bank or mortgage credit institution. However, the National Tax Assessment Council is entitled to allow for an exemption from the CFC rules for such companies if certain relatively strict conditions are fulfilled.

individuals are not dealt with. The rules applicable to individuals, in general, still only apply with respect to income in foreign companies subject to low taxation. Upon application, an individual can be exempted from CFC taxation if the company is resident in the European Union/ European Economic Area and has a genuine economic activity.

12. DK: Bill L 35 of 2 November 1994 and DK: Law 312 of 17 May 1995.

If the conditions for CFC taxation are fulfilled, the subsidiary’s entire net income should be included in the taxable income of the parent company in proportion to its ownership share. If the subsidiary has carried forward tax losses from previous tax years, these losses can be set off against the income attributed to the parent company. The same applies to losses transferred to the subsidiary as a result of participation in a local tax consolidation. When a parent company is subject to CFC taxation, relief is granted for taxes paid by the subsidiary under the ordinary credit method.<sup>13</sup>

## 3. Are the Danish CFC Rules in Breach of EU Law?

### 3.1. Introductory remarks

In the international tax literature, some authors have briefly discussed the possibility of expanding CFC regimes to include domestic subsidiaries. Schön (2012) for example remarks that a fully reliable move to save CFC rules would be to extend such rules to domestic companies.<sup>14</sup> Maisto and Pistone (2008), however, state that such a practice would be open to criticism in respect of compatibility with EU law.<sup>15</sup> The European Commission has also more generally argued that it remains debatable whether or not an extension of anti-avoidance rules to purely domestic situations, where no possible risk of abuse exists, can successfully bring all restrictive measures into line with Member State treaty obligations.<sup>16</sup> Moreover, it should be mentioned that the United Kingdom, back in 2007, actually considered expanding the scope of its CFC legislation to cover all subsidiaries, whether resident or not, and regardless of the applicable level of taxation. Taylor and Sykes (2007) conclude that it is unlikely that the ECJ would have been sympathetic to such a proposal<sup>17</sup> and, in the end, the UK government chose to follow another route.

In the Danish tax literature, several authors have argued that the current CFC rules might still be in conflict with the fundamental freedoms, in particular article 49 (freedom of establishment)<sup>18</sup> of the Treaty on the Functioning of the

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13. For a more thorough description of the Danish CFC regime see P. Koerver Schmidt, *Danish Branch Report – The taxation of foreign passive income for groups of companies*, in *supra* n. 9, at pp. 259-278.
  14. See Schön, *supra* n. 8, at p. 23. See also A. Rust, *CFC Legislation and EC Law*, Intertax 11, pp. 492-501 (2008), who proposes that the German CFC regime be redrafted based on a piercing-the-corporate-veil approach applicable to passive income in both foreign and domestic subsidiaries.
  15. See G. Maisto & P. Pistone, *A European Model for Member States’ Legislation on the Taxation of Controlled Foreign Subsidiaries (CFCs) – Part 1*, 48 Eur. Taxn. 10, pp. 503-513 (2008), Journals IBFD.
  16. See Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, COM (2007) 785 final of 10 December 2007 on the application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries.
  17. See D. Taylor & L. Sykes, *Controlled Foreign Companies and Foreign Profits*, British Tax Rev. 5, pp. 609-647 (2007).
  18. See A. Hansen & P. Lytken, *CFC-regler på tynd is?*, Danish J. of Intl. Taxn. 141, pp. 252-261 (2012); T. Rønfeldt, *Action Against Capital Funds the Danish Rules on CFC Taxation and Thin Capitalization are Inadequate*, Intertax 1, pp. 40-50 (2009); M. Nielsen, *CFC-reglerne ctr. EU-retten og dobbeltbeskatningsaftaler*, Danish J. of Intl. Taxn. 236, pp. 547-555 (2007); and L. Terkilsen, *Den danske CFC-beskatning og EU-retten*, IUR-information 5/6, pp. 22-25 (2007). A. Michelsen, *CFC-beskatning og retsmisbrugsbe-*

European Union (TFEU) (2007).<sup>19</sup> The main argument presented seems to be that a difference in treatment still exists, as the application of the CFC rules only entails an additional tax burden for the Danish parent company in circumstances where the subsidiary is resident in another country in respect of which the level of taxation is lower than the Danish level of taxation. However, the National Tax Assessment Council has concluded that the current Danish CFC rules do not conflict with EU law.<sup>20</sup> Unfortunately, the decision was extremely brief regarding this matter and the council mainly reiterated the point of view of the legislator, i.e. that no difference in treatment exists, as the rules also apply with respect to Danish subsidiaries. Subsequently, the Council's decision was brought before the National Tax Assessment Board, which, however, confirmed the Council's decision in a similarly brief manner.<sup>21</sup>

### 3.2. Basic analysis

As the objectives of the current Danish CFC rules and the CFC legislation previously applied in the United Kingdom appear to be quite similar, it seems reasonable to initiate the analysis of the Danish CFC rules on the basis of the reasoning used by the ECJ in *Cadbury Schweppes* even though the CFC rules in the United Kingdom only applied to income generated by foreign subsidiaries.<sup>22</sup> It is true that *Cadbury Schweppes* is now a fairly dated decision. The decision, however, still acts as the cornerstone of the theory of abuse in the field of direct taxes and EU law<sup>23</sup> and – together with *Test Claimants in the CFC and Dividend Group Litigation* (C-201/05)<sup>24</sup> – is the only decision that specifically concerns CFC taxation of income in a subsidiary resident in another Member State.

As mentioned in section 2., the Danish CFC rules for companies only apply if the group has “deciding influence” over the subsidiary. “Deciding influence” should be understood as the right to control the economic and operational decisions of the subsidiary. Accordingly, as the scope of the Danish CFC rules is aimed at situations in which the shareholder, or at least the group, has a definite influence over the subsidiary's decisions, it seems likely that the Danish CFC rules should only be examined in light of the freedom of establishment,<sup>25</sup> i.e. articles 49 and 54 of the TFEU, and

that an independent examination in light of the free movement of capital should not be carried out.<sup>26</sup>

In *Cadbury Schweppes*, the ECJ initially stated that the fact that the taxpayer sought to profit from tax advantages in force in a Member State other than his own cannot, in itself, deprive the taxpayer of the right to rely on the provisions of the treaty.<sup>27</sup> Furthermore, the ECJ emphasized that the freedom of establishment also prohibits the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation.<sup>28</sup> Subsequently, the ECJ concluded that it was common ground that the UK CFC rules resulted in a difference in treatment, as the rules only applied where a resident company had incorporated a subsidiary in another Member State in which it was subject to a lower level of taxation, and not where the resident company had incorporated a subsidiary in the United Kingdom or in another Member State in which it was not subject to a lower level of taxation.<sup>29</sup>

In the eyes of the ECJ, such a difference in treatment created a tax disadvantage for the resident company to which the CFC rules were applicable. The ECJ remarked that, under such legislation, the resident company is taxed on profits of another legal person. As this was not the case for a resident company with a subsidiary resident in the United Kingdom or a subsidiary established in another Member State in which it was not subject to a lower level of taxation, the CFC rules hindered the exercise of the freedom of establishment by dissuading resident companies from establishing, acquiring or maintaining a subsidiary in a Member State in which the latter is subject to a lower level of taxation. The CFC rules, therefore, constituted a restriction on the freedom of establishment.<sup>30</sup>

At first glance, the Danish CFC rules do not appear to entail a difference in treatment, as the Danish parent company has to include the income of both Danish and foreign subsidiaries if the general conditions for CFC taxation are fulfilled. Accordingly, in that case, the Danish parent company is, in principle, taxed on profits of another legal person, regardless of where this other legal person is resident.

However, if the level of taxation is lower in the Member State in which the subsidiary is resident, the actual Danish tax payable by the Danish parent company – seen in isolation – will be different depending on whether the subsidiary is resident in Denmark or in another Member State with a lower level of taxation.<sup>31</sup> The main reason is that

grebet i EU-retten, Danish J. of Intl. Taxn. 85, pp. 237-249 (2008) appears to be more cautious.

19. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD.  
 20. See DK: National Tax Assessment Council, 20 May 2008, SKM2008.450.SR.  
 21. DK: National Tax Tribunal, 6 May 2009, Case No. 08-02192, published in *Afgørelsesdatabasen for Skatterådet og Landsskatteretten*.  
 22. As the decision in *Cadbury Schweppes* has been subject to much interest in the literature, a full summary of the decision is not included in this article. Instead see, for example, L. de Broe, *International Tax Planning and Prevention of Abuse*, p. 805 et seq. (IBFD 2008), Online Books IBFD.  
 23. See A. Martín Jiménez, *Towards a Homogeneous Theory of Abuse in EU (Direct) Tax Law*, 66 Bull. Intl. Taxn. 4/5, pp. 270-292 (2012), Journals IBFD.  
 24. See UK: ECJ, 23 Apr. 2008, Case C-201/05, *The Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD. This decision, to a large extent, follows *Cadbury Schweppes* (C-196/04).  
 25. For a general discussion see D. Smit, *EU Freedoms, Non-EU Countries and Company Taxation*, p. 208 et seq. (Kluwer Law 2012).

26. See *Cadbury Schweppes* (C-196/04), at paras. 31-33. See also B.J.M. Terra & P.J. Wattel, *European Tax Law*, p. 79 (Wolters Kluwer 2012).  
 27. See *Cadbury Schweppes* (C-196/04), at paras. 34-38.  
 28. Id., at para. 42.  
 29. It has been debated whether the ECJ, in *Cadbury Schweppes*, applied only a vertical approach or a vertical approach as well as a horizontal approach. See, for example, J. Calderón & A. Baez, *The Columbus Container Services ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle*, Intertax 4, pp. 212-222 (2009).  
 30. *Cadbury Schweppes* (C-196/04), at paras. 43-46.  
 31. It seems as though the assessment should be made on a standalone basis for the parent company according to *Cadbury Schweppes* (C-196/04), at para. 45. See also *SGI*, in which the ECJ placed emphasis on the fact that the companies involved were separate legal persons subject to individual tax

relief is granted for taxes paid by the subsidiary according to the ordinary credit method. Thus, if the CFC conditions are fulfilled with respect to a subsidiary resident in Denmark, relief is granted for the Danish tax paid by the Danish subsidiary. As the same corporate tax rate (currently 25%) applies to both the Danish subsidiary and the Danish parent company, the relief granted – for taxes paid by the Danish subsidiary – should normally fully absorb the parent company's additional tax on the income from the Danish subsidiary. In other words, if the CFC conditions are fulfilled with respect to a Danish subsidiary, there should not be a higher tax burden.<sup>32</sup>

In contrast, if the subsidiary is resident in another Member State with a lower level of taxation, the relief granted for taxes paid by the subsidiary in the other Member State will normally not fully absorb the parent company's additional Danish tax on the income from the subsidiary. In other words, the tax advantage – i.e. the difference between the level of taxation in Denmark and in the other Member State – will be picked up at the level of the Danish parent company, if the CFC rules apply.<sup>33</sup>

### 3.3. Different treatment of comparable situations?

As explained in section 3.2., the application of the CFC rules in a domestic scenario normally does not result in an additional tax burden for the Danish parent company, whereas the Danish parent company – seen in isolation – may incur an additional tax burden if the subsidiary is resident in another Member State in which the level of taxation is lower than the Danish level of taxation. Accordingly, in line with *Cadbury Schweppes*, it may be argued that the Danish CFC rules still cause a difference in treatment of comparable situations, as the parent company – seen in isolation – may experience a tax disadvantage when establishing a subsidiary in another Member State in which the level of taxation is lower than the Danish level of taxation.

However, what should be considered is whether or not the additional tax charge – faced by the Danish parent company when establishing a subsidiary in another Member State with a lower level of taxation – should be seen as a mere consequence of the parallel exercise by two Member States of their fiscal sovereignty. Accordingly, in

liability: BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle (SGI) v. État belge*, paras. 51-52, ECJ Case Law IBFD. However, in its case law on cross-border offsetting of losses, the ECJ seems more willing to consider the group as a whole. See, for example, UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer v. David Halsey (Her Majesty's Inspector of Taxes)*, ECJ Case Law IBFD.

32. Annex 1 Bill L 213. Furthermore, it should be noted that if CFC taxation applies with respect to a subsidiary resident in Denmark, CFC taxation occurs after tax losses are apportioned among the group companies pursuant to the rules on mandatory national tax consolidation. Most authors seem to agree that, in the end, CFC taxation of the income in a Danish subsidiary does not give rise to an additional tax burden. In reaching this conclusion, some authors emphasize, primarily, that the Danish subsidiary will already be part of a mandatory Danish tax consolidation. See, for example, T. Rønfeldt, *Skatteværn og EU-frihed*, p. 371 et seq. (Jurist- og Økonomiforbundets Forlag 2009). Other authors place emphasis primarily on the fact that the relief granted – for taxes paid by the Danish subsidiary – should normally fully absorb the parent company's additional tax on the income from the Danish subsidiary. See A. Hansen & P. Lytken, *supra* n. 18.

33. For an illustrative example see A. Hansen & P. Lytken, *supra* n. 18.

*Columbus Container Services* (C-298/05) the ECJ found that a German switch-over clause – pursuant to which the credit method is used instead of the exemption method with respect to income from a partnership established in another Member State where the level of taxation is low – did not constitute a restriction on the freedom of establishment. In the eyes of the ECJ, applying the credit method to such foreign partnerships merely subjected the profits made by such partnerships to the same tax rate as profits earned by partnerships established in Germany.<sup>34</sup>

However, this reasoning does not seem to apply with regard to the Danish CFC rules, as the ECJ, in *Cadbury Schweppes*, clearly rejected the argument put forward by several Member States that the fact that the parent company did not pay more tax on profits originating from a CFC in another Member State than that which would have been payable on those profits had the profits been earned by a subsidiary established in the United Kingdom should have been taken into consideration. Instead, the ECJ considered it important that, as a result of the CFC rules, the resident parent company was taxed on profits of another legal person. Thus, it was crucial that the CFC rules created a tax disadvantage for the resident company to which the CFC legislation was applicable.<sup>35</sup>

Furthermore, it can be argued that the fact that the Danish CFC rules have been designed in such a way that the parent company, under certain conditions, has to include income from another legal person – regardless of whether the legal person is Danish or foreign – does not mean that a difference in treatment does not exist, as the application of the CFC rules to a Danish subsidiary, in effect, does not give rise to additional taxation at the level of the Danish parent company, as the credit relief would normally fully absorb the parent company's additional tax. In other words, it may be argued that the Danish parent company, in reality, is not taxed on profits of another legal person when that legal person is also resident in Denmark.

In *Cadbury Schweppes*, the ECJ does not elaborate in detail on whether or not the inclusion of the subsidiary's income in the resident parent company's income actually (also) results in a higher tax burden for the parent company. However, this is fully understandable since the ECJ specifically considered the CFC rules in the United Kingdom, which only applied to subsidiaries resident abroad that were subject to a lower level of taxation. Under such circumstances, the available credit relief would not fully absorb the additional taxation at the level of the parent company, and the inclusion of income from the subsidiary

34. See DE: ECJ, 6 Dec. 2007, Case C-298/05, *Columbus Container Services BVBA v. Finanzamt Bielefeld-Innenstadt*, paras. 29-54, ECJ Case Law IBFD. For a thorough analysis see J. Calderón & A. Baez, *supra* n. 29.

35. See *Cadbury Schweppes* (C-196/04), at para. 45. See also C. HJI Panayi, *The Anti-Abuse Rules of the CCCTB*, 66 Bull. Intl. Taxn. 4/5, pp. 256-269 (2012), Journals IBFD who concludes that *Cadbury Schweppes* is still highly prescriptive when assessing general CFC rules, whereas a switch-over mechanism can be introduced with relative ease. G.T.K. Meussen, *Columbus Container Services – A Victory for the Member States' Fiscal Autonomy*, 48 Eur. Taxn. 4, pp. 169-173 (2008), Journals IBFD concludes that *Columbus Container Services* (C-298/05) is not a CFC case and cannot be judged on the basis of reasoning based on an anti-abuse provision.

would, therefore, automatically increase the tax burden for the parent company resident in the United Kingdom. Accordingly, there was no need to draw a distinction between inclusion of the foreign subsidiary's income in the resident parent company's income and an increased tax burden. This supports the conclusion that the decisive issue in the eyes of the ECJ was whether or not the CFC legislation created a tax disadvantage for the resident parent company when establishing a subsidiary in another Member State.

In addition, it should be kept in mind that the ECJ seems to consider CFC legislation as an example of a pure anti-avoidance rule, whereas a switch-over clause – such as that considered in *Columbus Container Services* – should be considered part of the Member State's domestic relief provisions (despite the fact that the switch-over element is based on anti-avoidance considerations).<sup>36</sup> Although it appears to be difficult to make this distinction in practice, it has to be remembered when, for example, considering a switch-over clause, that the Member States exercise their fiscal sovereignty in parallel and that EU law, in its current state, does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the European Union.<sup>37</sup> In contrast, the ECJ seems to consider CFC rules as a selective inclusion within a Member State's taxing jurisdiction of income that normally falls outside that jurisdiction. Such a selective inclusion – made for anti-avoidance reasons – should be considered a restriction on the freedom of establishment and, therefore, needs to be justified and proportionate. In the author's view, these considerations should be taken into account when analysing the EU law implications of the Danish CFC regime.

Finally, it should be noted that Danish CFC taxation can be avoided if the group elects to apply the rules on voluntary international tax consolidation. However, in reality, very few groups choose to apply these rules because of their very wide scope (all group companies worldwide – including sister and parent companies – as well as all PEs and real estate in foreign jurisdictions must be included in the consolidation).<sup>38</sup> Moreover, it should be taken into

account that the possibility of applying another tax regime – in this respect the rules on voluntary international tax consolidation – may not necessarily be capable of remedying the possible discriminatory effect of the CFC regime.<sup>39</sup>

Admittedly, it is hard to conclude, with certainty, whether or not the current Danish CFC rules constitute a restriction on the freedom of establishment. However, in the author's assessment, the Danish CFC rules probably do constitute a restriction of the freedom of establishment due to the fact that a difference in treatment in reality still exists, as the application of the CFC rules entails an additional tax burden – i.e. a genuine tax disadvantage – for the Danish parent company if the subsidiary is resident in another country in which the level of taxation is lower than the Danish level of taxation.

#### 3.4. Justifications and the principle of proportionality?

Assuming that the current Danish CFC rules do constitute a restriction on the freedom of establishment, it becomes necessary to assess whether or not the rules can be justified and, if so, should be considered to be in line with the principle of proportionality.

When undertaking the justification assessment, the ECJ, in *Cadbury Schweppes*, focused on the need to prevent tax avoidance. In connection with this, the ECJ stated that a national measure restricting the freedom of establishment might be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned. Accordingly, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction had to be to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory. However, in addition to its considerations on prevention of tax avoidance, the ECJ also briefly mentioned that such arrangements jeopardize the balanced allocation between Member States of the power to impose taxes.<sup>40</sup>

With respect to the CFC legislation under consideration, the ECJ concluded that by providing for the inclusion of the profits of a CFC subject to a very favourable tax regime in the tax base of the resident company, the CFC legislation makes it possible to thwart practices that have no purpose other than to escape the tax normally due on the profits generated by activities carried on in national territory. Such legislation was, therefore, considered suit-

36. See C. Bardini, *The Fine Line between Anti-Abuse Measures and the Delimitation of a Member State's Tax Jurisdiction: The Italian Case*, 50 Eur. Taxn. 8, pp. 374-382 (2010), Journals IBFD.

37. See *Columbus Container Services* (C-298/05), at para. 45. A similar statement can be found, for example, in *Test Claimants in the FII Group Litigation*, although in that case the ECJ ended up concluding that the rules constituted a restriction on the freedom of establishment and on capital movements, as application of the imputation method to foreign-sourced dividends did not ensure a tax treatment equivalent to that resulting from the application of the exemption method to nationally-sourced dividends. See UK: ECJ, 13 Nov. 2012, Case C-35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue and The Commissioners for Her Majesty's Revenue and Customs*, para. 40, ECJ Case Law IBFD. Apart from this, Terra & Wattel, *supra* n. 26, at p. 1046 et seq. remark that the ostensible contradiction between the earlier decision in UK: ECJ, 12 Dec. 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD and *Cadbury Schweppes* (C-196/04) may be understood in light of the fact that the ECJ sees what happens before distribution as one thing and what happens after distribution as another.

38. Thus, many groups are, in reality, precluded from electing for international voluntary tax consolidation; see J. Guldmand, N. Vinther & E.

Werlauff, *Sambeskatning 2013/2014*, p. 321 et seq. (Karnov Group 2013). Furthermore, they conclude that the Danish rules on tax consolidation contain elements that constitute restrictions.

39. See, for example, NL: ECJ, 18 Mar. 2010, Case C-440/08, *F. Gielen v. Staatssecretaris van Financiën*, paras. 49-55, ECJ Case Law IBFD. See also Smit, *supra* n. 25, at p. 223. However, Terra & Wattel, *supra* n. 26, at p. 971 note, seemingly correctly, that the solution proposed by the ECJ in *National Grid Indus* seems to contradict *Gielen*. See NL: ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, ECJ Case Law IBFD.

40. See *Cadbury Schweppes* (C-196/04), at paras. 55-56.

able to achieving the objective for which it was adopted.<sup>41</sup> As the objective of the current Danish CFC rules and the CFC legislation previously applied in the United Kingdom appears to be quite similar, it is possible that the ECJ would reach the same conclusion concerning the Danish CFC rules.<sup>42</sup>

However, even assuming that the Danish CFC legislation is suitable to achieving the objective for which it was adopted, the principle of proportionality also has to be respected. In this context, the ECJ, in *Cadbury Schweppes*, concluded that in order for the CFC legislation to comply with EU law, the taxation provided for by that legislation must not be applied where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality. Moreover, the ECJ stated that the resident company, which is best placed for that purpose, must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine.<sup>43</sup>

However, as explained in section 2., the Danish CFC legislation has a very broad scope of application and is not limited to wholly artificial arrangements. Moreover, it is of no significance with regard to the application of the Danish CFC rules whether or not the Danish parent company, in fact, intended to escape the tax normally due, as the CFC rules automatically apply if the CFC conditions are fulfilled. Finally, no exemption clause has been introduced that would enable the parent company to escape CFC taxation by producing evidence that the CFC is actually established and that its activities are genuine.<sup>44</sup> Therefore, on the basis of the ECJ's reasoning in *Cadbury Schweppes*, it seems reasonable to conclude that the Danish CFC rules do not pass the proportionality test.

In subsequent case law, however, it seems the ECJ has become more willing to accept justifications for restric-

41. *Id.*, at para. 59.

42. However, some uncertainty exists, as the ECJ in *Cadbury Schweppes* to some extent seems to attach significance to the fact that the rules only covered situations in which a resident company had created a CFC that was subject, in the Member State in which it was established, to a level of taxation that was less than three quarters of the amount of tax that would have been paid in the United Kingdom. *See id.*, at para. 58. S. Whitehead, *Practical implications arising from the European Court's recent decisions concerning CFC legislation and dividend taxation*, EC Tax Rev. 4, pp. 176-183 (2007), criticizes the ECJ's reasoning and suggests that a more consistent conclusion would have been for the ECJ to find that the national provisions were not objectively justifiable and precluded rather than merely potentially disproportionate.

43. *Id.*, at paras. 65-70. The assessment – of whether an actual establishment intended to carry on genuine economic activities in the host Member State exists – must be based on objective factors that are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment. *See also* Council Resolution 2010/C 156/01 of 8 June 2010 on coordination of the Controlled Foreign Corporation (CFC) and thin capitalization rules within the European Union.

44. As mentioned in section 2., the National Tax Assessment Council is entitled to allow for an exemption from the CFC rules under certain circumstances. However, the possibility of granting an exemption only applies with respect to subsidiaries involved in activities within certain parts of the financial sector. Further, the exemption will only be given if certain relatively strict conditions are fulfilled. As a consequence, this (limited) possibility of being granted an exemption cannot, in general, help the Danish CFC rules pass the proportionality test. Moreover, some of the conditions for granting the exemption may, on their own, be subject to criticism from an EU law perspective. However, this issue is not explored further in this article.

tive national rules.<sup>45</sup> In this regard, the decision in *SGI* (C-311/08) is worth mentioning, which concerns a Belgian transfer pricing rule. After stating that the rule constituted a restriction on the freedom of establishment, the ECJ proceeded to assess whether or not the Belgian rule could be justified. In this connection, the ECJ first stated that it should be recalled that a national measure restricting the freedom of establishment might be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned. Moreover, and interestingly, the ECJ added that national legislation that is not specifically designed to exclude, from the tax advantage it confers, such purely artificial arrangements, devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory, may nevertheless be regarded as justified by the objective of preventing tax avoidance, taken together with that of preserving the balanced allocation of the power to impose taxes between the Member States.<sup>46</sup>

On the basis of *SGI*, it has been argued that the ECJ may be willing to relax its very tight limits on the acceptability of CFC rules.<sup>47</sup> More generally, it has been concluded that the ECJ is not always consistent in testing abuse legislation and sometimes permits more general abuse legislation that does not give the taxpayer the possibility to prove that, in the situation at hand, there is no abuse. Accordingly, it is not clear when the ECJ is satisfied with a somewhat broad anti-abuse provision or requires that the anti-abuse provision be focused on abuse and that the taxpayer be offered the opportunity to provide proof to the contrary.<sup>48</sup>

This development in the ECJ's case law creates uncertainty and makes it more difficult to assess whether or not the Danish CFC rules – if they do constitute a restriction on the freedom of establishment – can be justified, and if so can pass the proportionality test. However, for the following reasons, it is, in the author's opinion, still doubtful – at least at this stage – whether or not the Danish CFC rules, in general, should be considered justified and in line with the principle of proportionality. First, the scope of application of the Danish CFC rules is very broad, as the rules are no longer only aimed at income from subsidiaries resident in countries where the level of taxation is considerably lower than in Denmark. Moreover, the Danish CFC rules may apply even in a situation in which a subsidiary resident in another Member State reflects economic reality

45. *See* M. Hilling, *Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance*, Intertax 4, pp. 294-307 (2013), who – on the basis of *SIAT* – also states that the ECJ seems to be more demanding in its assessment of proportionality, as the proportionality test now includes additional requirements regarding legal certainty. *See* BE: ECJ, 5 July 2012, Case C-318/10, *Société d'investissement pour l'agriculture tropicale SA (SIAT) v. État belge (SIAT)*, ECJ Case Law IBFD.

46. *See SGI* (C-311/08), at paras. 65-66. *See, for example*, P. Baker, *Transfer Pricing and Community Law: The SGI Case*, Intertax 4, pp. 194-196 (2010).

47. *See* Terra & Wattel, *supra* n. 26, at p. 736 and p. 1014.

48. *See* D. Weber, *Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ – Part 2*, 53 Eur. Taxn. 7, pp. 313-327 (2013), who argues that the tendency to permit more general rules can be seen, for example, in VAT cases and cases concerning cross-border offsetting of losses.

in that Member State, where the subsidiary is remunerated in line with the arm's length principle<sup>49</sup> and where the subsidiary's income is not sourced in Denmark.<sup>50</sup> Finally, it is, in the author's view, still not certain that the ECJ is ready to deviate considerably from its reasoning in *Cadbury Schweppes*<sup>51</sup> with regard to cases that specifically concern CFC legislation with a relatively wide scope of application.<sup>52</sup>

#### 4. Conclusion and Final Remarks

Unlike other Member States, Denmark responded to *Cadbury Schweppes* by widening the scope of application of its CFC legislation to also cover purely domestic situations. Although it must be acknowledged that uncertainty exists, this article concludes that the Danish CFC rules probably still constitute a restriction on the freedom of establishment, as a difference in treatment, in reality, still exists because the application of the CFC rules only leads to an additional tax burden – i.e. a genuine tax disadvantage – for the Danish parent company, if the subsidiary is resident in another country in which the level of taxation is lower than the Danish level of taxation.

Given more recent ECJ case law, it has become even more difficult to assess whether or not the Danish CFC rules can be justified, and if so, pass the proportionality test. Taking into consideration the very wide scope of the CFC rules – including the fact that the rules may apply even in a situation in which a subsidiary resident in another Member State reflects economic reality in that Member State – it seems doubtful

whether or not the Danish CFC rules, in general, should be considered justified and in line with the proportionality principle. At a minimum, therefore, it appears reasonable to conclude that the Danish reaction to *Cadbury Schweppes* has led to uncertainty, as the current rules are not immune from criticism in the EU context. Accordingly, for this reason alone, it may not be expedient for other Member States to follow Denmark's approach.<sup>53</sup>

In addition, and as explicitly stated by the Commission, it would be regrettable for Member States, in order to avoid an accusation that they are treating comparable situations differently, to extend the application of anti-abuse measures designed to curb cross-border tax avoidance to purely domestic situations where no possible risk of abuse exists, as such unilateral solutions undermine the competitiveness of the Member States' economies, and are not in the interests of the internal market.<sup>54</sup> In this context, it should be noted that the extension of the Danish CFC rules' scope of application has resulted in a situation in which a Danish parent company – at least to some extent – has to assess possible CFC consequences/requirements with respect to all subsidiaries, regardless of whether the subsidiary is resident in a low-tax jurisdiction, a high-tax jurisdiction or even in Denmark. This does not appear to be expedient if it is also a priority to keep taxpayer compliance costs at a fairly reasonable level.<sup>55</sup> Thus, in the author's view, the Danish approach should hardly serve as inspiration for other Member States.

49. See M. Poulsen, *Freedom of Establishment and Balanced Allocation of Tax Jurisdiction*, Intertax 3, pp. 200-211 (2012), who concludes that the arm's length principle and the allocation of profits enshrined therein appear to be of significant importance in relation to evaluating domestic anti-abuse legislation.

50. In *SGL*, the ECJ seems to attach importance to the fact that the legislation at issue permitted Belgium to exercise its tax jurisdiction in relation to activities carried out in its territory: *SGL* (C-311/08), at para. 64.

51. As stated in the beginning of section 3.4., the ECJ, in *Cadbury Schweppes*, mentioned – in addition to its considerations on prevention of tax avoidance – that the arrangements in question jeopardized a balanced allocation between Member States of the power to impose taxes. Accordingly, it may be argued that the ECJ, in fact, took this justification ground into consideration and attached to it the importance it found appropriate in the CFC context. Thus, although the ECJ briefly touched on the balanced allocation of taxing powers, it concluded, in any event, that CFC legislation may only be used to counter purely artificial arrangements and that the resident company, which is best placed for that purpose, must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine.

52. M. Helminen, *EU Tax Law*, p. 125 (IBFD 2011), Online Books IBFD seems to be of the opinion that the ECJ – when considering anti-avoidance legislation – only disregards the requirement of wholly artificial arrangements in exceptional situations. For the opposite view, see M. Hilling, *supra* n. 45.

53. Moreover, the very broad Danish CFC regime also appears to create some uncertainty with regard to whether or not the rules are in line with Denmark's tax treaty obligations. See P. Koerver Schmidt, *Danske CFC-regler og dobbeltbeskatningsoverenskomster*, SR-skat 5, pp. 307-317 (2012).

54. See Communication from the Commission, COM (2007) 785 final. See also UK: Opinion of Advocate General Geelhoed, 29 June 2006, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD. Smit, *supra* n. 25, at p. 245, argues that such a practice may not be in line with the loyalty principle as stated in article 4(3) of the Treaty Establishing the European Community, 25 Mar. 1957, EU Law IBFD.

55. Admittedly, introducing an exemption for subsidiaries resident in other Member States that actually do reflect economic reality would also entail compliance costs. However, as such an exception would make it possible to reintroduce the low-tax condition, the basic scope of application of the Danish rules would, at the same time, be narrowed considerably.