



Newsletter No. 80 (EN)

**Controlled Foreign Company (CFC) Rules
with regard to a Hong Kong Ltd.**

April 2015

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The intention of this Newsletter is to provide an overview on § 10 AStG (Außensteuergesetz, German International Transaction Tax Act).

In particular, it shall be elaborated whether § 10 AStG applies to German owned companies located in Hong Kong which might lead to the consequence that the Controlled Foreign Corporation (CFC) rules (Hinzurechnungsbesteuerung) as laid down in § 10 AStG apply to the parent company located in Germany with regards to profits generated by the Hong Kong subsidiary.

I. Legal consideration

1. Elements of § 8 Clause 1 AStG

According to § 8 Clause 1 AStG, the CFC rules apply only if the following elements are met cumulatively:

- The German shareholder has dominant influence (more than 50 % of the shares) on the foreign company;
AND
the foreign company is established in a low tax jurisdiction;
AND
- the foreign company generates passive income only.

Dominant influence of the German shareholder is assumed if the shareholder holds more than 50 % of the foreign company's shares. It is further to consider that this condition is also satisfied if several German shareholders hold more than 50 % together. It is not relating to the quote of each shareholder.

From a German point of view, currently all jurisdictions with a corporate income tax rate of less than 25 % are regarded as low tax jurisdictions. In the course of Germany's corporate income tax reform in 2008 the corporate income tax has been reduced to 15 %. However, the definition of low tax jurisdictions remains at 25% and with a corporate income tax rate of 16.5 % Hong Kong is classified as a low tax jurisdiction under the AStG.

As outlined above, if Hong Kong already meets the first two elements of the CFC rules, the generating of passive income has to be avoided and active income should be made by the Hong Kong Limited in order to avoid the appliance of the rules

2. Active income

§ 8 Clause 1 No. 1 to 9 AStG declares the following as active income:

1. Income derived from agriculture and forestry (§ 8 Clause 1 No. 1 AStG),
2. Income derived from production and industrial services, energy production, mining of mineral resources (§ 8 Clause 1 No. 2 AStG),
3. Income derived from banking and insurance business (§ 8 Clause 1 No. 3 AStG),
4. Income derived from trading (§ 8 Clause 1 No. 4 AStG),
5. Income derived from services (§ 8 Clause 1 No. 5 AStG),
6. Income derived from rental and lease (§ 8 Clause 1 No. 6 AStG),
7. Income derived from borrowing or lending of capital (§ 8 Clause 1 No. 7 AStG),

8. Income derived from distribution of capital gains (§ 8 Clause 1 No. 8 AStG),
9. Income derived from selling shares in a company, from the company's liquidation or from the decrease of the company's capital (§ 8 Clause 1 No. 9 AStG).

As mentioned above, the CFC rules do not apply if the subsidiary (HK Ltd.) generates such active income in Hong Kong.

With regards to income derived from the distribution of capital gains the so called "part-income system" (Teileinkünfteverfahren) will apply in case the shareholder is a natural person and the shares belong to business assets. If the shares are attributable to the private property of the shareholder, the dividend is subject to personal income tax at 100%. If the shareholder is a juristic person such income will be received almost tax free.¹

The income discussed below is considered as active income of a foreign subsidiary in Hong Kong (see short summary in Appendix 1, examples for passive income please see Appendix 2).

(1) Income derived from trading (§ 8 Clause 1 No. 4 AStG)

Income derived from trading is generally considered as active income. However, in the two following cases trading income is considered as passive income:

- The HK Ltd. is regarded as a so called **sales company** (§ 8 Clause 1 No. 4 lit. a AStG) (i.e. the foreign company which is owned by an unlimited taxable person (§ 7) or according to § 1 Clause 2 owned by a person related to such unlimited taxable person, being taxable with its income as required by the AStG,

provides to the foreign company the authority to dispose over the traded goods).

OR

- The HK Ltd. is regarded as a **purchasing company** (§ 8 Clause 1 No. 4 lit. b AStG) (i.e. the foreign company provides to an unlimited taxable person or related person as defined above the authority to dispose over the traded goods).

However, even if these conditions are met, the AStG assumes active income if the taxable person provides the evidence, that

- the foreign company (HK Ltd.) maintains an office structure which is sufficiently supporting such trading business,

AND

- the preparation, the conclusion of contracts, and the actual execution of the business is executed **without "detrimental" involvement of the taxable person** or a related person according to § 1 Clause 2 AStG,

AND

- the foreign company participates in general commercial transactions.

In general, the first element of maintaining active income could be accomplished by an adequate office structure such as office space, equipment, employees etc. However, to realise active income it is very important that the company participates in general commercial transactions without involvement of the taxable person.

A person is involved in the trading activities of the foreign company if it executes actions which can be regarded as part of the preparation or execution of the business activities or the conclusion of contracts of the foreign subsidiary. That applies even if the activities of the person are remunerated in accordance with the arm's length principle.

¹ 5% generalized Restriction-on-Business-Deduction

If single unimportant transactions within the scope of active trading are carried out by the taxable person, or a related person, the consideration of passive income maybe omitted. However, § 1 AStG should be taken into consideration in such event.

A person participates in the trading activities of the foreign company, if it, e.g. carries out distribution, coordinates services of agents and/or takes over financial projects or takes over corresponding risks of trading.

(2) Income derived from services (§ 8 Clause 1 No. 5 AStG)

According to § 8 Clause 1 No. 5 AStG, income from services is generally regarded as active income. This income will however be classified as passive income if the foreign company

- uses for the services the assistance of an unlimited taxable person which holds shares of the company according to § 7 AStG, or the assistance of a person being related to such taxable person (§ 1 Clause 2 AStG), being taxable under German law (§ 8 Clause 1 No. 5 lit a AStG), thus the foreign company **purchases** services,

OR

- provides services to such a taxable person or a related person, unless such person provides the evidence that the foreign company has an established business for the provision of such services, participates in general commercial transactions and does not use the assistance of an unlimited taxable person or a related person (§ 8 Clause 1 No. 5 lit b AStG) when providing the services; thus the foreign subsidiary **provides** services.

The Controlled Foreign Company (CFC) rules can also be avoided if

- the foreign company has an established business for the provision of such services (so called qualified business)

AND

- **without using the assistance of the unlimited taxable person** or a related person

AND

- the foreign company participates in general commercial transactions.

In case the person can provide the evidence mentioned above the income is deemed as active income, contrary to § 8 Clause 1 No. 5 lit b AStG.

(3) Participation in general commercial transactions

a) Opinion of the German Federal Fiscal Court (“BFH”)

According to the BFH “participation in general commercial transactions” can be defined as follows:

BFH decision (I R 85/83) 9 July 1986:

Participation in general commercial transactions requires that the corresponding activities are carried out for remuneration on the free market and that such activities are offered to third parties in a transparent way.

It has to be distinguished between the participation in “commercial transactions” and participation in “general transactions”. The main focus of the definition lies on the participation in “general” transactions.

It is already regarded as **participation in “commercial transactions”** if a taxable person participates in the exchange of goods and services with the intent to generate profit out of such participation. Making the participation in “commercial transactions” a condition shall exclude businesses having in fact the intention to generate profit, however, without participating in the exchange of goods and services. For such

excluded businesses the CFC rules shall apply.

For **participation in “general transactions”**, however, it is required that the activity of the taxable person is openly available to third parties (the fact that the activity might be offered to a limited clientele only is thereby still regarded as participation in “general transactions”). Therefore, the decisive criterion is whether third parties are able to recognise the intent of the taxable person to conduct trade. It is however not necessary that the taxable person provides its commercial activities for several interested parties, or accepts offers of such interested parties. In order to fulfil the condition it might already be enough to have business relations with one single business partner.

By *decision of 29 August 1984 (I R 68/81)* the BFH confirmed that participation in “general transactions” is not to assume if services are provided only within the same company and such fact is based on the company’s business policy.

The BFH referred to § 1 of the executive order on municipal tax (Gewerbesteuer-Durchführungsverordnung). This executive order refers to participation in “general transactions” as well when defining the term “business establishment” for municipal tax purposes. Therefore, due to the fact that the law makers use the same term in the AStG without providing any definition, – in the absence of other indications – it has to be assumed that the term is to be understood alike as it was interpreted by the courts in connection with the executive order on municipal tax:

Participation in “general transactions” is assumed if the business establishment is arranged for a fluctuation in clientele. Such fluctuation in clientele is already assumed if the entrepreneur limits his offers to a certain clientele without committing to selective persons.

If, in contrast to the above, the foreign company provides its services only to its related company under the jurisdiction of Germany, it would not participate in “general transactions”.

b) Opinion of the German Federal Ministry of Finances (BMF)

According to the BMF’s opinion as laid down in its ordinance on governing principles on the appliance of the AStG dated 14 Mai 2004 (*Schreiben betreffend Grundsätze zur Anwendung des Außensteuergesetzes (IV B 4 - S 1340 - 11-04)*) participation in “general transactions” has to be assumed if the company provides its services to an undefined clientele to a not only insignificant extent. In order to fulfil this condition it is sufficient if the company provides either sale or purchase to an undefined number of persons but receives or supplies the goods exclusively from or to a related company.

Participation in “commercial transactions” is also assumed if due to the special character of the goods the undetermined number of customers is limited to a small group of persons. It is furthermore still regarded as participation in “commercial transactions” if the clientele of the foreign company is limited, however such limitation is not intended by the foreign company.

3. Consequences of applying the German CFC-Rules

If the German CFC-rules apply, the passive income generated by the foreign controlled company is deemed to be a profit distribution and is subject to personal income or corporate income tax of the shareholder(s) in Germany. Consequence is that the income of the foreign controlled company is determined by applying the German tax provisions which could be in some cases more restrictive than in Hong Kong.



The part-income-system (natural person as shareholder) and tax exemption (company as shareholder) are expressly excluded. The same income is subject to tax in Hong Kong as well, but the German revenue of-

the company grants a tax credit in the amount of paid tax. The deemed profit distribution is considered to be accrued at the end of the fiscal year regardless when the generated profit is really distributed.

*We hope that the information provided in this newsletter was helpful for you.
If you have any further questions, please do not hesitate to contact us.*

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Appendix 1

Income from trading, § 8 Clause 1 No. 4 AStG

Income derived from **trading** is generally considered as active income, § 8 Clause 1 **No. 4** AStG, unless (exception) the foreign company is regarded as

= selling company (No. 4 lit. a)), or
 = purchasing company (No. 4 lit. b)),

In this case the income is passive, unless (exception from the exception) the person provides the evidence, that

- (1) the foreign company (HK Ltd.) maintains an office structure which is sufficiently supporting such trading business,
AND
- (2) the foreign company participates in general commercial transactions,
AND
- (3) the preparation, the conclusion of contracts, and the actual execution of the business is executed without “detrimental” involvement of the taxable person or a related person according to § 1 Clause 2 AStG and

Income from services, § 8 Clause 1 No. 5 AStG

According to § 8 Clause 1 **No. 5** AStG income from **services** is generally regarded as active income.

This income would however be classified as passive income if the foreign company

- (1) **uses for the services the assistance** of an unlimited taxable person, which according to § 7 AStG holds shares in the company, or the assistance of a person being related to such taxable person (§ 1 Clause 2 AStG), being taxable under German law (§ 8 Clause 1 No. 5 lit a AStG), thus the foreign company **purchases services**,
OR
- (2) **provides services to such a taxable person or a related person**, unless such person provides the evidence that the foreign company has an established business for the provision of such services, participates in general commercial transactions and does not use the assistance of an unlimited taxable person or a related person (§ 8 Clause 1 No. 5 lit b AStG) when providing the service, thus the foreign subsidiary **provides services**.

Appendix 2

Examples for generally passive income:

- Income derived from banking and insurance business, when the company is not carrying on in business-like manner or when it is carrying on in business-like manner, but the foreign company predominantly concludes contracts with unlimited liable persons and related persons.
- Income derived from rental and lease of land.
- Borrowing/lending of capital, when the capital was received on the domestic capital market or from a related person.