

House Ways and Means Committee Hearing
“How Other Countries Have Used Tax Reform to
Help Their Companies Compete in the Global Market Place and Create Jobs”
May 24, 2011

Response to Questions Submitted to Jorg Menger by Reps. Rangel, Stark, and Blumenauer

In the following, I respond to the questions included with the August 17, 2011 letter from Chairman Dave Camp (R-MI), which concern the controlled foreign corporation (CFC) rules in Germany as they would apply to several specific fact patterns.

Overall Comment:

The questions posed refer to a CFC’s country of residence “X” as a “country with no income taxation” or a country with income taxation at the same rate as is imposed on the parent company, P, but with a “10 year tax holiday entitlement” (see question c. below). For purposes of my response, I have assumed that X is not a member state of the European Union (EU) or the European Economic Area (EEA), because all EU and EEA jurisdictions generally have a system of income taxation and do not extend significant tax holiday benefits. In the event that X would be an EU or EEA member state, the German CFC rules generally would not apply if the CFC carries out a meaningful economic operation in its country of residence (referred to as the “EU / EEA exception”). Given the above, I have not included in my response any comments with respect to the potential applicability of the EU / EEA exception.

Specific Questions and Answers:

How would the following situations be treated under your controlled foreign corporation (CFC) rules in Germany?

- a. P, a domestic corporation, owns 100% of a CFC in X, a country with no income taxation. The CFC earns income from manufacturing and selling widgets back to P.*

The German CFC rules subject so called “passive” income of a CFC to current taxation at full rates at the level of the German parent. They do not apply to “active” income of a CFC. Income from “industrial” operations is defined as active income, and manufacturing operations are generally considered “industrial” operations. Therefore, income of the CFC is not subject to taxation under the CFC rules if such income is derived from manufacturing.

Income from a CFC’s trading operations with German residents or parties related to the CFC, however, is only treated as active income if the CFC maintains a qualified fully operational trading business with typical operational trading functions (such as marketing, customer service, warehousing, payment administration, etc.), and is participating with that business to a material extent in general commercial trading operations with third parties and third party customers. P

would bear the burden of proof for the existence of such a qualified commercial trading operation.

In the current case, the CFC would be considered to pursue both a manufacturing operation and a trading operation. In those cases where the CFC manufactures or otherwise processes goods, and resells them to a related or German resident party, the operation is treated in its entirety as industrial if, as judged by generally accepted industry standards, the nature of the CFC's manufacturing operation exceeds the level of immaterial manufacturing procedures, and creates articles with a different marketability quality. Mere marketing, repackaging, refilling, sorting and compiling acquired goods as well as affixing brand or control marks would not meet this standard and would not qualify as manufacturing in this context.

Assuming that the CFC's manufacturing of widgets meets the materiality test, all the income of the CFC would be considered 'active' income from industrial operations, and would not be subject to taxation under the CFC rules. If the manufacturing materiality test is not met, all the income of the CFC would be considered trading income, and would be taxed at the level of P at full German rates under the CFC rules, unless P provides proof that the CFC maintains a qualified commercially established trading operation.

b. Same as (a), except that the CFC earns interest income from lending funds to unrelated parties outside X.

Under the German CFC rules, interest income generally is considered passive income, and is subject to taxation at full German rates at the level of P, unless one of the following exceptions applies:

- i) The CFC maintains a fully operational banking business which participates in general commerce and either the lending of the funds qualifies as a banking business operation or the interest income constitutes income on capital maintained for regulatory purposes. Note that the banking business exception does not apply if more than 50% of the CFC's banking business transactions are carried out with related parties.
- ii) The CFC qualifies as an "active" finance company. Active finance company status requires that both of the following requirements are met:
 - the CFC proves that the loaned funds were solely sourced on foreign capital markets and were not provided by a related party; and
 - the CFC proves that it loaned the funds to related or unrelated non-German resident businesses which derive 90% or more of their gross receipts from operations which qualify as "active" under German CFC rules (industrial / manufacturing operations, commercial trading and commercial service, banking and insurance, etc.).

- c. *Same as (a), except that X has a generally applicable corporate income tax at a rate identical to that imposed by the country on P, but the CFC is entitled to a 10 year tax holiday.*

If the manufacturing income qualifies as “active” income, the income would not be subject to CFC taxation, irrespective of the 10 year tax holiday (see above response to question (a)). In the event that the CFC’s income would not qualify as active income because the manufacturing materiality test is not met, the rules applicable to passive income would apply.

German CFC rules for passive income include a “high tax kick out” rule. The rule stipulates that passive income of a CFC is not subject to taxation under the CFC rules, if the CFC income is taxed by the country of its residence at an effective tax rate of at least 25%. Whether or not an effective rate of 25% or more is present is determined by applying German tax accounting rules. Because German tax law does not provide for a tax holiday, the CFC’s effective tax rate in this situation is below 25%. Thus, the CFC’s income would be subjected to German taxation at full rates at the level of parent P under the CFC rules, unless such income qualifies as active income from manufacturing (see above comments to question (a)).

- d. *Same as (a), except that the CFC earns royalties from the active conduct of a trade or business.*

Royalty income is generally treated as active income if it is derived from the licensing or utilization of intangible assets which were developed or created by the CFC’s own business without the material assistance of a related party. Assuming that this is the case, the royalties would not be subject to taxation at the level of P under the CFC rules.

- e. *Same as (a), except that CFC earns interest derived from another CFC controlled by P.*

The interest income would be subject to taxation at full rates at the level of Parent P under the CFC rules, unless either the banking business exception or the active finance company exception applies (see above response to question (b)) or the exception for certain ancillary income applies. Under the ancillary income exception, interest income of the CFC would not be subject to taxation at the level of P under the CFC rules if the income is ancillary to an active income item (e.g., interest customarily paid on a short term trade receivable, which stems from a qualified trading business operation).

- f. *Same as (a), except that the CFC buys widgets from P and resells them to another CFC controlled by P in a third country.*

In this situation, the CFC generates trading income. Trading income would only be active income if the CFC maintains a qualified fully operational trading business, and if P can prove the existence of such a qualified trading business (see above response to question (a)). Otherwise, the income would be subject to taxation at full rates at the level of P under the CFC rules.

- g. Same as (a), except that the CFC is predominantly engaged in the banking business and conducts substantial activity with respect to such business.*

Assuming that the CFC meets the active banking business exception (see above response to question (b)), the CFC's income would not be subject to taxation at the level of P under the CFC rules.

- h. Same as (a), except that the CFC is an insurance company.*

Income from insurance operations is considered "active" if the CFC maintains a fully operational insurance business which participates in general commerce and the operation qualifies by its nature as an insurance operation or the income constitutes income on capital maintained for regulatory purposes. As with the banking business exception, the insurance business exception does not apply if more than 50% of the CFC's insurance transactions are carried out with related parties. If the CFC's income is considered active under the insurance operation rule, the income would not be subject to taxation at the level of P under the CFC rules.

- i. Same as (a), except that the CFC lends its earnings from the sale of the widgets to P.*

The lending of earnings from a CFC to its parent generates income subject to taxation at the P level under the CFC rules only with respect to any interest income that is earned by the CFC on the loan transaction (see above response to question (e)).