Comments received on Public Discussion draft

BEPS ACTION 3: STRENGTHENING CFC RULES

5 May 2015

Part 2
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Comments to the OECD Discussion Draft on BEPS Action 3 “Strengthening CFC Rules”

The International Chamber of Commerce (ICC), as the world business organization speaking with authority on behalf of enterprises from all sectors in every part of the world, appreciates the opportunity to provide comments on the public discussion draft on BEPS Action 3 on strengthening Controlled Foreign Company (CFC) rules. ICC focuses its feedback on the most fundamental issues raised in the draft.

General comments

ICC is concerned about the introductory statement of the draft which mentions “secondary rules” that countries could introduce and apply “to income earned by CFCs that did not give rise to sufficient CFC taxation in the parent jurisdiction”. Different options for such rules which would “introduce a secondary form of taxation in another jurisdiction (for example the source country of the income earned by the CFC)” are obviously being considered by the responsible Working Party 6 primarily with regard to transfer pricing issues in the area of BEPS Action 8 – 10. ICC is highly troubled that deliberations on possible “secondary rules” in connection with CFC rules are dealt with outside the scope of the discussion draft. Should these proposals be taken forward, an opportunity ought to be ensured for stakeholders to comment.

Furthermore, ICC notes overlap and confusion with Action 3 and is concerned about the lack of coherence with other Actions, most notably with Action 2 (hybrid mismatch arrangements), Action 4 (interest deductions), Action 5 (harmful tax practices) and Action 8-10 (transfer pricing). Furthermore, ICC believes that some of the proposed rules are coming close to transfer pricing rules. Finally, given the fundamental differences in national tax systems, even a harmonised implementation of CFC rules throughout the G20/OECD countries would result in significant discrepancies.

Chapter 3: Threshold Requirements

A low tax threshold based on an effective tax rate causes significant problems. The following elements are causing problems for the computation of the effective tax rate: timing differences, different periods for the tax effectiveness of accruals and related costs, different periods for tax loss carry backs and tax loss carry forwards, etc: e.g. when the source country allows for a tax neutral business reorganisation, this should not be subject to CFC legislation in the parent jurisdiction. ICC therefore believes that only tax free or non deductible income with a permanent effect should be considered for the computation of the effective tax rate. Furthermore, CFC rules were historically designed as anti-avoidance legislation. ICC would therefore welcome the implementation of an anti-avoidance requirement.

Chapter 5: Definition of CFC Income

General comment

As set out in the note for consultation, chapter 5 does not yet include recommendations for the building block on the definition of CFC income. Instead, the chapter discusses several possible options that jurisdictions could implement. Obviously, the definition of the income earned by the CFC that should be attributed to shareholders or controlling parties is a key question for the entire system of CFC rules. ICC is concerned that the draft merely reflects a very early stage of discussions between countries with highly opposing views on how to best proceed. Chapter 5
seems to be far from a political consensus and therefore will most likely result in a menu of options for individual domestic issues rather than recommendations. With regard to the different approaches to defining CFC income and the individual options pointed out in the draft, the business community is concerned that it is not clear how these different rules are supposed to interact. Consequently, ICC believes that there is a strong need for more technical guidance, even if countries should agree on common recommendations in the 2015 report on Action 3, as envisaged in the introductory note for consultation.

**Categorical vs. Excess profits approach**

The categorical approach has some disadvantages as mentioned in the discussion draft such as a higher administrative and compliance burden, however, the problems arising from it should not be more difficult to address than in many already existing CFC systems. In general, ICC welcomes the approach of defining which CFC income should be considered as passive income instead of an active income approach. However, it is worrisome that the draft seems to be proposing rules for particular business sectors instead of clearly focusing on anti-avoidance. The purpose of CFC rules is defined by the draft as preventative measures which should be designed as “deterrent”. It is important to strike the balance between this objective and the risk of over-inclusion i.e. not to include income when the CFC engaged in substance.

ICC strongly opposes the excessive profits approach. The determination of the normal return as suggested in the draft would be highly complex and exposed to arbitrariness. To determine the risk free rate of return, the premium reflecting the risk associated with an equity investment and the eligible entity would be as intricate as an enterprise valuation process. In addition, ICC agrees with the objections raised by some countries that the excess profits approach would be overly broad and some design features could include profits in the CFC regime that were not shifted. The excess profits approach would therefore not only target BEPS situations. According to the BEPS Action Plan no or low taxation is not per se a cause of concern, but becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. The excessive profit approach would go far beyond this objective. Moreover, it would cause a high degree of legal uncertainty.

**Chapter 8: Rules to Prevent or Eliminate Double Taxation**

Preventing double taxation is a crucial objective. It therefore needs to be ensured that the national credit potential is high enough to actually and effectively avoid double taxation. ICC therefore welcomes the OECD’s recommendation to introduce a “meaningfully lower” threshold compared to the statutory tax rate of the parent jurisdiction. By the same token, ICC believes that countries should refrain from any limitation of the creditable amount, such as per year or per country limitations to eliminate double taxation.

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1 Discussion draft, paragraph 16.
The International Chamber of Commerce (ICC)
Commission on Taxation

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy. Founded in 1919, and with interests spanning every sector of private enterprise, ICC’s global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.
1st May 2015

Achim Pross,
Head,
International Co-operation and Tax Administration Division,
OECD/CTPA,
Paris

For e-mail transmission to: CTPCFC@oecd.org

Dear Mr Pross

BEPS Action 3: Strengthening CFC rules

Thank you for inviting comments on the above Discussion Draft, issued on 3rd April 2015.

The International Underwriting Association of London (IUA) represents international and wholesale insurance and reinsurance companies operating in or through London. Its purpose is to promote and enhance the business environment for its members. We estimate that premium income for the London company market in 2013 was some £24bn.

We are grateful for the opportunity to comment on recommendations to address base erosion and profit-shifting (BEPS) using controlled foreign company (CFC) rules. Our members support the objectives of the BEPS Action Plan and would welcome international tax regimes whose combined post-BEPS effect allows taxpayers to have certainty and predictability in organising their tax affairs.

The Discussion Draft makes the point that the work on CFCs is being co-ordinated with the work on other Action items and is most closely associated with Actions 1, 2, 4, 5, 8-10, 11, 14 and 15. The IUA is keen to see a coherence in the overall results of the Actions once implemented: the interaction of the various rules, notably those on CFCs, transfer pricing and the existence of PEs and the attribution of profits to them, needs to result in a tax result for a global group where the appropriate amount of profits is taxed (no more than once, after taking account of double tax relief) in the appropriate jurisdictions, in accordance with BEPS principles.

The Discussion Draft refers to a proposal for countries to introduce a “secondary rule”. That would be a secondary form of taxation in a territory other than that of the parent company of a CFC. The IUA considers that that would create additional uncertainty and administrative complexity and would increase the potential for double (or more than double) taxation.
Chapter 1: policy considerations

We note the comment at paragraph 21 that “CFC rules are ... often referred to as ‘backstops’ to transfer pricing rules” and that the “CFC rules generally do not complement transfer pricing rules in a coherent manner” in that, where a CFC regime applies a sufficiently high rate of tax, it “may make certain transfer pricing outcomes irrelevant to the MNE by removing the benefit of engaging in transfer pricing manipulation”.

While the transfer pricing and CFC rules are not entirely interchangeable, they are closely aligned and an effective CFC regime should ensure that there is a coherent rather than an accidental alignment. The IUA does not wish to see CFC rules which impose a level of parent company taxation to profits of an overseas subsidiary that are already properly priced in accordance with the value generated by the subsidiary. The IUA believes that the CFC regime in any jurisdiction should have limited impact and deal only with situations where transfer pricing does not offer a satisfactory and equitable decision.

Chapter 2: definition of a CFC

A practical point for determining which entities would be CFCs would be the level of information which is available to the head office jurisdiction about subsidiaries very low down the organisational chain. A suggestion would be to limit the reach of CFC rules, perhaps to the level of the lowest sub-holding company within a group which produces a consolidated set of accounts.

As the Discussion Draft is concerned with BEPS rather than in proposing an international CFC regime, the IUA considers that the narrow option of the modified hybrid mismatch rule in paragraph 36 is to be preferred.

Chapter 3: threshold requirements

A *de minimis* approach would be helpful in reducing compliance and monitoring costs. We would encourage the OECD to recommend best practice thresholds which would allow groups to identify whether a company meets the threshold requirements at the beginning of the accounting period in question. Suggested thresholds would include a monetary threshold by reference to a locally filed set of accounts or a fixed percentage of a local GAAP measure of income or balance sheet.

The IUA does not support a threshold test based on an effective tax rate calculation: if that is based on the local accounting measure of profits, it would fluctuate by reference to the specific permanent adjustments within the local direct tax regime for the year in question and that would be a particular problem for the insurance industry. The effective tax rate presented in such a way could be a distortion of the actual rate of tax applied to local profits.

If the effective rate is computed by reference to a consistent accounting standard for the group, that would require accounting adjustments to be made which would be required only for tax purposes. That would add to the compliance burden.

With both the above tests, the exercise would need to be performed year on year, which would create considerable administrative work in addition to the work required for transfer pricing purposes. The IUA would therefore prefer the simpler method of determining a CFC tax threshold by reference to the statutory rate of tax in the local jurisdiction and white lists.
Chapter 4: definition of control

The definition of control needs to be capable of being determined in a relatively objective manner to allow for certainty of analysis. Applying either legal or economic control could be by way of shareholdings, entitlement to profits and to capital and assets in certain circumstances. The phrase “at least” should be removed, as it adds to uncertainty about the level of analysis required.

In order to deal with parties “acting in concert”, a “fact-based analysis” is suggested in paragraph 71. The IUA believes that that would add significant complexity and would be time-consuming for groups to gather the information to analyse whether the rule applied. A rule based on the relationship between the parties should be more straightforward to apply and should deal with the concern expressed.

Chapter 5: definition of CFC income

The IUA is concerned that insurance income is given special focus distinct from other companies in the financial sector. The IUA would emphasise that the insurance sector is one of many within the financial sector where there is (theoretically) the risk of the facts differing from the documented position. That is a risk inherent in the nature of a service which can, in the absence of regulatory constraints, (theoretically) be provided from any location. This risk is dealt with outside of tax by stringent regulatory and licensing regimes. Within the BEPS framework, the associated tax risk is dealt with by Action 7 (Preventing the artificial avoidance of PE status) and Actions 8-10 (Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation and special measures)).

Accordingly, the IUA considers that it is unhelpful for CFC rules to seek to ascertain whether a CFC is overcapitalised where an intragroup transaction is priced in accordance with the arm’s length principle.

The IUA would emphasise that the comment in 103: “the question of whether an insurance company is engaged in an active trade or business” should not be applied to insurance or reinsurance companies which are part of an insurance group providing insurance services to third parties. In such situations, there will be value-creating economic activity and BEPS considerations will be addressed by transfer pricing rules.

The IUA therefore suggests that, where the facts and circumstances in which intra-group insurance activity takes place involve the following features, there should be no attribution of CFC income:

- both the insurer (cedant) and reinsurer are regulated entities, with the regulator requiring evidence of risk transfer and appropriate solvency and capitalisation levels;
- there is a real possibility of the reinsurer incurring underwriting losses as a result of accepting the reinsurance;
- the risk is initially accepted and subsequently managed by staff with the requisite skills and experience (typically including experienced underwriters and actuaries);
- the original insurance (accepted by the cedant referred to above) involves third party risks;
- the reinsurance contract is priced on arm’s length terms;
- the reinsurance contract provides a capital benefit to the group.

The existence of the above features should also disapply other CFC tests, such as the employees and establishment test discussed in paragraphs 91-92. Such an approach would recognise the specific features of insurance as a financial activity (where the number of employees is not always directly proportionate to the economic profits or losses generated).
Chapter 6: rules for computing income

The IUA agrees with the OECD recommendation that the parental jurisdiction’s rules should be used to compute CFC income, but it should be made explicit that such rules would only be applied to passive income.

Loss restriction can be difficult to track in practice and the IUA would recommend some further detailed work in this area.

Chapter 7: rules for attributing income

The IUA does not consider that a “top-up” tax should be applied to active income.

Chapter 8: rules to prevent or eliminate double taxation

The IUA considers that the existence of different CFC regimes could result in double or more than double taxation. Tax jurisdictions may be reluctant to amend their tax regimes to treat CFC tax paid in an intermediate country to qualify as a foreign tax eligible for relief [para 159]. The IUA would recommend some further detailed work in this area.

We would welcome the opportunity to engage further with you in this area.

Yours sincerely

Nick Lowe
Director of Government Affairs
Mr. Achim Pross,
Head of International Co-operation and Tax Administration Division
Organisation for Economic Cooperation and Development

Accounting & Tax Committee
Japan Foreign Trade Council, Inc.

Comments on Discussion draft on
Action 3 (Strengthening CFC Rules) of the BEPS Action Plan

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the “Discussion draft on Strengthening CFC Rules”.

The JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of JFTC’s Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

General Comments

Incorporation of low-taxed non-resident affiliates (CFCs: Controlled foreign companies) to which the parent companies shift their income may lead to erosion of taxable base of the related jurisdictions and may also impair fair competitions among MNEs. Therefore, as general remarks, we support OECD’s initiatives to "develop recommendations regarding the design of controlled foreign company rules".

However, the OECD’s final report on this issue should clearly state that, when countries introduce or modify the CFC rules based on the OECD recommendation, due attention should be paid to the following considerations:

- Minimization of the "gaps" of the CFC rules (especially, definition of CFC,
thresholds requirements and definition of control) among countries, for promoting fair global competitions

- Making proper and prudent design of the CFC rules so that there should not be "over-inclusion/ taxation" which deviates from the original objectives of "targeting BEPS"
- Implementation and enhancement of effective mechanism to prevent and eliminate double taxation

Especially, we are heavily concerned that, as duly pointed out under the paragraph 159, tightening of CFC rules in countries based on the OECD recommendations would risk increasing double taxation, including multiple application of the different CFC rules on the same CFC income. In this regard, as recommended under Chapter 8, proper and effective relief for such double taxation (e.g. establishment of common and clear rule-hierarchy among the different CFC rules and between the CFC rules and the Transfer Pricing rules, in addition to the foreign tax credit) should be implemented under the CFC rules in each jurisdiction, as well as substantially effective dispute resolution mechanisms to solve double taxation resulting from dysfunctional relief system.

Therefore, prior to issuance of the final report of BEPS Action 3, participating countries should make a commitment to implement such effective double taxation relief measures and dispute resolution mechanisms in the domestic laws. We believe that it is highly important that OECD “ensures commitments from countries” rather than “just provides recommendations” to mitigate double taxation concerns.

Specific Comments

Chapter 3: Threshold requirement

OECD Questions for Consultation:

4. What practical problems, if any, arise when applying a low-tax threshold based on an effective tax rate calculation?

5. How could these problems be addressed or mitigated?

- In determining the Effective Tax Rate (ETR), paragraph 60 states that "the definition of the numerator (i.e. tax paid) could be more straightforward if it instead focuses just on the final tax burden (including, for example,
subsequent rebates of taxes paid and non-enforcement of taxes).” However, there would be a number of practical issues that would need to be considered before such an approach could be applied. Especially, clear guidance would be required to deal with timing differences. We believe variation effect on tax paid due to such timing differences should be eliminated in calculation of the CFC’s ETR.

- Regarding threshold requirements (including safe-harbor rules like de-minimas thresholds), we suggest not only monetary threshold but also time threshold should be considered as explained below.

- Due to difference in threshold requirements of CFC rules among countries and/or effective tax rates calculated under tax laws in the relevant parent jurisdictions, a newly acquired company, which has not been treated as a CFC under the CFC rule in the previous parent jurisdiction may be treated as a CFC under the CFC rule in the new parent jurisdiction regardless of the BEPS intention immediately after M&A transaction. Generally, after M&A transaction, corporate reorganization and business restructuring would be often considered due to some reasonable business reasons, as a result of which the acquired company might be not subject to CFC taxation. However, since it would usually take certain period to complete such reorganization and/or restructuring, some exempt period for application of CFC taxation should be provided (for instance, in UK, even if a foreign company became a subsidiary that is subject to CFC taxation, certain exempt period is provided, that is called “exempt period exemption”, where the period is basically “12 month after being treated as a CFC” but could be extended at HMRC’s obligations).

OECD Questions for Consultation:

6. Does the discussion above correctly address the situation of permanent establishments that are subject to a different tax rate than CFCs?

- Regarding question 6, even if a company is located in the country where the effective tax rate is below low-tax threshold, if the company bears an appropriate tax in other countries where its business operation is carried out (including permanent establishment taxation and withholding taxes), that tax should be treated as the tax borne by the company. In this case, the company should not be categorized as a CFC, if the tax rate calculated based on all the taxes paid in any countries exceeds low-tax threshold. In some countries, simply because of the reason that the statute tax rate is zero in the country where the company’s head office is located, the company is categorized as a CFC and the income is attributed to the parent company as the CFC income. Irrespective of
the tax rate under the law of the country where the company’s head office is located, all the taxes paid in any countries should be taken into consideration.

Chapter 4: Definition of Control

OECD Questions for Consultation:

7. What practical problems, if any, arise when applying a control test?

8. Are there particular practical problems that arise when applying a control test that considers interests held by unrelated or non-resident parties? If so, what are they, and how can they be dealt with?

- Paragraph 65 recommends that “CFC rules should at least apply both a legal and an economic control test so that satisfaction of either test results in control.” We agree that objective legal and economic tests can be effective in determining control, but we would encourage to strengthen its recommendation to establish the use of such tests as a best practice, removing the words “at least.” We believe that combining legal and economic control tests should, in the vast majority of cases, identify CFCs in an appropriate way.

- As stated in paragraph 71, “acting-in-concert” approach is heavily based on a fact-based analysis and not very common because it creates significant administrative and compliance burdens. Although it is stated that “one of the advantage is that it may more accurately identify when shareholders are in fact acting together”, we are quite unsure whether the accurate fact-based analysis is always performed by tax authorities and therefore a more mechanical test should be recommended.

- Further, considering non-related residents generally cannot “control” a CFC jointly with each other, we think that it is reasonable to use the approach by looking at the relationship of the parties as proposed in paragraph 73.

- We can understand the concept of the concentrated ownership requirement proposed in paragraph 75 to some extent. However, the Discussion Draft misses that, in case where a listed company intermediates in the ownership structure, practical difficulties arise in determining the level of control based on the direct/indirect economic ownership and voting rights, which is illustrated bellow.
Under the CFC rule of Country A, threshold of the control level is “more than 50%” and concentrated ownership requirement is also provided. A Co and B Co own just 50% interest in C Co, respectively. Both A Co and B Co are listed companies. The shareholders of B Co are not disclosed except for big shareholders owning more than certain percentage of the shares and none of the disclosed shareholders is the resident of Country A. Although there might be a few individual shareholders of B Co who are the residents of Country A, A Co is unable to obtain such shareholder information from generally available public sources.

In such a case, since there is no room for A Co to do “acting-in-concert” with such individual shareholders at all, considering the practical difficulties, we believe it would be an appropriate approach not to consider the shareholders of such a listed company included in the ownership structure to determine whether the concentrated ownership requirement is met. Therefore, in the illustrated case above, A Co has the 50% share in C Co and no other residents in Country A have any interest directly and indirectly in C Co, C Co shall not be treated as a CFC under the CFC rule of Country A. Including this type of example, a clear guidance would be required to deal with such a case where listed companies intermediate in the ownership structure.

Chapter 5: Definition of CFC Income

OECD Questions for Consultation:

16. What practical problems arise with applying the categorical approach and the excess profits approach?

17. How could the practical problems be addressed or mitigated?
We believe that the proposed excess profits approach is overly broad and we are heavily concerned that it would risk overriding other existing important international tax rules. Even if the excess profits approach is adopted, the chargeable income should be limited to the income deriving from IP which is legally registered. As long as transfer pricing rules work, the excess profits approach is unnecessary and rather would increase the administrative burden and compliance costs both for taxpayers and tax authorities. Further, unless the scope of the chargeable income is limited clearly, tax authorities might not perform appropriate transfer pricing analysis and insist expanding their taxing right, about which we would have serious concerns.

Chapter 6: Rules for computing income

OECD Questions for Consultation:

24. Do the rules on computing the income of a CFC present any difficulties in practice? If so, what are these and how could they be dealt with?

If all CFC incomes shall be recalculated in accordance with the parent jurisdictions' relevant tax rules from scratch under Option 1 proposed in paragraph 132 of the Discussion Draft, significant compliance burden would be placed on taxpayers. In this regard, the second half of Option 1 mentions “jurisdictions could achieve a broadly similar outcome by starting with the income calculated according to the rules of the CFC jurisdiction and then adjusting the income in line with the rules of the parent jurisdiction”, which would reduce compliance burdens from taxpayers. We are of the view that this approach should be explicitly mentioned in the recommendation (paragraph 131 of the Discussion Draft) as an appropriate method to calculate the CFC incomes.

OECD Questions for Consultation:

25. Does this chapter accurately reflect the issues that could arise with losses or are there any other situations that need to be considered?

Under CFC rules, income of a CFC is aggregated to the parent’s income and is subject to taxation in the parent’s jurisdiction. In this regard, the CFC loss should also be offset against the parent’s income as well as those of the CFC itself or the other CFCs in the same jurisdiction, considering the balance with aggregation of the CFC income into the parent. CFC rules are to tax highly mobile and/or passive incomes as if these incomes were earned by the parent
company. Therefore, if that mobile/passive business arises losses, it is reasonable to attribute these losses to the parent company, since these losses would occur even if the business were carried out by the parent company itself. At least, the loss incurred during the liquidation of the CFC should be offset against the parent's income, as there are many cases where liquidation of a CFC leads to arising losses in the hands of the CFC that cannot be offset against any income.

**Chapter 7: Rules for attributing rules**
- Paragraph 147 addresses how much income should be attributed in case of CFCs whose ownership lasted for only a portion of the year, wherein it is discussed “which date should be based for the determination of ownership” and “to which entity the CFC income should be attributed”. In this regard, considering the limitation on the accuracy of taxable income and the increasing of the administrative burden and compliance costs by calculating to allocate the CFC income (e.g. the shares of the CFC owned by many parents are sold many times in the same year), the convenience of the last-day-of-the-year standard should be appreciated, as the BEPS concerns are well addressed if CFC income is taxed in any jurisdictions adopting CFC rule..

**Chapter 8: Rules to prevent or eliminate double taxation**

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<td>29. What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?</td>
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- We are heavily concerned that tightening of CFC rules in countries would risk increasing double taxation. Double taxation, which imposes the multiple taxes at different jurisdictions on one taxable income, is critical issue, which obstructs cross border trades and investments. The best way to avoid such double taxation under CFC rules is that CFC rules at each jurisdiction must be well designed so that such double taxation is prevented under the CFC rules. Although the remedy like foreign tax credit mechanism is very important relief, but the foreign tax credit mechanism itself is not necessarily the fundamental solution for double taxation.

- Under the current CFC rules, there are possibilities that the same CFC income is subject to different CFC rules in more than one jurisdiction and as
a result, double taxation (as the case may be, multiple taxation) may be triggered. In this regard, the proper and effective relief for such double taxation (e.g. establishment of rule hierarchy among the different CFC rules and between the CFC rules and the transfer pricing rules, in addition to foreign tax credit mechanism) should be implemented under the CFC rules in each jurisdiction, and countries should commit to introduce the same or at least similar relief provisions in its domestic tax laws.

- It is indispensable that common “rule hierarchy” regime is established by OECD. However, the proposed rule hierarchy might give rise to significant administrative and practical difficulties, including effective tax rate calculation at each jurisdiction under its CFC rules and tax due calculation corresponding to difference in the effective tax rate among the relevant jurisdictions. In this regard, considering the balance between effectiveness of CFC rules and administrative burden, we would like to suggest alternative “rule hierarchy” regime to prevent the multiple CFC taxation, under which the effective tax rates of a foreign subsidiary is calculated including tax imposed under CFC taxation in other jurisdictions in respect of that CFC and then the low-tax threshold test is made under the CFC rule of the parent jurisdiction, which is illustrated as follows.

- In above case, if C Sub’s income is already subject to Country B’s CFC rules and attributed to B Sub’s income on which 20% tax rate is imposed, then A Parent will calculate the effective tax rate of C Sub as 20% for Country A’s CFC rules purposes. Therefore, as long as C Sub’s income is subject to CFC taxation under the CFC rules of Country B and low tax threshold under CFC rules of Country A is less than 20%, A parent is not subject to CFC taxation for Country A’s CFC rules purposes (because the ETR after reflecting CFC
taxation in country B, i.e., 20%, is more than 15% set as low tax threshold in Country A). This mechanism would be helpful to maintain a balance between the effectiveness of CFC rules recommended by this Action Plan and administrative burden by reducing double (or multiple) recalculation burden at the relevant jurisdictions.

- Further, in order to ensure the effectiveness of such double taxation relief measures, we would like to suggest that, prior to issuance of the final report, OECD should obtain commitments from the participating countries to implement fully effective double taxation relief measures and relevant dispute resolution mechanisms under the domestic laws.
Japan Foreign Trade Council, Inc.

World Trade Center Bldg. 6th Floor,
4-1, Hamamatsu-cho 2-chome,
Minato-ku, Tokyo 105-6106, Japan
URL. http://www.jftc.or.jp/

Members of the Accounting & Tax Committee of JFTC

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Inabata & Co., Ltd.
ITOCHU Corporation
Iwatani Corporation
JFE Shoji Trade Corporation
Kanematsu Corporation
Kowa Company, Ltd.
Marubeni Corporation
Mitsubishi Corporation
Mitsui & Co., Ltd.
Nagase & Co., Ltd.
Nippon Steel & Sumikin Bussan Corporation
Nomura Trading Co., Ltd.
Shinyei Kaisha
Sojitz Corporation
Sumitomo Corporation
Toyota Tsusho Corporation
Yuasa Trading Co., Ltd.
Dr. Achim Pross  
Head of the International Co-operation and Tax Administration Division, CTPA  
Organisation for Economic Co-operation and Development

Comments on the Public Discussion Draft on BEPS Action 3  
(Strengthening CFC Rules)


1. Introduction

Keidanren supports the OECD’s work on Action 3 from the perspective of developing truly effective and efficient controlled foreign company (CFC) rules as measures against base erosion and profit shifting (BEPS), and of creating a level playing field for companies. For instance, the Double Irish Dutch Sandwich structure is regarded as a typical BEPS technique. While this structure is made up of various elements, it has been argued that had there been robust CFC rules in the parent jurisdictions, the structure’s effects could have mostly been nullified. As a representative of the business community of Japan which reputedly has one of the world’s strictest CFC regimes, we believe that creating a level playing field for companies requires, at first instance, for jurisdictions with inadequate CFC rules to revise such rules. As a following step, it is hoped that efforts will be made to minimize differences among the CFC rules of individual jurisdictions to the extent possible, giving primary consideration for the need to prevent and eliminate any double taxation resulting from subjecting taxpayers to the CFC rules of more than one jurisdiction. At the same time, a certain degree of relaxation of CFC rules is a highly feasible option for jurisdictions with over-inclusive rules.

On the other hand, CFC rules in various forms have been already introduced in numerous jurisdictions and firmly established as part of their systems. Therefore, simply trying to standardize national rules in a uniform manner will not work. For example, the European Union nations have to ensure the consistency of their CFC rules with the European Court of Justice’s case law, as mentioned in the Public Discussion Draft. Given that a large number of OECD countries are also members of the EU, it is expected that the OECD’s recommendations have to be made with the EU in mind. Still, thorough examination is required as to whether those recommendations are suitable for the existing rules of non-EU countries as well.

With respect to the definition of CFC income, we have no objection to the proposed policy that a partial-inclusion system should be employed for the purpose of efficiently combatting BEPS. Nevertheless, a wider variety of approaches, including an entity approach, should be allowed as a means to achieve policy objectives. In particular, an entity approach that refines the range of application of CFC rules on an entity basis prior to applying substantial analysis provides a simple solution for both tax administrations and taxpayers because the approach allows an easy determination of
whether a company is subject to a CFC rules.

In the current environment in which CFC rules in various forms are enforced globally, what is required of the OECD is not to recommend a single best practice, but to define essential principles of CFC rules that are truly effective in combatting BEPS. Furthermore, any CFC rules enforced must be clear and workable, take into consideration companies’ compliance costs, and ensure that they are not applied subjectively.

Based on the viewpoints stated above, we present below our comments. It should be noted that these comments are the result of an examination conducted in a short period of time to meet the deadline. The Japanese business community continues to have a strong interest in CFC rules, and hopes that there will be more opportunities to voice our views and opinions in the future.

2. Approaches to Defining CFC Income

(1) Evaluation on Categorical Approach

In comparison with the excess profits approach set out in the Public Discussion Draft, the categorical approach would be consistent with the purpose of CFC rules, as it is designed to categorize the types of income subject to the rules and capture the very income that raises BEPS concerns. The OECD’s proposal that active income be excluded from, and passive income be included in, CFC income is understandable as a basic concept. When conducting a substance analysis to determine whether income is active or passive, it is desirable to take into account the business substance of the analyzed company and, if the company presents little BEPS risk, to keep the analysis as simple as possible by using objective factors relating to the company so as to alleviate the administrative and other burdens. However, in the case of companies in the financial and leasing sectors whose income tends to be deemed passive due to the nature of their business, individual jurisdictions should endeavor to harmonize their criteria for determination taking into consideration that such income would have been earned from an active business.

Considering these points and the need for an approach that is as objective as possible, it may be appropriate to adopt a method similar to an employees and establishment analysis when carrying out the substance analysis referred to in paragraph 89.

Paragraphs 106 and 112 of the Public Discussion Draft propose that a substance analysis be conducted with all sales and services income treated as passive. However, sales and services income account for the majority of income of a company having genuine business substance. Hence, we disagree with this proposal as it would excessively widen the scope of income subject to CFC rules in the name of combatting BEPS and substantially increase the administrative burden on companies. We support an active presumption for services and sales income, unless specific thresholds are breached by taking into consideration the active conduct of business by the companies.

Insurance income demands careful consideration based on its nature when determining whether such income is passive or active. Attention should be paid, at least, to the fact
that income from certain intragroup transactions and reinsurance deals, among other things, should sometimes be treated as active income due to the uniqueness of the insurance market.

Additionally, whereas no recommendation has been made in the Public Discussion Draft, we cannot find any rational reason why capital gains arising from corporate reorganizations and other events should be treated differently from income such as dividends and interest. For example, in a globalized economy, it is not unusual for a MNE to acquire a foreign MNE in pursuit of growth and competitiveness. In this situation, the acquiring MNE may wish to restructure the corporate holding structure of the acquired company and its subsidiaries in various jurisdictions to create synergies among member companies. It is obvious that there is a bona fide business reason for the acquiring MNE to transfer shares of some subsidiaries to other constituent entities, but in a certain jurisdiction the capital gain arising from that transfer might be classified as CFC income depending on the situation. It should therefore be recommended that capital gains arising from active business operations not be treated as CFC income.

**2) Evaluation on Excess Profits Approach**

The excess profits approach, which relies on subjective criteria for determining factors such as the rate of return and eligible equity, is likely to become a source of disputes between tax administrations and taxpayers. In addition, the rate of return creates a risk of tax administrations imposing taxes based on an assumption not in accordance with the substance of business activities. For these reasons, we are not in support of the proposed excess profits approach being recommended as a best practice.

It appears that the excess profit approach is proposed mainly with a view to capturing IP income shifted from a parent jurisdiction to a low tax jurisdiction. However, the proposed Option 1 of the potential special measures in the Discussion Draft on "Risk and Recharacterisation" is also aimed at the taxation of excess returns derived from exploiting IP assets transferred to a low tax jurisdiction. Although the relationship between the two proposed measures is currently unclear, multiple taxation of the same profit should be avoided and we request the OECD to ensure that the final recommendations on Action 3 (CFC) and Actions 8-10 (Transfer pricing) will be mutually consistent.

**3. Clear Prioritization of Building Blocks**

For the purpose of reducing the administrative burdens on tax administrations and taxpayers, it is extremely important to clearly prioritize the building blocks of CFC rules. This means that the issues able to be determined based on objective factors should be dealt with first while those requiring substantive judgments should be examined last. Therefore, the Public Discussion Draft should explicitly recommend that priority between building blocks be given to the issues that can be determined based on objective factors such as the definition of a CFC, threshold requirements, and the definition of control.
4. Specific Issues

(1) Secondary Rules

We feel that the possibility of secondary rules on page 3 of the Public Discussion Draft could be disruptive. These rules could be construed as permitting third countries to introduce a form of taxation other than the CFC rules proposed in the Public Discussion Draft. While the explanation is not sufficiently detailed for us to judge, generally speaking, it is desirable to avoid a complicating of rules.

(2) Definition of a CFC

Paragraph 34 of the Public Discussion Draft proposes that permanent establishments (PEs) be taken into account for CFC rules in certain cases. However, there are varying national treatments of what constitutes a PE and different views between taxpayers and tax administrations. For that reason, it is desirable to take a PE into account for CFC rules only when it has been registered in the jurisdiction or its treatment has been otherwise clarified.

Another concern is in relation to the acquisition of a company as part of reorganization and other schemes. There have been cases where an acquired company's subsidiaries are captured by the CFC rules as a result of a mechanical application of the CFC rules of the acquiring company's jurisdiction, irrespective of whether there has been any intention to engage in a BEPS technique. We believe that it is not appropriate for the CFC rules to be applied in this manner as no tax base has been eroded. Consideration should be made for corporate acquisitions, for example by allowing a certain grace period during which time the acquiring company can reorganize its group structure without being subject to CFC rules.

(3) Threshold Requirements

We agree with the Public Discussion Draft’s recommendation that a low-tax threshold be introduced, but emphasize that such a threshold must be clear and simple.

When establishing a low-tax threshold based on the tax rates of individual countries, that threshold should be meaningfully low in order to focus on CFC jurisdictions where the BEPS risk is expected to be extremely high. Whereas the Public Discussion Draft simply recommends that a low-tax threshold be set at 75% or lower of the statutory corporate tax rate, this does not make complete sense in the current situation in which some countries continue to keep their effective corporate tax rates high. It would be preferable for some countries to set a threshold at 50% of the statutory corporate tax rate of the parent jurisdiction.

In conjunction with this, in order to reduce the burden of examining the effective tax rates of the relevant countries, a white list approach should be introduced that allows the exclusion from such examination of countries posing little BEPS risk.
Paragraph 51 of the Public Discussion Draft states that there is no general recommendation for or against de minimis thresholds. However, from the perspective of enhancing measures against BEPS and reducing administrative burdens, consideration should be given to introducing a de minimis threshold in combination with an anti-fragmentation rule, as suggested by the Public Discussion Draft.

(4) Definition of Control

We basically agree with defining “control” as holding more than 50% control, as recommended in paragraph 65 of the Public Discussion Draft. In principle, it is desirable that the determination of control is made uniformly based on ownership on the last day of the fiscal year. Our concern relates to paragraph 65, which states that the interests of unrelated resident parties are also to be counted in determining the level of control. Assume a CFC is owned by a resident taxpayer and a non-resident partner entity with each holding a 50% stake. In this case, a determination of whether the CFC falls under the definition of control would require an investigation into the shareholders of the partner entity, including unrelated parties. Such an investigation, however, would be very difficult, especially in the event of the partner entity or its shareholders being listed companies that have a diverse range of shareholders. Therefore, the scope of investigations and examinations required of a company should be clarified.

(5) Rules for Computing Income

Paragraph 131 of the Public Discussion Draft recommends that a calculation of a CFC’s income be made in accordance with the rules of the parent jurisdiction. However, there are cases where recalculating a CFC’s income pursuant to the rules of the parent jurisdiction would impose an excessive burden on the taxpayer that has many CFCs subject to this process. From this perspective, attention might also be paid to certain situations that require the application of the third option of paragraph 132, under which taxpayers are allowed to choose either the computational rules of the parent jurisdiction or those of the CFC jurisdiction.

(6) Rules for Attributing Income

Paragraph 147 presents two approaches to determining how much of income to attribute: one being income based on ownership on the last day of the year, and the other being income based on the period of ownership. We consider it appropriate to attribute income based on ownership on the last day of the year, rather than that based on the period of ownership, from the perspective of accurately calculating and attributing taxable income and reducing administrative burdens.

(7) Rules to Prevent or Eliminate Double Taxation

For CFC rules, preventing and eliminating double taxation is of paramount importance. From this standpoint, paragraph 157 of the Public Discussion Draft refers to a foreign
tax credit as a means to eliminate double taxation. Yet, it is more important to work out ways to prevent double taxation from arising in the first place. We are also concerned that relief for double taxation provided for in existing CFC rules is inadequate.

In this regard, paragraphs 159–162 of the Public Discussion Draft recommend that, in the event of a CFC being subject to the CFC rules of multiple jurisdictions, the rules to apply first be those of the jurisdiction whose resident shareholder is closer to the CFC in the chain of ownership. The problem is that, when taxation methods, exemption criteria, and other conditions vary among the relevant jurisdictions, it is highly difficult to identify which part of the income has been taxed under CFC rules, resulting in a high chance of double taxation occurring. To avoid this, consideration may need to be given to an approach under which, in the case of a CFC being subject to the CFC rules of multiple jurisdictions, the jurisdiction whose resident shareholder is closer to the CFC in the chain of ownership is given the sole taxation right.

Sincerely,

Subcommittee on Taxation
KEIDANREN
Comments on OECD CFC Discussion Draft

Professionals in KPMG’s Global International Tax Services group welcome the opportunity to comment on the OECD’s Public Discussion Draft BEPS Action 3: Strengthening CFC Rules (the “CFC Draft”).

I. General remarks

CFC rules clearly have a role to play in preventing base erosion and profit shifting (“BEPS”). However, we consider that BEPS should be primarily addressed through other measures, such as transfer pricing, permanent establishment and hybrid mismatch rules, with CFC rules acting as a “backstop” to deal with stripping of the parent jurisdiction’s base.

CFC rules should be targeted at income that gives rise to BEPS concerns. An appropriate substance-based exemption should apply to exclude income that arises from genuine activities of a CFC. Indeed, Member States of the EU would need to include such an exemption in order for their CFC rules to be compliant with EU law.

Applying CFC rules creates a very significant annual compliance burden for multinational groups. It is, therefore, important that CFC rules contain practical entity-based exemptions, particularly a white/black list and de minimis threshold based on accounting profits, so that the vast majority of CFCs which do not pose a BEPS concern can be relatively easily excluded. In this way, the more detailed work that is required to analyze different types of
income under a categorical approach and to apply the substance-based exemption would be limited to a much reduced number of CFCs which are more likely to present BEPS concerns. We do not consider an excess profits approach to be workable.

Recognizing that countries have very different tax systems and economies, it is important for the final recommendations that are made under Action 3 to be sufficiently flexible so that different countries may tailor CFC rules to suit their own particular circumstances. Overly strict CFC rules can lead to competitiveness concerns and, in the past, has been cited as a reason for companies inverting.

We finally note that the CFC proposals, as with other OECD BEPS actions, assume a level of information and certainty in application that is often lacking as a practical matter. For example: a payment that is considered deductible may turn out not to be; an amount that is considered arms-length may, to settle a dispute, be accepted as not being so; an entity considered resident of one country may turn out to be resident of another country. These technical uncertainties are often exacerbated by regimes that depend on revenue authority assessments and varying periods during which an assessment may be open. Invariably, these periods do not coincide with the period in which a parent investor must determine a CFC, its CFC attributable income and related tax credits. A model CFC regime must be flexible enough to allow correction of such positions in light of subsequent developments, so that the opportunity for double taxation is minimized.

We have set out below our specific responses to certain of the questions for consultation that are set out in the CFC Draft.

II. Chapter 2: Definition of a CFC

1. Would any particular practical issues arise from treating transparent entities as separate entities in the cases listed above? If so, what are they and how could they be dealt with?

   a. Complexities arise from treating transparent entities as separate entities for CFC purposes. For example:

   1 The preface to the CFC Draft suggests that some countries have proposed that, in addition to CFC rules, a “secondary” rule could be applied to income earned by CFCs that does not result in sufficient CFC taxation in the parent jurisdiction. If the decision is made to take such a proposal forward, it is important that a discussion draft is published so there is an opportunity for business and others to provide comments given the potential complexity and consequences of such a rule.
i. Tax may be paid on a transparent entity’s profits by persons other than the entity itself, such as a partner and trustee, including where such persons are based in a different country. The effective tax rate (“ETR”) calculation for applying the low-tax threshold in Chapter 3 would need to be adapted to take into account taxes paid on the profits of a transparent entity treated as a separate entity by other persons.

ii. In determining the control of transparent entities, such as partnerships and trusts, there would be different considerations as compared to a company. For example, a trust would normally be established by a settlor, administered by a trustee and have beneficiaries entitled to its income and/or capital, but who would be said to have control of the trust, particularly if the trustee has discretion over which of the beneficiaries actually receive its income/capital? The control tests in Chapter 4 would need to be adapted so that they could be properly applied to transparent entities that were treated as separate entities.

iii. The CFC Draft does not currently address how the substance tests in Chapter 5 would be applied to income earned by transparent entities that are owned by CFCs. For example, at what “level” would the requisite activities need to be conducted?

b. The objective here should be to design CFC rules which ensure that transparent entities cannot be used to avoid the attribution of relevant income, but not to go further than this. The parent jurisdiction should be given the flexibility to decide how best to achieve this based on its own particular tax system. Whether CFC rules are applied to a particular foreign entity should normally depend on its treatment under the parent jurisdiction’s tax rules (many jurisdictions have “entity classification” rules for determining the treatment of foreign entities).

i. Where the parent jurisdiction treats an entity which is owned by a CFC as transparent and treats its profits as part of the CFC’s taxable profits for CFC purposes, it should not be necessary to treat the transparent entity as a separate entity. As an example, the UK’s CFC rules do not treat entities that are considered to be transparent for UK
tax purposes as separate entities, because, for example, where a CFC has a permanent establishment ("PE") or an interest in a partnership, the profits of the PE or the relevant share of the profits of the partnership are included in the CFC’s profits for CFC purposes. Any foreign tax paid on the profits of the PE or partnership would also be taken into account.

ii. In contrast, the U.S.’s CFC rules apply a blend of separate entity and transparent treatments depending on the particular aspect of the U.S. CFC rules being applied. For example, whether a transparent entity’s income is from an active business operation is generally determined at the transparent entity level and not at the owner level. On the other hand, the U.S. CFC rules look through a transparent entity to its CFC partners in determining whether “U.S. Property” held by the transparent entity may create a CFC income inclusion.

iii. Whether a PE is a separate entity or not for the purposes of the CFC rules should depend on the purpose of the specific rule. If the concern is that a CFC would otherwise qualify to be an automatically exempt CFC (because it is resident in a relevant listed country) while using a branch exemption provided by that country, this concern can be better addressed by excluding CFC’s which apply a branch exemption from so qualifying. If the concern is that the active income of the CFC can shelter passive income of a PE which is not taxed in the country of the PE or of the CFC, the PE can be separately tested for passive income.

3. Are there any practical problems with either the narrow or the broad version of the modified hybrid mismatch rule mentioned above?

   a. Addressing hybrid tax planning in the context of the “Definition of a CFC” is odd, because the discussion in ¶¶ 36-41 describes taking into account intragroup payments as opposed to overriding the hybrid classification. The hybrid rule should be considered as part of the consideration of what income, if any, should be attributed to the parent investor. Taking hybrid instrument mismatches into consideration in that determination will provide a more coherent view of what should be attributed.
b. The broad option is over-inclusive, unnecessary to address BEPS concerns, and could lead to double taxation. Using the example in Figure 1, any income earned by C Co must already be tested under Country A’s CFC rules at the level of B Co. A payment from C Co to B Co that is not deductible in Country C does not present sufficient BEPS concerns to warrant inclusion within newly developed CFC rules. By using the narrow approach, taxpayers and administrators can use their limited resources to focus upon payments that do present BEPS concerns.

c. The CFC draft proposes an ETR comparison test in several contexts as a method to focus on base erosion, including the Chapter 2 narrow hybrid mismatch rule and Chapter 3’s threshold. To reduce complexity and redundancy, countries should implement consistent standards for ETR comparison tests when the tests are used for these different purposes. As a practical example, when the U.S. Treasury proposed such a narrow hybrid mismatch system in 1998 (Notice 98-35 and Prop. Reg. 1.954-9), they borrowed the existing ETR comparison test from the CFC sales income rules.

III. Chapter 3: Threshold Requirements

4. What practical problems, if any, arise when applying a low-tax threshold based on an effective tax rate calculation?

See comments under question 5.

5. How could these problems be addressed or mitigated?

a. We agree that a low-tax threshold can be a useful tool to focus CFC rules on those companies which pose a greater BEPS concern. The threshold should be applied on a company-by-company basis. However, to require an ETR calculation to be undertaken for every CFC in a multinational group, including, as it does, a computation of the CFC’s profits under the parent jurisdiction’s tax rules, would impose a very significant annual compliance burden. It is, therefore, important that CFC rules also contain other more

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2 It is not unusual for the larger multinational groups to have 300-500 CFCs and for the very largest groups to have in excess of 1,000 CFCs.
practical entity-based exemptions, such as a white/black list and *de minimis* threshold based on accounting profits, to more easily exclude the vast majority of CFCs which do not pose a BEPS concern because they are resident in high-tax jurisdictions or have minimal profits.

b. We repeat our comment 3.c. above regarding the benefits of consistency in ETR approaches for different aspects of a CFC regime. We also note that the mechanism for computing a deemed-paid foreign tax credit, discussed under Chapter 8, provides a useful reference point in designing an ETR test. For example, the United States deemed-paid foreign tax credit rule for CFC inclusions compares the amount of foreign tax actually paid by the CFC with the CFC’s earnings as computed under the CFC parent’s tax system (that is, the United States).\(^3\) The CFC Draft appears to approve of this method (that is, local tax expense versus parent jurisdiction tax base) and it may offer the best opportunity to measure how “low”-taxed the CFC is relative to the hypothetical of the shareholder conducting the same activities in its home jurisdiction.

c. Insofar as a test based on the parent country’s rules will require a recalculation of the CFC’s income under the parent country’s rules, the parent investor will incur a cost even if no income is attributed because the CFC passes the test. A test based on the financial statement income may reduce that cost. Such a test, however, may understate or overstate the ETR because financial statement income may include some items and exclude others which are in the parent company’s tax base. It is also unlikely that the financial statements will recognise all income and expenditure at the same time as the parent’s tax system. Targeted modifications to a financial statement test may improve its utility (for example, adjusting only for permanent differences while accepting timing differences).

d. Even a CFC resident in a high-tax jurisdiction could potentially fail the low-tax threshold, based on an ETR calculation, as a result of timing differences (for example, due to accelerated tax depreciation) causing its tax base calculated under the CFC jurisdiction’s tax rules to be lower than that under the parent jurisdiction’s tax rules in particular accounting periods. This could potentially be avoided by allowing effective tax rates to be averaged

\(^3\) See generally U.S. Internal Revenue Code (“IRC”) §§ 902, 960, and 964.
over a number of years, not adjusting for timing differences or allowing carry back of “excess” foreign tax, but these would all add to the complexity of the rules. The use of a white list, as mentioned above, would substantially mitigate this problem. We also note that the presence of a deferred tax liability for a particular item would suggest that the item is within the tax base of the CFC’s jurisdiction. This could be considered as a basis for determining whether a timing difference should be adjusted.

e. The ETR calculation currently in the CFC Draft does not take into account foreign taxes that might be suffered outside the CFC jurisdiction on the CFC’s income (for example, withholding taxes on dividend/interest/royalty income or corporate tax on profits of a PE). If such taxes are creditable under the CFC jurisdiction’s tax rules, this would reduce the tax paid by the CFC in the CFC jurisdiction and could cause the low-tax threshold to be failed. The UK’s CFC rules use an ETR calculation, but this compares the tax paid in the CFC jurisdiction with the corresponding UK tax, both after allowing relief for foreign taxes under the respective jurisdictions’ double taxation relief rules.

f. Alternatively, the ETR test could be applied by reference to all the taxes actually imposed on an item of income. As all such taxes should be creditable if the CFC income is attributable, this appears to us to be the better measure of foreign tax paid/payable.

g. Where a CFC is a member of a consolidated tax group, there need to be rules for determining the tax paid by the group which is attributable to the CFC in applying the ETR calculation. Under the UK’s CFC rules, this is generally done by allocating the tax to the profitable members of the consolidated tax group in proportion to their respective taxable profits. The U.S. CFC rules similarly allocate taxes paid amongst members of a combined group by reference to their respective contribution to the local tax base.

h. Taxes could be imposed on the CFC’s income either in the CFC jurisdiction or another jurisdiction after the ETR calculation is initially applied, so it is important that CFC rules allow for the calculation to be subsequently adjusted if this results in the CFC’s ETR exceeding the low-tax threshold.
Chapter 4: Definition of Control

7. What practical problems, if any, arise when applying a control test?

See comments under question 8.

8. Are there particular practical problems that arise when applying a control test that considers interests held by unrelated or non-resident parties? If so, what are they, and how can they be dealt with?

a. We agree that the control test should address both legal and economic control, and should require resident taxpayers to hold greater-than-50% control under one of those tests.

b. If CFC rules allow this level of control to be established through the aggregation of interests of related parties this should adequately address BEPS-related concerns that are presented by multiple owners of a non-resident company.4

c. If instead it is necessary to aggregate interests of unrelated resident parties, there may be situations in which it is difficult for a resident taxpayer, or indeed tax authorities, to identify the residence status of other persons with interests in non-resident companies and also the level of their interests, particularly in the case of public and widely held companies, thereby creating a significant compliance burden. If such a company was a CFC the listing and other insider trading rules might prevent the company from providing to the shareholder the necessary information to comply with the CFC rule. This possibility further highlights the difficulty and inequity of imposing CFC rules on such shareholders. A concentrated ownership requirement would clearly help to reduce the compliance burden here by only requiring interests of residents to be aggregated where each interest is higher than a set percentage (for example, 10%). If a concentrated ownership requirement is not adopted, then a “carve-out” should be added for minority/portfolio investors in public and/or widely held companies. We note that substantial shareholder disclosure notices that are required by a

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4 See ¶73, footnote 33 of the CFC Draft.
jurisdiction for listed entities may be a practical indicator of potentially relevant shareholders.

d. Applying an “acting-in-concert” test would add significant complexity and subjectivity to determining the control of a non-resident company without necessarily targeting BEPS-driven arrangements.

e. Similar to other Action items, the CFC Draft’s recommendations present special implications for the mutual fund and alternative investment industries, particularly for portfolio companies that are largely or entirely owned by private equity firms. In practice it is difficult to calculate the ownership held by managers with contingent ownership rights (e.g., the “carry”) in a subsidiary, and more generally to apply the control tests where the legal control has been separated from the majority of economic ownership. Some care also needs to be taken with an “acting in concert” approach to such funds. Although their investments may be managed by the same manager, different fund investment mandates would indicate that the funds have different purposes and should not be treated as a single investor.

f. Furthermore, if such a fund is transparent (as they tend to be), consideration needs to be given to the treatment of both the fund’s investors and the fund itself in the relevant jurisdictions. For example, would the fund have to calculate CFC income under the rules for each country in which its investors reside?

Chapter 5: Definition of CFC Income

9. What are the practical problems with any of the three substance analyses set out above? How could these practical problems be dealt with?

   a. See comments under question 10.

10. Do you have experience with applying substance analyses in existing CFC rules? If so, how can these be made more mechanical while still accurately attributing income?

   a. The three forms of substance analysis set out in Chapter 5 each have their own advantages and disadvantages. As highlighted, there are already
countries which have adopted approaches in their existing CFC rules that are similar to each of those set out in the CFC Draft. Given this, it may be difficult to reach consensus on the best approach to follow. If so, the final recommendations could include all three approaches as being acceptable while explaining how each should be structured to best combat BEPS.

b. The substance analysis should, however, reflect the reality of how international businesses structure their operations. Intra-group activities are increasingly being centralized (e.g., procurement activities, shared-services, such as IT, payroll, accounting services and R&D) and operating companies are sub-contracting non-core activities, whether to third parties or to other group companies, in order to reduce costs and increase efficiency and focus. The employees and establishment (“E&E”) approach does not fit well with these developments.

c. Certainly, a one-size fits all approach does not work well in practice when one is considering different businesses. A subjective approach, like the viable independent entity approach, is better as it focuses on what substance is necessary for each business on a case-by-case basis. It recognizes the outsourcing of non-core activities as acceptable, provided that the activities could be outsourced to third parties and the CFC’s employees are able to exercise management and control over those activities. The downside of such an approach is that it requires detailed analysis of the facts and an element of judgment, which increases the compliance burden. However, as highlighted in the CFC Draft, the situations in which it is necessary to undertake such analysis can be minimized through the use of practical entity-based exemptions and other suitably targeted exclusions, as is the case under the UK’s CFC rules.

d. The U.S. substantial contribution rules have worked reasonably well for both taxpayers and administrators. Combining this test with a categorical income approach permits CFC rules to focus both upon the genuine activities of the CFC as well as income that is most likely to present BEPS concerns.

e. Contrary to the suggestion in the CFC Draft, a substantial contribution approach could and is applied outside of the manufacturing context. The U.S. system uses a substantial contribution concept in the active rental and royalty tests, which require the CFC’s “own employees” to perform key
tasks. This approach thus incorporates a mechanical requirement that the CFC Draft suggests is a positive aspect of the E&E approach.

f. Thus, substantial contribution should be considered further. Concerns over “swamping” are only presented in an entity-based, rather than categorical, approach and in that context can be addressed by raising the threshold of the required contribution.

g. The VIE analysis may more directly target activities and profits that have been artificially diverted, in that it requires a comparison against “normal commercial conditions” of the companies’ activities and functions. In practice, however, this analysis can be complicated and may be difficult to administer unless paired with substantial entity-level exemptions.

h. A more advanced substantial contribution analysis would be preferable to the E&E analysis. The E&E analysis suffers from the same outdated “fixed base,” “establishment” concept that has been at the forefront of permanent establishment concerns. In this regard, the E&E analysis does not appear responsive to modern business arrangements involving skilled professionals and “on-site” projects that do not also include a traditional fixed workplace. As noted above, it is possible to incorporate elements of the E&E analysis, such as the requirement that the CFC have its own employees instead of outsourcing core functions, into a substantial contribution test.

11. How can CFC rules accurately attribute income that raises concerns about BEPS (i) in a business that is licensed under an appropriate regulatory body and is market-facing in a particular jurisdiction, (ii) in a reinsurance business carried on by a CFC of a multinational insurance group or (iii) in a “captive” insurance business of a CFC that is not part of an insurance group? Are there practical problems with current rules that distinguish between these two situations? If so, what are they and how can they be dealt with?

a. We understand this question is intended to prompt discussion of the extent to which regulatory and licensing approval and interactions with external customers can function as a surrogate for the more general substance requirements proposed in the CFC Draft. As the question suggests, these questions may be presented most commonly in the financial services context. Many CFC regimes have discrete “active financing” and/or “active
insurance” tests that function separately from the more general substance requirements. In our experience, providing tailored and more flexible standards for specific industries in this manner has worked well and does not present any material risk of undermining the general CFC regime.

b. We note that the regulatory and licensing aspects are generally focused on the minimum capital required to carry on the relevant activity. Such capital tests may need to be adapted to allow a certain excess of capital over the regulatory minimum so that any such rules can target the BEPS CFC concerns.

12. Are there practical problems with applying the same rule to sales and services income and IP income?

a. There are similar, but not identical, substance tests used for sales vs. services vs. royalties income under the U.S. tax rules. A more modern system should apply a similar test to prevent character manipulation.

b. It is important to distinguish the purpose of CFC rules with that of transfer pricing and “exit charge” rules. It is more efficient, and would provide more certainty to taxpayers and administrators, to address such concerns fully with specific rules and to leave CFC rules serving a more general anti-abuse function.

16. What practical problems arise with applying the categorical approach and the excess profits approach?

a. Under the excess profits approach, the calculation of the normal return would not be straightforward in practice. For example, what assets should be included and how should they be valued in order to calculate eligible equity (e.g. where a CFC is purchased by a multinational group, it would pay market value consideration, but the CFC would hold any historic IP at book value which might be significantly lower)? This could lead to significant disputes between taxpayers and tax authorities over the inputs, similar to current transfer pricing disputes. As an example, the U.S. tax system used to permit a similar “formula” approach for taxpayers to determine the amount of goodwill acquired by taxpayers when they
purchased an ongoing business. The difficulty in valuing goodwill led the U.S. Congress and Treasury to mandate a different approach for this purpose approximately thirty years ago.

18. Which approach is most likely to accurately attribute income that gives rise to BEPS concerns? Is one approach likely to be more effective than the other in terms of dealing with IP income?

a. The categorical approach is clearly defined and is consistent with many current CFC regimes. We consider that it is most likely to accurately attribute income that gives rise to BEPS concerns and provided it includes an appropriate substance-based exclusion for income should be EU compliant.

b. We do not consider the excess profits approach workable as a “stand-alone” approach. Without a substance-based exclusion, it will not accurately attribute BEPS income and will not be EU compliant.

19. Could the excess profits approach be applied to income other than IP income and what would be the practical implications of this?

a. The excess profits approach could feasibly be applied to other types of income, provided that suitable data to enable the calculations can be found. However, as already mentioned, without a substance-based exclusion, it will not accurately attribute BEPS income and will not be compatible with EU law.

21. What difficulties or practical problems arise in applying an entity approach or a transactional approach?

a. The problem with a pure entity approach is that it is “all or nothing,” so that it might capture more or less income than is appropriate to address BEPS

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5 See, e.g., Rev. Rul. 68-609, 1968-2 C.B. 327 (valuing goodwill as the excess over routine returns, through a comparison of a company’s earnings history to industry benchmarks).

6 See, e.g., S. Rep. 99-313 at 253-254, discussing proposed enactment of U.S. Internal Revenue Code § 1060 (“Purchase price allocations have been an endless source of controversy between the IRS and taxpayers, principally because of the difficulty of establishing the value of goodwill and going concern value.”).
concerns. It is also more susceptible to manipulation, as taxpayers may seek to hide “bad” income in a CFC that engages primarily in activities that generate income that is not subject to CFC rules.

b. A transactional approach, focusing on individual income streams to determine their treatment, is a better approach from a BEPS perspective.

22. What concerns arise from the two approaches in terms of administrative burdens and compliance costs?

a. See comments under question 23.

23. How could these concerns and/or practical problems be dealt with while still ensuring that the CFC rules achieve an accurate result and attribute income that raises BEPS concerns?

a. The transactional approach creates an additional compliance burden for taxpayers. This could be reduced by taking a “mixed” approach. Initially, an entity based approach could be followed with entity-based exemptions, such as a white/black list, de minimis threshold and low-tax threshold, available to exclude the vast majority of CFCs which do not pose a BEPS concern because they are resident in high-tax jurisdictions or have minimal profits. A transactional approach would then be applied to a much reduced number of CFCs which are more likely to present BEPS concerns.

Chapter 6: Rules for computing income

25. Does this chapter accurately reflect the issues that could arise with losses or are there any other situations that need to be considered?

a. At least with a categorical system, CFCs can earn CFC income or non-CFC income, and also can incur losses with respect to activities that would or would not give rise to CFC income. CFC rules should take this into account and neither over-include income by making limited allowances for losses, nor under-include by not appropriately aligning losses with the income side. The latter concept is not dissimilar from other types of “basket” or “bucket” approaches to different categories of income (capital vs. ordinary, passive vs. active, trading vs. non-trading, etc.) used by particular tax systems to
prevent losses from one type of activity from offsetting income arising from another activity, and vice versa.

b. Thus, while we support the general concept that CFC losses should carry over and be available in other years, this concept should be refined to account for the distinct types of income (CFC income vs. non-CFC income) that a CFC may earn.

c. We also note that the CFC Draft provides very little discussion of the allocation and attribution of expenses. If this framework is not properly designed and coordinated, there is a risk of double taxation if different jurisdictions allocate expenses differently.

Chapter 7: Rules for attributing income

27. Does the description of a top-up tax set out all the advantages and disadvantages of such an approach?

a. It should left to individual jurisdictions to decide whether to apply the domestic tax rate to CFC income or a top-up tax in order to limit competitiveness concerns. If a top-up tax is used, then we agree it is most sensible to harmonize this with the low-tax threshold proposed in Chapter 3 of the CFC Draft.

Chapter 8: Rules to prevent or eliminate double taxation

29. What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?

a. Foreign taxes may be imposed on CFC income after CFC taxation has been calculated and paid in the parent jurisdiction. In this situation, it should still be possible for double taxation relief to be claimed for the additional foreign tax, with any CFC tax that has been over-assessed being repaid.

b. Time limits on claiming foreign tax credits as well as the lack of carry forward/back rules may also create problems. As noted in our general comments, there is no global alignment for statutory assessment and reassessment periods. Nor is there global alignment of when particular
items of income and expense are included in the tax calculation. A credit for foreign taxes paid may not be available due to the time at which a reassessment is made (including allowing time for a dispute to be settled or decided upon by a Court) or due to the timing of when the income or expense is recognized. The OECD should make specific recommendations to ensure that foreign tax credits are readily and clearly available.
Public Comments on a discussion draft of BEPS Action 3: Strengthening CFC rules released on 3th of April 2015

1 Introduction
I have decided to deliver my comments on a discussion draft of BEPS Action 3: Strengthening CFC rules released on 3th of April 2015, because I am dealing with the problem of applying CFC rules widely as a PhD candidate at the Department of Public and International Law, University of Oslo starting from September 2012. My PhD research project is titled: “Controlled Foreign Companies and Tax Avoidance: International and Comparative Perspectives with Specific Reference to Polish Tax and Constitutional Law, EU Law and Tax Treaties”. I sincerely believe that my comments may be relevant and useful for the final outcome of the WP11 works over the BEPS Action 3: Strengthening CFC rules.

My comments focus solely on paragraph 14 of the discussion draft of BEPS Action 3 which regards drafting CFC rules in a way that their application will be compatible with EU treaty freedoms and more effective with preventing tax avoidance.

I agree with the WP11 that due to the competitiveness concern it will be ideally to draft, implement and then apply the same CFC rules for EU Member States and non-EU Member States. Nevertheless even the WP11 acknowledges that EU Member States may not have the same effective CFC rules in force as third countries due to the wholly artificial arrangement’ limitation.

It is true, though, that for CFC rules to be effective it is not enough to combat mere wholly artificial arrangements. Simultaneously providing effectiveness of CFC rules cannot overrule the requirements stemming from the CJEU’ case law for their compatibility with EU law. In order to
develop recommendations for CFC rules that are effective in dealing with base erosion and profit shifting (which is the ultimate purpose of Action 3)\(^1\) within EU., the WP11 developed four recommendations for CFC rules: (i) including a substance analysis that would only subject taxpayers to CFC rules if the CFCs did not engage in genuine economic activities; (ii) **applying CFC rules equally to both domestic subsidiaries and cross-border subsidiaries**; (iii) designing CFC rules to explicitly ensure a balanced allocation of taxing powers; and (iv) **applying CFC rules to transactions that are “partly wholly artificial”.**\(^2\) The recommendation (i) was in fact followed by all EU Member States with CFC rules, albeit more or less successfully, after the CJEU’s judgment in the *Cadbury Schweppes* case.\(^3\) Moreover, it does not provide the sufficient level of effectiveness of CFC rules within EU. Hence, **I have decided to focus only on the three remaining recommendations.**

2 Comments

2.1 Applying CFC rules equally to both domestic and cross-border companies

Indeed such a legal solution would make CFC rules also more effective as their application would not be restricted solely to wholly artificial arrangements due to the lack of a restriction. Presumably for these reasons, the Danish legislator, unlike legislators in other Member States, decided to widen the scope Danish CFC rules to domestic companies and stated that this leads to a situation under which:

> there is no different treatment, no matter 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.\(^4\)

Providing the compatibility of CFC rules with EU law via such approach, however, seems to be highly questionable due to the following reasons.

First and foremost, generally the main purpose of CFC rules is to prevent tax avoidance via CFCs located in low tax jurisdictions.\(^5\) In purely domestic situations, no risk of tax deferral or tax avoidance exists, since controlled domestic company is taxed on a current basis under the domestically applicable tax rate. As a rule, there is no difference in the level of taxation between

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\(^3\) See Dahlberg, M., Wiman, B., *General Report: The taxation of foreign passive income for groups of companies*, Cahiers de droit fiscal international Vol. 98a, IFA 2013, Copenhagen, p. 44.


the controlled and controlling company and even if such may exist, it is the full responsibility of
the one and the same Member State for existing of this difference. It means that a difference in
taxation level between companies within the territory of one Member States is rather unlikely and
even if it takes place, it is usually made by this Member State’s tax policy reasons, such as
supporting less developed parts of that State by tax incentives that apply for active businesses,
decreasing unemployment rate, etc.\(^6\) Thus, extending CFC rules to purely domestic situations
contradicts their purpose and thus the policy rationale for their implementation and application.\(^7\)

In that respect, while analyzing the compatibility of thin capitalization provisions with EU law,
AG A. Geelhoed said that:

Nor am I of the view that, in order to conform with Article 43 EC [now: Article 49 of the
TFUE], Member States should necessarily be obliged to extend thin cap legislation to purely
domestic situations where no possible risk of abuse exists. I find it extremely regrettable that
the lack of clarity as to the scope of the Article 43 EC [now: Article 49 of the TFUE]
justification on abuse grounds has led to a situation where Member States, unclear of the extent
to which they may enact prima facie ‘discriminatory’ anti–abuse laws, have felt obliged to
‘play safe’ by extending the scope of their rules to purely domestic situations where no
possible risk of abuse exists. Such an extension of legislation to situations falling wholly
out with its rationale, for purely formalistic ends and causing considerable extra administrative
burden for domestic companies and tax authorities, is quite pointless and indeed
counterproductive for economic efficiency. As such, it is anathema to the internal market.\(^8\)

Having said this, it is clear that extending the application of CFC rules to purely domestic
situations entirely contravene their rationale and is counterproductive for economic efficiency.

Thus, the main reason for such legislative practice seems to be avoiding a possibility to consider
the application of CFC rules as being restrictive towards fundamental freedoms. This practice
conflicts with the principle of loyalty under Article 4(3) of TEU.\(^9\) Indeed domestic anti-avoidance
provisions could be seen as being non-restrictive if it applies both to domestic and cross-border

\(^6\) Such tax incentives may be accepted by the European Commission as state aid compatible with EU law pursuant to
Articles 107-108 of the TFUE. Applying CFC rules of a Member State to CFCs tax preferentially under such tax
regimes (accepted by the European Commission) violates the principle of loyalty under Article 4(3) according to
which the Member States shall facilitate the achievement of the Union’s tasks and refrain from any measure which
could jeopardise the attainment of the Union’s objectives. See Helminen, M., Is There a Future for CFC-regimes in

\(^7\) Concurring: Mai sto, G., Pistone, P., A European Model for Member States’ Legislation on the Taxation of
Controlled Foreign Subsidiaries (CFCs) – Part I, European Taxation 2008, No. 10, p. 508.

\(^8\) See AG A. Geelhoed’s opinion delivered on 29 June 2006 in the Test Claimants in the Thin Cap Group Litigation
case C-524/04, paragraph 68.

\(^9\) See Smit, D., EU freedoms, non EU-countries and Company Taxation, Eucotax, Alphen aan den Rijn: Wolters
situations and such application fully matches the purpose of the provisions.\textsuperscript{10} This is, though, not the case of CFC rules or any other provisions dealing with cross-border tax avoidance.

Similarly, the analysed solution for avoiding a restriction of fundamental freedoms was condemned by the European Commission:

\begin{quote}
In the Commission’s view it would be regrettable if, in order to avoid the charge of discrimination, MSs extended the application of anti-abuse measures designed to curb cross-border tax avoidance to purely domestic situations where no possible risk of abuse exists. Such unilateral solutions only undermine the competitiveness of the MSs’ economies, and are not in the interest of the Internal Market. (…) Moreover, it remains debatable whether such extensions can successfully bring all restrictive measures into line with MSs’ EC Treaty obligations.\textsuperscript{11}
\end{quote}

It means that the European Commission does not share the point of view under which CFC rules, or other anti-avoidance provisions, applicable on the same conditions domestically and internationally, are not discriminatory or restrictive and therefore they do not need to pass tests of their justifiability and proportionality established by the CJEU in the field of fundamental freedoms.

Likewise the CJEU’s case law implies, albeit implicitly, that consequences of applying domestic provisions for their compatibility with EU law should be drawn from their actual rather than merely formal scope of application.\textsuperscript{12}

Another argument against the discussed approach for compatibility of CFC rules with EU law is that none of EU Member States decided to follow it, apart from Denmark. Indeed the UK considered to do so in 2007, but the conclusion of the UK Government was that it most likely would not be accepted by the CJEU and therefore the UK chose a different legal solution.\textsuperscript{13}

The vast majority of the Danish scholars argue that the application of the Danish CFC rules, after the extension of their scope to domestic companies, still entails different tax treatment of resident Danish companies controlling domestic and foreign companies. It stems from the fact that only in the latter case the application of the CFC rules triggers an additional tax burden for


\textsuperscript{12} See the CJEU’s judgment of 8 July 1999 in the Baxter case C-254/97, ECR 1999, p. I-04809, paragraphs 12-13.

\textsuperscript{13} See Taylor, D., Sykes, L., *Controlled Foreign Companies and Foreign Profits*, British Tax Review 2007, No. 5, pp. 609-647.
the Danish controlling 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.14

Finally, I must indicate that in my opinion the WP11 misinterpreted the wording of the quoted paragraph 45 of the CJEU’s judgment in the Cadbury Schweppes case. The WP11’s interpretation implies that the CJEU based its conclusion regarding the restrictive effect of applying the UK CFC rules merely by using the so called migrant/non-migrant test. In my opinion, in turn, this paragraph implies that what entails the restriction in the view of the CJEU is the very fact that in result of applying the UK CFC rules, the resident company is taxed on profits of another legal person which is not the case for a resident company with a subsidiary taxed in the UK or a subsidiary established outside that Member State which is not subject to a lower level of taxation. In the former case, the CJEU made a traditional comparison between a cross-border situation and a domestic situation (the so called migrant/non-migrant test), i.e. vertical comparison,15 while in the latter case it was used a more original comparison between two cross-border situations, i.e. horizontal comparison.16 Different tax treatment in either of these situations17 constitutes a hindrance to freedom of establishment and is contrary to the notion of


17 That is to say, different tax treatment of a resident company having share in profits in other resident company in comparison to a resident company having share in profits in non-resident EU’s company on the one hand, and
internal market as it may lead to its fragmentation depending on the level of taxation among Member States.\textsuperscript{18}

This being said, it is clear that applying CFC rules equally to both domestic and cross-border companies does not eliminate the restrictive effect of these rules in the light of horizontal comparison.

For all of the mentioned above reasons, extending CFC rules to domestic companies is not an appropriate approach to provide their compatibility with EU law.

2.2 Designing CFC rules to explicitly ensure a balanced allocation of taxing powers

I my view, the CJEU’s case law shows that the need for safeguarding a balanced allocation of taxing powers between Member States does not constitute a separate, autonomous justification. It is rather used for justification in combination with other reasons, e.g. tax avoidance or coherence of tax system.\textsuperscript{19} The only exception in that regard in the CJEU’s case law occurs in relation to preventing a free transfer of profits being tax deductible expenses/losses at the choice of a taxpayer since, in the Court’s view, it may lead to undermine a balanced allocation of the power to impose taxes between the Member States via increasing in the taxable base in low tax Member State and reduced in the high taxed Member State to the extent of the losses will be transferred.\textsuperscript{20}

Thus, in such cases safeguarding the balanced allocation of taxing powers between Member States can be considered as a separate autonomous justification.\textsuperscript{21} This does not include case on CFC rules.
As a matter of fact both judgments to which referred WP11 regarded cases on preventing a free transfer of profits being tax deductible expenses/losses at the choice of a taxpayer. *E contrario*, in other cases, such as the ones concerning CFC rules, the need for safeguarding the balanced allocation of taxing powers between Member States cannot be used as a separate justification instead of the need for preventing wholly artificial arrangements.

There are, though, viewpoints of some scholars that support the conclusion of the WP11. The point is nevertheless that such views are solely based on references to the CJEU’ case law on thin capitalization or transfer pricing provisions allowing for preventing a free transfer of tax deductible expenses/losses. Crucial differences in scope and effect of applying these types of legislation and CFC rules were skipped either. Thus, in my opinion, the said views are based on an unconvincing reasoning.

Most importantly, the CJEU in *Cadbury Schweppes* case (paragraphs 55-56) and in other cases made a direct link between “wholly artificial arrangements” and “avoidance of tax on profits made in a national territory of a Member State”. This case law implies that a balanced allocation of the power to impose taxes between Member States would be threatened if tax avoidance via wholly artificial arrangements were to be permitted. In other words, there is a direct causal link made between creation and exploitation of wholly artificial arrangement for the sole purpose of tax avoidance and jeopardizing the balanced allocation of taxing rights – the former leads to the latter. In the same vein one may indicate the existence of the causal link between preventing of wholly artificial arrangements for sole purpose of tax avoidance and safeguarding the balanced allocation of taxing rights between Member States – the preventing the former automatically safeguarding the latter, but not vice versa. Hence, the CJEU did not consider the need for safeguarding the balanced allocation of taxing powers between Member States as a separate justification for applying CFC rules in a restrictive manner, but perceived this issue as immanently linked with the need to prevent the exploitation of wholly artificial arrangements for the sole tax avoidance purpose.

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Furthermore, the CJEU have an occasion to refer to paragraph 66 of the judgment in the *SGI* case in its judgment of 13 November 2014 in the *European Commission v United Kingdom* case\(^{25}\) on domestic anti-avoidance provisions with the effect of application similar to the one under CFC rules, but it did not happen. Likewise the CJEU in its judgment of 23 April 2008 in the *Test Claimants in the CFC and Dividend Group Litigation* case could refer to paragraph 81 of its judgment of 13 March 2007 in the *Test Claimants in the Thin Cap Group Litigation* case, but it did not happen either. Instead of it, in both cases the CJEU stated that the restrictive effect of applying such rules can be justified by preventing the creation and use of *wholly artificial arrangements which 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.*\(^{26}\) It means that there is nothing in the CJEU’s case law on CFC rules implying that the balanced allocation of taxing powers may replace wholly artificial arrangement as a separate autonomous justification. Since it is for the CJEU to decide when a domestic provision can be justified exclusively by the need to safeguarding the balanced allocation of taxing powers between Member States,\(^{27}\) and this Court never did it in relation to CFC rules, the recommendation of the WP11 must be seen as the inappropriate one.

**2.3 Applying CFC rules to transactions that are “partly wholly artificial”**

In my opinion, the phrase “partly wholly artificial” does not withstand the very basic linguistic critique, since the phrases “wholly” and “partly” are mutually exclusive, i.e. “wholly” means “completely” while “partly” means “not completely”.\(^{28}\) Thus any transaction or arrangement cannot be at the same time “partly wholly”. What, in my view, could be seen as being implied by the WP11 by using the phrase “partly wholly” in relation to a transaction is that if an income from such a transaction is considered to be artificial, then taxation of such income under CFC rules can be justified in the light of preventing the exploitation of “wholly artificial arrangement”. Nevertheless the use of the phrase “partly wholly artificial” does not seem to be correct.

It is also worth to observe that the WP11 based its reasoning in the discussed regard on paragraph 81 of the CJEU’s judgment of 13 March 2007 in the *Test Claimants in the Thin Cap*...
Group Litigation case,\(^{29}\) while paragraph 92 of this judgment, in which the CJEU’s reached the conclusion regarding the problem in questions 1 and 3 of the case, was ignored. The point is that in paragraph 92 is nothing that may suggest that a restriction of the freedom of establishment triggered by applying thin capitalization provisions may be justified by preventing “party artificial transactions”. Instead of it, the CJEU referred only to “a purely artificial arrangement”. Naturally, a conclusion constitutes the essence of every judgment as only the conclusion is included in the final decision of the Court and thus drives the legal outcome of the judgment. Thus, it seems that the WP11 purposively omitted the conclusion of the CJEU’s judgment in the Test Claimants in the Thin Cap Group Litigation case and focused only on the part of this judgment that in its view could be used as the basis for its recommendation on applying CFC rules to transactions that are “partly wholly artificial”.

More comprehensively, the CJEU’s case law to which referred the WP11 concerned domestic anti-avoidance provisions preventing a free transfer tax deductible expenses/losses, such as thin capitalization and transfer pricing provisions. Such provisions focus on a particular transaction or transactions among associated entities and they apply only if a transaction triggers flows of profits and is realized between associated/controlled entities under conditions seen by a legislator as unacceptable from tax point of view. Whereas CFC rules are mainly designed to prevent establishing controlled foreign companies in low or no tax jurisdictions and exploiting them for tax deferral/tax avoidance purposes. Therefore their essential effect of application is to eliminate the whole CFC structure rather than particular transactions between associated taxpayers. What’s more CFC rules apply regardless of any transaction triggering flows of profits between taxpayers controlling CFC and the CFC. Similar points were made by the WP11 in relation to differences between CFC rules and transfer pricing provisions.\(^{30}\)

Thus, it is reasonable that the CJEU in cases regarding the former provisions focuses on artificality of a transaction (no business purposes for providing a loan or paying business expenses)\(^{31}\) and the terms under which a taxpayer engaged in a transaction (the arm’s length principle)\(^{32}\) rather than the factors related to artificiality of the whole establishment (the lack of

\(^{29}\) C-524/04, ECR 2007, p. I-02107.


\(^{31}\) See the CJEU’s judgment of 5 July 2012 in the SIAT case C-318/10, ECLI:EU:C:2012:415, paragraphs 41-42.

sufficient premises, staff and equipment).\textsuperscript{33} It naturally stems from differences in the scope and effects of application of the indicated provisions, i.e. CFC rules target the whole tax avoidance structures and therefore the justification relevant for them is construed under the concept of “wholly artificial arrangement”, while anti-avoidance provisions regarding transactions involving transfer of profits may include one or several steps and for this reason could be only partly genuine or partly artificial.\textsuperscript{34} Clearly, such differences entail the need for different understanding and application of the justification for the restrictive effect of discussed domestic anti-avoidance provisions on fundamental freedoms. It should be also remembered that factors relevant for determining the artificiality of a transaction or a structure are versatile and their evolution depends on the facts of the case pending before the CJEU.\textsuperscript{35} Likewise the concept of wholly artificial arrangement should be understood differently when different fundamental freedoms are applicable in context of the application of CFC rules, since different freedoms require different criteria to be met by taxpayers for being protected under them.\textsuperscript{36}

This being said, I am of the opinion that the CJEU’s case law mentioned by the WP11 cannot be automatically transposed for purposes of justifying the restrictive effects of applying CFC rules on fundamental freedoms.\textsuperscript{37} In that respect, it should be noted that in result of applying CFC rules a foreign legal and tax personality of a CFC is ignored which is seen by the CJEU as the main restrictive effect on fundamental freedoms.\textsuperscript{38} Provisions countering free transfer of tax deductible expenses or losses, in turn, are not so much far reaching as they do not ignore the legal and tax personality of a foreign entity. Instead of it, their application affects only some


\textsuperscript{36} For example, in case of the application of free movement of capital, as opposite to the freedom of establishment, the question of an actual establishment should be distinguished from the question regarding genuine investments. Similarly, if the freedom of establishment requires to carry on genuine economic activities in the Member State on a stable and continuous basis, whereas under freedom to provide services it is sufficient to carry on activities on a temporal basis.


\textsuperscript{38} See the CJEU’s judgment of 12 September 2006 in the \textit{Cadbury Schweppes} case C-196/04, ECR 2006, p. I-07995, paragraph 45.
transactions between controlled entities. Hence, since the application of CFC rules has clearly more restrictive effect on fundamental freedoms than application of thin capitalization or transfer pricing provisions, it is logical to establish and apply the higher threshold for justifying such restriction for CFC rules than for the latter legislation.

On should, however, notice the analogy between the artificiality factors relevant for situations covered by thin capitalization or transfer pricing provisions under the CJEU’ case law on the one hand and for CFC rules under AG P. Léger opinion in the Cadbury Schweppes case on the other. Artificiality in the former case implies no business purposes for providing a loan or paying business expenses and the lack of arm’s length conditions. In the latter case for this purpose it is relevant to determine the lack of genuine nature of the activity provided by a CFC and the lack of economic value added of activity of a CFC with regard to the parent company and the entire group. Both types of factors in fact converge as they concern payments for services that are either over or under paid, comparing to their real value, and/or economically redundant for recipients of such services. All such payments can be seen as being artificial and their predominant or sole purpose is to divert profits from high tax EU Member State to low tax EU Member State or third country. Such payments constitute artificial income and CFCs may be considered as wholly artificial arrangements to the extent to which they derive this income. Consequently, if an application of CFC rules leads only to taxation of the artificial income, such CFC rules may be considered as being applicable only to wholly artificial arrangements. In other words, this type of CFC rules would allow for taxation exclusively the income that is not derived from genuine economic activities.

The point is, though, that beyond the new UK CFC rules which aimed to apply only to income “artificially diverted” from the UK, there are not CFC rules in force that apply exclusively to such income.

39 See the opinion of AG P. Léger delivered on 2 May 2006 in Cadbury Schweppes case C-196/04, paragraphs 111-114.
40 See similar conclusion with respect to CFC rules applying substance test for defining the CFC’s income in WP11, Public Discussion Draft BEPS Action 3: Strengthening CFC rules, paragraph 90 (in fine).
42 See Dahlberg, M., Wiman, B., General Report: The taxation of foreign passive income for groups of companies, Cahiers de droit fiscal international Vol. 98a, IFA 2013, Copenhagen, pp. 34-36.
Still, even the UK CFC rules are seen by many practitioners as not being fully compatible with EU mainly because of the lack of excluding their application to CFCs actually established in another Member State and carried on genuine economic activities there. Moreover, these rules are extremely extensive, running to 104 A4 pages, complex and complicated. Thus one may wonder if all tax compliance’ burdens related to their application are not too heavy to not constitute for taxpayers undue administrative constraints and if these rules meet the requirements of the principle of legal certainty in accordance with which domestic provisions must be clear, precise and predictable as regards their effects, in particular where they may have unfavourable consequences for individuals and undertakings. The both of those features of the UK CFC rules may be considered in the light of the CJEU’ case law as not being proportional to the objective pursued by them.

By contrast, CFC rules application of which leads to taxation of artificial income exclusively that are not that mind-blowingly extensive, complex and complicated will most likely be compatible with EU law.

3 Conclusions and recommendations
Due to the all reasons mentioned above I argue that the discussed recommendations of the WP11 under BEPS Action 3 are not entirely appropriate and thus should not be followed by Member States in order to provide the compatibility of their CFC rules with EU law. Indeed, the concept “wholly artificial arrangement” is not very clear and simultaneously its application significantly reduces the effectiveness of CFC rules of EU Member States, but increasing such effectiveness cannot be done by inappropriate interpretation of the CJEU’s case law regarding the compatibility of CFC rules with EU law. In my view, following the criticized by my recommendations of the WP11 entail the risk of drafting CFC rules in a way that they will be applicable automatically after meeting uncertain conditions for their application without a need for an analysis of a genuine economic substance and activities of the CFC. This does not seem to be proportionate to the purpose of CFC rules that may be considered to be compatible with EU law.

44 See the CJEU’s judgment of 5 July 2012 in SIAT case C-318/10, ECR 2012, ECLI:EU:C:2012:415, paragraph 58. See also to that effect the CJEU’s judgments of 7 June 2005 in the VEMW and Others case C-17/03, ECR 2005, p. 1-4983, paragraph 80 and of 16 February 2012 in the Costa and Cifone joined cases C-72/10 and C-77/10, ECR 2012, paragraph 74.
I observe that doubts regarding an understanding of the concept “wholly artificial arrangement” has been interpreted by the WP11 under Action 3 in favor of Member States. However, I my view, such doubts should neither be interpreted (i) in favor of taxpayers nor (ii) Member States (tax authorities) but (iii) in favor of development of internal market. The main argument speaking in favor of it is that establishment and development of internal market constitute one of the most important purpose of functioning of the EU and therefore the internal market is the key standard on which the Court built its case law, including the one establishing the concept of “wholly artificial arrangement”.

The results of interpretation of the concept “wholly artificial arrangement” in favor of taxpayers and Member States may distort developments of internal market. It stems from the fact that under the first method of interpretation the pressure would be put on the part “wholly”. Thus, even blatant CFC tax avoidance schemes having marginally commercial purpose and substance would not be combated by CFC rules. That is to say, an interpretation of the concept “wholly artificial arrangement” in favor of taxpayers may lead to the lack of application of CFC rules to CFCs predominantly, but not wholly, disengaged from business activities and essentially established and used for tax motives constitutes a vividly inappropriate incentive to the EU cross-border activities that may result in non-taxation of an income generated within the EU. An arrangement similar to “double Irish with Dutch sandwich” is a good example of the CFC tax avoidance arrangement that should fall within the scope of application of CFC rules, but, most likely, under the said interpretation it would not be wholly artificial and thus falls outside the scope of their application.

Following the interpretation of the concept “wholly artificial arrangement” in favor of Member States, in turn, may place the center of gravity to proving the existence of “real

48 In that regard one may conclude that the high complexity of the US CFC rules combined with the check-the-box rules allow US-based multinational companies to defer their tax on foreign sourced income infinitely, which gives them a clear competitive advantage on international arena. See Van Weeghel, S., Emmerink, F., Global Developments and Trends in International Anti-Avoidance, Bulletin for International Taxation 2013, No. 8, p. 434.
establishment” instead of “wholly artificial arrangement”. It could lead to pushing boundaries of unacceptable tax avoidance at the EU level to the domestic level. As a result, CFC rules might be construed and applied by tax authorities of Member States in still too restrictive (not proportional) way⁴⁹ so that the EU cross-border genuine activities of taxpayers controlling CFC that deserve the protection under fundamental freedoms could be targeted by CFC rules. This will be detrimental for development of internal market.

One may also say that since the concept of “wholly artificial arrangement” has been developed by the CJEU as the justification for applying CFC rules in a restrictive manner for fundamental freedoms under the “rule of reason”, its interpretation requires reasonable approach. It is reasonable to assume that “wholly artificial arrangement” is an arrangement used by taxpayers predominantly for tax avoidance purposes, while its commercial purposes and substance is merely marginal,⁵⁰ and, when, after analyzing all relevant facts and circumstances, it is clear that tax advantages of exploiting such arrangements considerably overweight their non-tax (commercial) advantages. Even if such interpretation visibly deviates from the linguistic meaning of “wholly artificial arrangements”, it nevertheless is in line with establishment and development of internal market. Since the latter constitutes one of the most important purposes of functioning of the EU, the said interpretation seems to be the appropriate, purposive interpretation of the autonomous EU’s concept. As it was metaphorically put by M. Lang:

Any interpretation that contents itself with the mere wording of a rule would indeed not correspond to the state of the art of legal method [and] (...) send us back to the stone age of legal method (...).⁵¹

To sum up: the effectiveness of CFC rules within the EU can be strengthened by narrowing the scope of their application to artificial income. Such CFC rules would allow for taxation solely the income that is not derived from genuine economic activities⁵² and therefore they may be considered as being applicable only to wholly artificial arrangement under understanding of this concept given to it by its reasonable interpretation in favour of development of internal market. Consequently, proving the “whole artificiality” of a CFC would

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⁴⁹ With respect to the Norwegian CFC rules see Kuźniacki, B., EEA Exemption from Norwegian CFC rules, Skatterett 2014, No. 3, pp. 275-283 and 301.
⁵² See similar conclusion with respect to CFC rules applying substance test for defining the CFC’s income in WP11, Public Discussion Draft BEPS Action 3: Strengthening CFC rules, paragraph 90 (in fine).
not be necessary to apply CFC rules which make these provisions more effective with preventing tax avoidance and simultaneously taxation only "artificial income" derived by the CFC would not infringe developments of internal market but rather enhance it by eliminating unfair tax competition and unbalanced allocation of taxing rights between Member States. Eventually, the recommended by me CFC rules could be the same for EU Member States and non-EU Member States, since their effectiveness will be high in either case.

Yours sincerely,

[Signature]
To:
Achim Pross,
Head, International Co-operation and Tax Administration Division
OECD/CTPA

Public Discussion Draft – BEPS Action 3: Strengthening CFC Rules

Dear mr. Pross,

We are pleased for the opportunity to submit our comments on the OECD Public Discussion Draft BEPS Action 3: Strengthening CFC rules (the Draft).

In this respect, we respectfully provide hereinafter our observations in relation to the preliminary considerations reported in the Draft, addressing some of the specific questions identified therein.

General remarks

i. The Draft is targeted on the design of the Controlled Foreign Company (CFC) legislation. Following the mandate developed by the Action Plan on Base Erosion and Profit Shifting (OECD, 2013, 20), the objective of the Discussion Draft is to "develop recommendations for CFC rules that are effective in dealing with base erosion and profit shifting" (pages 6 and 7). In particular, one of the BEPS concern “is the possibility of creating affiliated non-resident taxpayers and routing income of a resident enterprise through the non-resident affiliate” (OECD, 2013, 20). This objective can lead to two different approaches (and to the following, logically consequent, recommendations):

a. On one hand, CFC legislation can be intended to cover any form of foreign investments made by resident companies (or entities), irrespective of the level of taxation of the country where the CFC is resident and of the nature of the activity carried out. CFC legislation must thus apply to the whole (active and passive) income produced in the foreign jurisdiction, without exceptions. In this approach, CFC legislation shall be characterized as systemic, leading to the realization of the Capital Export Neutrality (CEN);

b. On the other hand, the above mentioned objective can be fostered through an anti-abuse legislation, targeted on the aim of
preventing the use of low-tax jurisdictions and/or artificial shifting of income to low-tax jurisdictions. In this case, CFC legislation shall be designed to exempt the so-called “active income”, i.e. income that is economically linked with the CFC jurisdiction, and aimed at preventing exclusively the shifting of income to low-tax jurisdictions.

The Draft should specify which of such approaches underlies its considerations, since it is rather ambiguous on the point. For example, page 9 of the Draft states that the exemption of “active” income is not “entirely effective in combating BEPS”; page 10, dealing with the consistency of CFC legislation with European Union (EU) Fundamental Freedoms, hints on the possible application of “CFC rules equally to both domestic subsidiary and cross-border subsidiaries”; pages 21 and 22, discussing about the threshold requirement, report that a “low-tax threshold can, however, mean that CFC rules do not prevent all base erosion and profit shifting, since they still allow erosion of the parent jurisdiction’s base to high-or medium-tax jurisdictions, so a few jurisdictions do not include such a threshold”. On the other side, the same Draft judges inadequate for the BEPS objectives the “full-inclusion systems”, since it “will catch categories of income that do not raise specific profit shifting concerns” (page 34) or it draws a clear distinction between transfer pricing rules, aimed at re-establishing the fair allocation of the tax base among the different jurisdictions, and the CFC legislation, which, only in certain circumstances may have the same effects (page 13).

In our view, CFC legislation should curb only the artificial transfer of income to low-tax jurisdictions. Accordingly, only income not economically connected with the jurisdiction where the CFC is resident should fall within the scope of application of the legislation and, therefore, be attributed to the parent company. This rationale is wholly consistent with the BEPS objectives to contrast the profit shifting as well as with the competitiveness concerns balanced with them. In addition, the approach appears fully coherent with the EU Fundamental Freedoms, which allow the justification of the CFC legislation only in the case the CFC is a “wholly artificial arrangement”. The theoretical foundations of this perspective lies in the economic freedom and free competition. It must be recognized to enterprises the freedom to decide the place to make their investments, also on the grounds of the (effective) tax rate of the jurisdiction. The sole restrain is the reality of the foreign establishment, in terms of economic integration with the jurisdiction.
ii. The Draft does not address the issue relating to the consistency of the CFC legislation with tax treaty law. The reason may probably be found in the 2003 update to the Commentary, which has expressly stated that tax treaty law does not prevent the application of CFC legislation (paragraph 23 of the Commentary to Article 1 of the OECD Model Tax Convention). This conclusion is based on the inquiry on the legitimacy of the anti-abuse provisions adopted by domestic jurisdictions to counteract the circumvention of tax treaty law. Assuming that there is no reason why the Draft reaches a different solution, this is an indirect confirmation that CFC legislation has (or should have) an anti-abuse purpose, leading to the protection of the domestic tax base.

iii. According to the Draft, the recommendations will ideally be the same for EU Member States and non-EU Member States. This conclusion must in principle be encouraged and fostered, since it reduces the compliance costs for enterprises and strengthens the coherence of the project. On the other hand this approach may also be a threat for the realization of the objectives of the project, insofar as the basic foundations of the EU Internal Market are not in line with the prevention of profit shifting.

Notwithstanding the efforts carried out by the Draft (pages 9-11), the ECJ case-law remains steadily based on the “wholly artificial arrangements” doctrine developed in *Cadbury Schweppes* (case C-196/04). According to this doctrine, Member States cannot introduce any tax hinder – such as the CFC legislation – to the establishment in another Member State jurisdiction insofar it encompasses a genuine economic link with that jurisdiction. In different words, the CFC legislation is applicable only if the establishment does not involve (a) the exercise of an economic activity and (b) a physical location. The arguments developed by the Draft seem to be in this respect either misleading or not perfectly consistent with the aims of the CFC legislation.

iv. In particular, the Draft refers to paragraph 81 of the case C-524/04, *Test Claimants in the Thin Cap Group Litigation*, reaching the conclusion that the EU Fundamental Freedoms may also be justified by those national measures “targeted at arrangements that are not wholly artificial” (par. 11). This assumption is based on the statement that domestic legislation can design objective elements in order to determine “whether the transaction in question represent, in whole or in part, a purely artificial arrangements, the essential purpose of which is to circumvent the tax legislation of that Member State”.


Even from a simple literal interpretation, it can be inferred from the mentioned statement that the quantitative qualification – “in whole or in part” – is not an attribute of the “artificial arrangements” but, differently, of the taxable transactions. The Court stated that the objective element of the domestic measure can lead to the wholly or partial recharacterization of the transaction (as distribution of dividends). In particular, the question concerned the UK legislation allowing the recharacterization of intragroup interest payments as dividends only insofar they exceed the arm’s-length basis. This interpretation is confirmed by the following paragraphs of the decision. Reference, uniformly throughout the decision, is made to the “purely artificial arrangements”, in paragraphs 82 and 83 (“the consideration of those elements leads to the conclusion that the transaction in question represents a purely artificial arrangement without underlying commercial justification”). At the same time this interpretation is confirmed by the mentioned Itelcar judgment (case 282/12), which defines the “wholly artificial arrangement” as the absence of any “economic reality”, having the “sole purpose (...) to avoid the tax normally payable on the profits generated by activities carried out on the national territory” (paragraph 34). In addition, the analysis of the Draft overlooks the recent EFTA Court decision in the cases E-3/13 and E-20/13 (9 July 2014, Fred. Olsen and Others and Petter Olsen and Other). First of all, we highlight that both ECJ and EFTA Court have stated the need to ensure the uniform interpretation of the common rules contained in the EEA Agreement and in the EU Treaties (case C-286/02, Bellio Fratelli, paragraph 34). Secondly, as far as the interpretation of the “wholly artificial arrangements” is concerned, the EFTA Court has recognized that the expression involves the lack of any “economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory” (paragraph 167).

v. The arguments developed by the Draft are also not entirely consistent with the objectives of the CFC legislation. We have already expressed the view that the rationale behind this legislation should be the prevention of abusive practices, aimed at transferring income that is economically connected to the parent jurisdiction to low-tax jurisdictions. In this sense, CFC legislation should be targeted on fictitious establishments, i.e. establishments without any economic substance in low-tax jurisdictions. According to this premise, the balanced allocation of the taxing rights among Member States perfectly overlaps with the “wholly artificial arrangements” test. Member States are allowed to capture only the income that is economically connected with their jurisdictions and is
fictitiously localized in low-tax jurisdictions. In the ECJ cases quoted in the Draft, the balance allocation motive was employed to justify those regulations which taxes (or not, as in the Oy AA) income effectively accrued in the jurisdictions which exerted the power to tax. This is also the solution adopted in the more recent ECJ decisions on the compliance with the Fundamental Freedoms of exit taxes (cases C-470/04 and C-371/10). In this sense, the balanced allocation of taxing rights justification may have (at least) two different meanings. The first, is systemic and concerns the Member States’ power to tax income (and capital gains) accrued within their jurisdictions (but also allows the exclusion of the income produced and the losses suffered outside the jurisdiction). The second meaning has an anti-abuse purpose and involves the power to tax income (and capital gains) fictitiously localized in low-tax jurisdictions (for further references on this point, see B.J.M. Terra and P.J. Wattel, European Tax Law, Alphen aan de Rijn, 2012, 922 ff.). Anyway, a position favourable to the extension could be found in the quoted case Olsen, which, though in a generic and widen way, states: “[i]that type of conduct must be considered such as to undermine the right of the EEA States to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardise a balanced allocation between EEA States of the power to impose taxes” (paragraph 168).

vi. In order to avoid any problem of compliance with EU Fundamental Freedoms, the Draft refers to the adoption of the same regulation both for cross-border and pure domestic situations, as already tested in Denmark. In practice, this solution leads to the introduction of a pass-through approach also for the resident members of group of companies. Aside from any constitutional issues which this solution may involve in some Member States, it is questionable whether this proposal solves any EU law problems. In order to be consistent with the supranational level, in fact, domestic and cross-border regulation must be wholly uniform and extended to all Member States. Any exception to this uniformity, i.e. any exclusion of items of income o jurisdiction, may lead to the violation of the Fundamental Freedoms.

However, the very issue at stake of this solution is its coherence with the aim and the structure of the CFC legislation in discussion. It is clearly evident that the extension of the look-through approach to domestic groups of companies and to all cross-border situations is not properly proportional with the contrast of base erosion and profit shifting, which can be easily reached through the genuine economic link approach.
vii. Following to the premise that the recommendations contained in the Draft shall be applicable alike to EU Member States and non-EU Member States, we kindly invite to analyse the CFC provision contained in the Corporate Consolidated Tax Base (CCTB) proposal of 16 March 2011 (COM(2011)121. Article 82, in fact, deals with the direct imputation of the income of third State entities to the EU parent. The analysis of this article should have two goals: (a) harmonize the OECD and EU approaches; (b) learn the EU Institutions approach on the issue.

Chapter 2: Definition of a CFC

1. *Would any particular practical issues arise from treating transparent entities as separate entities in the cases listed above? If so, what are they and how could they be dealt with?*

viii. The application of CFC rules in respect of tax transparent partnerships that are treated as taxable entities under the laws of the parent jurisdiction requires further clarifications as to the application of low tax thresholds (Chapter 3). Tax transparency would indeed imply that the low tax threshold is always met if taxes applied at the level of the CFC are only taken into account. It would hence be appropriate to clarify that the effective tax rate of the tax transparent partnership (par. 43) shall be determined taking into account taxes applicable in the CFC jurisdiction on the partnership’s income both at the level of the partnership and at the level of the partner.

2. *Should the recommendations consider any other issues related to determining which entities could be considered to be CFCs?*

ix. It may be appropriate to consider the exclusion of some entities from the scope of CFC regulations. We refer, in particular, to the case of collective investment vehicles that may typically have the legal form of a company, trust or partnership. The tax regimes of such vehicles is generally aimed at providing for a neutrality between direct investments and investments through the vehicle (par. 6.8 of the Commentary to Art. 1 of the OECD Model). It may hence be appropriate to provide for a carve out for such vehicles to the extent they are widely-held, hold a diversified portfolio of investments and are subject to investor-protection regulations in the country in which they are established.

Chapter 3: Threshold requirements
4. What practical problems, if any, arise when applying a low-tax threshold based on an effective tax rate calculation?

5. How could these problems be addressed or mitigated?

x. We believe that the determination of the effective tax rate should be based on the ratio of the actual tax paid in the CFC jurisdiction to the total taxable income computed according to the jurisdiction of the parent/shareholder’s country and not by referring to international accounting standards such as IFRS. The computation of the taxable income according to the jurisdiction of the parent/shareholder’s country is indeed in any case required if the low-tax threshold is determined as a portion of the parent company’s own rate. By contrast, International accounting standards are rarely adopted for the purpose of statutory accounts so that reference to such standards would require a complex reclassification of the CFC accounts. The same practical reasons that led to exclude the adoption of IFRS for determining income to be attributed to the parent company (paragraph 132(4) of the Draft) shall a fortiori exclude a reference to such standards for the purpose of verifying the preliminary conditions for the application of CFC rules.

xi. Practical problems in determining the effective tax rate of the foreign company arise in relation to losses carried forward. Indeed, in case of acquisition of the control over a company with tax losses carried forward, such losses would have to be recomputed on the basis of the rules applicable in the parent jurisdiction and such a recomputation may not be possible due to the lack of available information for past tax periods. For simplification purposes it may hence be considered to avoid considering losses realized prior to the acquisition of the control for the purpose of computing both the parent company’s tax rate and the foreign effective tax rate. Similar issues arise in relation to the determination of the tax basis of the assets of the CFC to be used to determine the taxable income according to the rules of the parent company. Also in such a case a simplification is necessary that may make reference to the accounting value of the assets at the time of the acquisition of the control.

xii. Major practical interpretative issues and uncertainties may in our view arise from the indication reported in note 30 of the Draft that differences in the tax rules that do not raise policy concerns may not be taken into account in determining the effective tax rate. For example, notional interest deduction
mentioned in note 30 as an example of tax advantage not making sense in theory and increasing the risk of profit shifting may represent a legitimate tool to minimize the debt vs. equity tax bias rather than to attract offshore capital. Further guideline is hence required in this respect to avoid inconsistencies in the identification of the advantages that should not be taken into account in determining the effective tax rate.

6. Does the discussion above correctly address the situation of permanent establishments that are subject to a different tax rate than CFCs?

xiii. Paragraphs 34 and 63 of the Draft suggests the application of CFC rules to permanent establishments on a separate basis if the residence jurisdiction of the PE company applies the exemption method to the income attributable to the PE. It is however appropriate that the Draft clarifies that in such a case the effective tax rate of the company of which the PE is a part shall consistently be adjusted to eliminate the income attributable to such PE. Indeed, to the extent the jurisdiction of the parent company does not apply an exemption method, the effective tax rate of the participated company (determined on the basis of the taxable income computed according to the jurisdiction of the parent/shareholder) would not otherwise be meaningful.

Chapter 4: Definition of control

7. What practical problems, if any, arise when applying a control test?
8. Are there particular practical problems that arise when applying a control test that considers interests held by unrelated or non-resident parties? If so, what are they, and how can they be dealt with?

xiv. We do not fully share the statement made in par. 67 of the Draft that economic control focused on rights to the profits, capital and assets is a relatively mechanical test that is easy for both tax administration and taxpayers to apply. This may hold true in relation to corporate entities. However, due to the very broad subjective scope of CFC regulations outlined in chapter 2, they may also be applicable in relation to contractual arrangements (for example, trusts or collective investment vehicles), where there are different persons that are economically entitled to the underlying asset’s value and control the same assets. In other words, the formulation of the different types of control is targeted on companies not on different entities or contractual structures. The
latter is the case of trusts, in which also the “rights to the profits, capital and assets” may be wholly irrelevant. In the case of discretionary trusts, in fact, the general (and generic) criterion recommended by the Draft may be inapplicable (or, at least, unlikely applicable). The Draft should, in our view, deepen the analysis on the types of control in order to pinpoint different solutions for the different subjective situations.

xv. Paragraph 65 of the Draft specifies that if countries want to achieve broader policy goals or prevent circumvention of CFC rules, they may set their thresholds at a level lower than 50 per cent. Similarly, Par. 69 states that because owning 50 per cent or less could still allow parent companies to exert influence in certain situations, jurisdictions are free to lower their control threshold below 50 per cent. We believe that it would be important for the Draft to take a clear stance in excluding the application of CFC rules in situations where the shareholder does not have the power to exercise a definite influence over the participated company, limiting the application of CFC rules to minority shareholders only in case of circumvention of the control requirement. In the lack of a sufficient influence over the foreign company and its tax policy, the application of CFC rules would indeed not be consistent with its ultimate purposes to act as deterrent by preventing tax avoidance (paragraph 16 of the Draft). Needless to say that this issue falls within the general remark raised at point (i) of these comments. The application of the CFC legislation to situations when the parent company does not exert a definitive influence on the CFC characterises that legislation as a systematic one. As already stated, in this version, CFC legislation appears unproportioned to the prevention of base erosion and profit shifting.

xvi. The Draft is clear in clarifying that recommendations included in the document are only a minimum and that broadening the scope of control for the purpose of CFC legislation is not a recommendation, but rather an option available to countries that want to achieve broader policy goals. However, this does not take into account the strong interrelations between the various “building blocks” of the CFC regulations addressed in the Draft that cannot be examined on a stand-alone basis. This is manifestly evident in relation to the definition of control in Chapter 4, since the application of CFC rules to minority shareholders would exclude the practical viability of most solutions proposed in other parts of the Draft. Minorities shareholders would not indeed be in a legal position to obtain from the participated companies data and information required for the
application of such solutions. For example, they could hardly obtain the
information for the recomputation of the taxable income of the subsidiary
according to the rules applicable in their jurisdiction (as recommended in
Chapter III of the Draft for applying the tax threshold requirement) and would be
precluded from applying the partial inclusion system analysed in Chapter IV.

Chapter 5: Definition of CFC income

9. What are the practical problems with any of the three substance analyses set out
above? How could these practical problems be dealt with?
10. Do you have experience with applying substance analyses in existing CFC rules?
If so, how can these be made more mechanical while still accurately attributing
income?

xvii. Options one and three, referring to the contribution of the employees to the
income earned by the CFC and to business premises and establishment raise
major practical issues in relation to activities that to not require a material
amount of employees or premises. This is clearly the case for intra-group
financial services and holding companies, whose activities generally do not
require significant physical presence, as also acknowledged by the Commission

xviii. The viable independent entity analysis (option 2) is based on an exam of the
functions, risks and assets of the CFC that is possible only in case the CFC
belongs to the same group of the person applying CFC regulations. Only in
such a case the comments made in page 40 of the Draft as to the reduction of
overall administrative complexity and compliance costs may hold true. However,
on the other side, it is not in our view reasonable to assume that a minority
shareholder may obtain a disclosure of the transfer pricing analysis of the group
to which the participated company belongs. It is also unreasonable in our view
to assume that a minority shareholder may be in a position to apply the
suggested second or third options as a proportional test, thus determining the
substance and activities that would have to be performed to earn the CFC’s
income. As mentioned above, such a proposal shall hence necessarily be
coordinated with the analysis of the control requirement under Chapter 4 of the
Draft.
xix. In relation to the viable independent analysis (option 2), it would be appropriate to specify whether the statement that the capability to approve decisions is not sufficient to assess whether the CFC would have owned the asset is specifically referable to the example in page 37 of the Draft relating to IP-related profits or is rather intended to have a general application. The application of such principle in relation to, for example, intra-group financial services and holding companies, would indeed lead to the same issues highlighted in paragraph xvii above also in relation to the viable independent analysis approach.

Chapter 7: Rules for attributing income

26. What difficulties, if any, arise under existing CFC provisions for attributing income?

xx. Given that the purpose of CFC regime is to assert taxing rights over income that has been shifted to a low or no tax jurisdiction, the Draft should specify that income shall be attributed to the taxpayer that is economically entitled to the CFC income and for the amount corresponding to its actual entitlement. Paragraphs 145-147 are not entirely clear in this respect tying the income attribution to the determination of control (paragraph 145) and referring to each taxpayer’s “ownership” (paragraph 147). As mentioned above, there might however be a split between the economic and administrative rights that may derive from the nature of the entity or contractual arrangement (such as trusts or collective investment vehicles) or from the features the instruments owned by the taxpayers (such as, for example, preferred equity instruments). In such cases, in order to avoid double taxation or the attribution of the CFC income to more than one taxpayer, it would be necessary that the Draft clarifies that priority shall be given to the economic entitlement of the taxpayer to the CFC’s income.

* * *

We remain at your disposal for any further clarification needed on the above comments.

Yours sincerely

(Ludovici & Partners)
Dear Mr Pross

**BEPS Action 3: Strengthening CFC rules**

Matheson welcomes the opportunity to comment on the public discussion draft issued under Action 3 (the “Discussion Draft”) of the base erosion and profit shifting (“BEPS”) project.

Matheson is an Irish law firm and our primary focus is on serving the Irish legal and tax needs of international companies and financial institutions doing business in Ireland. Our clients include over half of the Fortune 100 companies. We also advise seven of the top ten global technology companies and over half of the world’s 50 largest banks. We are headquartered in Dublin and also have offices in London, New York and Palo Alto. More than 600 people work across our four offices, including 75 partners and tax principals and over 350 legal and tax professionals.

Comments made in this letter are made solely on our own behalf.

1 **Policy considerations – the scope of CFC rules**

The Discussion Draft suggests in a number of places that CFC rules can be designed either (i) to protect the parent jurisdiction’s base only or (ii) to protect against both stripping of the parent jurisdiction’s base and third countries’ bases. Countries should be discouraged from introducing CFC rules designed to protect against stripping of third countries’ bases as such provisions are more likely to give rise to unrelieved double taxation.

The Discussion Draft suggests two reasons why countries may wish to design their CFC rules to also protect against stripping of third countries’ bases:
(a) it may not be possible to determine which country’s base has been stripped (for example in the case of stateless income); and

(b) the BEPS Action Plan aims to prevent erosion of all tax bases, including those of third countries. [Our emphasis]

We do not believe that these reasons are sufficiently compelling to warrant a jurisdiction implementing CFC rules that are so broad in scope. Indeed, we believe that they overstate the scope of Action 3 and pay little regard to the work being undertaken by the OECD under the other 14 actions.

We agree with the statement at (b) that the BEPS Action Plan aims to prevent erosion of all tax bases but that is a statement in respect of the complete Action Plan, not just Action 3. To our mind the complete Action Plan should aim to prevent erosion of all tax bases by targeting particular types of base erosion under each action. While we accept that there may be some overlap between the various actions, we do not agree that the outcomes of each action should seek to solve all BEPS issues. CFC rules that are designed to capture erosion of third countries’ tax bases, in our view, are seeking to solve the types of base erosion that are targeted by other BEPS actions (in particular those addressed under Actions 8–10). It seems inevitable that such an approach will cause additional double tax issues for more taxpayers, particularly if it is adopted by numerous jurisdictions.

Separately, in response to (a), if it is not possible to determine which country’s base has been eroded, how can a tax authority be satisfied that some country’s base has been eroded?

While we accept that countries should be permitted to design their tax rules as they see appropriate, it is important that countries who seek to protect against stripping of the parent and third countries’ bases recognise that such CFC provisions are more likely to give rise to double taxation. Accordingly, such CFC provisions must include robust provisions to relieve such double taxation. An appropriate caveat should be included in the final report issued under Action 3 for countries that choose to design CFC rules to protect against stripping of the parent and third countries’ base.

2 Definition of a CFC

We generally agree with the approach adopted under chapter 2 of the Discussion Draft. However, we believe that further consideration should be given to the interaction of CFC rules and rules that permit entities to be treated as transparent for tax purposes. Countries that introduce such provisions do so to achieve legitimate policy aims. This seems to be overlooked in chapter 2, particularly under the broad option outlined in paragraph 37.

3 Low tax threshold

While we agree that the low tax threshold should be based on the effective tax rate, clear guidance should be given in the final recommendations on how the effective tax rate should be calculated. The Irish Department of Finance published a paper in October 2014 which examined the different methodologies that can be applied to determine effective tax rate (Effective Rates of Corporation Tax in Ireland: Technical Paper, April 2014).1 In that

paper alone, eight approaches for calculating effective tax rates on company profits are identified. Given the potential variance in approach to calculating effective tax rates, it would be useful if clear guidance was given on the most appropriate method.

4 Control

7. What practical problems, if any, arise when applying the control test?

We agree that it is appropriate to include legal and economic tests to determine who controls a company. We note that Working Party 11 is open to countries introducing a de facto control test. We believe that such a test will give rise to additional uncertainty for taxpayers. As noted in the Discussion Draft such assessments are subjective and it seems likely that different tax authorities could take different interpretations of the same facts. Further, it is not clear from the Discussion Draft how de facto control should be measured if more than one person exerts influence over a company. Clear guidance should be given by Working Party 11 on how de facto control should be measured and attributed to each controlling person if it is to be included as a viable option for countries in designing their CFC rules.

8. Are there particular practical problems that arise when applying a control test that considers interests held by unrelated or non-resident parties? If so, what are they, and how can they be dealt with?

It seems reasonable in principle that the interests of shareholders that are related are aggregated for the purposes of determining how a company is controlled. It is more difficult to comment on the proposal that the interests of shareholders who are “acting-in-concert” should be aggregated without an explanation of what is covered by that phrase. We would welcome some guidance on how the phrase should be interpreted.

We do not agree that the interests of non-resident taxpayers should be included when applying aggregation rules for the purposes of determining control. If such an approach is recommended, it will unjustifiably broaden the scope of CFC rules. This is likely to lead to increased instances of unrelieved double (or triple) taxation. Countries should be discouraged from adopting such an approach.

It seems clear that if indirect control is taken into account in the control analysis, the potential for double taxation will increase. Accordingly, the outcomes under Action 3 should recommend that specific rules should be included to relieve double taxation to the extent a jurisdiction takes indirect control into account in the control analysis.

5 CFC Income

9. What are the practical problems with any of the three substance analyses set out above? How could these practical problems be dealt with?

IP income

While we do not object to the employees and establishment substance analysis, we do not agree with the conclusions reached on page 38 or under the analysis in the example at paragraph 31. Both require a CFC that earns income from intellectual property (“IP”) to demonstrate that it had the skilled employees required to undertake the research and development (“R&D”) required to develop the IP. This interpretation seems extreme and
ignores the possibility of entities buying in IP (eg, from third parties). We note that this point recurs at paragraph 109 of the Discussion Draft. Has it been agreed that IP income that is earned in a jurisdiction other than where the R&D was undertaken should always be considered as CFC income? That approach is unreasonable where IP is acquired from a third party. If a CFC acquires IP on arm’s length terms from a related party and the CFC has sufficient personnel to manage and exploit the IP, we see no reason why that income should be treated as CFC income.

The BEPS process is focussed on profit shifting and not the transfer of economic activity from one country to another. Treating an entity that acquires IP as a CFC because it did not develop the IP moves beyond the stated aims of BEPS. It also seems to conflict with the developments under Action 8 which look to attribute arm’s length returns to companies involved in the development, enhancement, maintenance, protection and / or exploitation of intangibles. Transfer pricing principles require profit to be aligned with substance. Applying a broadly based CFC rule that focusses only on certain types of substance (for example in the case of IP income, development of the underlying IP) will conflict with transfer pricing principles and result in unrelieved double taxation.

**Proportionate and threshold approaches**

As noted in the Discussion Draft, applying a proportionate approach to CFC analyses will increase complexity and compliance for taxpayers and tax authorities. Accordingly, we consider that jurisdictions should be encouraged to adopt a threshold approach.

**Anti-base stripping proposal**

Paragraph 94 of the Discussion Draft suggests that an anti-base stripping rule could treat income from sales to related parties and income from sales to unrelated parties in the parent jurisdiction as CFC income. Whether the adoption of such a rule by a European Member State would be in compliance with EU law merits consideration. Paragraph 94 goes on to suggest that some countries could consider treating any income generated in a jurisdiction other than the CFC jurisdiction as CFC income. The compliance of such a rule with EU law should also be considered. However, separate to any EU law concerns, we consider that such a rule would favour larger economies with a larger customer base and will unduly penalise entities located in smaller economies. We do not understand why taxpayers with operating subsidiaries (with real substance) located in smaller economies should be penalised in this way.

12. Are there practical problems with applying the same rule to sales and services income and IP income?

We do not agree that it is appropriate to treat sales and services income as equivalent to IP income. Adopting this approach shifts the onus of proof to the taxpayer to establish that subsidiaries engaged in sales and services have adequate substance. This will place an additional compliance burden on taxpayers.

We understand that there is a risk that taxpayers may seek to re-characterise IP income as sales and services income. However, this risk could be addressed through anti-avoidance and re-characterisation rules where there is a nexus between the sales and services income and underlying IP.
If Working Party 11 recommends applying the same rule to sales and services income and IP income, the importance of a fair and reasonable substance test cannot be overstated.

16. What practical problems arise with applying the categorical approach and the excess profits approach?

**Categorical approach**

Following on from our reply to question 12, we do not agree that sales and services income should be categorised as passive income. In most case such income will be active and this should be reflected in the categorical approach. If sales and services income is categorised as passive income, virtually all income of operational CFCs will be treated as passive and taxpayers will be required to establish that the income of their CFCs is active. This will unnecessarily increase the compliance burden on taxpayers. We consider that the better approach is to treat sales and services income as active income unless the CFC cannot meet the requirements of a substance analysis.

**Excess profits approach**

We have fundamental concerns about the excess profits approach. To suggest that a “normal return” can be identified for any company is overly-simplistic and wholly lacking in foundation in the normal commercial world. At best, it may be possible to identify an average return for an entity operating in a particular industry or market (and this is what the Discussion Draft appears to be based on). However, to treat income in excess of that average return as CFC income is penally harsh on the more successful companies in any particular industry.

It is suggested that the excess profits approach could be targeted, for example, to situations where a CFC made use of IP acquired from or developed with the assistance of a related party. We do not agree that this approach is in any way targeted. Virtually any subsidiary of a multinational group will have use of group IP that has been developed by or with the assistance of another group company. The excess profits approach would therefore automatically apply to those subsidiaries even in the absence of any evidence of profit stripping.

If an excess profits approach is included in Working Party 11’s final recommendations, the calculation of a “normal return” should be based on established transfer pricing principles. Those principles will have regard to the particular circumstances of the relevant CFC, the assets it owns, the functions it undertakes and the risks it controls and manages. This should result in a more appropriate “normal return”.

We strongly believe that Working Party 11 should not endorse the excess profits approach. If such an approach is endorsed, the calculation of any normal return should be based on established transfer pricing principles and it should be combined with substance based exclusions.

6 **Computation of CFC income**

25. Does this chapter accurately reflect the issues that could arise with losses or are there any other situations that need to be considered?
It would be helpful if the final report issued under Action 3 explicitly confirmed that loss relief should be available in respect of CFC income to the same extent it would have been available had the CFC been resident in the parent jurisdiction. For example, to the extent the parent jurisdiction permits indefinite carry forward of historic losses, a CFC that was historically in a loss-making position should be able to obtain relief for those losses against future CFC income. In addition, to the extent there is more than one CFC in a CFC jurisdiction, CFC losses incurred by one should be available to offset the CFC income earned by another.

7 Attribution of CFC income

26 What difficulties, if any, arise under existing CFC provisions for attributing income?

We generally agree with the proposals set out in chapter 7 of the Discussion Draft. However, one point that is not addressed is how CFC income should be attributed when the various control tests applied by a jurisdiction result in more than 100% of the income of the CFC being allocated to shareholders. For example, shareholder A, located in the parent jurisdiction holds 60% of the shares in a CFC. Those shares permit it to exercise 60% of the voting rights and entitle it to 40% of the profits available for distribution. Shareholder B, also located in the parent jurisdiction, holds the balance of the shares, voting rights and rights on distribution. Under the legal test shareholder A would be attributed 60% of the CFC income. Under the economic test shareholder B would be attributed 60% of the CFC income. We expect that it is not the intention of Working Party 11 that 120% of the CFC income should be attributed to the shareholders in this example. However, it would be helpful if the final report issued under Action 3 explicitly addressed how these scenarios might be dealt with.

8 Double tax

28. Are there any other double taxation issues that arise in the context of CFC rules that are not dealt with here?

Following on from our reply to question 8, to the extent indirect control is taken into account for the purposes of a jurisdiction’s control analyses, the OECD should also recommend that those jurisdictions grant credit for CFC charges imposed on CFC income by intermediate jurisdictions. Failure to include such a provision will lead to double taxation. In addition, countries should be encouraged to include provisions that relieve double taxation under CFC rules where an entity held by unconnected parties in different jurisdictions is treated as a CFC in more than one jurisdiction.

For example, shareholder A, located in jurisdiction X holds 60% of the shares in a CFC. Those shares permit it to exercise 60% of the voting rights and entitle it to 40% of the profits available for distribution. Shareholder B, located in jurisdiction Y holds the balance of the shares, voting rights and rights on distribution. Jurisdiction X applies a legal test to determine control and attribute CFC income and under that test shareholder A would be attributed 60% of the CFC income. On the other hand, jurisdiction Y applies an economic test and under that test, shareholder B would be attributed 60% of the CFC income. The double tax treaty agreed between jurisdictions X and Y is very unlikely to allocate CFC charging rights and accordingly, 120% of the income earned by the CFC could be taxed in jurisdictions X and Y. These circumstances are more likely to occur if more countries adopt CFC rules based on the recommendations made under Action 3. Therefore, we
would strongly recommend that Working Party 11 make recommendations as to how double tax should be mitigated in these circumstances.

As noted in the Discussion Draft, where a transfer pricing adjustment reduces the income earned by a CFC in a CFC jurisdiction, that reduction should be reflected in the CFC charge applied in the parent jurisdiction. Although the Discussion Draft states that such circumstances may not be common, in our experience, we have seen an increasing propensity for tax authorities to make aggressive transfer pricing adjustments. We expect, therefore, that it may become increasingly common for the interaction of CFC rules and transfer pricing rules to give rise to double taxation. In our view, it is imperative that the final recommendations under Action 3 should provide that CFC charges should also be reduced to the extent a transfer pricing adjustment is made to the income of a CFC.

Thank you for the opportunity to comment on the Discussion Draft. Should you wish to discuss any of the points raised, please do not hesitate to contact us.

Yours faithfully

Sent by email, bears no signature

MATHESON
Comments on BEPS action 3: Strengthening CFC rules

Dear Sir or Madam,

MEDEF is pleased to provide comments on the Discussion Draft “Strengthening CFC rules” issued on the 31\textsuperscript{st} March (hereafter “the draft”).

French companies consider OECD’s work in general and BEPS Action Plan in particular as crucial if it is to provide a fair, competitive and coherent global fiscal landscape. The forthcoming changes are numerous and will have a gigantic impact on the running of their business. Companies are in the best position to identify difficulties related to implementation, to give feedback on the practical feasibility and to geographically and temporally assess the OECD proposals. They believe, however, that the operating mode, process and time-frame are inadequate to ensure a full and comprehensive analysis of the draft submitted for consultation. They regret the strengthening of this trend which will be detrimental to all: companies and Governments.

We understand the objective of the OECD when trying to tackle profit shifting through the implementation of an effective CFC regime.
However, we regret that instead of providing taxpayers and administrations with clear guidelines, this draft -as many others- appears as a wide range of options or possibilities. Our concern is that countries might use it to select the most appropriate one depending on their territoriality principle/type of activities located in their territory/tax regimes or CIT rate, for taxation purposes. This would inevitably lead to a confusing and unfair situation depending on the CFC regime adopted.

We believe that if a CFC regime should be internationally accepted, it should encompass the following criteria:

- **Active business:** Operational activities should be prevented from a CFC inclusion and the condition to prove the activity should be easy to provide (mainly substance in line with the activity carried out). This is a question of competitiveness among Groups headed in different countries.

- **Threshold:** Presumption that no low tax jurisdiction is involved if its nominal CIT rate is higher than a certain threshold (e.g. approx. half of the parent’s rate). The Tax Administration could rebut it if the ETR is lower (e.g. special tax holiday or deductions).

- **Scope:** Rebuttable presumption: all entities held at 50% or less and which are not fully consolidated under IFRS (or equivalent) is not a CFC.

- **Income’s inclusion:** Full inclusion mechanism only (which is acceptable if the exemption for operational activity is clear and broad).

- **Overlap:** only one CFC regime should apply at a time: it is the one of the ultimate parent (consolidated entity i.e. probably the one that will need to provide a CbCR soon). This avoids managing several regimes and significantly reduces the cases of double taxation (mainly the case of change of control of the ultimate parent – a 12 month holiday period could be provided in such a case to allow for some restructuring to limit the impact).

- **CFC regimes are not set up to complement TP rules:** TP issues deal with the cost of a transaction between two States whereas CFC deals with revenues located in a low tax country.

We hope our contribution will give you a clearer insight into our expectations.

We remain at your disposal and are willing to speak during the public consultation on the 12th of May, on the need to address double taxation issues.

Yours Faithfully,

Vanessa de Saint-Blanquat
General comments

1. Necessary clarification of the objective

It is not clear from the current draft whether Action 3 (§1) aims at tackling profit shifting of income from one entity - resident in a high tax jurisdiction - to an affiliate - resident in a low tax jurisdiction - OR, whether it intends to reallocate any unjustified or unfair profit (whatever its origin) earned by a low tax affiliate, to the parent as a last resort solution or a backstop to tax what may not have been sufficiently taxed elsewhere whatever the reason.

Since the right to tax the so-called profit shifting is different in both cases (i.e. the entity suffering the profit shifting in the first case and the parent or one of the parent of the affiliate in the second case) it is necessary to clarify this key policy consideration before designing the regime further.

We agree with the principles set forth in paragraph 3 for a CFC regime:

i) balance between taxation of foreign income and preservation of competitiveness of parent State,
ii) limitation of compliance costs versus effective rules,
iii) avoidance of double taxation.

However, we believe that many of the suggestions of the draft do not meet those criteria (e.g. excess profit, multiple applications of CFC regimes on the same income ...) and, worse, that it will be very problematic to find a way to implement them if the rules are as complex as some proposed in the draft.

We strongly believe that the OCDE should rather limit the scope of the CFC to its original purpose (i.e. taxing in the ultimate parent State passive incomes earned by controlled affiliates, resident in a low taxed jurisdiction, without the adequate substance to justify their localisation in said jurisdiction) and find which of the other BEPS actions is more appropriate to implement to address other potential profit shifting situations (e.g. transfer pricing, tax treaty, ...).

2. Necessary clarification of the standard

§4, 10: It is also not clear whether the current draft aims at defining a (minimum?) standard to be implemented by G20/OECD countries, or, only to provide for a menu with several alternatives to be elected by the States. Indeed, several paragraphs mention that States could adopt another approach (generally a wider approach than the one recommended by the draft to tax even more CFC income). We fear that if one State implements a wider CFC regime than the standard one, the principle of non double taxation of the same CFC income quoted above in §3 will not be met unless another State agrees to tax less.

§7 to 28: In terms of policy consideration, we believe that a CFC regime should be designed to only tax at the ultimate parent’s level the income of an affiliate resident in a low tax jurisdiction for tax reasons.
Therefore, competitiveness will be preserved because companies with genuine business will not be subject to a CFC regime even if their activities are located in a low tax jurisdiction. The regime will be EU compatible because when substance is consistent with the CFC’s activity, the CFC regime will not apply either. Administrative burden will be limited to exceptional cases since the deterrence nature of the CFC regime will in most cases prevent businesses to locate income in low tax jurisdiction for tax purposes. Since the number of entities will be limited a full inclusion system could be provided which is much easier to implement and to control than a proportional one.

We strongly believe that a regime applied only to controlled entities (legal or economic control) and providing for an exemption in case of genuine activity performed, but with a full inclusion, in case no exemption applies, is by far easier to implement than a regime with an extensive scope with partial inclusion. Moreover, it still acts as a deterrent since the tax cost is high if the entity qualifies for a CFC regime. Such a mechanism should also be EU as it is targeted to artificial arrangements.

The taxation at the ultimate parent only is justified since the objective is not to tax several times the same income and since the localisation of the ultimate parent is rarely tax driven. In case the ultimate parent’s State does not enforce a CFC regime, the second tier holding could be liable to apply its CFC regime. In addition since the ultimate parent is often the one bearing significant shareholder costs, it could be sensible to allocate taxable basis which has been diverted for tax reason.

3. Need to address double taxation issues

§20: We have identified at least 4 types of double taxation situations for which solutions deserve to be further addressed in the draft:

1. When an entity is subject to several CFC regimes due to the existence of intermediate holdings between the parent and the CFC

Example:
The income realised by the CFC might be taxed twice: in the UK (at the intermediary’s level) and in France (at the parent’s level).

Since UK and France do not have the same set of rules to compute the taxable basis of the CFC at their respective level (especially items giving rise to timing difference e.g. depreciation period/techniques, capitalisation vs expense) it might not be easy to demonstrate which tax paid in the UK gives rise to a tax credit available in France to offset the tax due in France on the same CFC income. It is even more complicated if there are additional layers or when the CFC is owned by different entities of the Group or when the holding structure changes over the time and the CFC do not keep its CFC tax attribute for the new controlling entity.

In case the parent company generates losses and the CFC generates profits that are lower than the parent’s losses. The parent company is not be able to use the tax credit (corresponding to the CIT paid by the CFC) although the CFC benefit has correlative reduced the amount of the parent’s loss. So a specific rule should allow the carry forward of the tax credit arising either from the CFC or the intermediate State.
1. **When the same income is earned by several entities and taxed under the CFC rules several times**

   **Example:** Dividend distribution from lower tier subsidiaries (ref § 99)

   If the dividend is fully taxable in France (i.e. participation exemption conditions not met) the same dividend could be taxed three times in France (twice via the taxation of CFC1 and CFC2 by virtue of the CFC rules and once when the French parent effectively receives the dividend from the US). It is also taxed at least at 5% in Belgium. The triggering event can happen at very different moments which complicates significantly the implementation of specific rules preventing double taxation of the same income within a group, even if there is no change in the shareholder chain. The work becomes impossible in case of change in the chain.

   If the French participation exemption applies, 5% of the dividend is taxed in France (at the level of CFC1, CFC2 and French parent) unless if there is a specific rule preventing double taxation of the same income. It is also taxed at 5% in Belgium.

   Please note that to date the French regime does not provide for a tax credit for taxes paid in another country than the CFC (indirect tax credit for the CIT and direct tax credit for any WHT).
2. **When other limitation rules than CFC rules apply to the CFC income**

*Example:* Interest limitation rules whatever the nature of the limitation (thin cap, interest barrier...)

Both Opco and Finco are resident in a low tax jurisdiction (the same or a different). French Parent will tax their income applying the French rules regarding interest deduction. It is assumed that Opco cannot deduct 100% of the interest paid to Finco under French rules. France will then tax 100% of the interest received by Finco and not deduct 100% of the expense incurred by Opco leading to a double taxation, unless it is specifically provided in the CFC rules that an income already taxed under a CFC regime shall not be taxed twice whatever the legal basis of the second taxation.

![Diagram](image)

3. **When a CFC is subject to a transfer pricing adjustment after a tax audit either with the parent as related party or with another affiliate as related party.**

![Diagram](image)

TP adjustment in the US leading to a higher taxation in the US several years after the FY (assuming no treaty between the US and low tax State)
France will tax Opco income as initially reported for FY 1 in the French FY2 tax return and the US will tax part of the profit of the CFC which has been qualified as a profit shifting after the audit in Y6. So the same profit will be taxed twice in two different jurisdictions unless a specific rule allows the French Parent to claim a refund even if the year of the taxation (FY1) is time bared.

To limit the impact of the overlap of those different rules it would be preferable to tax the income of the CFC only at one entity’s level. The most logical and less likely to be manipulated would be to designate the ultimate parent (e.g. the consolidating entity under IFRS or other GAAP).

Those double taxation risks exist already today and are not properly handled by the CFC regime. Should action 3 extend the number of States with a CFC regime and should the 15 actions of the BEPS plan be implemented it is sure that the number of double taxation cases will significantly increase (more TP reassessment, more interest nondeductible ...).

We also would like to stress that these double taxation issues might be multiplied or further complicated:

- after a merger or an acquisition as a result of which a group ends up with one or more new CFC entities to manage. The question of the filing of the income tax return is not resolved: should both the previous and the current parent complete it and hence produce two declarations?
- if the situation is modified in the course of the year (change of control following an acquisition): how and when should the date of control be assessed?
- when the CFC entity is in a benefit situation one year and in a deficit position the next one: the parent company will be taxed on the CFC income the first year but has no possibility to take into account the losses on the second year. There is currently no indication on how to treat losses. Would a carry-back be possible to avoid the double penalty (taxation at the parent level + no possibility to offset losses?)
- in the situation of timing/accounting differences: an allowance of 100 that is deductible at the CFC level in year N (taxable income 0 x 20%=0) will be added back in the parent taxable income (taxable income 100 x 33.33%=33.33 CIT). As this allowance is temporary it will be added back in the CFC taxable income in year N+1 (100 x 20%=20 CIT). The principle of annuality in tax matters prevents from the offsetting. The group is then subject to a double taxation on 20.

§21: We urge the OECD not to mix the transfer pricing concepts and logics with the CFC target. All the references to a detailed functional analysis (i.e. § 89 for the analysis of the substance) should be restricted to the TP area.

CFC rules should provide for an exemption for genuine activities as far as the location of the affiliate is not essentially driven by tax considerations.
Specific comments

Threshold requirements

§56: The benchmark rate should be significantly lower than the rate of the State applying the CFC and the average rate of the CIT rates in the world. France defines the level of taxation below 50% of its domestic rate which is justified since its corporate rate is high (38%). For countries having a lower rate the 75% threshold proposed might be appropriate. We believe that the targeted rates should be lower than [18%].

Note that some entities are incorporated in one State (usually for legal reason) and tax resident in another. In such a case the CFC jurisdiction should be defined as the State of the tax residency of the CFC and all the CFC analysis should be carried out at the level of the State of residency.

Definition of CFC income

§ 86-95: Substance based analysis is preferable to a form-based analysis in terms of implementation (control, compliance).

To define substance, we believe that the option 1 called “substantial contribution analysis” is much easier to implement than the two others and meet the objective to address artificial profit shifting in a low tax jurisdiction. The second approach is close to a functional analysis approach and the third one to a profit split approach (or the new nexus approach proposed for IP box).

§ 106: We do not believe that a CFC regime should treat differently sales and services income earned from related party of from third party. If the service provider has the required substance it should be exempted from CFC rules. Whether the remuneration is arm’s length or not is a TP issue (action 13). Within a MNE there are many intercompany services or sales due to the fact that an MNE tries to gather and specialise its support functions (e.g. creation of shared service centers) or centralize some activities to improve their optimization or cost efficiency (e.g. centralize team to manage procurement contracts). So if any entity with a significant part of its costs or turnover realized with related parties were to be deemed a CFC, many entities of a MNE could qualify as a CFC. It would not be consistent with the objective of a CFC regime to put a strict burden of proof on the taxpayers to rebut said presumption of profit shifting.

§117-125: We strongly urge the OECD to put aside the excess profit approach due to its complexity of implementation:

- The definition of the “normal return” expected is difficult to determine precisely: it depends heavily of the business profile and of the economic environment at the time of the decision so the methodology described is over simplistic.
- The determination of the return effectively earned is also difficult to compute since the “eligible equity” is hard to define especially at one entity’s level: which books, which currency, which period of time (usually costs are not capitalized at the beginning of a project)? ...
- When an investment is decided the expected return is computed over a certain period of time depending of the nature of the project : it is an average rate and the actual return
during the first years is often lower than the expected return and vice versa after a certain period.

- This method seems in contradiction with the substance analysis: why would any threshold be necessary if there (enough) substance?
- How can an approach be based on the income of intangibles when there is currently no international consensus on what an intangible exactly is and how its value should be determined (and consequently the associated income)?

For these reasons, we completely disagree with the statement in § 117 that the excess profit could be simpler and more mechanical.

In any case as stated in § 122 when there is a reference to the substance-based exclusion, it is essential that any business realized with the appropriate substance should not fall under the excess profit approach. Indeed, we do not see any reason why specific rules should be applied only because of a lower tax rate.

Considering the broad definition of the “intangible” in § 119, the scope of application of this proposed method could be significant. In any case it should not be extended further to other items than intangible for instance. Indeed, on top of the complexity, there is a bias in looking at only one entity to determine whether an excess profit has been generated from an activity. For instance in risky business requiring significant CAPEX (e.g. Oil & Gas, pharmaceutical …) it is not rare to incur losses on certain projects which happen to be not economically viable, and, earn standard or high revenues on other projects which prove to be worth. Since a CFC regime is determined at an entity’s level, the excess profit approach may lead to tax an excess profit realized in one State but not accept to deduct the loss in another country.
To: Achim Pross, Head, International Co-operation and Tax Administration Division, OECD/CTPA
Date: 30 April 2015
Re: Comments to the OECD’s discussion draft of 03-04-2015 on Action 3, (CFC’s) of the BEPS Action Plan

Dear Achim,

Here are my comments to the above draft (“the Draft”). I am happy to expand on any issues you require.

I want to break a lance for European multinationals. I think it is necessary to create fair competition with US multinationals and to preserve EU multinationals’ legal rights to a functioning internal market within the EU.

A. It is unfair to tighten CFC regimes for everyone but the US

While I agree that CFC rules are necessary to achieve the G20 goals regarding BEPS, I do not think that it is fair to apply CFC rules to all the world’s MNE’s, except for US ones. Irish-Dutch sandwiches and Luxembourg hybrids work, because the US subpart F rules do not. Thus many US MNE’s can grow internationally at single digit tax rates, whilst European competitors can only reinvest 85% or less of their profits into further growth.

In view of the very argument made in the last sentence of paragraph 11 of the Draft and as long as subpart F does not work, it would fair to:

i) require the US not to apply the check-the-box rules to subpart F going forward;
ii) implement an effective defensive mechanism in action 3, akin to the hybrid rules within Action 2; or
iii) allow for exceptions in other countries’ CFC rules, like the UK CFC finance company exemption.

B. EU governments should not avoid EU rules as aggressively as they say taxpayers are avoiding tax rules

When they are at the OECD, EU governments shed neither their obligations under the Treaty on the functioning of the EU (“TFEU”), nor their obligations under the Vienna Convention on the law of treaties regarding good faith. However, the Draft pushes (beyond) the limits of EU law in several instances. It will be a pity if EU governments neglect their EU duties in drafting OECD documentation, only to later argue before the Court of Justice of the EU (“CJEU”) that the OECD papers they drafted themselves, justify the restrictions EU governments impose on the EU fundamental freedoms.

The goal of the EU internal market is economic growth, just as the goal of the OECD. Therefore, the undermining of that market through back door restrictions on the fundamental freedoms is ultimately an undermining of the goals of both the OECD and the EU. The rules for these two cannot be the same, as the OECD is not striving to create an internal market. In addition, the OECD rules are soft law, the TFEU is not.

1. Re. paragraph 12, last sentence: it is not true that EU law only applies to CFC’s within the EU and the EEA. This has been clearly illustrated by the CJEU in its decision of 13 November 2014 (C-112/14), in which it determined that the UK law that taxed UK shareholders for capital gains realised by the non-UK companies they hold, constituted a restriction on the free movement of capital. The Draft does address this issue in footnote 31 on page 29, but without reference to the above case. In addition, the last sentence of that footnote may be worded overly restrictive.

2. Paragraph 14 encourages EU governments to avoid, if not evade, EU law. A couple of points:
   a. First bullet: The CFC rules must be applied on a case by case basis and taxpayers must be able to prove, without undue administrative burden, that their arrangements do constitute a genuine economic activity. This is not some voluntary action EU governments “could potentially consider”. This is an obligation which the CJEU and the EFTA Court have repeated time and again, see footnote 5 of the Draft, page 9; in particular the words “if, on each occasion”. See also Olsen and Olsen paragraph 173 in the Annex hereafter.

1 A further recent decision on EU law which deserves mentioning is the EFTA Court’s decision in Olsen and Olsen (E-3/13 and E-20/13) on CFCS’s of 9 July 2014. Highlights from this decision are included in the Annex to this letter.
b. Second bullet: The application of a government’s CFC rules to its own local companies is a “wholly artificial arrangement” by that government to evade EU law. I know no other country outside of the EEA that applies its own CFC rules to itself, especially not where a “meaningfully lower” rate is required to trigger the legislation; the reasons are obvious. This kind of legislation is the same as the very worst that governments accuse taxpayers of, and has been condemned by the Commission\(^2\) and Advocate Generals to the CJEU\(^3\) alike.

c. Third bullet: I do not understand “two more recent developments” and “in whole or in part”:

i. First, the bullet mentions one development only, the thin cap GLO decision.

ii. Second, Cadbury Schweppes was decided on 12 September 2006 and Itelcar 3 October 2013; the thin cap GLO was decided on 13 March 2007. Itelcar only talks about “wholly artificial” and does not mention “in whole or in part” or anything like it. How is 13 March 2007 more recent than 3 October 2013?

iii. Likewise the previously mentioned CJEU decision against the UK of 13 November 2014 also discusses “wholly artificial arrangements” without using the words “in whole or in part” and so does the EFTA court in Olsen and Olsen in 2014.

d. Fourth bullet: The references to both the cases relied on (Oy AA and SGI) are inappropriate.

i. OY AA: OY AA did not concern anti-abuse legislation: OY AA wanted to apply the Finnish tax consolidation facility to its UK parent. Finland allows for the consolidation to take place by letting the profitable company make a tax deductible gift to its loss making related party (so, contrary to footnote 13 of the OECD draft on page 11, this was not about intercompany lending either). So what the CJEU said was Even if the Finnish tax consolidation facility is not specifically designed to exclude ... purely artificial arrangements ... such legislation may nevertheless be regarded as proportionate to the objectives pursued, taken as a whole. This has nothing to do with anti-abuse legislation not being limited to wholly artificial arrangements.

ii. SGI: SGI concerned the denial of director’s fees paid by a Belgian company to a Luxembourg shareholder on the grounds that they were disproportionate compared to the benefits they conveyed. Paragraph 60 referenced in footnote 14 of the Draft starts with the word “First”. This in the very least should have led the Draft’s authors to look for “Second” (paragraph 65), and subsequently to read paragraph 71: National legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance where, first, on each occasion ... the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification ...for that transaction.

I do not understand how this case is used to argue that the “wholly artificial arrangements” criterion is not fully applicable in case of a balanced allocation of taxing powers.

In short, none of the points made in paragraph 14 are correct.

\(^2\) “In the Commission’s view it would be regrettable if, in order to avoid the charge of discrimination, MSs extended the application of anti-abuse measures designed to curb crossborder tax avoidance to purely domestic situations where no possible risk of abuse exists. Such unilateral solutions only undermine the competitiveness of the MSs’ economies, and are not in the interest of the Internal Market.” Commission Communication COM(2007) 785 final, page 6, 10-12-2007

\(^3\) “Nor am I of the view that, in order to conform with Article 43 EC, Member States should necessarily be obliged to extend thin cap legislation to purely domestic situations where no possible risk of abuse exists. ... Such an extension of legislation to situations falling wholly outwith its rationale, for purely formalistic ends and causing considerable extra administrative burden for domestic companies and tax authorities, is quite pointless and indeed counterproductive for economic efficiency. As such, it is anathema to the internal market.” Opinion AG Geelhoed, Thin cap GLO, Case C-524/04
In addition the following observations must be made with regard to EU law.

1. The OECD should be aware that there is a gap between “genuine economic activity” under EU law and “economic substance” in terms of OECD Model Convention and the Transfer Pricing Guidelines. This can be seen from the facts in cases such as Cadbury Schweppes, RBS Deutschland Holding (Case C-277/09) and the EFTA Court’s decision in Olsen and Olsen (E-3/13 and E-20/13). (see point A in Annex).

2. Further, EU multinationals have the right to put an economic activity – such as an inter-company financing vehicle – in an EU Member State, for the sole reason of that state’s low effective tax rate on financing activities, provided they pursue a genuine economic activity – such as intercompany finance. It is not for the OECD to recommend ways in which EU and EEA Member States can infringe these rights.

What does the above mean for CFC laws within the EU?

In short, the EU tries to emulate an internal market, just like the ones in the US, German and Switzerland have. Just as it would seem strange to have CFC legislation applicable between US states, German länder or Swiss cantons, the application of CFC rules between EU countries does not fit well (see Cadbury Schweppes).

Does this mean that there should be no CFC rules between EU countries? Yes.

Does this then mean that EU governments should tolerate BEPS within the EU? No.

It means that EU governments should make the internal market work, also for corporate income tax. This is very different from the EU governments trying to make the internal market work for everything but corporate income tax. It means that the EU governments should finally adopt the Common Consolidated Corporate Tax Base (“3CTB”) that they have been working on for several years and which successive Commissioners and the European parliament have given priority. Under a 3CTB (but not a 2CTB), actions 2 – 10 and 12 – 14 will all be dealt with and under 3CTB MNE’s will not be subject to double taxation in the EU either. One may wonder how EU governments can not work on 3CTB and still say that they do everything they can to fight BEPS.

C. Final observations regarding the Draft:

Re. paragraphs 98 and 99. Why are dividends CFC income if the parent country exempts them from tax, when they are received directly, instead of via the CFC? There is no BEPS as there is no revenue lost and it thus goes beyond the BEPS mandate. It becomes important in a full inclusion system, as it could dramatically lower a company’s threshold for being a CFC. Further, it is unlikely that a full-inclusion system is EU compliant as justifications for restriction on EU freedoms have to be proportionate and not go further than needed.

Re. paragraphs 123 to 125. This example is not realistic because: i) if the purchase price of the IP for 600 was at arm’s length, it is difficult to see why the income should not accrue to Sub B and ii) Sub B manufactures and sells; it is an active company; why should its income be subject to CFC taxation?

Re. paragraphs 82 and 83: As a full inclusion system will also target income which is not BEPS income, it would be neither EU compliant, nor stay within the boundaries of the BEPS mandate.

Re. paragraphs 128 and 129. I fully agree with footnote 60 and with conclusion leading up to footnote 61.

Thank you for taking the time to read this. I have registered to attend the public consultation of 12 May 2015. Should you wish me to elaborate on any of my points at that meeting, I would be happy to do so.

Yours sincerely,

Johann H. Müller
Annex – Highlights from Olsen and Olsen (cases E-3/13 and E-20/13)  

97 The essential feature of real and genuine business activities that constitute establishment is that a person or an entity carries on a business, such as by offering services, which are effected for consideration, for an indefinite period through a fixed establishment.

99 If a specific assessment reveals, for example, that the trust is involved in the management of a group’s companies or other activities for a group, such as managing a pool of resources, and its actual incorporation reflected its actual activities, it has to be regarded as a real and genuine economic activity, ...

141 That difference in treatment creates a tax disadvantage for the resident taxpayers who are subject to the legislation on CFCs. They are hindered in exercising their right of establishment because they are dissuaded from establishing, acquiring or maintaining an undertaking in another EEA State in which the latter is subject to low levels of taxation. That differential treatment constitutes a restriction on the freedom of establishment, ...

166 The need to prevent loss of tax revenue is not a matter of overriding general interest that would justify a restriction on a freedom guaranteed by the EEA Agreement (compare Cadbury Schweppes and Cadbury Schweppes Overseas, cited above, paragraph 49). For the purposes of preventing tax avoidance, a national measure restricting the right of establishment or the free movement of capital may be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and the sole purpose of which is to avoid the tax normally payable on the profits generated by activities carried out on the national territory (compare Case C-282/12 Itelcar, judgment of 3 October 2013, paragraph 34...).

168 That type of conduct must be considered such as to undermine the right of the EEA States to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardise a balanced allocation between EEA States of the power to impose taxes (compare Cadbury Schweppes and Cadbury Schweppes Overseas, cited above, paragraph 56, and case law cited).

173 In order to comply with the principle of proportionality, a measure pursuing the objective of preventing wholly artificial arrangements which do not reflect economic reality and whose only purpose is unduly to obtain a tax advantage must enable the national court to carry out a case-by-case examination, taking into account the particular features of each case, based on objective elements, in order to assess the abusive or fraudulent conduct of the persons concerned (see, for comparison, Glaxo Wellcome, ..., paragraph 99).

175 The intention to benefit from a tax advantage is not in itself sufficient to constitute an artificial arrangement and neither is the fact that the activities of the foreign entity could have been carried out by an entity established in the home State.

176 Therefore, an arrangement is not wholly artificial if the legal construction reflects economic reality in the State of establishment that can be certified on the basis of objective and verifiable elements set out in paragraphs 96 to 99 of this judgment.

177 If the assessment of those factors leads to the finding that the entity is a fictitious establishment not carrying out any genuine economic activity in the territory of the State of establishment, the creation of that entity must be regarded as having the characteristics of a wholly artificial arrangement there. That could be so in particular in the case of a “letterbox” or “front” subsidiary (compare Case C-341/04 Eurofood IFSC [2006] ECR I-3813, paragraphs 34 and 35).

179 In those circumstances, in order for the legislation on CFCs to comply with EEA law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC or the holding of assets that constitutes capital movement reflects economic reality

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5 A video discussion of the case is also available at https://www.youtube.com/watch?v=M6LsDgA4mtk
Historically, the captive insurance industry started in the early 1950's with the coverage of risks centering around the oil industry where the type of risks to which the oil industry was exposed were too large or unusual for the insurance industry to underwrite or cover. Consequently, industry itself established and placed these risks in insurance companies they either owned outright (100% of capital) or shared with other industry members who understood the nature of the risks and were willing to commit capital to try to manage (create loss prevention systems/disciplines, provide detailed risk analysis) their common exposures. Contrary to the impression given in the CFC ACTION plan (see 102), the risk analysis in a captive insurance contract is very detailed and the captive managers need expertise in understanding the nature of the risks insured by the captive to underwrite the risk. Generally, unless they are extremely large, the expertise needed to manage the various industry specialties needed for captives has been concentrated in the very large insurance brokerage firms like MARSH, who have the technical skills to rate the risks, find insurers to write the policies within the country where the insured is located if required by the laws where the insured is located and seek the reinsurance that the captive may need to spread the risk in the same manner that the insurance/reinsurance industry spreads risk on third party contracts.

Over the past 65 years the captive insurance industry has grown to include over 2700 companies formed and operating in many jurisdictions around the world. Below listed are the most popular jurisdictions of incorporation and licensing by insurance regulatory authorities of the companies located and regulated within the jurisdiction and an estimate of numbers of separate captive operations in each.

States of the USA: Vermont 588, SO.Carolina 145, Hawaii 184, total 817.
Bermuda 845, Cayman 759, Ireland 142, Isle of Mann, 125, Malta 31. Of the 1900 plus companies formed outside the USA, it is estimated that well over 60% of these non US incorporated captives are currently fully taxed as if they were US incorporated insurance companies under a provision of the IRS Code.

In many instances so called captives are also writing within the captive independent third party risks from unrelated parties as well. There are very few that underwrite only the risks within the parent company or its subsidiaries that provided the capital.

Action Plan 3 in relevant part seems to indicate that captive insurers are simply a vehicle to transfer profit from a high tax to low tax jurisdiction but each insurance contract with a captive bears significant risk of loss within the contract in the same manner as any insurance industry reinsurance contract whether it is related or unrelated to the owner of the capital outright or had an ownership/capital shared interest. Captives have ended in bankruptcy from time to time by misjudging the risks and incurring too much loss within their contracts against the capital they had which is a major reason why they are subject to insurance regulation.
For BEPS negotiators who do not fully understand insurance/reinsurance/or captive insurance BUT ARE CONCERNED about it's cross border nature and mobility, or suspicious of potential profit manipulation by reinsuring to a captive, the Year 2008 Change in THE INTERPRETATION OF THE ACCOUNTING DEFINITION OF WHAT CONSTITUTES AN INSURANCE/REINSURANCE CONTRACT SHOULD ALLAY THEIR CONCERNS. The 2008 accounting reporting change required that THERE MUST BE "SIGNIFICANT RISK IN THE CONTRACT and a REASONABLE POSSIBILITY FOR SIGNIFICANT LOSS" which can NOT BE REMOTE. (See ASC-944-20-15-46) The interpretation results in a much higher accounting standard than that which previously existed where the transfer of a 10% risk of a 10% loss was the standard. This accounting change in interpretation eliminated several categories of reinsurance including types of related party reinsurance which may have raised tax questions in the past concerning whether real SIGNIFICANT insurance risk OF LOSS was being transferred in the contract. The tax rules in most jurisdictions follow the accounting rules in measuring taxable income of any insurer including captives.

Lastly one misunderstanding/confusion that appears to creep into the action plan is that for most industry risks the insurer/reinsurer does not need to be licensed in the jurisdiction in which the risk is located in order to write the insurance policy. Property/casualty insurance and particularly catastrophic risk policies cover risks situated throughout the world in a single policy where the underwriting company may be licensed and have it's active business in the jurisdiction where incorporated. Personal lines insurance, like auto, homeowners, accident & health require a company to be licensed where the risk is located, all of which are not underwritten in so-called captives.
Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Mr. Achim Pross
Head, International Co-operation and Tax Administration Division
OECD/CTPA
2, Rue Andre’ Pascal
75775 Paris, France

Re: Comments on Discussion Draft on BEPS Action 3: Strengthening CFC Rules

Dear Mr. Pross:

The National Foreign Trade Council (the “NFTC”) is pleased to provide written comments on the Discussion Draft on BEPS Action 3: Strengthening CFC Rules, published on April 3, 2015 (the “Discussion Draft”).

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC’s Board of Directors is attached as Appendix I.

This letter is divided into two parts. The first part provides general comments and observations regarding the Discussion Draft as a whole. The second part addresses the specific elements of CFCs outlined in the Discussion Draft.

The preamble to the Discussion Draft on BEPS Action 3 begins by saying that the document does not necessarily reflect consensus views of either the CFA or Working Party 11 regarding the issues addressed. The headnote to Chapter 5 of the Discussion Draft says that the 2015 report on Action Item 3 will include recommendations on the definition of CFC income. It is unclear how consensus
will be gained on this very important issue, nor is how the CFC rules will be implemented articulated in the options presented in the Discussion Draft.

The introduction includes some fundamental policy considerations that need to be closely examined when designing CFC rules, such as how to strike a balance between the need to tax foreign income, and the need to maintain competitiveness in the system. The Discussion Draft states that there must be balance struck between jurisdictions with CFC rules that apply broadly (who may find themselves at a competitive disadvantage relative to jurisdictions without CFC rules), with those jurisdictions who apply their CFC rules more narrowly focused. This is a critical component of the Discussion Draft. If certain countries are “locked into” their current CFC regimes, and are unwilling to modify them, or if they are unable to adopt CFC regimes because of EU law, it seems unlikely that uniform CFC standards can be reached, and there will be inherent competitive disadvantages built into the system.

The preamble also includes a comment that refers to the consideration of a secondary rule, to apply to CFC income that had not been subject to “sufficient” CFC taxation in the parent company jurisdiction. While the Discussion Draft states that this proposal has not yet been considered by the CFA, the prospect of additional imposition of CFC-type taxes by third party jurisdictions is of great concern to the NFTC, as this would add significant complexity, administrative cost, as well as increased uncertainty.

The NFTC appreciates the commitment of the OECD Secretariat to coordinate the work on the development of CFC rules with the on-going work of the other parts of the BEPS Action plan. Unfortunately, the Discussion Draft does not make clear how such that coordination will occur, and there does not appear to be a clear interaction between the CFC recommendations and those on other actions. The NFTC would welcome more details on how the various Action Items will be reconciled to eliminate redundancy and potential conflict.

**General Comments**

The NFTC commends the OECD for addressing the important issues raised in the Discussion Draft and appreciates the opportunity to provide comments on the draft.

The BEPS mandate for CFC rules was for the Working Party to “develop recommendations regarding the design of controlled foreign corporation rules...that are effective in dealing with base erosion and profit shifting.” Does this mandate require the development of “best practices” recommendations that individual countries can choose to adopt and implement in their domestic law, or does the mandate require the development of a coordinated and consistent CFC policy that most countries would agree to implement in a consistent and timely manner? We are concerned that the lack of consensus that is apparent in the Discussion Draft will lead to a menu of options, which countries may adopt when one of the options is consistent with their domestic policy or concerns. The Draft acknowledges the EU member states may need to modify the CFC recommendations to comply with EU law. The NFTC is concerned that a recommendation that sets out only policy options will not result in clear and consistent implementation and interpretation of CFC rules, and will lead to greater compliance costs and uncertainty. This, in turn, will lead to double taxation and
Paragraphs 18 and 19 of the Discussion Draft discuss the scope of base stripping. There is an implied recommendation that CFC rules should be designed to protect against both base stripping in the parent jurisdiction, and “foreign-to-foreign” base stripping as well. This expands the scope of many current CFC rules and creates uncertainty over taxing rights, double taxation, and tax treaty application. We are concerned that the broader objective of the CFC rules appears to be the design of a principle of minimum taxation that will be applied to all multinational corporations when transfer pricing, interest deductibility restrictions, hybrid mismatch rules, and the recommendations on harmful tax practices does not lead to an effective tax rate that is within an “acceptable” range. We are also concerned that there could be discriminatory application of these rules by jurisdictions looking to tax particular industries that they consider to be “abusive.” The excess profits approach is a material change in the principles applied to international taxation. Deeming a level of return to some or all entities without reference to actual activities or investments is a radical change that has not been justified by reference to any specific information on the use of CFCs. At a minimum, an excess profits tax, is a fundamental change in international tax policy and practice and we strongly caution against its application.

Specific Comments

1. **Definition of a CFC**

The Discussion Draft recommends to broadly define the entities that are within the scope of CFC rules. Specifically, the Discussion Draft would include: corporate entities, partnerships, trusts, and PEs when those entities are either owned by CFCs or treated in the parent jurisdiction as taxable entities separate from their owners. It also sets out hybrid mismatch rules.

Any rules for the treatment of transparent entities as separate entities should be consistently interpreted and applied across all taxing jurisdiction, and appropriate consideration should be given to the treatment of the entity in intervening jurisdictions as well as in the parent’s jurisdiction. CFC rules that apply on an entity basis rely on the calculation of profits and taxes paid by that entity. Where the entity is transparent and is not required to prepare separate accounts, or is a branch or PE, and where full and separate accounts are not prepared, there will be additional administrative and compliance costs and challenges in obtaining the information required to do the CFC calculations.

The broad version of the hybrid mismatch rule may be easier in application because there is no requirement to determine whether there is a base-eroding mismatch, but both versions of the rule would require additional analysis and possibly substantial additional costs for the collection of information and preparation of returns.

2. **Threshold Requirements**

The Draft recommends excluding companies from the CFC rules by reference to a “low-tax threshold” based on an effective tax rate. Under the recommendation, in order for a parent company’s foreign subsidiary to be a CFC to which the CFC rules would apply, its effective tax rate would be meaningfully lower than the tax rate in the parent country. The low-tax benchmark should
be set at 75% or less of the statutory corporate tax rate.

Calculation of effective tax rates is frequently affected by differences in capitalization, amortization and/or depreciation of assets, timing differences, differences in revenue recognition between different accounting and tax regimes, loss calculations, and currency fluctuations. These can cause wide fluctuations in effective tax rates and can cause a temporarily low effective tax rates in a high tax jurisdiction where timing differences, investment incentives, or tax holidays are part of the local tax system.

Income splitting rules can create particular challenges for multinational corporations that operate through separate business units with no common management, accounting, or reporting systems. CFC rules that evaluate risk on a country-by-country basis rather, than on a separate entity basis, can create reporting difficulties for multinational corporations whose financial reporting systems do not make information readily available for country-by-country consolidation.

3. Definition of Control

The Discussion Draft recommends that satisfying either a legal or economic control test should be sufficient to constitute “control.” De facto tests may also be applied.

Control tests that include criteria other than readily available legal ownership or economic control will create significant practical problems. De facto control is difficult to establish without retrospective review of actions and analysis of the facts and circumstances, and will, in most cases also involve an element of subjective determination. Unless it can be established that a de facto control test is a requirement to address particular circumstances where base erosion is evident, the cost, complexity, and uncertainty caused by such a test cannot be justified.

4. Definition of CFC Income

The Discussion Draft does not provide recommendations for determining the types of income that should be included within the definition of CFC income. Although no recommendations are made, as we mentioned earlier in our comments, it was promised that the BEPS 2015 deliverables will include recommendations on the definition of CFC income.

The Discussion Draft states that CFC rules should attribute income that raises BEPS issues within each of the listed categories, and should not attribute income that arises from value-creating activity in the CFC jurisdiction. (¶ 85) The Draft also says that the CFC rules are designed to apply to only the stripping of the tax base of the parent jurisdiction and that income should not be attributed if it arises from value-creating activities in a non-parent jurisdiction. In paragraph 19, however, the Discussion Draft document says that foreign-to-foreign stripping is a concern, and that it may not be possible to determine which country’s base has been stripped.

The Discussion Draft mentions the importance of the foreign-to-foreign stripping for developing countries. Some governments, such as the U.K., have changed their CFC rules in recent years to protect their own tax base. This seems to be the underlying premise behind paragraph 85, but is contrary to other parts of the Discussion Draft on foreign-to-foreign base stripping.
The Draft provides three possible substance tests. All of the substance analyses have some practical problems and require a greater or lesser functional analysis to arrive at a reasonable conclusion with a suitable audit trail and rationale. Some tests are highly complex and difficult to interpret and apply, depending on the drafting and interpretation of the CFC laws in the parent jurisdiction.

The first option is a substantial contribution analysis, based on the U.S. CFC rules.

The second option is a viable independent entity analysis, based on the U.K. rules. The NFTC is concerned that this second option would be difficult to apply and would be subject to arbitrary enforcement by tax authorities. This option requires the greatest level of subjectivity and is, therefore, more likely to create dispute and controversy.

The third option is an employee and establishment analysis. We are concerned that this option does not take into account risk and asset ownership that it would be inconsistent with the work being done in Working Party 6 on transfer pricing, the taxation of intangibles, and risk and recharacterization.

The Discussion Draft evaluates the pros and cons of two potential approaches for accurately identifying and attributing CFC income that raises BEPS concerns: a categorical approach and an excess profits approach.

The Discussion Draft appears to be based on the view of international business that most transactions relate to high value products (with significant IP content) where sales and service income includes (or could include) an embedded royalty or other return for an intangible asset such that CFC treatment of sales and service, income is appropriate. The default position of paragraph 114, states that all sales and service, income should be treated as passive unless one of the substance analysis requirements can be met. There are many international business transactions where these assumptions are not appropriate, and where there is no direct link between sales or services income with valuable IP. This is reflected in the active trade or business test found in some existing CFC regimes. Reversing the burden of proof on the basis of limited analysis is unjustified. Enforcement of transfer pricing rules would address most (if not all) of the concerns relating to invoicing companies and the correct pricing of IP.

For most businesses, that follow a traditional business model, and CFC rules that define attributable income should be clear that sales and services income should only be included where there are significant related party transactions or other characteristics that would justify CFC treatment.

As we stated in our earlier comments, the excess profits approach is a material change in the principles of international taxation. Deeming a level of return to some or all entities without reference to actual activities or investments is a radical change and that cannot be justified by reference to any specific information on the use of CFCs. At a minimum, an excess profits tax, is a fundamental change in international tax policy and practice and we strongly caution against its application.
5. **Rules for Computing Income**

The Discussion Draft recommends using the rules of the parent jurisdiction to calculate the CFC’s income. The Draft further recommends that CFC losses be permitted to be used only to offset profits of CFCs in the same jurisdiction.

Many businesses experience practical difficulties in computing income of its CFCs, particularly where local reporting, accounting and tax information is not in the same ERP system used by the parent, and where there are differences between local accounting and tax rules and those of the parent’s jurisdiction. Many businesses are required to prepare duplicate accounting and tax reporting for the CFC to compute income under the same principles as the parent. They must maintain this data for several years to deal with balance carry forwards and tax adjustments. If different CFC regimes are adopted, this will exponentially increase the level of complexity and cost of compliance.

6. **Rules for Attributing Income**

With respect to the way in which the parent company includes CFC income in its own income, the Discussion Draft identifies five issues. Many existing CFC rules tie the income attribution to a determination of control. If a taxpayer meets a minimum control threshold, then that taxpayer would also have income attributed to it.

Footnote 65 states that to limit competitiveness concerns, countries could also adopt a top-up tax. Given the more detailed recommendations on how income should be attributed, it is surprising to see a potential recommendation floated in a footnote. "Top up tax" is not defined nor its features described, and the advantages and disadvantages of a top-up approach, and how such an approach would work in practice, are not vetted.

7. **Rules to Prevent or Eliminate Double Taxation**

The Discussion Draft provides that double taxation is a concern in three situations: 1) Where the CFC income is subject to foreign corporate taxes; 2) where CFC rules in more than one jurisdiction apply to the same CFC income; and 3) where previously taxed income is distributed or a resident shareholder disposes of its shares in the CFC.

Many countries have complex rules relating to the use of foreign tax credits against taxes due in the parent company’s jurisdiction. This complexity is made more challenging through audit adjustments to domestic and foreign income and taxes which can arise several years after the original taxable year. It is rarely a simple matter to obtain full relief for all foreign taxes paid and this is often made more difficult where the nature of the income received by the parent is dividend income or some other type of non-trading income. Double taxation can arise in situations not delineated in the Discussion Draft, such as where there has been a transfer pricing adjustment between two jurisdictions, and a CFC charge arises in a third jurisdiction. The Draft Discussion underestimates the actual complexity in calculating double taxation relief and makes an apparent assumption that relief will always be available, which is simply not the case.

Relief from double taxation is a major concern of our Members, and the lack of detail and
understanding of all of the situations where double taxation can arise is more than troubling. Additional and more detailed guidance on this issue would be welcome.

Conclusion

Most of the building blocks for best practices for CFC regimes included in this Discussion Draft include draft recommendations or options. The excess profits discussion is one of the key items on which the working group apparently cannot reach a consensus view. Another is the high level proposal to add a secondary form of taxation (perhaps in the source country). Unless countries agree to a degree of harmonization, these proposals will add significant complexity to an already complicated array of rules given the range of objectives and the way countries have chosen to apply their own CFC Rules.

The NFTC is concerned about the degree of latitude given to tax authorities in implementing CFC rules, and particularly its interaction with tax competitiveness concerns of some of the jurisdictions. The Discussion Draft recommendations will lead to a wider range of CFC measures being adopted by countries. Given the complexity of these proposals, together with the expected variation in the way they will ultimately be implemented, the CFC rules represent a significant administrative and compliance burden to multinational corporations. The overlap with the other BEPS work will exacerbate these very significant costs even further.

Sincerely,

Catherine Schultz
Vice President for Tax Policy
cschultz@nftc.org
202-887-0278 ext. 2023
Appendix to NFTC Comments on BEPS Action Item 3: Discussion Draft on Strengthening CFC Rules

NFTC Board Member Companies
McKenna Long & Aldridge LLP
ABB Incorporated
AbbVie Pharmaceuticals
Applied Materials
Baxter International Inc.
British American Tobacco
Caterpillar Incorporated
Chevron Corporation
Chrysler Corporation
CIGNA International
Cisco Systems
Coca-Cola Company
ConocoPhillips, Inc.
Deloitte & Touche
DHL North America
eBay, Inc.
E.I. du Pont de Nemours & Co.
Ernst & Young
ExxonMobil Corporation
Fluor Corporation
Ford Motor Company
General Electric Company
Google, Inc.
Halliburton Company
Hanesbrands Inc.
Hercules Group
Hewlett-Packard Company
Johnson & Johnson
JPMorgan Chase & Co.
KPMG LLP
Mars Incorporated
Mayer Brown LLP
McCormick & Company, Inc.
Microsoft Corporation
Occidental Petroleum
Oracle Corporation
Pernod Ricard USA
Pfizer International Inc.
PricewaterhouseCoopers LLP
Procter & Gamble
Prudential Insurance
Ridgewood Group International, Ltd.
Siemens Corporation
Sullivan & Worcester LLP
TE Connectivity
Toyota
Tyco International
United Parcel Service, Inc.
United Technologies
Visa, Inc.
Walmart Stores, Inc.
Public Discussion Draft

BEPS Action 3: Strengthening CFC Rules

Comments by Prof. Dr Pasquale Pistone

Shanghai, 23 April 2015

1. Introduction

Action 3 of the Action Plan on Base Erosion and Profit Shifting (BEPS) aims at strengthening controlled foreign company (CFC) rules. The goal of such action is to comprehensively and effectively counter tax deferrals that can be obtained by setting up a non-resident subsidiary in a low(er) tax jurisdiction. Stronger CFC rules are expected to interact with further actions aimed at neutralizing the effects of hybrid mismatch arrangements (Action 2), as well as limiting base erosion via interest deductions and other financial payments (Action 4).

A published discussion draft (the “discussion draft”) on BEPS Action 3 was released on 3 April 2015, and the Committee on Fiscal Affairs (CFA) has invited interested parties to submit written comments by 1 May 2015.

In the framework of an informal consultation held in Paris on 13 April 2015 with selected representatives from non-governmental organizations and academia, the author has already made some oral remarks on selected issues raised by the discussion draft.

2. Scope

This comment focuses exclusively on the problems of compatibility of CFC legislation with fundamental freedoms of the European Union (EU), as the author is concerned that the discussion draft has the potential to generate legal uncertainty as to the output of BEPS Action 3 and its implementation, which could seriously undermine the desirable effect of the BEPS project and, more generally, negatively affect business.

1 Academic Chairman of IBFD – International Bureau for Fiscal Documentation, Amsterdam, The Netherlands. Holder of a Jean Monnet ad Personam Chair of European Tax Law and Policy at WU Vienna University of Economics and Business, Vienna (Austria) and at the University of Salerno (Italy). The author can be contacted at p.pistone@ibfd.org.

The author submits that the compatibility with EU fundamental freedoms does not per se give rise to an insurmountable obstacle to the application of more effective CFC legislation by EU Member States, provided that such CFC legislation is drafted in line with the technical requirements set by EU law.

From the perspective of EU law, the setting up of (controlled) companies in a different EU Member State is an expression of the exercise of the right to secondary establishment, and, as such, is protected under article 43 ff. of the TFEU. All tax measures creating a hindrance to the exercise of such right are therefore incompatible with EU law to the extent that they give rise to unjustified discrimination or restriction.

The discussion draft duly acknowledges the existence of issues of compatibility with EU law in the section focused on policy considerations, and clearly spells out two desirable goals, namely:

- the legal obligation of EU Member States to comply with the supremacy of EU law;
- and
- the desirability, from a policy perspective, to avoid situations where the limits set by EU law create a bias in favour of EU parent companies by imposing less stringent requirements for the application of CFC legislation within the EU internal market.

The discussion draft contains a technically appropriate selection of relevant case law from the Court of Justice of the European Union (CJEU, or the Court). However, the author suggests that the Commission v. United Kingdom case also be considered, as it can be relevant for addressing the position of minority shareholders within the framework of the free movement of capital, also applicable to the relations of the EU with non-EU Member States (so-called third countries).

The discussion draft refers to the concept of “wholly artificial arrangements” in a way that generally reflects the judicial developments from the Court.

Under the system of vertical separation of competences inside the European Union, the CJEU is the only supranational judicial body having jurisdiction to interpret EU law. It is ultimately up to the Court to draw the thin line between admissible and non-admissible domestic tax measures. No absolute degree of certainty as to the compatibility of CFC legislation with EU law can be achieved without the intervention of the Court. As a consequence, neither national governments, nor the European Commission – both of which officially participate in the

\[3\] *Discussion Draft*, paras. 11 to 14.

\[4\] *Discussion Draft*, paras. 11 to 14.

\[5\] UK: CJEU, 13 Nov. 2014, Case C-112/14, *Commission v. United Kingdom*.

\[6\] Art. 63 Treaty on the Functioning of the European Union (TFEU).

\[7\] The so-called external dimension of the free movement of capital. In this regard, see also PT: CJEU, 3 Oct. 2013, Case C-282/12, *Itelcar*; PL: CJEU, 10 Apr. 2014, Case C-190/12, *Emerging Markets Series*; DE: CJUE, 11 Sept. 2014, Case C-47/12, *Kronos International*. 
BEPS project meetings – are in a position to provide the OECD with a final or binding view as regards the interpretation of EU law.  

As it is not possible to consult the CJEU on purely hypothetical cases or, more generally, with an *ex ante* approach, the assessment of the compatibility of the proposed strengthening of CFC rules with EU law becomes a particularly delicate interpretative exercise. In such context, the only possible way to proceed is to use all relevant elements – be they arising from CJEU case law or principles of the Union – which the Court may apply in the future to address this issue in the framework of a preliminary ruling or an infringement procedure.

3. Two Potential Problems of Compatibility with EU Law

The author sees two potential problems of compatibility with EU law arising from the discussion draft.

First, the discussion draft concludes that the new CFC rules may also apply to *partly artificial arrangements*, reaching conclusions (paragraph 14) that have neither been the object of a judgment of the CJEU, nor may be reasonably drawn on the basis of an accurate reading of its existing case law.

Second, the new CFC rules may go beyond the limits drawn by the Court for domestic anti-abuse rules insofar as they apply in a *mechanical (or automatic) fashion*. Such *modus operandi* would prevent an analysis of the underlying substance and would therefore produce a *disproportionately* restrictive impact on the exercise of EU fundamental freedoms and the effective protection of taxpayer rights in concrete situations.

4. Analysis

The analysis of such issues will now more specifically focus on the four elements indicated in paragraph 14 of the discussion draft for CFC legislation, namely:

– the relevance of *substance analysis*;

– the broadening of the scope of CFC legislation to cover *both domestic and foreign subsidiaries*;

– the application to cover *partly artificial transactions*; and

– its justification with a view to achieving *a balanced allocation of taxing powers*.

Three issues potentially arise in this regard:

a) the *compatibility of the third element with EU law* is very questionable from a technical perspective;

b) the mere description of the four elements in paragraph 14 *constitutes an additional source of uncertainty*. The plain wording of paragraph 14 suggests that EU Member

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8 The validity of arguments brought up by the EU Commission as to the compatibility with EU law rather depends on how accurately such arguments reflect previous CJEU case law and the principles of EU law, thus being able to anticipate or correspond to potential developments at the level of supranational judicial interpretation within the European Union. Therefore, the value of interpretation by the EU Commission would be no different from that of interpretation provided by States or scholars.

States may choose to include one or more of these four elements, which is questionable in the author’s view; and

c) it is questionable whether the fourth element can be considered as a new justification for the assessment of the compatibility of CFC rules with EU law.

Each of these three points is the subject of more in-depth analysis, below.

a) **On partly artificial transactions**

CFC rules offset lower (corporate) income taxes levied by a different EU Member State in respect of a subsidiary established in such country. Therefore, their compensatory effects are per se an (EU law) problem when the parent has merely carried out a genuine exercise of its right of secondary establishment.

When applying CFC legislation, the taxing jurisdiction of the EU Member State of the parent company is stretched up to the point of establishing a nexus with a (subsidiary) company resident in a different State. Some tax system, also outside the European Union, may take the view that this is normally justified by the need to effectively counter tax deferral. However, the CJEU considers that the application of CFC rules is justified only in respect of abusive practices. The CJEU did not include any reference to tax avoidance in the wording of the Cadbury Schweppes\(^\text{10}\) decision, but developed the concept of abusive tax practices as an equivalent expression in tax matters to a more general category of EU law (i.e. the prohibition of abusive practices), which in fact comes very close to that of tax avoidance.

As the CJEU analyses the impact of abusive practices on the exercise of the right of establishment by a parent company and its foreign subsidiary, it should not surprise that the Court in fact set a fairly high threshold of tolerance when assessing genuine practices (for CFCs on the basis of staff, equipment and premises of the foreign subsidiary),\(^\text{11}\) i.e. companies that may not be restricted in their exercise of a fundamental freedom.

Taking also into account the factual context of the Cadbury Schweppes case,\(^\text{12}\) the author therefore rejects the notion that the CJEU may justify a restriction on a fundamental freedom based on the need to counter abusive practices in respect of partly artificial arrangements.

The author is aware that elsewhere in tax matters the CJEU has interpreted the prohibition of abusive tax practices to encompass also transactions that were entered into essentially to circumvent the payment of taxes.\(^\text{13}\) However, he believes that a different standard can be required by CFC legislation, taking into account its immediate impact on the entity that exercises the right of establishment.\(^\text{14}\)

\(^{10}\) UK: CJEU, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes*.

\(^{11}\) *Cadbury Schweppes* (C-196/04), para. 67.

\(^{12}\) Namely, that foreign subsidiaries established in the International Finance Services Centre in Dublin may have been set up for a number of reasons (including the purpose of taking advantage of the lower tax rates in its country of establishment) and have in fact replaced a similar structure that was previously created for the same purposes in Jersey.

\(^{13}\) Such arguments were also developed in respect of other taxes, such as VAT. See IT: CJEU, 21 Feb. 2008, Case C-425/06, *Part Service*, para. 42.

\(^{14}\) Or, in some cases, to the free movement of capital.
Furthermore, the author admits that, as indicated by the discussion draft, the CJEU judgment in the Thin Cap GLO case refers (in paragraph 81) to a transaction that represents in whole or in part a purely artificial transaction.\textsuperscript{15}

However, this sentence cannot be taken out of its context, i.e. cannot be separated from the conclusions that the CJEU then reached in paragraph 92 of that judgment, where it stated as follows:

“that legislation provides for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allows taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question and, secondly, where it is established that such an arrangement exists, such legislation treats that interest as a distribution only in so far as it exceeds what would have been agreed upon at arm’s length.”\textsuperscript{16}

The wording of this paragraph is clear evidence that the Grand Chamber of the CJEU did not intend to establish conceptual differences between its rulings in the two cases.\textsuperscript{17} By contrast, this excerpt confirms that the Court always requires a case-by-case analysis.

The author is concerned that some additional potential threats to compatibility with EU law could arise insofar as the strengthening of CFC legislation could apply in a mechanical (or automatic) manner that could prevent the taxpayer from presenting evidence of the substance. This situation would almost certainly have a disproportionally restrictive impact on the exercise of a fundamental freedom.

Based on the limits set by EU law on the burden of proof and the impact of procedural restrictions on the exercise of fundamental freedoms,\textsuperscript{18} problems regarding compatibility

\textsuperscript{15} The mentioned paragraph states: “The fact that a resident company has been granted a loan by a non-resident company on terms which do not correspond to those which would have been agreed upon at arm’s length constitutes, for the Member State in which the borrowing company is resident, an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State”. UK: CJEU, 13 Mar. 2007, Case C-524/04, Test Claimants in the Thin Cap Group Litigation, para. 81.

\textsuperscript{16} Thin Cap (C-524/04), para. 92 (emphasis added).

\textsuperscript{17} Besides, the Cadbury Schweppes and Thin Cap cases had the same judge rapporteur and were decided by the Grand Chamber of the Court of Justice of the European Union, which had a substantially similar composition.

\textsuperscript{18} In the field of VAT, the Court considers that “the principle that the burden of proving the entitlement to a tax derogation or exemption rests upon the person seeking to benefit from such a right is to be viewed as being within the limits imposed by Community law”. Thus “it would be contrary to the principle of legal certainty for a Member State, having laid down the requirements for applying the exemption for intra-Community supply, such as by prescribing a list of the documents to be presented to the competent authorities, and which initially accepted the documents presented by the supplier as documentary evidence of the right to the exemption, subsequently to require that supplier to account for the VAT on that supply where it becomes apparent that, by reason of a fraud by the buyer of which the supplier could not have been aware, the goods concerned did not in fact leave the territory of the Member State of supply”. NL: CJEU, 27 Sept. 2007, Case C-184/05, Twoh
would also arise if the concept of CFC legislation were to include a general reversal of the burden of proof in the presence of non-resident subsidiaries, or even if it were to include a requirement to provide narrow *ex ante* evidence of the genuine function of such companies.

Further problems of compatibility would arise to the extent that subsidiaries established in another (EU or EEA) Member State were required to operate only in their State of (secondary) establishment, as such a situation would be in open conflict with the fundamentals of the EU internal market.

The conclusions reached up to this point do not imply that a strengthening of CFC legislation is not possible for EU Member States, or that other tools may supplement the reaction to abusive practices in compliance with EU law.

Three points should be singled out in this regard.

*First,* if a non-resident subsidiary genuinely exists, but was allocated income or expenses not corresponding to its function and substance, *States could challenge this outcome by applying other anti-avoidance techniques,* including GAARs, specific rules targeted at base erosion schemes and transfer pricing rules. From the perspective of compatibility with EU fundamental freedoms, relevant elements arise from the Court’s decision in the *SGI* case, also quoted in the discussion draft. In the author’s opinion, that decision should be read in such a way that, on the one hand, arm’s length transactions between related parties constitute a safe harbour and may never be deemed to constitute an abusive practice and, on the other hand, non-arm’s length transactions do not automatically constitute abuse, but can justify a proportionate reversal of the burden of proof.

*Second,* the concept of abusive practices and the boundaries within which CFC legislation is currently considered admissible by the CJEU do not prevent States from going a step further (beyond tackling tax avoidance). The BEPS project is evidence that States are willing to coordinate the exercise of their taxing powers in order to *counter the exploitation of disparities* by taxpayers (for purposes of eroding the tax base). The author therefore sees no problem in the fact that CFC legislation can also be used to counter the exploitation of disparities, i.e. the advantages that can be derived from mismatches between tax systems. This would allow CFC legislation to counter aggressive tax planning. However, not even in such cases could States use mechanical or automatic CFC rules in a way that does not take into account the substance of the non-resident subsidiary.

*Third,* insofar as a proper analysis of the substance related to a controlled foreign company is included in the application of CFC legislation, no problem of compatibility with EU fundamental freedoms would arise – even in the case of *de facto control.* Evidence of such control by tax authorities would certainly play an important role in this case, with a view to achieving a proportionate approach to any potential tax deferral constituting an abusive practice. However, this should not necessarily prevent forms of reversal of the burden of proof to taxpayers in the presence of clear elements that indicate the existence of de facto control.


19 BE: CJEU, 21 Jan. 2010, Case C-311/08, *SGI.*
b) The indication of the four elements gives rise to legal uncertainty

The second issue previously raised in this comment refers to the elements described in paragraph 14 of the discussion draft, i.e. the mere descriptions of such elements. In the author’s view, several problems arise in this regard.

It is not clear whether all conditions must be cumulatively met. The author believes that the answer to such question requires a prior analysis of the admissibility of such elements under EU law.

For the reasons indicated earlier in this comment, the author believes that the first element is strictly indispensable and the third one should simply be removed from the final version of the document.

The second element could – at first sight – be regarded as an easy way to avoid all possible cases of discrimination. One could theoretically argue that insofar as lower taxes of controlled and foreign subsidiaries were equalized, no different treatment would arise. However, the author questions the validity of such conclusion.

To the extent that foreign subsidiaries are genuinely established in another EU Member State, a genuine nexus (or link) with such jurisdiction exists for direct tax purposes. Therefore, the State of residence of the parent may not simply eliminate such genuine link by compensating the lower tax burden (of the non-resident subsidiary) in order to achieve tax neutrality. Such goal could be admissible from a general tax policy perspective geared at countering tax deferrals through CFCs. However, it is at odds with the level playing field within the EU internal market, except in the presence of abusive practices (provided that the reaction is proportionate). Nevertheless, even in such cases, the reaction would be justified by the need to counter the artificial structures, rather than by the need to equalize the tax burden at the levels of the State of the parent and in the State of the subsidiary.

A different conclusion may be reached in respect of other anti-avoidance measures (such as thin cap legislation), where a structural reform of the tax system could effectively disallow deductions between related parties in both domestic and cross-border situations, thus removing discrimination.

c) CFC legislation and the justification based on balanced allocation of taxing powers

Paragraph 14 of the discussion draft describes the fourth element in a rather vague way, thus causing more problems than it solves. Such problems relate to the uncertainty surrounding the possibility of invoking this justification on a stand-alone basis and its potential relevance for the CJEU in respect of CFC legislation.

The author acknowledges that case law of the CJEU has accepted this argument as a justification, generally bundling it together with one or more other justifications. He also acknowledges that the BEPS project pursues essentially the same goals, insofar as measures are proposed in order to avoid profit shifting by taxpayers.
From the standpoint of EU law, profit shifting is neither a new element nor a new justification, nor can it substantially alter the way in which the CJEU applies its arsenal of accepted justifications.

Over the past few years, the Court has consistently assessed CFC legislation against the need to fight abusive practices. The author finds it highly unlikely that the CJEU would change such position. Any shift away from the justification in respect of abusive practices would, in fact, undermine the exercise of the secondary right of establishment in genuine cases.\(^\text{20}\)

One should not forget that the CJEU has full powers of determining whether and to what extent it should accept a given justification, as the Court is also allowed to differently characterize for EU law purposes the arguments put forward by Member States.

Accordingly, the author regards as technically highly improbable the development suggested in paragraph 14 of the discussion draft, according to which:

Although the Court has not yet found that CFC rules are justified by the need to maintain a balanced allocation of taxing rights, these cases suggest that CFC rules could be permitted to apply more broadly if they could be explained by the need for a Member State to tax profits arising from activities carried out in its territory.

The author believes that only the first of the four elements indicated in paragraph 14 of the discussion draft truly matters.

The list of requirements should include a reference to wholly artificial arrangements, without admitting that partly artificial arrangements could be in line with EU fundamental freedoms (as instead the third element of the discussion draft currently does).

It should also add the requirement that CFC legislation be designed in a way that remains within the limits of a reaction to actual abusive practices.

Any type of mechanical (or automatic) application of CFC rules targeted at preventing all tax deferrals with disproportionate effects on the exercise of the EU right of establishment, should be avoided.

Furthermore, the author sees no problem if the BEPS “strengthened” CFC legislation also allows the tackling of aggressive tax planning, as in the case of subsidiaries lacking staff, premises and equipment suitable for genuinely performing the functions for which they were set up or are reportedly carrying out.

Likewise, no problem would, in principle, arise in respect of including de facto control situations within the scope of stronger CFC rules, provided that sufficient evidence is given of the effects of profit shifting achieved in this way.

\(^{20}\) Similar conclusions could be reached, on the basis of the Commission v. United Kingdom case, already cited, in respect of the free movement of capital.
Finally, the author would like to emphasise that the technical criticism expressed in this comment is meant to prevent the arising of possible uncertainties as to the compatibility with EU law, which certainly could be brought before the Court in the framework of preliminary ruling procedures or of infringement procedures resulting from letters of complaint to the European Commission. The author therefore believes that his remarks will be understood as a pragmatic approach to showing support for such a desirable initiative as the BEPS project and its Action 3, which, if properly applied, can strengthen the reaction to base erosion and profit shifting without creating a bias as to its application within the European Union and elsewhere in the world.

Prof. Dr Pasquale Pistone

Academic Chairman of the IBFD

P.O. Box 20237
1000 HE Amsterdam
The Netherlands
Tel. +31 20 554 01 07
E-mail: p.pistone@ibfd.org

21 The author is aware that there is no actual right for persons to compel the European Commission to commence an infringement procedure as a consequence of the filing of a letter of complaint. However, in the presence of a clear position by the (Grand Chamber of the) European Court of Justice in respect of a very relevant topic, the author would certainly argue that the European Commission should in fact exercise its function in a way that allows the single judicial body competent to interpret European law to activate its jurisdiction on this matter.
Dear Mr. Pross,

BEPS Discussion Draft: Action 3: Strengthening CFC rules

PricewaterhouseCoopers LLP (PwC) welcomes the opportunity to comment on the OECD’s Public Discussion Draft on Action 3: Strengthening CFC rules.

In light of the complexity of the subject matter and the diversity of existing approaches adopted by territories, we recognize the difficulty of the task being addressed in Action 3, and accordingly, we commend the Working Party (the WP) for its efforts to date in reaching agreement over many of the best practice recommendations. We set out in this document our concerns over some areas and our responses to your specific questions. In the body of this letter we set out our overview comments, providing more detail and specific responses to your questions in the Appendix.

We appreciate your consideration of our comments on the Discussion Draft and we would be pleased to assist the OECD further in its efforts under Action 3.

The response in the pages that follow reflects the views of the PwC network of firms.

Overview comments on the Discussion Draft

Prior to considering detailed comments, we would like to set out our key concerns in relation to the Discussion Draft. These relate, firstly, to clarifying the overall aim of the Action and the Discussion Draft, and secondly, the huge potential for increased complexity, administrative burden and unrelieved double taxation which could arise under badly implemented CFC rules and the inadequately thought-through interactions with the other BEPS Actions.

In relation to the overall aims of the Action and Discussion Draft, the 2013 Action Plan called for “recommendations regarding the design of CFC rules”. We are concerned whether the Discussion Draft is seeking to go too far and in particular have concerns over both the scope of the CFC rules outlined in the document and the suggestion that a “secondary rule” be introduced. We set out our views on the proposed scope of CFC rules below, but here we would like to express our concern that the WP is seeking to go beyond the remit of Action 3 in proposing the use of such a secondary rule.
This rule seems to be a potential extension to source country taxation rights and hence seems to be beyond what Action 3 was tasked with considering.

In terms of the scope of the CFC rules which are considered in the Discussion Draft, some of these appear to be far too broad to achieve consistency amongst nations (in particular the potential for CFC rules to challenge ‘foreign-to-foreign’ shifting). Given many territories adopt a territorial tax system, frequently supplemented by anti-abuse rules, such an approach is likely to be anathema to them and hence trying to make them mandatory is likely to be politically impossible. We could then be in the situation of many territories with strict CFC rules and others with none and even more competition between nations (especially between OECD and non-OECD nations). We would strongly recommend that the WP aim to recommend a realistic, focused set of provisions to prevent the artificial diversion of profits from parent territories which may actually be adopted by the majority of territories.

Another concern we have is in relation to the interactions with the other Actions. Some of the more far-reaching proposals set out in the document appear to be trying to resolve problems which may not effectively be dealt with by other BEPS Actions. We are concerned that this overlap of remit and unresolved interactions will lead to an unworkable international tax system. This can either be resolved through detailed investigation of the complex interactions or, more reasonably given the time scale, through accepting that each Action does not have to independently solve BEPS.

If territories were to implement some of the proposals in the Discussion Draft, it would be inevitable that we would have a much greater incidence of unrelieved double taxation suffered by taxpayers who are not undertaking BEPS activities. We already have examples of double taxation with existing CFC rules and whilst we note that the WP does intend to include recommendations to deal with the interaction between CFC rules, even if these interactions are properly legislated for in each member territory, which cannot be guaranteed, there could also be a significant amount of double taxation arising as a result of interactions between the CFC rules, the CFC rules of non-member territories and the output from other Actions. Whilst some businesses may be able to restructure their operations to remove this economic double taxation, many could find this infeasible and could end up with medium to long term structural double taxation.

In our view, only by proposing balanced, reasonable CFC rules will the OECD be able to achieve any level of coherence between countries – removing both the incentive for competitive behaviour between countries and, we hope, reducing the risk of unrelieved double taxation. We consider that there are some very good examples of CFC rules which effectively deal with BEPS concerns, whilst at the same time not putting the parent territories at a significant competitive disadvantage compared to other territories (see, for example, our discussion of the UK below). We feel that these should be the key aims of recommended CFC rules.

In relation to most of the ‘building blocks’ which are set out in the Discussion Draft, we are in broad agreement with the WP. The main area where we have concerns from a policy perspective is that of identifying the appropriate income to be apportioned to the parent territory set out in Chapter 5. We consider that the recommendations which the WP ultimately make in relation to defining CFC income will fundamentally determine the success or otherwise of Action 3. We strongly agree with the position set out in Para 83 that full inclusion and excessively broad partial inclusion systems go beyond what is necessary to prevent BEPS and furthermore, may ultimately impact negatively on international trade and growth. Leaving to one side the position for EU/EEA Member States, which we cover in more detail below and in the Appendix, it is our firm belief that CFC rules should not seek
to tax activities in territories where there are genuine economic activities. To go further than this in our opinion would permit protectionist behaviour supposedly in the name of challenging BEPS.

HMRC in the UK (and accordingly our UK firm) have had the recent experience of the modernisation of CFC rules. These new rules have, at their core, this principle. Genuine activity should be respected and the CFC rules should target artificial shifting of profits from the UK. This is mainly achieved through the use of a Gateway which is based on the principle of attributing profits to the Significant People Functions (SPFs) who manage assets and risks and, if those SPFs are outside the UK, does not seek to charge tax under the CFC rules. The role of the CFC rules is thereby focused on preventing artificial avoidance strategies – in particular those which split ownership of income-producing assets and risks from the functions who manage them – whilst permitting businesses to actually structure themselves in the most economic manner. We believe that such an approach, when combined with effective transfer pricing rules, is more than sufficient to challenge BEPS behaviours. To go further in the OECD’s recommendations could inadvertently permit or even encourage states to enact rules which dissuade international trade.

In relation to EU/EEA states, we are in agreement that this does give rise to particular restrictions on the potential application of CFC rules and we fully agree with the analysis in paragraphs 11 to 13. In paragraph 14, however, we feel that two of the bullet points may give a slightly misleading impression as to the current state of EU jurisprudence. Accordingly, in the Appendix we set out some analysis which the WP may find helpful.

We hope that the comments we make above and in the Appendix are helpful to the WP and we remain available to provide any assistance that the OECD may require.

Yours sincerely,

Matt Gibson  
Partner  
PricewaterhouseCoopers LLP, London

cc Stef van Weeghel, Global Tax Policy Leader

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<th>PwC Contacts</th>
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<tbody>
<tr>
<td>Suchi Lee</td>
<td><a href="mailto:suchi.lee@us.pwc.com">suchi.lee@us.pwc.com</a></td>
</tr>
<tr>
<td>Andy Boucher</td>
<td><a href="mailto:andrew.boucher@uk.pwc.com">andrew.boucher@uk.pwc.com</a></td>
</tr>
<tr>
<td>Matt Gibson</td>
<td><a href="mailto:matthew.d.gibson@uk.pwc.com">matthew.d.gibson@uk.pwc.com</a></td>
</tr>
<tr>
<td>Peter Collins</td>
<td><a href="mailto:peter.collins@au.pwc.com">peter.collins@au.pwc.com</a></td>
</tr>
<tr>
<td>Denis Harrington</td>
<td><a href="mailto:denis.harrington@ie.pwc.com">denis.harrington@ie.pwc.com</a></td>
</tr>
<tr>
<td>Stefan Schmid</td>
<td><a href="mailto:stefan.schmid@ch.pwc.com">stefan.schmid@ch.pwc.com</a></td>
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<tr>
<td>Sherry Grabow</td>
<td><a href="mailto:sherry.y.grabow@us.pwc.com">sherry.y.grabow@us.pwc.com</a></td>
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Appendix – General comments and responses to questions for consultation

Chapter 2: Definition of a CFC

Our main comment in relation to this chapter is that we do not see the rationale, from a BEPS policy perspective, for modified hybrid mismatch rule to be on the broader basis in para 37. If a payment is not base eroding then by definition what we are considering does not exhibit BEPS characteristics and accordingly should not, in our opinion, form part of a BEPS recommendation.

1. Would any particular practical issues arise from treating transparent entities as separate entities in the cases listed above? If so, what are they and how could they be dealt with?

Firstly, we have a specific comment regarding one of the forms of entity discussed in the paper which may cause problems in practice - that of trusts. The issue here can arise with certain forms of trust, such as English law discretionary trusts, where establishing precisely who ‘owns’ the interest in the entity cannot be defined prior to a decision being made by the trustees. This gives rise to difficulties in working out to whom profits should be apportioned prior to the funds actually being distributed. The UK domestic and CFC laws have been developed to accommodate such trust issues by focusing more on ensuring that, when any income is derived from trusts, this is correctly taxed.

More generally, broadly defining a CFC to include transparent entities would potentially be over inclusive, so it would be important that other elements of the CFC rules operate to limit double taxation situations (e.g. where the income is taxed to the transparent entity’s owner(s)) and limit taxation to the types of income that are problematic under BEPS (i.e. not active business income). Exceptions will need to be defined to avoid over-inclusion/double taxation where the disparate treatment of an entity between the parent and entity jurisdictions does not give rise to BEPS concerns.

Furthermore, determining the classification of an entity for tax purposes, in most countries, is driven by the legal classification of the entity which can vary according to the terms of establishment of the entity. As a result, an entity could be classified differently by multiple jurisdictions (e.g., entity, owner and ultimate parent) due to differences in how each country’s law classifies the entity. As such, it may be necessary to determine how the entity is taxed in each of these jurisdictions to determine whether BEPS is occurring. For example, intermediary jurisdictions may tax the income of the CFC or its owners. This complexity should also be considered.

The extension to non-corporate entities could have some unintended consequences in the financial services sectors. A number of insurers operate through such entities in overseas jurisdictions for entirely commercial reasons, in particular in the life insurance and savings market.

2. Should the recommendations consider any other issues related to determining which entities could be considered CFCs?

If the parent entity jurisdiction’s rules are to govern the determination and computation of CFC income, as suggested, then the parent jurisdiction rules should apply for purposes of determining which entity is a CFC. The proposed rules would give rise to circumstances where a transparent entity would be treated as a separate entity even when the parent
jurisdiction’s rules disregard the entity. As noted above, this rule would be overly-inclusive and add complexity to the analysis as it would require analysis of the treatment of the entity in multiple jurisdictions.

### 3. Are there any practical problems with either the narrow or the broad version of the modified hybrid mismatch rule mentioned above?

Firstly, we struggle to see how either approach is consistent with a territorial system of taxation which exists in many territories. If the broad approach were adopted, then as noted above there would appear to be a completely unjustifiable (within a BEPS context) risk of double taxation. We consider that any justifiable BEPS output should take into account valid reasons for the exemption of the income (e.g. participation exemption, approved patent regimes) and should be limited in the types of income that are considered problematic under BEPS (i.e. not active business income). More fundamentally, we do wonder if a hybrid mismatch rule is required in the context of the CFC rules in light of the output of Action 2.

In relation to practical issues, assuming CFC rules are self-assessment (rather than applying by direction), with modern groups of companies with multiple tiers this could be a lot of work in practice. Both the narrow and broad options require that each parent company in a chain assesses how their subsidiary entities or arrangement between subsidiary entities would be classified (in both payee and payer jurisdiction). It then requires the parent company to determine if in their territory they had classified the entities and arrangements in the same way whether it would have been included in CFC income. Understanding how entities and payments are treated in each and every payee/payer and then taking this classification and transposing it to the parent location may be a huge exercise even where the position is clear cut.

It is also not clear what is meant by "classified the entities or arrangements in the same way". For example, if this is a country which taxes income on (say) a receipts basis do you need to bear this in mind when performing "in the same way" the analysis? It becomes even more difficult where entity classification or arrangement classification is not clear cut and the analysis is not relevant to the treatment in B or C. Entity classification often requires detailed legal and technical analysis and even then often requires confirmation from the relevant tax authority (e.g. UK entity classification of foreign entities). There are also situations where some concepts under local law do not exist elsewhere e.g. France has opaque, transparent but also ‘translucent’ entities. In the UK, we have just opaque and transparent.

As above, the broad option would seem to be wholly at odds with tackling tax avoidance in that it catches situations where there is no base erosion or profit shifting and prima facie could result in a CFC charge where there is no tax benefit from the arrangements between B and C.

There is also potentially a lot of work for taxpayers when dealing with differences between domestic tax systems e.g. credit vs branch exemption etc.

### Chapter 3: Threshold requirements

As a practical matter, for groups operating in many territories, we agree with the WP that entity-based threshold requirements are a vital part of a practical yet focused CFC regime.
We set out our more detailed thoughts on a low-tax threshold below, but would like to discuss further the appropriateness of a de minimis exemption with suitable anti-abuse protection. In our experience, such an exemption can greatly simplify compliance with CFC rules whilst not exposing territories to a significantly increased risk of BEPS.

4. **What practical problems, if any, arise when applying a low tax threshold based on an effective tax rate calculation?**

Whilst we agree with the WP that a low tax threshold exemption based on an effective tax rate calculation is appropriate for a recommended CFC regime, we should highlight how such an exemption is utilised in practice and hence the limitation of solely relying on a low tax entity exemption.

Our experience is that taxpayers do not by default rely on lower level of tax exemptions even for entities located in higher tax jurisdictions. The key reason for this is the complexity that derives from the need to recomputed taxable profits of every entity under the rules of the parent territory. Complexities which have to be dealt with include fiscal unities, losses (including classifying different types of loss) and timing differences. Instead of being one of the first exemptions considered by groups, it typically becomes an exemption considered for the residue of entities not exempt under another method.

In addition, the recommendation will have to conclude on how the denominator is calculated (currently considering either the parent jurisdiction’s rules or an amount computed under an international standard, with adjustments made to reflect tax base reductions that cause the CFC’s tax on the income to be low). As acknowledged in the report, not all differences between the parent and entity’s tax base computations would give rise to BEPS concerns. Therefore, strictly applying the tax principles of the parent jurisdiction in determining the income base for the ETR calculation could cause the ETR to appear low when the driver for that lower effective rate is not a tax advantage that should give rise to BEPS concerns (e.g. participation exemptions, patent box, exclusions/tax holidays based on people activities). The lack of specificity in the report on this topic and other aspects of the calculation leave room for a great deal of discretion for the adopting countries to determine how the rule should apply which, in addition to the complexity of the calculation, could lead to inconsistent results for taxpayers.

Another potential issue to be aware of with a lower level of tax threshold is that it can exacerbate competition between holding company locations – by offering a lower rate than other territories, even if based on the same percentage (i.e. 75% of a lower headline tax rate extends the competitive advantage into the CFC arena).

5. **How could these problems be addressed or mitigated?**

Whilst including a lower level of taxation exemption should certainly be recommended, a more practical form of entity exemption is a white list approach. Whilst we appreciate the need for additional criteria to ensure that such a methodology is not abused, in our experience, such an approach is much more heavily relied upon by taxpayers to eliminate from consideration low risk entities than a low tax entity exemption based on an effective tax rate. We would also note that such a list should also have a carveout for genuine economic arrangements so that it does not fall foul of EU/EEA concerns for relevant territories. We would strongly support such a proposal aimed at making the rules more effective and focused in practice.
6. **Does the discussion above correctly address the situation of permanent establishments that are subject to a different tax rate than CFCs?**

Subject to our earlier comments on the consistent application of parent territory rules, we consider that a PE which is treated as exempt from tax in the CFC jurisdiction should be considered as a separate entity for CFC purposes and hence a low level of tax test should be applied separately to the ‘head quarters’ in the CFC territory and the exempt PE.

**Chapter 4: Definition of control**

In light of the often complex ownership structures which exist in the real world, we agree with the general approach here of ensuring that a variety of tests are recommended. In particular we agree with both a legal test and an economic test. Reliance on too narrow or mechanical a set of rules may encourage behaviours aimed at circumventing the desired objectives of the CFC rules.

What we do, however, have concern over are the circumstances in which the draft recommendations give apparent approval to lowering the control threshold below 50%. Whilst we agree that it may be appropriate to aggregate ownership of related parties and also when parties are found to be acting in concert, we do not see a BEPS-related policy reason for a blanket aggregation of the ownership of unrelated parties who are not acting in concert, but who just happen to be resident in the same territory. This would put such taxpayers, who individually have no control over the actions of a CFC, at a competitive disadvantage compared with CFCs held by shareholders in different territories. Whilst we accept the draft paper notes that such tests may be to achieve “broader policy goals”, as this is a discussion of a set of CFC rules to challenge BEPS, we feel including mention of them in the recommendation is inappropriate.

7. **What practical problems, if any, arise when applying a control test?**

In the context of related parties then there should not be any significant problems applying a control test. In addition, if parties are genuinely acting in concert such that they are affecting control of a CFC, again it should be reasonably straightforward for taxpayers to self-assess their control in relevant circumstances. We would, however, suggest that the onus should be on tax authorities to prove that parties are acting together.

We do see joint venture situations where partners are not willing to share full details of their ownership structure with JV partners and this can be a problem in identifying control.

8. **Are there particular practical problems that arise when applying a control test that considers interests held by unrelated or non-resident parties? If so, what are they, and how can they be dealt with?**

In the context of non-resident but related parties, we do not consider that there should be significant difficulties in establishing control.
In the case of unrelated parties who happen to be resident in the same territory, then for listed groups, the respective ownership of significant shareholders is frequently in the public domain. What can complicate matters, however, is identifying who exactly is the actual owner of shares from such public records (e.g. due to nominee arrangements) and then establishing where they are resident. For privately held groups, however, the information requirements can be even more burdensome and in some cases identifying precisely who else owns shares and their residence status may not be possible (e.g. if other investors refuse to share the information required to make an assessment of control).

Local legal requirements may make this measure difficult for taxpayers to comply with, e.g., stiftings, where beneficiaries may not have legal rights to understand the ownership structure.

**Chapter 5: Definition of CFC Income**

In addition to the comments made in the main body of the letter, we have the following additional comments in relation to Chapter 5.

- We recognise and appreciate the objective of the WP in seeking to identify mechanical rules where possible. We also note, however, that in the context of an international tax system where groups are becoming more skilled in undertaking functional analyses for transfer pricing purposes, proportional substance-based rules relying on transfer pricing principles may not entail excessive incremental burdens on businesses – provided they apply consistent transfer pricing principles. To have one set of functional analysis rules for transfer pricing and another for CFCs would be a huge burden for businesses and tax authorities alike. Accordingly, we would strongly recommend that the WP consider substance-based rules which leverage from existing transfer pricing functional analysis methodologies.

- We have significant concerns over the potential for an ‘excess profits’ approach to become a recommendation unless it is significantly restricted in its scope. On its own we feel it is too blunt an instrument and when combined with necessary additional substance exclusion(s) would lose the benefits of relative simplicity. Whilst we have a strong preference for the categorical approach for these reasons, a suitably restricted excess profits approach might be used as an additional exclusion to ensure that the categorical approach was in line with EU/EEA obligations where relevant – i.e. profits relating to genuine activities in the territory in question would still benefit from an exemption.

- In terms of IP income and sales income, other BEPS Actions would seem to be addressing these concerns (e.g. intangibles, CBCR, PE threshold) and it is not clear why these will not effectively tackle cases of avoidance. Therefore tackling these actions under CFC as well would seem to be an added complication. If it is thought that these other Actions will not successfully address all circumstances perhaps the CFC rules could be targeted more narrowly to avoid significant analysis being undertaken where there is no avoidance or where other rules already catch the avoidance?

- Whilst we appreciate the desire of the WP to ensure that passive, thickly capitalised financing income should be within scope, again, it is important to ensure that where a different BEPS Action (e.g. interest deductibility, hybrid
mismatch, etc) mean that the income is not deductible, this is taken into account for CFC purposes so there is no double taxation.

- Whilst we accept that the development of the digital economy has blurred the lines between certain forms of income, we do think that a form-based approach targeting types of highly mobile income streams is the most practical solution to ensuring any rules are focused on BEPS activity and do not become overly burdensome to business and tax authorities.

- We strongly believe that substance-based exclusions are not only important in the context of EU/EEA Member States, but are important in developing rules for all states interested in preventing BEPS whilst embracing international development.

- We agree with the WP’s proposal to recommend a transactional approach and not an entity-by-entity approach.

Financial Services specific comments:

There are concerning comments about the link between people activities and active business. In Financial Services business, value is a function of both people and capital, and to link the definition of active business to simply that of people (common to most of the substance analysis tests in Para. 89) does not reflect commercial reality.

We have concerns that captive reinsurer activities are again highlighted as de facto passive profit shifting activities. There are many good commercial reasons as to why an insurance group may wish to reinsure third party policies into a single location, and many good commercial and regulatory reasons as to why that group reinsurer should be located in an offshore financial centre like Bermuda, for instance regulatory capital benefits and less constrained investment rules. It is simply not true, as is suggested in Paras 102 and 103, that where a captive re/insurer does not have external business that it is engaged in profit shifting. We note that in 9 of the last 16 years, the tendency has been to shift losses from the insurer to the reinsurer, not to shift profits.

We also note that captive insurance in a non-insurance context is considered to give rise to passive income. There are often significant benefits to insuring risks in multi-national groups to a captive insurance company, including geographical diversification, better access to external insurance and a greater control over the retained risk. If you accept the premise that the risks would be externally insured anyway, there can be significant non-tax benefits to the group from pooling risks and reinsuring a portion of that risk portfolio externally. These benefits are not brought out in the paper.

There is a general concern that insurance of risks outside of the jurisdiction of residence is seen as profit shifting and to be discouraged through the use of CFC rules. In highly regulated markets, there may be significant commercial benefits to insurers being resident outside of the territory of their target markets. This may be true even in multi-jurisdictional areas with a common regulatory framework. It would be regrettable if free choice of regulatory jurisdiction were to lead to disparity in tax rates depending on where the corporate group holding company was incorporated, creating an imbalance in competition between inbound and outbound groups.

There are concerns as to how the word ‘over-capitalised’ might be interpreted and applied. There are a number of different potential measures of capitalisation, including regulatory, rating agency and the decisions of the managers of the business and how
prudently they want to run their business. Inconsistent interpretation and application could lead to excessive taxation through multiple layers.

There are concerns as to how the excess profits test could work in the context of insurance, which by its very nature is cyclical. Therefore, whilst over a longer period of time there is an expectation of a particular rate of return, from year to year there can be very significant swings in profitability, with some years producing significant losses whilst other years produce significant profits. The ‘excess profits’ proposal does not adequately consider the impact of the cyclical nature.

There are currently regulatory pressures in the financial services sector to be operating through local territory companies rather than branches. This gives the local regulator a greater level of security over the assets of that company. However, with this pressure is an additional pressure to strongly capitalise the company so as to maximise the substance of that security. Unless there is consensus over what constitutes ‘over-capitalisation’ there is a risk that regulated companies are going to be unfairly judged as being over-capitalised when actually it is merely responding to the desires of the local regulator.

Additionally it is not generally possible for any regulated entity to operate with the minimum regulatory capital requirement, as a cushion is needed to ensure minimum capital is maintained even after unexpected external events. This would need to be factored into any definition of over capitalisation.

In much the same way as insurers use risk centralisation and diversification vehicles, banks and other financial services sector groups employ similar strategies with their higher risk products, such as derivatives. This is often encouraged by the local regulators. This allows the bank to better manage its net risk position, and determine the level of net risk that they are prepared to accept. It would be inappropriate for this sort of vehicle to be the subject of a CFC charge unless it was significantly overcapitalised.

**EU/EEA specific comments:**

As noted in the covering letter, in relation to EU/EEA states, we are in agreement that EU/EEA law does give rise to particular restrictions on the potential application of CFC rules and we fully agree with the analysis in paragraphs 11 to 13. In paragraph 14, however, we feel that two of the bullet points may give the misleading impression as to the current state of EU jurisprudence. We presume that the OECD does not want to encourage EU/EEA Member States to implement CFC rules which ultimately are unenforceable and accordingly set out our views on these matters below.

- In the second bullet point of Paragraph 14, it is stated that applying CFC rules equally to domestic and cross border situations would mean that they cannot be inconsistent with the freedom of establishment. This is not the case. In a number of tax and non-tax cases at the CJEU it has been found that, although a law is not discriminatory between Member States, it can still constitute an unjustifiable restriction on the freedom of establishment (see, for example, Deutsche Shell GmbH v Finanzamt für Großunternehmen in Hamburg [C-293/06] and Caixabank France [C-442/02]). Even in the absence of this technical position, however, from a practical perspective, applying ‘CFC’ rules...
in a domestic context would greatly increase the admin burden borne by businesses.

- In relation to the third bullet point, covering the concept of “partly wholly artificial”, whilst we feel this paragraph is closer to being accurate, we again consider it to be incomplete. Paragraph 81 of the decision in the Thin Cap Group Litigation case (C-524/04) indeed refers to "whether the transaction represents, in whole or in part, a purely artificial arrangement". However, paragraphs 92 and 133 of that decision in contrast use the phrase "the existence of a purely artificial arrangement". Paragraph 81 is a reference to the excess over arm’s length being a distribution or otherwise disallowed and therefore applying this in the context of a CFC should mean that no CFC apportionment should be made where profits represent the arm’s length remuneration of Significant People Functions of the CFC outside the parent jurisdiction.

9. **What are the practical problems with any of the three substance analyses set out above? How could these practical problems be dealt with?**

The main practical problems with both a substantial contribution test and a viable independent entity test are that they are both quite subjective and will potentially require significant analysis. Again, we would recommend ensuring consistency between any functional analysis required for CFC purposes and that which will be required for transfer pricing purposes to minimise complexity and burden.

If the objective is to have a more mechanical test looking at whether the CFC has sufficient employees and establishment, then this can superficially appear to be less burdensome. The main issue with the employees and establishment analysis (EEA) is, however, that determining whether activities are substantial is an inherently factual inquiry and varies by industry and company. See further discussion below regarding the “substantial contribution” rules. While the goal of the EEA test is administrative simplicity, it has the strong potential to produce the wrong results (i.e., negatively impact companies that are earning a justifiable profit) and is inconsistent with existing transfer pricing and value creation principles.

Whichever methodology to identify appropriate substance is recommended, we consider that it would be preferable to have a full exemption once a requisite threshold is reached in any recommended test. To retain proportionality, however, and to ensure EU/EEA compliance, then if the threshold test is not satisfied there should be some way to exempt the value attributable to the activities/employees in the CFC territory.

10. **Do you have experience with applying substance analyses in existing CFC rules? If so, how can these be made more mechanical while still accurately attributing income?**

As noted above, the UK have adopted several substance-based tests in their recently introduced CFC rules. Whilst the introduction of significant people functions (“SPF”) based exclusions certainly required a significant change in approach for UK groups, this should be seen in the context of a much broader education of taxpayers in terms of
transfer pricing methodologies. As SPFs are becoming a key part of transfer pricing methodology, this consistency with the CFC rules has encouraged groups to analyse their global operations on one basis, thereby making it more straightforward and cost-efficient to comply.

The US Subpart F rules contain an exception for activities that constitute a “substantial contribution” to manufacturing. Due to the factual nature of the determination and to account for differences that inherently exist in how companies conduct their operations, the US substantial contribution rules operate as guidelines which are intentionally flexible and not mechanical. To attempt to apply a mechanical rule that would not account for differences in companies’ business operations, value drivers, risk profile, industry standards, etc., would lead to a distortion of income in many cases and is not conducive to accurate income attribution.

11. **How can CFC rules accurately attribute income that raises concerns about BEPS (i) in a business that is licensed under an appropriate regulatory body and is market-facing in a particular jurisdiction, (ii) in a reinsurance business carried on by a CFC of a multinational insurance group or (iii) in a “captive” insurance business of a CFC that is not part of an insurance group? Are there practical problems with current rules that distinguish between these two situations? If so, what are they and how can they be dealt with?**

We consider that the UK approach is generally an acceptable one, where the question is whether the ultimate source of the risk is third party or connected party. Therefore, the reinsurance of third party business is acceptable in principle, whereas captive insurance (of UK risks) in a general corporate context is not (although please note our concerns regarding captive insurance above). There is then a secondary test whereby profits can still be caught where the capital level maintained by the insurer is excessive compared to that which might be expected in a comparable company writing insurance with third parties, or where the offshore insurance company is reliant on people working in the UK for that company. There has been significant progress with HMRC in understanding what is meant by overcapitalisation, and a variety of methodologies have been accepted, including the expectations of ratings agencies, intended short-to-medium term use for the capital (and therefore anticipated capital requirements), capitalisation relative to other companies within the group and management’s own capital management policies (i.e. insurers with very prudent capital retention policies could maintain higher levels of capital in overseas insurance companies without being overcapitalised).

12. **Are there practical problems with applying the same rule to sales and services income and IP income?**

Treating all sales and services income as passive income we believe would be over-inclusive as many entities earn such income without it being connected to IP, which is the concern the rule intends to address. This approach would put the burden on the taxpayer to rebut a presumption that all sales and services income is passive CFC income, which, as a practical matter, would encompass many entities in the structures of MNCs that are conducting activities that should not give rise to BEPS concerns. Such a rule would accordingly be onerous to taxpayers.
13. Are there existing CFC rules that accurately attribute any or all of these categories of income while also reducing administrative and compliance burdens?

Here are some examples:

UK – under the UK's CFC rules, the effective use of threshold exemptions significantly reduces the overall administrative burden by effectively excluding many low risk entities. The more detailed ‘Gateway’ approach, which identifies different forms of income stream in higher risk entities and tests each separately is then applied. The Gateway splits income streams into: general trading (which would inter alia cover sales and service and IP income streams), finance (trading and non-trading), captive insurance and solo consolidation. The substance/SPF tests are then applied to these categories of income in proportion to their respective risks. In practice we are finding that this combination of rules is not causing a disproportionate level of compliance burden whilst at the same time effectively focusing on the higher risk areas.

US – the US rules apply an attribution approach that identifies categories of income by CFC accurately, but in conjunction with quite detailed reporting requirements, the compliance burden is high. Therefore, carve outs to CFC income, as discussed above, such as white lists and de minimis exceptions, would be helpful in reducing compliance/administrative burdens.

14. Does the discussion above consider all categories of income that should be attributed under CFC rules?

We feel that the categories set out are sufficient to target BEPS activities. In particular, we consider that property-based income streams such as rental income should remain outside of the scope of CFC rules due to the inherent low risk of BEPS behaviours in relation to real estate.

In relation to dividends, the paper correctly outline that different countries have different rules regarding the taxation of dividends and indeed most do now provide an exemption. It is not clear why a dividend paid out of passive income should be taxed again at the level of the receiving CFC (given that it will presumably have generally been taxed at the level of the subsidiary). Tracking good and bad income through multiple tiers of holding companies can be burdensome. Perhaps tracking could be restricted to higher risk avoidance cases.

15. Is it clear how the two approaches above would work? If not, what further detail is required to clarify the approach?

The categorical approach seems clear enough in general, although recommendations on the specific definitions of income to be included in each category and which categories should be treated as CFC income would be helpful to ensure consistency. The excess profits approach on the other hand inherently involves complexity and uncertainty in establishing a standard for a “normal” return, as this would vary by company and industry.

16. What practical problems arise with applying the categorical approach and the excess profits approach?
While the categorical approach allows for more precision in identifying income streams that pose a BEPS concern, and thus limits the risk of over-inclusion, it requires taxpayers and countries to distinguish between types of income, which can pose challenges particularly when IP is involved. However, such classification and the determination of the income in a related party context should be consistent with and supported by transfer pricing analysis which would assist and align with income categorization.

Although mechanical and, therefore, theoretically simpler, the Excess Profits Approach is quite arbitrary and also puts the burden on the taxpayer to prove that the assets are used in the active conduct of a trade. Furthermore, as described in the report, the nature of the excess return calculation seems to presume that the price paid by the CFC for the acquisition of the IP did not account for the “supernormal” returns that accrue to the IP. These aspects of the Excess Profits Approach, along with the shift away from focusing on the active nature of the activity as an exception to treatment of the income as CFC income, are distinct disadvantages of this approach.

17. How could the practical problems be addressed or mitigated?

See points above.

18. Which approach is most likely to accurately attribute income that gives rise to BEPS concerns? Is one approach likely to be more effective than the other in terms of dealing with IP income?

We consider that a categorical approach with suitable substance tests would be most appropriate in challenging BEPS behaviours. The Excess Profits Approach has a high likelihood of being over-inclusive. For the same reason, it would clearly capture more IP income. However, whether IP income in general should be treated as CFC income simply because it is taxed at a favourable rate and/or because it has a higher than “normal” return under the terms in the report, are both debatable. The Discussion Draft seems to take the view that all IP income is inherently problematic if it is located in a low tax jurisdiction. However, there are certainly instances where favourable treatment of IP income should not be viewed as problematic – e.g., patent box regimes, self-developed intangibles. Therefore, a more tailored, categorical approach would be better because it is narrower in its application.

19. Could the excess profits approach be applied to income other than IP income and what would be the practical implications of this?

If the Excess Profits Approach were applied to other types of income as with IP the results can be arbitrary. As such, exceptions would need to be added to the rule to avoid potential double taxation and ensure the rule applies to the type of income intended to be addressed (i.e. those with specific BEPS concerns). Additionally, the “normal” return calculation would need to be tailored to address what would be considered appropriate returns for other types of income that would be covered by the expanded Excess Profits Approach rule.
20. What other approaches could be considered for determining excess profits or excess returns?

None noted.

21. What difficulties or practical problems arise in applying an entity approach or a transactional approach?

An entity approach could lead to over-inclusion. The entity approach can also lead to swamping or tainting.

A transactional approach may result in more administrative effort by companies but benefits from being proportionate. Furthermore, given that these transactions which are the focus of the CFC rules are related party cross-border transactions, reconciliation of the information reported by entities in different jurisdictions may be required to accurately analyse and report the transactional information.

A joint approach with an entity based approach (with safe harbour limits for levels of high risk income), coupled with a transactional approach where safe harbour levels are breached would allow taxpayers the best of both worlds – namely simplicity where an entity does not have significant high risk income, and proportionality where the safe harbour limits are breached.

22. What concerns arise from the two approaches in terms of administrative burdens and compliance costs?

We recommend a combination approach to balance the aim of challenging BEPS without introducing undue burden on businesses. For lower risk entities, an entity approach with threshold exclusions is most appropriate as a way of eliminating these from further consideration. For higher risk entities, then the increased cost of complying with transactional rules – in terms of more detailed financial analysis and complexity of rules – is, in our opinion, not excessive and is justified by the need to challenge BEPS.

23. How could these concerns and/or practical problems be dealt with while still ensuring that the CFC rules achieve an accurate result and attribute income that raises BEPS concerns?

As for question 22 and as noted previously, more alignment with and combining of reporting in conjunction with transfer pricing reporting could minimise the overall burden by eliminating any duplicative information gathering and reporting.

Chapter 6: Rules for computing income

We are in broad agreement with the draft recommendations in this Chapter. In relation to the use of losses in a CFC territory, we agree that following parent territory loss offset rules would seem reasonable, but do not see any policy reason why losses within a CFC should not be capable of being used against profits in other entities in the CFC territory, and also respect losses used in the context of fiscal unities.
24. Do the rules on computing the income of a CFC present any difficulties in practice? If so, what are these and how could they be dealt with?

The use of parent territory rules of computation will in practice be very familiar to the persons within a group responsible for computing any CFC income. Accordingly there should be little additional burden in relation to understanding the rules. From a policy perspective, however, applying the law of the parent jurisdiction presumes that the primary concern is erosion of the parent jurisdiction’s tax base. As noted above, such an approach may not account for differences in the computation in the CFC’s and parent’s tax bases that do not give rise to BEPS concerns. Exceptions to limit double taxation in these situations would need to be implemented in conjunction with this rule.

A practical difficulty may arise where multiple entities are in a CFC territory and where that territory allows for fiscal consolidation or group relief of losses. Here if the parent territory rules do not, a CFC charge could arise by virtue of having more than one entity in a territory when there is no overall profit. This would seem to give unfair results where the existence of more than one entity in the CFC territory does not have a tax avoidance motive.

The other practical difficulty we see in existing CFC regimes which adopt this approach is in obtaining information. Whilst high level accounting information is typically straightforward to obtain, the complexity arises when trying to adjust the CFC local GAAP profits into parent territory taxable profits. This usually occurs because the local accounting systems have not been configured to allow easy identification of adjusting items and also because non-accounting based items (e.g. values of assets for tax depreciation rules) may require detailed analysis to determine values. The former issue can be dealt with by appropriate accounting system configuration (which could be justified if regular CPC apportionments of the same income are required). The latter item requires the parent territory CFC rules to include sensible valuation methods to establish tax values in the first year of apportionment – accepting that it is unreasonable to expect a taxpayer to recreate the entire history of ownership of assets for a purpose that was never anticipated.

25. Does this chapter accurately reflect the issues that could arise with losses or are there any other situations that need to be considered?

No additional situations noted. We do have concerns over the potential recommendation of a rule to prevent loss offset against “bad” income within a CFC territory. This would seem to be unfair/ disproportionate if such relief would have been available if the income was earned in the parent territory. The mitigation proposed (carry forward/ carry back) would only help if the losses were indeed utilised and certainly would not alter significant potential timing disadvantages with tax being paid in year 1 and mitigation for a loss of the same year not being available for potentially many years to come (or indeed potentially ever).

Chapter 7: Rules for attributing income

We are again in broad agreement with the recommendation of the WP in this Chapter. Our only proviso is to reiterate the point made above in relation to Chapter 4; we see no BEPS policy reason why unrelated parties who are not acting in concert should satisfy the
control definition and accordingly do not consider it appropriate for income to be attributed to shareholders in such circumstances.

26. **What difficulties, if any, arise under existing CFC provisions for attributing income?**

Under US Subpart F rules, income is attributed to shareholders based on their relative ownership percentages in the CFC stock. Because the US employs a foreign tax credit system to alleviate double taxation, the attribution of income based on stock ownership and treatment of that income as a deemed dividend to the shareholder allows the shareholder the opportunity to mitigate double taxation with the foreign tax credits associated with the dividend. If a transactional approach to CFC rules were taken, rather than an entity approach as is currently the case in the US Subpart F rules, consideration would need to be given as to how the CFC income would be attributed to the parent and how it should be treated (i.e., deemed dividend or earned by the parent) to ensure double taxation can be mitigated.

27. **Does the description of a top-up tax set out all the advantages and disadvantages of such an approach?**

The description appears to fairly capture the advantages and disadvantages of a top-up tax.

**Chapter 8: Rules to prevent or eliminate double taxation**

28. **Are there any other double taxation issues that arise in the context of CFC rules that are not dealt with here?**

The proposed recommendations do not seem to consider the CFC rules of countries who do not adopt the proposals of paragraphs 154-155 where such entities exist in the ownership chain. This gives the possibility of double taxation.

29. **What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?**

Generally speaking, we find that the parent territories’ double tax relief rules, applied with suitable contextual changes, are not unduly burdensome in this context. The complexity and administrative work related to the computational and information tracking aspects of the US foreign tax credit computation, however, seem to generally outweigh the exemption system used by many countries. If the proposed CFC recommendations are enacted in a way that, as noted above, results in the same CFC income being subjected to tax by more than one jurisdiction, then the complexities of a foreign tax credit computation could be exacerbated. An exemption approach for taxes imposed under other countries’ CFC rules may be a simpler approach.
Mrs. Esther Martin
Associate Director of International Taxation (North America and Brasil)

Mrs. Susana Bokobo
Associate Director of Tax Policies and Global Practices

REPSOL, S.A.
Méndez Álvaro 44
28045 Madrid (Spain)

Mr. Achim Pross
Head of the International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration Organisation for Economic Co-operation and Development
2, rue André-Pascal 75116 Paris France
CTPCFC@oecd.org

Comments on Discussion Draft on BEPS Action 3: Strengthening CFC Rules

REPSOL appreciates the opportunity to provide input to the OECD with respect to its Discussion Draft on BEPS Action 3: Strengthening CFC Rules released on 3 April 2015.

Our comments are set forth below this brief introduction. We look forward to the opportunity to participate in the public consultation to be held on 12 May 2015 with respect to this topic and we also stand ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Chapter 3.- Threshold Requirements

4. Problems:

i. Distortion of effective average taxation in the medium/long run due to: (a) Corporate Income Tax timing differences; (b) temporary tax incentives granted by developing countries with high/very high statutory rates (e.g., oil & gas long-term investments).

ii. Cumbersome calculations where applying the rules of the parent jurisdiction.
5. Mitigation by (i) disregarding temporary differences; (ii) disregarding temporary incentives granted by high tax jurisdictions for genuine medium/long term economic activities; (iii) white lists excluding CFCs located in listed jurisdictions which are sufficiently similar in terms of tax base and tax rate to the parent jurisdiction.

Chapter 5: Definition of CFC Income

II. How CFC rules can accurately attribute income that raises BEPS concerns

12. The challenges/difficulties to accurately attribute IP income cannot be concluded against the taxpayers by treating all sales and services income as passive and therefore taxable under CFC rules by the parent jurisdiction (conclusion of par. 106, reiterated in last sentence of par. 110). Such a conclusion just challenges the existing Tax Treaties. Full-inclusion would be then the only available approach.

Nowadays certain activities generating IP income or income from the sale of digital goods and services require very little resources (“substance”) and still be genuine economic activities. Consensus should be reached as to whether CFC rules are the right tool to address what jurisdiction should be entitled to tax this type of income (customers jurisdiction? IP developers’ jurisdiction?....). If it is not, income from sales and services should not be treated as passive income under CFC rules.

Traditional industries (infrastructures, oil & gas, engineering, etc) cannot be penalized with cumbersome conclusions focused on digital economy.

14. What category of income is actually left to sustain an actual partial-inclusion system?

III. Possible approaches

15. The Excess Profits approach is formulated as a cumbersome computation that may be discretionary and subjective. The methodology is not clear for the following reasons:

- to the extent that almost each of the items factored in allow different options/interpretations ("eligible equity", “risk-inclusive rate", “equity investment", etc). It is difficult to understand the specific concern/goal to be addressed/achieved by these rules.
- The entry criterion combined with a prove-out (excess profits approach would only apply to all CFCs unless they could show that they did not make use of any intangible property acquired from or developed by or with the assistance of a related party) is not feasible as long as intangible property can only be defined by reference to the "normal returns". I.e., no matter what the economic activity consists of, the excess profits computation seems unavoidable.
- Why the excess profits approach should be applied to income that remained after TP rules had been applied? Shouldn’t these rules precisely address what is a “normal return”? What type of income is targeted by the excess profits approach unaddressed by the TP rules?
For the sake of clarification of the scope/goal of these rules, consensus would be necessary at least on certain key principles (rather than features):

- Foot note 37 (full inclusion).- It should not be a foot note but a principle governing CFC. Consensus as to whether or not fully-inclusion systems conforms article 7 and 10 of OECD Treaty Model would be welcome.
- Income derived from third parties (with no parent involvement) should preclude the application of CFC.
- Attribution should be limited to income that has been stripped from the base of the parent jurisdiction rather than from the base or third countries. Should this principle not be agreed on, taxpayers should be granted protection against over-inclusion or double taxation. All jurisdictions affected by an over-inclusion situation should commit to automatically relieve the taxpayer of any potential double taxation.

16. Practical problems (excess profits approach):

- Of the 4 options proposed for the risk-inclusive rate of return, only the fourth one would flexible enough to address the multiple types of industry, leverage and jurisdictions. Actually, a multinational group could use different CAMP or another accepted calculation for different business lines. In any event, should any of the chosen options depart from the TP accepted methodologies, inconsistent outcomes may be achieved and unreasonable administrative costs incurred.
- The determination/isolation of “eligible equity” (only equity invested in assets used in the active conduct of a trade or business, including IP assets, should be treated as eligible equity) may be very difficult/impossible as to certain assets may have multiple uses.

IV. Should CFC rules apply an entity or transactional approach?

21. The transactional approach would overlap with TP rules. TP rules should actually prevent situations described in par 128 in fine. The term “stream of income” under the transactional approach may be subjective and difficult to be determined for companies with interdependent streams of income.

22. The transactional approach would necessarily require the implementation of specific analytical cost accounting.

23. No solution is foreseen to sort out or minimize the above issues under the transactional approach.

Chapter 6: Rules for computing income

24. The full application of the law of the parent jurisdiction may be very too cumbersome. Timing differences should be excluded from this exercise.
Chapter 7: Rules for attributing income

26. Attribution of income based on the period of ownership could be administrative cumbersome and inaccurate where the CFC derives the income seasonably (how would it be determined?). Depending on how the attributable income is computed under this criteria, it could be as inaccurate as the determination based on the last day of the year.

Chapter 8: Rules to prevent or eliminate double taxation

28. Income attributed under CFC rules should only be taxed once.- If taxed twice in the parent jurisdiction, no domestic limitation should prevent the taxpayer from taking the relevant tax credit to the extent that it does not exceed the actual tax assessed for the attributed income at the parent jurisdiction. Any unutilized foreign tax credit should be allowed in the following years subject to the same cap (e.g. 2-year limitation for foreign tax credits).

Timing issues.- A credit should be allowed for any increase of foreign taxes as a result of TP adjustments, or any kind of tax assessment in a given year even if exceeding the tax assessed for the attributed income of such given year if the additional tax so assessed had not exceeded this cap if credited in the relevant audited calendar year.

Once that the CFC income has been directly or indirectly taxed in various jurisdictions at an aggregate effective tax rate equivalent or higher than that of the parent jurisdiction, no attribution should be required.
April 21, 2015

Mr. Achim Pross
Head of International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue Andre Pascal
75775 Paris Cedex 16
France

Mailto: CTPCFC@oecd.org

Comments on the Public Discussion Draft on BEPS Action 3 (Strengthening CFC Rules)

Dear Mr. Pross,

Thank you very much indeed for the opportunity to provide comments on the Public Discussion Draft on BEPS Action 3: Strengthening CFC Rules.

Rödl & Partner is an international professional service firm that is currently active at 91 wholly-owned locations in more than 40 countries. The integrated firm for audit, legal, management and tax consulting owes its dynamic success more than 3,700 entrepreneurial partners and colleagues. It is the largest international legal, tax law and auditing firm with German origin. In close collaboration with our clients we develop information for well-founded economic, tax, legal and IT decisions that we implement together – both nationally and internationally. We therefore submit our comments to the Public Discussion Draft based on our capacity as a professional organization.

We are grateful for the OECD’s leadership efforts to develop and promote a broad international consensus on the taxation of controlled foreign companies. We acknowledge that the Policy Considerations contained in Chapter 1 of the Public Discussion Draft are not open to discussion. However, we would like to stress the following aspects from our experience with respect to Germany:

In Germany, but from our perception also in many other countries, CFC-rules have a very strong prohibitive effect. In Germany, there are hardly any case law and comparatively rare administrative circulars and guidelines that deal with controlled foreign companies. This is even more surprising since the history of German CFC-rules go back to the year 1972. Particularly the absence of case law and also the small number of tax audits with respect to CFC-related aspects indicate that most taxpayers do their international tax planning without structures that may conflict with CFC-rules.
At least for Germany it is fair to say that because of the above, base erosion and profit shifting due to the use of CFC-structures is not a serious issue in practice. The above observations are also true vis-à-vis EU Member States. In German practice, there are still uncertainties about the consequences of the ECJ case in Cadbury Schweppes (C-196/04). The German tax authorities do not interpret the phrase “genuine economic activity” in line with the findings of the ECJ. Therefore, even in an EU context, German taxpayers tend to avoid structures that are likely to trigger CFC-rules. The “substance-test” has brought about some clarification, but is yet far from being clearly understood.

Rödl & Partner explicitly welcomes the idea of having in principle one set of rules for EU as well as non-EU countries (see No. 13 of Chapter 1 of the Public Discussion Draft). Future CFC-legislation should in any event concentrate on the “core idea” of CFC-rules and should therefore be limited to “wholly artificial arrangements that do not reflect economic reality and whose only purpose is to obtain a tax advantage”, as the ECJ has rightly put it.

The American Subpart F-Legislation once served as a model for the German CFC-rules and for the rules of many other European countries. The idea of the US originally was to cover only scenarios in which income was of a sort that could be artificially shifted. In all other cases, i.e. when a genuine economic activity takes place abroad, tax structures should largely be accepted even if this activity takes place in a low-taxing country. In these cases, the principle of capital import neutrality should prevail over the principle of capital export neutrality. We understand it would be in line with the OECD’s findings in No. 10 of Chapter 1 of the Public Discussion Draft to say that a genuine economic activity is in general a sufficient nexus to the State of Source so that CFC-rules should not apply. This is regardless of the fact whether the State of Source is an EU Member State or not.

It should also be noted that if the recommendations of the OECD should extend the scope of CFC-legislation to foreign partnerships, permanent establishments and the like as well (as suggested in No. 30 of Chapter 2 of the Public Discussion Draft), it should be ensured that the “substance test” is also applicable respectively. In Germany, the German tax authorities derive their legitimation to carve out foreign partnerships and permanent establishments from the “substance test” because of the ECJ decision in the case Columbus Container Services (C-298/05). In our view, this is due to a clear misinterpretation of the ECJ court rulings about the comparability of foreign subsidiaries and partnerships and permanent establishments respectively. The OECD recommendations should reflect the fact that capital import neutrality is also valid in case a domestic taxpayer acts through a foreign partnership or permanent establishment.

It also has to be noted that the BEPS initiative should strategically step back in case of measures that conflict with the principles of other law institutes and mechanisms which have long been established under the national laws of the Member States. One example is again the CFC-legislation. In the last sentence of No. 53 of Chapter 3 of the Public Discussion Draft, for instance, the OECD is arguing that even base erosion to high- or medium-tax-jurisdictions should trigger the CFC-rules. However, the CFC-rules historically only aim at preventing profit shifting with respect to low-taxing countries because only that was deemed to be a “harmful tax competition”. From our perspective, it is not helpful for the discussion to make use of a set of rules that originally aimed in a totally different direction.

In the remainder of this letter we have identified a number of items for further consideration by the OECD in its next version of the Public Discussion Draft. We believe that it would be beneficial if the output of the current OECD work results in clear and public recommendations to its Member States.
Detailed comments:

Chapter 2: Definition of a CFC

Question 1)
Treating transparent entities as separate entities in the context of CFC-rules goes to the very heart of the taxation of partnerships and corporate bodies according to the national law of the OECD Member States. The Pros and Cons should therefore be outweighed very carefully. Rödl & Partner thinks it will be of utmost importance not to introduce a separate qualification scheme for foreign partnerships for purposes of CFC-rules other than the one already used in the international tax law of a parent jurisdiction. Treating foreign transparent entities always as separate entities would also mean to think over the findings of the OECD Partnership Report 1999. The qualification of foreign entities for CFC-purposes must not be different than the qualification of foreign entities in other circumstances. This is particularly true for foreign entities in which a CFC holds directly or indirectly a participation.

In general, qualification conflicts with respect to foreign entities can be solved in two different ways: Option 1 is to have “linking rules” in a way that the State of Residence has to follow the viewpoint of the State of Source. Option 2 is that each State applies the viewpoint of its national tax law, irrespective of the qualification in the State of Source. Option 1 is preferable in theory, because a potential conflict is finally solved – however, it is not likely to be implemented in all OECD Member States on a political level. Option 2 is easy to be applied from the viewpoint of the State of Residence and the State of Source at the same time, but this in the end may result in double taxation or double non-taxation. According to our practical experience, Option 2 is applied in most OECD Member States.

It will be decisive for the OECD to reflect the above-mentioned issues when working out their recommendations. There are several problems that go along with treating transparent entities as separate entities in the context of CFC-rules – most of them are not innate to CFC-structures, but generally result from qualification conflicts relating to entities. In many countries, for instance, a double taxation in a CFC-structure is eliminated by using the credit method, i.e. the parent jurisdiction grants a tax credit for the taxes which have been paid by the CFC in the State of Source. However, most countries require for the application of the credit method that it is the same taxpayer that is taxed in the State of Residence and the State of Source. When States of Residence are forced to treat foreign transparent entities as separate entities, it may well be that the credit method fails. One of course could work with fictitious tax credits, but this is an instrument most countries have abolished.

The second problem that could arise when treating transparent entities as separate entities in the context of CFC-rules is that in a chain of CFC-entities double taxation issues can arise in case dividends are not regarded as “active income”. The third problem would be the determination of the CFC-income. If a partnership, to which for instance the Authorized OECD Approach is applicable, is not treated as transparent (but as a separate entity), it is questionable how the balance sheet positions and also possible amendments made outside the balance sheet can be transferred onto the “taxwise corporation”. This problem is also related to the question of whether the income of a CFC shall be determined under the laws of the parent or under the laws of the CFC jurisdiction. The fourth problem is how to deal with restructurings on the level of the CFC, i.e. if a corporation is converted into a partnership (or vice versa) or if a CFC is merged with another CFC or a normal subsidiary in the same or a different country. What happens if the foreign corporate law or the parent jurisdiction provides for a universal succession and what happens if not? Is it possible for a corporation to “inherit” a CFC-status? The recommendations should include suggestions for such scenarios.

Question 2)
In No. 30 of Chapter 2 of the Public Discussion Draft, the OECD is suggesting that CFC rules would possibly be extended to partnerships, trusts and permanent establishments “when those entities are
either owned by CFCs or treated in the parent jurisdiction as taxable entities separate from their owners”. In our view, the part of the sentence before the “or” is unclear in meaning. From the German perspective, income of a permanent establishment or partnership that is owned by a CFC would under German national law principles automatically be attributed to the CFC as though it was the CFC’s genuine income. This in effect means that Germany does not have any specific regulations pertaining to e.g. partnerships that are owned by a CFC, but does tax the CFC including the partnership’s income. Therefore, there is no need in separately addressing a partnership as a CFC.

In our view, CFC-regulations should in general be confined to entities that are subject to taxation from the viewpoint of the parent jurisdiction. Tax-transparent entities should be carved out of the scope at least in those cases in which the parent jurisdiction applies the transparency principle and in which the parent jurisdiction does not tax the income because of the exemption method under a double tax treaty. Trusts and “orphanised structures” that economically hold themselves should not be defined as a CFC. Base erosion in general aims at shifting profits, and it furthermore implies that the taxpayer in the State of Residence keeps control of the structure and the income streams. The latter criterion is often not fulfilled with trusts. Trusts also clearly do not play an important role in multinational groups that actually carry out real economic activities. Therefore, in order to avoid looking at each individual structure of a trust (which can be very tricky and sometimes almost impossible), it is advisable to leave trusts out of the scope.

**Question 3)**

Both options require a detailed comparison of the laws of the parent jurisdiction and the laws of a third country in case of triangular situations and are therefore not favorable from a practical point of view. By saying that an intragroup payment would only be taken into account if, inter alia, the payment would have been included in CFC income if the parent jurisdiction had classified the entities and arrangements in the same way as the payer or payee jurisdiction, the laws of a third country come into play, apart from the laws of the parent jurisdiction and the laws of the CFC, if we have a triangular situation. This makes CFC-rules even more complicated.

Moreover, the example that has been chosen in No. 30 of Chapter 2 of the Public Discussion Draft is not of that practical relevance. It is clearly not a structure specifically designed to circumvent CFC-legislation in Country A. The first reason is that the usual structure for evading CFC-rules is to have a direct subsidiary in a high-taxing country that earns passive income and an indirect subsidiary in a low-taxing country that earns active income (as has been done very regularly in tax regimes of, e.g., Malta). This structure is different, because it only plays with the tax arbitrage between Country B and Country C. Granting a loan between two countries with different tax rates only is not the sort of “structuring” that should be addressed by the BEPS initiative. Such “planning” is not in any way harmful, nor is it dependent on a qualification conflict between the involved countries.

The qualification or mismatch, however, as the OECD rightly confirms in the last sentence of No. 30 of Chapter 2 of the Public Discussion Draft, is rather between the parent jurisdiction and Country B. The second reason is that the mismatch results mainly from the deviating qualification of C-Co from the viewpoint of Country A. Between Countries B and C there is no mismatch, but just normal tax planning as discussed above. Moreover, in the chosen example, disregarding C-Co from the viewpoint of the parent jurisdiction would in effect mean to neglect income as well as cost. If C-Co is treated as tax-transparent, neither income nor expenses must be taken into account when calculating the profit of B-Co under the laws of the parent jurisdiction for CFC-purposes. The balance should instead be nil. Therefore, we suggest abolishing either option. If one option must be implemented, it should in our view be rather the narrow option than the broad option.
Chapter 3: Threshold Requirements

Questions 4 and 5)
The first and foremost problem is what kind of taxes shall be taken into account when calculating the effective tax burden. Most international CFC-rules aim at taking into account taxes on income only. But in reality, for instance in the Asia-Pacific region, Afrika and South America, there are often taxes that are levied on a business which are systematically not regarded as income taxes, but as some kind of general business tax (e.g. ongoing taxes on a turnover basis, stamp duties indirectly connected to a business or income, etc.). In our view, these taxes shall also be taken into account. A low taxation should be determined on the basis of all taxes on income in the broadest sense. This shall include all direct taxes; only indirect taxes shall be carved out of the scope.

The second problem is that many countries look at the taxation of the individual CFC only, and not at group taxes. The OECD’s recommendations should therefore include an idea of how to deal with situations in which the potential CFC is part of a fiscal unity or tax group in the State of Source. The recommendations should cover a group taxation positively and negatively, i.e. it should be accepted that taxes paid by another entity in a tax group of which the CFC is a part of are fully taken into account when calculating the effective tax burden of the CFC.

The third problem is that – at least from a German point of view – the low-taxation threshold is even for corporations considerably higher than in many pure domestic cases. The German corporate tax rate is only 15%, and if a German corporation does not pay any trade tax (e.g. corporations that only hold real estate), this is also the domestic effective tax burden. The OECD’s recommendations should therefore in our view stress the importance that a foreign low-taxation threshold should in any case be lower than any possible effective tax rate in a domestic scenario.

Question 6)
At least from a German point of view, the low-taxation requirement for permanent establishments as it reads today is systematically wrong. The low-taxation threshold in German law is 25%, as the OECD rightly points out in No. 56 of Chapter 3 of the Public Discussion Draft. This threshold has historically been taken from the old corporate tax rate which had been 25% until the year 2008, and it clearly aimed at a hurdle for corporations as foreign CFCs only. For foreign PEs, it is not appropriate, particularly not if a foreign PE is held by a German individual.

There are many cases in which a foreign country applies a progressive tax rate to individuals (as Germany does), but it may well be that for taxpayers with lower income the individual tax rate in the foreign country is lower than in Germany and possible also effectively below 25%, whereas taxpayers with higher income might be taxed even higher than in Germany. Therefore, the OECD’s recommendations should in our view include two different low-taxation thresholds for (i) corporations and (ii) individuals as owners in control of a CFC.

Chapter 4: Definition of control

Question 7)
Apart from the problems addressed at Nos. 71-78 of Chapter 4 of the Public Discussion Draft, the main problems with a control test indeed arise with respect to indirect shareholdings in a CFC if the relevant threshold is set at 50%. Figure 5 of Chapter 4 is an example with respect to indirect shareholdings, but the following Figures illustrate the problem in greater detail:
If one compares the two scenarios of Figure 1, both cases are objectively comparable with respect to control in Ltd. 2. The degree of control is roughly 26% which is in most countries not sufficient for the application of CFC-rules. However, one cannot deny that in the left hand example the taxpayer X has strictly speaking enough legal control to influence the economic activities of Ltd. 2 and therefore might also aim at base eroding tax planning. This is even more surprising in the example of Figure 2. The OECD recommendations should therefore particularly focus on indirect shareholdings and a solution to the underlying problem of indirect control interest.

Question 8)
There is an obvious problem that relates to Chapters 3 and 6 of the Public Discussion Draft. In case income would also be attributed to minority shareholders (Example: A domestic shareholder holds 60% in a CFC and a non-related domestic shareholder holds 5%), how can the non-related minority shareholder determine his income if he is not in a legal position to check the books and records of the CFC? The determination of income in accordance with the laws of the parent jurisdiction and therefore drawing up an “add back balance sheet” requires in a first step sufficient and succinct information about the balance sheet and tax situation of the CFC under the laws of the State of Source. A disclosure of books and records, however, is usually not granted to minority shareholders. Minority shareholders should therefore be carved out of the scope of CFC legislation in general.

Chapter 5: Definition of cfc income

Question 9)
The main problem with Options 1 and 3 is that they substantially rely on the employees of a CFC. This is in our view not an appropriate approach in general, because the number of employees must always be seen in the light of the specific economic activities of an entity. There are quite some activities that need only a limited number of employees or just one or even no employee at all, e.g. asset administration activities or e-commerce activities. In our view, any kind of economic activity in the broadest sense should be regarded as sufficient substance for CFC purposes.

The findings of the ECJ in Cadbury Schweppes (C-196/04) should be extended also to non-EU countries. It is true that the legal basis for these findings is set forth in the European Contracts, but the ECJ also made a sensible and wise decision: Only structures that aim at circumventing the law shall be covered by CFC legislation. As indicated above in the opening remarks, the aims of the BEPS initiative are in contrast with these historic purposes of CFC-rules. We suggest not to systematically make use of measures that are by nature not appropriate to reach the goals of the BEPS project.

Option 2 has close links to the area of transfer pricing. This may complicate things a lot, and in practice such an approach is very rarely chosen by OECD Member States so far, and that is for good reason. Moreover, this approach mainly covers transactions between the domestic taxpayer and the foreign CFC, but has its weakness when the CFC deals with unrelated parties.
Question 10)
In Germany, we have substance requirements within the exceptions of the active income catalogue (section 8 para 1 German Foreign Tax Act) as well as substance requirements in the sense of the Cadbury Schweppes judgment (C-196/04), section 8 para 2 German Foreign Tax Act. In our view, a substance test will always have to bear an element of evaluation of the circumstances as a whole because substance cannot be a fixed term, but should rather be seen in the light of the nature, degree and duration of the economic activities of a presumptive CFC in an individual case. Making the substance test more mechanical means in effect to go away from the concept of the individual case which can be tested by the taxpayer in a tax court. In our view, this is not an appropriate approach.

Question 11)
No comments.

Question 12)
Any kind of substance requirements with respect to IP income should be reduced to an absolute minimum. Managing IP does not by itself require many people/staff, nor does it require a large office or other ancillary assets. With respect to IP income, the recommendations should therefore include a suggestion that the place where the IP is managed is sufficient to create substance. Furthermore, it should explicitly not be of any importance where the IP has been created because nowadays and particularly with multinational IT companies it is almost impossible to determine this place.

Question 13)-23)
No comments.

Chapter 6: Rules for computing income

Question 24)
We support the OECD’s view that the rules of the parent jurisdiction should apply when calculating the income of the CFC because only that is in line with the underlying aims of the BEPS initiative. Moreover, most countries have always followed that approach. However, the recommendations should also include a suggestion that the income shall be calculated in a way as though the CFC was a domestic corporation of the parent jurisdiction. This should be done in a way that also advantageous tax rules that are usually applied to such corporations are also applicable in case of a CFC, e.g. like participation exemptions under national law, tax-free amounts in general, etc.

Question 25)
The recommendations should clarify the relationship between CFC-rules and the effects of the ECJ judgments regarding so-called “definitive losses” as developed particularly in the ECJ Cases Marks & Spencer (C-446/03), Lidl Belgium (C-414/06), etc. If the parent jurisdiction bars foreign losses of the CFC from setting them off against potential income of the CFC or of the parent, the question arises whether these losses may be imported into the parent jurisdiction under specific circumstances as required by the ECJ in the aforementioned rulings.

Chapter 7: Rules for attributing income

Question 26)
The difficulties of attributing income are described properly. However, the issues raised under Point D. should be emphasized because the way the parent jurisdiction treats the income also influences the way in which an existing double tax treaty must be enforced. When the CFC-income is treated as a deemed dividend, most countries will apply the tax treaty article equivalent to Art. 10 of the OECD
Model Convention, whereas in case of treating the income as income of the taxpayer, the equivalent to Art. 7 of the OECD Model Convention will apply. The latter then also relates to the question whether the CFC-rules in question are technically a treaty override or not and which requirements national law provides to allow for such a technique.

Question 27)
It depends on how one evaluates the principle of capital import neutrality compared to other factors (e.g. the aims of the BEPS initiative). In our view, this principle of capital import neutrality should prevail over CFC-rules in general, but if the OECD enforces CFC-rules, the idea of a top-up tax indeed is a good compromise. However, one also has to see that in that case probably not all foreign taxes can be credited against the income taxes paid in the parent jurisdiction, so that international double taxation would not be eliminated, but just mitigated.

Chapter 8: Rules to prevent or eliminate double taxation

Question 28)
In our view, the recommendations cover all relevant scenarios. Emphasis should, however, be placed on cases of a timing mismatch. With respect to some countries, the CFC-taxation in the parent jurisdiction takes place in a fiscal or calendar year different than the year relevant for the taxation in the State of Source. For those cases, the credit method should be made fit to be applicable as well. Emphasis should further be placed on cases in which the taxes of the CFC are usually very low, e.g. for dividends which are often regarded as active income (see idea of a fictitious tax credit below).

Question 29)
In our view, there is no further administrative burden or practical issue that would be peculiar to a CFC-situation. There are just the “usual” problems that go along mainly with the credit method, i.e. the problem of providing evidence that and to what extent taxes have been paid in the foreign country, etc. Since CFC-rules are in a strict sense a sort of penalty, it should be discussed whether some kind of relief from the requirements of the credit method would be appropriate in some cases, e.g. a fictitious tax credit or a lump-sum tax credit, etc.

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For any questions related to the above comments sent on behalf of Rödl & Partner, please contact:

Prof. Dr. Christian Rödl
Rödl & Partner, Nuremberg office
cristian.roedl@roedl.com
+49 911 9193 1000

Prof. Dr. Florian Haase
Rödl & Partner, Hamburg office
florian.haase@roedl.com
+49 40 229 297 520
Mr. Achim Pross  
Head International Co-operation and Tax Administration Division  
Centre for Tax Policy and Administration  
OECD  
2, rue André Pascal  
75775 Paris Cedex 16  
Per e-mail: CTPCFC@oecd.org

Basel, 30 April 2015  
A.149/JBR

Public Discussion Draft – BEPS Action 3: Strengthening CFC Rules

Dear Mr. Pross,

The Swiss Bankers Association (SBA) is the leading professional organisation of the Swiss financial centre. Its main purpose is to maintain and promote the best possible framework conditions for the Swiss financial centre both at home and abroad. The SBA was founded in 1912 in Basel as a trade association and today has 317 institutional members and approximately 18'500 individual members.

The SBA thanks the OECD for the opportunity to provide comments on its discussion draft on Action 3 (Strengthening CFC Rules) of the Base Erosion and Profit Shifting (BEPS) Action Plan issued on 3 April 2015 (“discussion draft”).

We generally agree with the comments provided by the BIAC but would like to stress the following points, which reflect a financial sector perspective.

General comments

The SBA believes that the discussion draft attempts to address a number of competing objectives, which (partly) conflict with other action items. This is in particular valid with regard to transfer pricing rules. We are of the opinion that effective transfer pricing rules address BEPS concerns more effectively than CFC rules and should not be undermined by conflicting rules resulting in the re-allocation of profits, which were already allocated through transfer pricing and arm’s length rules. The discussion draft lacks any analysis and proposal on how such conflicts (and other conflicts with respect to other action items, in particular 2, 4, 5, and 8-10, 11, 14 and 15) shall be addressed.

Since no clear objective has been identified in the discussion draft for implementing CFC rules, we are of the opinion that these do not cover the initial objective of the BEPS action plan. We furthermore believe that any CFC rule (if adopted) should be introduced as a best practice rule and not as a minimum standard.
Secondary Rules

The SBA is concerned about the idea to introduce secondary rules that apply "to income earned by CFCs that did not give rise to sufficient CFC taxation in the parent jurisdiction". From our point of view such rules cut against the original intention of the BEPS action plan and would lead to a re-allocation of taxing rights purely based on the level of taxation in a particular country. Such an approach would have a significant impact on the cross-border business and as a consequence countries applying lower tax rates might loose tax revenues and hence their overall competitiveness only because they are not high tax countries.

Sector specific Rules

If CFC rules are adopted in the BEPS context, the SBA is of the opinion that there is a need for sector specific rules. The discussion draft does not address this possibility and does not make any suggestion for rules in this regard. In particular with respect to the definition of CFCs, income specific rules for the financial industry might need to be taken into consideration. It is for example obvious that interest income in case of regulated banks should not generally be considered as passive (and therefore as CFC) income. Banks have many different types of interest income which need to be analyzed in more detail and which might require special rules (e.g. interest income on client positions vs. positions of the bank).

Substance Analysis

The SBA has concerns regarding substance analysis based on employees. In the current international business environment such criteria might not be adequate in all situations. Applying such rules would lead in particular in case of outsourcing to results that do not reflect the value chain adequately. Usually the outsourced activities are of a preparatory or auxiliary nature (e.g. production of reports) and do not contribute significantly to the value of a certain product/service. On the other hand, such auxiliary work is typically performed by a large number of employees located abroad; the number of these employees can be much higher than the amount of employees contributing effectively to the value of the product/service provided. In this context, one should rather focus on where the functions and risks are located or assets are booked instead of on employee headcounts. This being said, we recognize that countries might have different interpretations in this respect. A substance analysis based only on the number of employees would nevertheless lead to a situation where more profits than justified are allocated abroad and where the contribution to the value chain is not correctly reflected in such an allocation.

Final comments / Summary

The discussion draft lacks addressing clearly enough the aims of the CFC rules and conflicts with other action items. It is also missing an analysis and discussion of the existing (and up and running) CFC systems (these are only mentioned at some points as examples). In addition the excessive profit approach and the secondary rule are not embedded in the CFC rules but are somehow isolated as a separate building block.
Finally, no suggestion is made how the complexity of CFC rules can be reduced. If CFC rules are nevertheless to be adopted in the BEPS context, these should constitute best practices and not minimum standards.

The SBA thanks the OECD for taking due account of these comments.

Yours sincerely,

Swiss Bankers Association

[Signatures]

Regula Häfelin
Jean Brunisholz
30 April 2015

Via E-Mail
CTPCFC@oecd.org

Mr. Achim Pross
Head International Co-operation and Tax Administration Division
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

Comments of SwissHoldings on the BEPS Action 3 Discussion Draft (Strengthening CFC Rules) of 12 May 2015

Dear Mr. Pross

The business federation SwissHoldings represents the interests of 61 Swiss based multinational enterprises from the manufacturing and service sectors (excluding the financial sector). SwissHoldings is pleased to provide comments on the BEPS Action 3 Discussion Draft (Strengthening CFC Rules) (hereafter referred to as “the Draft”). Our comments mainly endorse comments made by BIAC and/or BUSINESSEUROPE.

I. General Comments

Clear Policy Objective
SwissHoldings strongly believes that the OECD’s Discussion Draft lacks a clearly articulated policy objective. At present, the Discussion Draft attempts to satisfy multiple competing objectives, resulting in a set of complicated and conflicting proposals. Before refining the existing recommendations, it is critical to determine exactly what the purpose of CFC rules should be. Attempting to pursue conflicting policy objectives will naturally result in confused and problematic proposals.

It seems wrong to deliver a minimum standard for income inclusion if no minimum standard exists to protect legitimate active income resulting from real and substantive business activity. The Discussion Draft, as it stands, risks substantially increasing the compliance burden faced by business, and bringing into scope legitimate transactions that ought not be subject to CFC rules.

Complexity and Interaction with other BEPS Actions
The OECD’s proposals and options risk creating substantial complexity for taxpayers and tax administrations alike. Many recommendations and options would require additional detailed guidance to fully understand how they could be implemented and applied in practice. Without such guidance, proposals may be interpreted and implemented by countries in different ways – presenting taxpayers with an increasingly complex web of rules.
Having a broad range of substantially different CFC rules, even if loosely based on the same ‘minimum standard’, would substantially increase compliance costs for taxpayers, and would risk creating double taxation.

SwissHoldings supports the development and implementation of clear and consistent CFC rules that are designed to target specific behaviours and do not impose an undue compliance or reporting burden on business. However, there is a risk that a recommendation that only sets out policy options will not result in clear or consistent implementation and interpretation of CFC rules and will lead to greater compliance cost and uncertainty, with an effect on foreign direct investment.

The BEPS Action Plan will deliver a range of proposals that will be implemented in various ways (for example, a new multilateral tool, bilateral treaties, domestic legislation and Transfer Pricing Guidelines). We are increasingly concerned that, when proposals and recommendations are taken together, taxpayers will be presented with an almost insurmountable compliance burden, detracting resources from real commercial activity.

The Discussion Draft states that the work on CFCs is closely associated with other BEPS Action Items (including Actions 1, 2, 5, 8-10, 11, 14 and 15). Due to the overlapping nature of the Action Plan, specific abuses may be targeted (and addressed) through multiple recommendations. A holistic and detailed review process is critical prior to delivering the package of actions to develop clear agreement over i) which abuses should be targeted by which Actions, and ii) how the proposals should be implemented and ordered so to mitigate unnecessary rules and compliance costs.

Targeting BEPS: Transfer Pricing vs. CFC rules

The Discussion Draft explains that Transfer Pricing and CFC rules can be closely related in several ways, and that both types of rules can exist side-by-side to fulfil different roles. SwissHoldings however fears that the CFC proposals could undermine the detailed work being undertaken by Working Party 6, for example, in the area of risk and capital, and go beyond tackling base eroding or profit shifting activities.

Targeted CFC rules that can be clearly and objectively applied may well be an appropriate solution to target ‘cash box’ (i.e., highly capitalised low substance) entities, but we are concerned that very broad rules could implicate commercial transactions with appropriate substance, simply because the tax-rate applied is low when compared to the parent country. One of the primary objectives of the BEPS Action Plan is to realign profits with substance - well drafted Transfer Pricing guidance should be capable of doing this in many instances, without the need for additional rules (and associated compliance burdens). In this regard, the Discussion Draft states that the Excess Profits Approach would only “apply to income that remained after transfer pricing rules had been applied,” suggesting that countries do not have confidence that work being delivered by Working Party 6 will provide the tools to challenge transfer pricing issues through the application of Article 9. We are concerned that some of the OECD’s CFC proposals would have the impact of undermining legitimate and substantive transactions that have been priced and evidenced in accordance with Article 9 and the OECD’s Transfer Pricing Guidelines. Countries could seek to apply such an approach to transfer pricing results solely based on the applicable tax rate, rather than because profits and substance have been misaligned.

Excess Profits Approach

SwissHoldings believes that the Excess Profits Approach is overly broad, and is not sufficiently targeted at BEPS to warrant inclusion in the OECD’s recommendations. We are particularly concerned about:
SwissHoldings comments on the BEPS Action 3 Discussion Draft (Strengthening CFC Rules)

- **Timing differences and distortions** (including any differences in the parent-jurisdiction vs. local-jurisdiction accrual of income, deductions, or the treatment of Net Operating Losses) – Any attempt to use multi-year averaging to correct for such differences will be complex or not correct for longer-period timing differences (e.g., different depreciation rates, or a growing asset base).
- **Determining the “excess profits” with accuracy** – Although proposed as a mechanical approach, the Discussion Draft sets out a number of complicated calculations, where a range of answers could be possible.
- **Overriding exemption or deferral systems** – In its application, the Excess Profits Approach will risk overriding the intended application of exemption or deferral tax systems to legitimate transactions in many cases.
- **Anti-competitive consequences** – No country has yet adopted such a rule. The implementation of an Excess Profits Approach would likely have substantial anti-competitive effects. Given the untested nature of this proposal, it should not be considered a ‘best practice’.

**Hierarchy of Rules**

Ensuring proper and effective relief from double taxation is critical to the success of Action 3 and the wider BEPS project. A clear common hierarchy of rules that would apply across different CFC regimes and between CFC regimes, Transfer Pricing rules and actions on interest deductions should be developed as a matter of priority. Broad consensus among the participants in the BEPS process on the hierarchy should be achieved to reduce the risk of disputes between countries and MNEs over the order of utilizing different measures. Furthermore, within CFC rules there should be clear guidance on the order of foreign tax relief methods to ensure that effective relief is available for foreign taxes paid on both ordinary income and CFC income.

As with other BEPS Actions, the design and implementation of an effective and efficient dispute resolution process is very important and needs to be linked with the hierarchy of CFC rules and double tax relief. Thereby it shall be ensured that any practical failures to give effective relief across different country regimes can be rectified promptly.

**Secondary Rule**

Following from the previous point, the Discussion Draft notes that some countries have proposed a “secondary rule” that could be “applied to income earned by CFCs that did not give rise to sufficient CFC taxation in the parent jurisdiction.” We are concerned that such a proposal would cut against the original intention of the BEPS Action Plan, and would reallocate taxing rights purely based on the level of taxation imposed in a particular country. SwissHoldings does not believe that CFC rules applying to substantive activity simply because the applicable tax rate is low is the right approach. Such an approach could have a substantial negative impact on competition and cross-border trade.

In Paragraph 19 of the Draft, in a discussion on the scope of base stripping, there is an implied recommendation that CFC rules should be designed to protect against both base stripping in the parent company jurisdiction and “foreign to foreign” stripping, as the BEPS plan is intended to prevent erosion of all tax bases. This expands the scope of many current CFC rules and creates great uncertainty over taxing rights, double taxation and the applicability of double taxation conventions. This proposal, combined with the reference to potential consideration of a secondary CFC rule, leads to the conclusion that the aim of Action 3 may go beyond the development of best practice in the design and implementation of CFC rules that balance administrative costs with targeted action on abusive structures (SwissHoldings supports the latter two objectives). The broader objective appears to be the design of a principle of minimum taxation to be applied for all international businesses where transfer pricing, loan interest restrictions, hybrids and
other rules, together with action on harmful tax practices of countries does not lead to an effective tax rate that is within an (undefined) acceptable range. If this is indeed the intent of Action 3, the principle requires detailed explanation and justification as a fundamental change in current international tax policy and practice.

II. Specific Comments

CHAPTER 1: POLICY CONSIDERATIONS

SwissHoldings welcomes consideration of the impact of EU Law on the OECD’s proposals, and the need to bear the EU freedoms in mind when developing minimum standard rules. We strongly agree that MNEs not based EU Member States should not be at a competitive disadvantage compared to those that are.

No unequal treatment of EU and non-EU countries: As a business organization representing the interests of companies not based in EU Member States we are disappointed that the Discussion Draft already indicates the possibility of parallel standards, stating in Paragraph 13 that “EU Member States may need to modify these recommendations to comply with EU law”. We encourage the OECD to develop its minimum standard in a way that is EU Law compliant, so that it is capable of consistent adoption.

SwissHoldings fully agrees that effective rules should not unduly increase compliance costs and administrative burdens to taxpayers and tax administrations, and that “CFC rules must strike a balance between the reduced complexity inherent in mechanical rules and the effectiveness of more subjective rules.” (Paragraph 15). With that in mind, we are concerned that many of the options and recommendations identified in the Discussion Draft lean towards more subjective tests that would vastly increase the difficulty of application. We also note that in a significant number of areas, the OECD has not made clear recommendations, providing countries with full flexibility to adopt substantially different approaches.

CHAPTER 2: DEFINITION OF A CFC

OECD Questions for Consultation:

1. Would any particular practical issues arise from treating transparent entities as separate entities in the cases listed above? If so, what are they and how could they be dealt with?
2. Should the recommendations consider any other issues related to determining which entities could be considered to be CFCs?
3. Are there any practical problems with either the narrow or the broad version of the modified hybrid mismatch rule mentioned above?

Any rules for the treatment of transparent entities as separate entities should be consistently interpreted and applied across all countries and appropriate consideration given to the treatment of the entity in intervening jurisdictions as well as the parent’s jurisdiction.

CFC rules that apply on an entity basis rely on the calculation of profits and taxes paid or payable in that entity. Where the entity is transparent and is not required to prepare separate accounts, or is a branch or PE and full separate accounts are not prepared, there may be administrative and compliance challenges in
obtaining the information required to make CFC calculations: some flexibility in compliance with CFC requirements where accounts are not available would be helpful.

Paragraph 1 of the Discussion Draft states that “the objective is to develop recommendations for CFC rules that are effective in dealing with base erosion and profit shifting.” Given that broader rules are likely to bring more income into scope, creating additional compliance burdens and risk of double taxation, we would recommend narrow approaches that clearly target BEPS related issues.

CHAPTER 3: THRESHOLD REQUIREMENTS

OECD Questions for Consultation:

4. What practical problems, if any, arise when applying a low-tax threshold based on an effective tax rate calculation?

5. How could these problems be addressed or mitigated?

6. Does the discussion above correctly address the situation of permanent establishments that are subject to a different tax rate than CFCs?

Paragraph 57 recommends the use of the effective tax rate (ETR) of a CFC to determine the low-tax threshold. Paragraph 58 goes on to suggest that the ETR would need to be calculated based on rules of the parent/shareholder’s country or International Financial Reporting Standards (IFRS). For MNEs operating a substantial number of subsidiaries, perhaps owned by parents in different jurisdiction, the application of different rules and accounting standards would substantially increase the cost of complying with CFC Rules. Even differing definitions of income can cause substantial difficulties and anomalies. Clear and effective threshold rules would be welcomed to remove many low-risk entities from the scope of such calculations.

Experience of applying low-tax threshold tests in practice is that a critical issue is the availability of data to allow the calculation of the threshold test to be carried out. This would be exacerbated where PEs and other transparent entities are included where accounting and tax information is not currently available. The availability of information becomes more of a challenge where parent company CFC reporting or calculation requirements are required at an early date before local accounting and tax reporting has been completed. A consistency in the timing of CFC calculations of several months after the accounting year would be helpful.

Calculation of effective tax rates is frequently affected by differences in the capitalization, amortization or tax depreciation of assets or differences in timing of revenue recognition between different accounting and tax regimes. This can cause wide fluctuation in effective tax rates, and temporary low effective rates in higher tax countries where timing differences, investment incentives or tax holidays are part of the local tax policy.

CHAPTER 4: DEFINITION OF CONTROL

OECD Questions for Consultation:

7. What practical problems, if any, arise when applying a control test?
8. Are there particular practical problems that arise when applying a control test that considers interests held by unrelated or non-resident parties? If so, what are they, and how can they be dealt with?

Control tests that include criteria other than readily available legal ownership or economic control using data that is relatively easy to establish or calculate can create significant practical problems. De facto control is difficult to establish without retrospective review of actions and analysis of facts and circumstances and will in most cases also involve an element of subjective determination. Unless it could be clearly demonstrated that a de facto control test was a requirement to address particular circumstances where significant BEPS behaviors were evident, the cost and complexity of this test would not be justified.

For most international businesses legal ownership and consolidation tests, which are generally carefully examined by external auditors, would be sufficient to establish which entities are controlled and which are not and these tests are unlikely to produce a different result from an economic control test for most MNEs.

CHAPTER 5: DEFINITION OF CFC INCOME

OECD Questions for Consultation:

9. What are the practical problems with any of the three substance analyses set out above? How could these practical problems be dealt with?

10. Do you have experience with applying substance analyses in existing CFC rules? If so, how can these be made more mechanical while still accurately attributing income?

All of the substance analyses have some practical problems and require a greater or lesser level of functional analysis to arrive at a reasonable conclusion with a suitable audit trail and rationale. Some tests are highly complex to interpret and apply, depending on the drafting and interpretation of the CFC laws in the parent jurisdiction. While there may be some common ground between the substantial contribution analysis and functional analysis required for transfer pricing documentation, the tests and analysis are not identical and it should not be assumed that a substantial contribution analysis can be easily developed from existing transfer pricing documentation.

Of the three the viable independent entity analysis requires the greatest level of subjectivity and is therefore more at risk of dispute and controversy, and is less easy to support with a clear audit trail. The employees and establishment test is in theory more mechanical and easier to apply, but in determining whether the CFC has the necessary premises, establishment and employee functions, the analysis becomes in practice similar to a viable independent entity analysis with a requirement to use judgement. As different MNEs have a range of business activities, accounting systems and levels of internal management and control, there is no single type of analysis that works equally effectively for all. Therefore an approach that permits the reporting group to use its own preferred method to initially determine and document which CFCs have sufficient substance, using one or a combination of the three types of analysis may be more effective and efficient.

OECD Questions for Consultation:

11. How can CFC rules accurately attribute income that raises concerns about BEPS (i) in a business that is licensed under an appropriate regulatory body and is market-facing in a particular jurisdiction,
(ii) in a reinsurance business carried on by a CFC of a multinational insurance group or (iii) in a “captive” insurance business of a CFC that is not part of an insurance group? Are there practical problems with current rules that distinguish between these two situations? If so, what are they and how can they be dealt with?

12. Are there practical problems with applying the same rule to sales and services income and IP income?

13. Are there existing CFC rules that accurately attribute any or all of these categories of income while also reducing administrative and compliance burdens?

14. Does the discussion above consider all categories of income that should be attributed under CFC rules?

The Draft appears to be based on a view of international business that most transactions relate to high value products with significant IP content where sales or service income includes or could include an embedded royalty or other return for an intangible asset so that CFC treatment of sales and service income is appropriate. The default position as proposed at paragraph 114 is that all sales and service income should be treated as passive unless one of the substance analysis requirements can be met. There are many international business transactions where these assumptions are not appropriate and where there is no direct link between sales or service income and any valuable IP and this is reflected in the active trade or business test found in some existing CFC regimes. Reversing the burden of proof on the basis of the limited analysis in paragraphs 105-106 is unjustified, particularly as enforcement of appropriate transfer pricing rules would address most of the issues relating to invoicing companies and the correct reward for IP.

For the many businesses following a more traditional business model, any CFC rules that define attributable income should therefore be clear that sales and service income are only included where there are significant related party transactions or other characteristics that would justify CFC treatment.

**OECD Questions for Consultation:**

15. Is it clear how the two approaches above would work? If not, what further detail is required to clarify the approach?

16. What practical problems arise with applying the categorical approach and the excess profits approach?

17. How could the practical problems be addressed or mitigated?

18. Which approach is most likely to accurately attribute income that gives rise to BEPS concerns? Is one approach likely to be more effective than the other in terms of dealing with IP income?

19. Could the excess profits approach be applied to income other than IP income and what would be the practical implications of this?

20. What other approaches could be considered for determining excess profits or excess returns?

It is not clear how the two approaches would work and in particular, it is not clear how the excess profits approach would work, or how it would be consistent with the other established principles of international taxation included in the OECD guidelines. The approach may be a “simpler and more mechanical”
approach as claimed in the Draft, but it introduces a novel principle that seems inconsistent with other BEPS actions as well as the Arm’s Length Principle and some EU law principles.

If the excess profits approach is based on current or proposed domestic legislation in any country, providing more details of that legislation and, in particular, the criteria for including or excluding entities from the test would be required before any informed response to the questions posed in the Draft could be made. It would also be necessary to understand why this approach would be needed if all the other recommendations of the BEPS Action Items were implemented. In what circumstances would there still be an “excess return” in a company and would a more targeted measure aimed at those particular circumstances be more effective and efficient that a broad measure that could require calculation and reporting for many entities where no adjustment would be required.

As the excess profits approach applies a hypothetical “normal” return on almost any investment in a CFC, it is difficult to see how this approach could “accurately attribute income that gives rise to BEPS concerns”. If the purpose of the Draft is to target particular BEPS concerns accurately, the categorical approach would be the more appropriate of the two.

OECD Questions for Consultation:

| 21. | What difficulties or practical problems arise in applying an entity approach or a transactional approach? |
| 22. | What concerns arise from the two approaches in terms of administrative burdens and compliance costs? |
| 23. | How could these concerns and/or practical problems be dealt with while still ensuring that the CFC rules achieve an accurate result and attribute income that raises BEPS concerns? |

The likely practical problem that would arise from the transactional approach is the difficulty of obtaining sufficient accurate data to apply CFC rules on a transactional basis. Experience with existing CFC regimes is that information can be obtained relating to local entity activities and financial results so that existing financial systems can be used, with suitable adaptation and additional information, to compute income attribution. Depending on how the “transaction” is defined, preparing an accurate determination of the profit attributable to that transactional stream could be complex and may require allocation of costs against income that would need to be based on estimates or allocation keys and therefore subject to dispute on audit.

As information at an entity level is more easily available, SwissHoldings would recommend that best practice would be for attribution to be made on an entity level in most cases, as it is likely that there would be no benefit in carrying out a transactional level analysis for most CFCs. Using some appropriate threshold to identify those entities where further analysis on a transactional level was required to address the concerns noted in paragraphs 128-9 would reduce overall administrative costs and focus on those entities where there could be a material adjustment.

CHAPTER 6: RULES FOR COMPUTING INCOME

OECD Questions for Consultation:
24. Do the rules on computing the income of a CFC present any difficulties in practice? If so, what are these and how could they be dealt with?

25. Does this chapter accurately reflect the issues that could arise with losses or are there any other situations that need to be considered?

Many businesses experience practical difficulties to a greater or lesser extent in computing the income of CFCs, particularly where local reporting, accounting and tax information is not in the same system as the parent and where there are differences between local accounting and tax rules and those of the parent.

Effectively, many businesses are obliged to prepare duplicate accounting and tax reporting for the CFC to compute income under the same principles as the parent, and to maintain this data for several years to deal with balance carry forwards and tax adjustments. The Draft recommends the use of the parent jurisdiction’s rules, which will result in the continuation of the existing practical difficulties that many businesses experience.

If more countries decide to implement CFC rules as a result of this Action, there would be an additional level of complexity. For each tier of CFC reporting, data analysis and calculation would be required in the local rules of that tier of CFC, so that several different calculations could be required if the business has several tiers of ownership, which many do for historical reasons rather than tax planning.

CHAPTER 7: RULES FOR ATTRIBUTING INCOME

OECD Questions for Consultation:

26. What difficulties, if any, arise under existing CFC provisions for attributing income?

27. Does the description of a top-up tax set out all the advantages and disadvantages of such an approach?

The description of the top-up tax, which is limited to a single paragraph does not set out all the advantages and disadvantages of this approach as little detail of how this might work in practice is provided. The fundamental principle of whether a top up tax that targets a minimum acceptable tax rate has not been explained in detail, but the top-up tax would probably only be appropriate for some jurisdictions that operate a worldwide taxation approach.

CHAPTER 8: RULES TO PREVENT OR ELIMINATE DOUBLE TAXATION

OECD Questions for Consultation:

28. Are there any other double taxation issues that arise in the context of CFC rules that are not dealt with here?

29. What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?

Many countries have complex rules relating to the use of foreign tax credits against taxes due in the parent company jurisdiction and their complexity is made more challenging through audit adjustments to domestic and overseas income and taxes which can arise several years after the end of the accounting period. It is
rarely a simple matter to obtain full relief for all foreign taxes paid and this is often made more difficult where the nature of the income received by the parent is dividend or deemed dividend income or some other non-trading income. In many countries (also in Switzerland) foreign tax credits are not carried forward, so loss making parents are subject to double taxation (using their losses up to the CFC income inclusion and losing the benefit of foreign tax credits).

The participation exemption regimes of some countries provide for a 95% or similar exemption, giving an effective tax on 5% of each dividend. A successive dividend through such regimes creates an effective additional tax at each level that is difficult to obtain relief for.

Therefore, while the Draft notes the principal issues, it appears to underestimate significantly the actual complexity in calculating double taxation relief and makes an apparent assumption that effective relief will be available which is often not the case.

The draft suggests a hierarchy of CFC rules and tax relief applied from the lowest tier upwards, with full relief being granted for CFC taxes paid in each lower tier before calculation of the tax due in that jurisdiction. As this hierarchy is critical to improving the chances of effective relief of double taxation, it should be a much clearer recommendation than a single sentence in one paragraph of the Draft, the process for notification of lower tier CFC adjustments and their treatment in the higher tier jurisdiction should be the subject of clear and precise recommendations. The principle of how each tier of CFCs should deal with income and taxes of lower tiers appears to SwissHoldings to be fundamental to the development of best practice in CFC rules and should therefore be given much greater priority and prominence in the Draft.

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We kindly ask you to take our comments and proposals into due consideration.

Yours sincerely

SwissHoldings
Federation of Industrial and Service Groups in Switzerland

Christian Stiefel
CEO

Dr. Martin Zogg
Member Executive Committee

Cc: - SwissHoldings Board
    - Will Morris, Chair BIAC Tax Committee Bureau
    - Krister Andersson, Chair BUSINESSEUROPE Tax Policy Group
Dear Mr. Pross:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries’ tax bases are being eroded or profits shifted improperly. Pursuant to Action 3 of the Plan, on 3 April 2015 the OECD published a document entitled *BEPS Action 3: Strengthening CFC Rules* (hereinafter the Discussion Draft or Draft). The OECD solicited comments from interested parties on the Draft no later than 1 May 2015.

On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD’s request for comments. In addition, TEI requests the opportunity to speak in support of these comments at the Public Consultation regarding Action 3, to be held in Paris on 12 May 2015.

**TEI Background**

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws,
at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the
largest companies in the world.¹

TEI Comments

Lack of Consensus in the Draft: Double Taxation and Administrative Complexities

TEI commends the OECD for its thorough discussion and analysis of CFC rules and the
building blocks necessary to make them effective. The section of the Discussion Draft regarding
rules to prevent double taxation² is particularly welcome, as it is clear that the OECD recognises
that widespread adoption of CFC rules will result in more than one country’s CFC rules
applying to a single CFC’s income. Regrettably, the Discussion Draft underestimates the
complex issues that will arise should countries adopt inconsistent, and yet broadly applicable
and overlapping, CFC rules.

This will undoubtedly occur unless the OECD produces specific and robust
recommendations regarding the design of CFC rules. The Discussion Draft fails at this critical
task. While the Draft includes sections entitled “recommendations,” most of those sections state
recommendations in the alternative or as minimum standards, especially on the more difficult
issues. For example, for purposes of “control,” the Draft states a CFC should be controlled
“where residents hold, at a minimum, more than 50% control, although countries that want to
achieve broader policy goals or prevent circumvention of CFC rules may set their control
threshold at a lower level.”³ A recommendation that says control can be established above or
below 50% control is no recommendation at all. Finally, the Draft makes no recommendations
regarding the definition of CFC income.

Multiple, overlapping, inconsistent and potentially tiered CFC rules are a recipe for
rampant double taxation. As noted, the OECD addresses the issue of potential double taxation
in the Discussion Draft, recommending that countries provide an indirect foreign tax credit for
local taxes paid and also for any taxes paid to an intermediate jurisdiction in a tier of CFCs as a
result of that jurisdiction’s CFC rules. The Draft acknowledges that countries may need to
change their double tax relief provisions for CFC tax paid in an intermediate country to qualify
an eligible foreign tax for crediting purposes.⁴ Similarly, the Discussion Draft states that
countries should provide a tax credit for any withholding taxes imposed on a subsequent
dividend distribution from a CFC to its parent. Finally, the Draft notes that “it may be

¹ TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of
the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S.
Internal Revenue Code of 1986 (as amended).
² Discussion Draft, p.61-64.
³ Id. at 27.
⁴ Id. at 62.
appropriate to provide a refund of CFC taxes paid equal to the amount of the withholding tax if the dividend was paid out of profits that were subject to CFC tax . . . .”

TEI agrees that a foreign tax credit should be provided in these situations to alleviate double taxation. The example in the Discussion Draft, however, misleadingly suggests that claiming and determining the amount of a foreign tax credit in the presence of multiple CFC rules will be a simple matter. But the situation quickly becomes much more complicated when more CFCs are added to the picture, where CFCs are not wholly owned, where timing differences in when tax is due and paid arise, in determining the mechanics of claiming a credit for taxes paid in Country B by Subsidiary B for income earned in Country C by Subsidiary C, and if countries have different CFC rules. In addition, the Draft does not address how these rules would apply in the case of a cross-border merger or acquisition or where there is a change in control of a CFC.

Further, it is unclear how multiple tiers of CFC rules may interact with some of the newly enacted taxes intended to combat BEPS, such as the U.K. Diverted Profits Tax. The Draft also does not discuss the interaction of the CFC rules with double tax treaties. Thus, even with an indirect foreign tax credit and/or some kind of hierarchy of the application of multiple CFC rules across jurisdictions (by, e.g., giving priority to the CFC rules of the jurisdiction whose resident shareholder is closer to the CFC earning the income in the chain of ownership), there will be situations that give rise to double taxation.

These practical concerns and other difficulties make it even more essential that countries adopt consistent CFC rules and that the OECD make robust recommendations to further help shepherd the process in that direction. It would be hard enough for multi-national enterprises (MNEs) to comply with a consistent set of substantive CFC rules adopted around the world merely because of different administrative rules (e.g., different year ends, tax due dates, estimated tax payments), and this would only be exacerbated with inconsistent and overlapping CFC rules.

What is the Role of CFC Rules in the BEPS Project?

The Discussion Draft notes that the work on BEPS Action 3 is being coordinated with the work on Actions 1 (digital economy), 2 (hybrids), 4 (interest expense), 5 (harmful tax practices), 8-10 (transfer pricing), 11 (data analysis), 14 (dispute resolution), and 15 (multilateral instrument). The overlap with so many other BEPS actions raises the question of whether CFC rules would even be needed should countries adopt the recommendations under the other actions. Indeed, it might be prudent for the OECD to suspend its work on CFC rules, which it historically has not addressed, until it has had time to review results of the remainder of the BEPS project. The OECD could then determine whether CFC rules are necessary at that time.

5 Id. at 63.
Such a review could be timed with the review of the country-by-country reporting template, which is to take place in 2020.

More broadly, the substantial overlap with the other BEPS actions and the clear lack of consensus among OECD member states raises the question of what role CFC rules should play in the BEPS project. Historically, CFC rules have been a way to force the distribution of certain income earned overseas, in particular low taxed or passive income. In addition, very few countries have implemented CFC rules historically, raising the question of why the OECD is advancing such an uncommon method of combating tax avoidance in the BEPS project, especially when the avoidance at issue – the use of offshore IP to generate untaxed royalty income (it seems) – appears to be a problem only in isolated countries. In this regard, the excess profits approach appears to be a way to combat this sort of tax avoidance, and yet it is included within a discussion of CFC rules generally, when their historic focus on passive or low taxed income. The excess return approach, however, would tax all income above a certain level no matter its character. If this kind of tax planning and income is the focus of the OECD’s efforts in this area of the BEPS project, why not say so directly and dispense with the lengthy discussion of CFC building blocks, control thresholds, income streams, low tax calculations, double taxation, etc.? While TEI would oppose such an approach as generally in conflict with the arm’s length principle, the excess return approach – which has its own complexities and uncertainties – would appear to at least eliminate the need for an additional set of complex CFC rules.

Finally, the lack of widespread adoption of comprehensive CFC rules to date may indicate that most countries do not view them as necessary to police base erosion and profit shifting. If that is the case, why are these rules included in the BEPS project? This would counsel caution when recommending countries implement these rules across the board and again perhaps the OECD would be better advised to put off recommending CFC rules to address base erosion and profit shifting until it is clear such rules are needed and a consensus can be developed.

Specific Points and Answers to Selected Questions for the Consultation

Question #9: What are the practical problems with any of the three substance analyses [of CFC income] set out above [substantial contribution; viable independent entity; and employees and establishment]? How could these practical problems be dealt with?6

The viable independent entity analysis would likely lead to increased disputes between taxpayers and the tax authorities with the associated increase in time and expense on both sides. This will occur because the analysis requires the creation of hypothetical situations (i.e., how

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6 The lack of comments on the “substantial contribution” analysis in this section should not be viewed as agreement with that analysis as set forth in the Discussion Draft.
unrelated parties “would have been most likely to allocate assets and risks”), instead of looking at the actual activities performed by a CFC to determine its substance.

The employees and establishment analysis subjects the CFC to taxation if the CFC outsources its core business functions or value-creating activities and only retains management or oversight activities. Many MNEs outsource functions to other countries for legitimate business reasons (e.g., lower labour costs) and not to avoid tax. This approach would penalise those companies and create a competitive disadvantage for them even in situations where tax planning played no role in the outsourcing decision.

Question #12: Are there practical problems with applying the same rule to sales and services income and IP income?

Applying the same rule to sales and services income and IP income will substantially and unnecessarily increase the administrative and compliance burden for many if not most taxpayers (and tax authorities). This is because: (i) most taxpayers will have sales and/or service income even if they do not have royalties and IP income; and (ii) most sales and services income that is active business income will be included in CFC income unless the taxpayer can substantiate that it meets the “substance” test.

Categories of CFC Income

Page 46 of the Discussion Draft states that “interest and financing income earned by a CFC will generally be treated as passive (and therefore included) unless the CFC had the required substance to earn the income itself and the CFC was not overcapitalised.” It would be useful if the OECD provided additional guidance regarding when a CFC is overcapitalised.

Also, with respect to sales, services, royalties and IP income, royalties and IP income are often bundled into the pricing of goods and services and therefore it may be difficult to separately determine such income. This would not be an issue if sales and service income are also included in CFC income; however, such inclusion would raise the difficulties we discuss above under question 12. If sales and services income are not included in CFC income, it would be helpful to have a de minimis threshold where splitting out royalties and IP income would not be required (e.g., if royalties and IP income was less than 15% of the total price or less than some specific threshold amount). Thus, if a taxpayer were confident that its royalties and IP income was less than 15% of sales it would not need to separately state such income, even if the taxpayer was uncertain of the exact percentage of sales.
Question #16: What practical problems arise with applying the categorical approach and the excess profits approach?

The excess profits approach would subject income in excess of a “normal return” from the activities that produced the income to taxation as CFC income. Such an approach targets IP income earned in low tax jurisdictions under the theory that any income in excess of a “normal return” from purchasing and selling and providing services or manufacturing must be attributable to intellectual property.

TEI recommends that the OECD clarify and provide examples as to how this approach would function, or how it is even necessary, in light of the transfer pricing rules. Specifically, it is unclear what is meant by “Transfer pricing rules would apply prior to the application of the excess profits approach, so this would only apply to income that remained after transfer pricing rules had been applied.”7 If transfer pricing rules are appropriately applied, it seems that the return left in the CFC should be arm’s length. By taxing any “excess” profit over a normal rate of return, the OECD appears to be saying either that (i) the transfer pricing rules have not been applied appropriately, or (ii) CFCs can only make a certain percentage return no matter what industry they operate in and anything in excess will be taxed at the parent’s rate. If the issue is that the arm’s length principle has not been applied appropriately, then the perceived problem should be fixed via changes to the transfer pricing rules and not through CFC rules, which will be new and difficult to administer in many jurisdictions.

By dictating how much of a return a CFC is entitled to, especially after transfer pricing rules have been applied to determine that the return is arm’s length, tax authorities are either admitting that they cannot reliably administer the transfer pricing rules or simply declaring that a return that is “too high” is evidence of some kind of undetectable yet real manipulation of the international tax system by taxpayers. If an excess profits tax is to be implemented, there should at least be an annual update of acceptable normal rate of return by industry provided by tax authorities. In addition, if this normal rate of return will override profits determined under transfer pricing rules, this would make transfer pricing studies irrelevant; therefore, CFCs subject to the excess profits tax should no longer be required to conduct transfer pricing studies or keep transfer pricing documentation to justify their return.

Conclusion

TEI appreciates the opportunity to comment on the OECD Discussion Draft regarding CFC rules. As noted above, TEI requests the opportunity to speak in support of its comments at the scheduled public consultation in Paris on 12 May 2015.

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7 Discussion Draft at 48.
These comments were prepared under the aegis of TEI’s European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of TEI’s legal staff, at +1 202 464 8353, bshreck@tei.org.

Sincerely yours,

TAX EXECUTIVES INSTITUTE, INC.

Mark C. Silbiger
International President
Dear Mr. Pross,

RE: Taxand responds to the OECD discussion draft on BEPS Action 3: Strengthening CFC rules

Further to the publication of the OECD’s invitation for public comments on the discussion draft on BEPS Action 3: Strengthening CFC rules, Taxand is honoured to provide written comments based on the practical experience we have as tax advisors.

Our response provides comments and recommendations based on our global experience of operating CFC rules in a number of different territories.

We would like to salute the efforts of the OECD Committee of Fiscal Affairs for its continual and vast work on laying down the cornerstones for the ambitious and comprehensive Action Plan aimed at strengthening CFC rules.

Taxand can confirm that we have no objections with posting the comments on the OECD website and that comments represent Taxand and are based on our experience working with multinationals worldwide.

We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further and to participate in any further discussion on these matters.

More information about Taxand is provided below. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

If you wish to discuss any of the points raised in this letter, please do not hesitate to get in touch with us directly via the contact details below.

Yours sincerely,

Taxand

CONTACT DETAILS
Claire Lambert
Taxand UK
T. +44 7583 553544
E. clambert@alvarezandmarsal.com

Richard Syratt
Taxand UK
T. +44 20 7863 4722
E. rsyratt@alvarezandmarsal.com
ABOUT TAXAND

Taxand provides high quality, integrated tax advice worldwide. Our tax professionals, more than 400 tax partners and over 2,000 tax advisors in nearly 50 countries - grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

We're passionate about tax. We collaborate and share knowledge, capitalising on our expertise to provide you with high quality, tailored advice that helps relieve the pressures associated with making complex tax decisions.

We’re also independent—ensuring that you adhere both to best practice and to tax law and that we remain free from time-consuming audit-based conflict checks. This enables us to deliver practical advice, responsively.

Taxand has achieved worldwide market recognition. Taxand ranked in the top tier in Chambers Global Guide 2014 global network rankings and in the International Tax Review’s (ITR) World Tax 2015, 41 Taxand locations were commended and a further 26 locations listed in ITR's World Transfer Pricing Guide 2015. 31 countries were voted top in the ITR Transaction Tax Survey 2014 and 29 in ITR Tax Planning Survey 2013. Taxand has received 65 national awards and 14 regional awards in the ITR European, Americas and Asia Tax Awards since 2009. These include Latin America Tax Disputes Firm of the Year, European TP Firm of the Year, European Indirect Tax Firm of the Year, Asia Transfer Pricing Firm of the Year, and Asia Tax Policy Firm of the Year. Full details of awards can be viewed at www.taxand.com/about-us

www.taxand.com
Introduction

Taxand would like to thank the OECD for the opportunity to provide the following comments to “BEPS Action 3: Discussion draft on the strengthening of CFC rules”. Our comments below intend to be practical and experience-based, as well as constructive, in our responsibility as global tax advisors to contribute to a more comprehensive debate on the important issues raised.

This response will address the specific questions as raised by the OECD in the discussion document as well as providing comments on the policy considerations set out in the document. The authors have decades of experience with the operation of the UK CFC rules (in their various forms) which were first introduced in 1984.

Key points

The key points set out in this response are summarised below:

- The rules should target profit shifting from parent company jurisdictions only, and not foreign to foreign transactions
- The rule should only target artificial profit shifting, not commercial transactions backed up by real substance
- The rules need to be applied in a consistent manner across all jurisdictions
- The rules should not apply to domestic entities
- There should be an anti-avoidance rule included in any recommendations
- There should be a combination of entity level exemptions and a substance based test
- The substance based test should be based on a combination of the viable independent entity analysis and the substantial contribution analysis with a threshold above which activity carried out outside the parent company jurisdiction means the income is not attributed as CFC income. There should be proportional test for attributing income if this test is failed
- There is no need to specifically identify IP income and sales and service income if the above substance based test is used
- The categorical approach should be used to attribute income under CFC rules
- A transactional approach should be taken rather than an entity approach in allocating CFC income

1. Policy considerations

Our general comments on the policy points set out in the document and the overall design of CFC rules are as follows:

- The CFC rules should be a minimum standard, and there should not be a secondary rule
- We agree the rules should target profit shifting but should target artificial profit shifting, not commercial transactions backed up by substance (should be targeting tax avoidance)
The rules should target profits shifted from the parent jurisdictions and should not be targeting foreign to foreign transactions – this is very important for competitiveness as we have first-hand experience in the UK of dealing with groups that have left the UK because of CFC rules that were all encompassing in relation to foreign to foreign transactions. It would not be particularly difficult for groups to go down this route again and find territories that do not implement these rules to put their parent company jurisdictions in, if the recommendations are disproportionate.

We agree that TP and CFC rules are both needed. Following the wider BEPS outputs around transfer pricing and transfer pricing of intangibles, permanent establishments and hybrid mismatches, these rules should all apply first to protect the tax base of jurisdictions, and CFC rules should then only apply to tax motivated transactions.

The key to this will be ensuring that all territories implement the proposals in a consistent manner otherwise groups will move their entities to locations who have not implemented these provisions.

We do not recommend the rules should apply to domestic entities – this would add a significant compliance burden to wholly domestic groups or groups who only have a minimal number of overseas subsidiaries where there is little risk of profit shifting.

We agree there should be the entity level exemptions as set out in the discussion document, which are generally easier to apply (plus the substance based tests as commented on below). This gives groups alternative choices as to which tests they find easier to apply – this can vary in our experience based on each group’s individual facts and circumstances.

We strongly believe an anti-avoidance rule should be included as part of the overall CFC rules. The concepts applied in an anti-avoidance rule should be considered as part of the assessment of what income should be attributed as CFC income – genuine commercial transactions that result in income in a low tax territory with sufficient substance to manage that activity and no tax avoidance motive, should not be subject, as a policy matter, to CFC rules.

It should be recognised that with any CFC rules comes the risk certain territories will try and specifically implement local systems/entities/regimes that try and circumvent CFC rules of other jurisdictions.

2. Chapter 2

Questions 1 – 2

We agree with the recommendations that entities within the scope should be corporate entities and transparent entities that are owned by CFCs or treated as taxable entities separate from their owners.

Specifically, we consider these tests should all be looked at from the position of the parent company jurisdiction law. If in the view of the parent company jurisdiction an entity is taxable, or an entity is transparent/non-taxable, but its income would be taxable at the level of the investor, the entity or the investor respectively should be assessed to consider whether it is a CFC or not (and should be assessed based on the income that would be allocated to it under parent company jurisdiction rules).
We believe this is important in reducing the compliance and administrative burden as it is ultimately the parent company jurisdiction that will have to assess which entities are CFCs. Using any method that is not consistent with law in the parent company jurisdiction would significantly increase the compliance costs and time commitment in applying a CFC regime.

Entities that would not otherwise be subject to tax because they are exempt (and assuming their income would not be allocated to anyone else and taxed) in the parent company jurisdiction, should not be subject to CFC rules in a parent company jurisdiction.

Question 3
The narrow and broad versions of the modified hybrid mismatch rules that are described are methods of calculating the income that is included in any CFC income, and are not tests to identify which entities should be CFCs.

The mechanism in this scenario (and in the example in Figure 1) to potentially capture the income in hybrid entities should be a rule that ensures that the entities are regarded on a stand-alone basis for the purpose of identifying whether they are CFCs. It should not at this stage of the test be trying to identify certain types of income that should be included. It would not then be necessary to have a specific hybrid mismatch rule, as each entity would be assessed on a stand-alone basis and the provisions set out in the discussion draft (and commented on in this paper) should then apply in relation to identification of what income is subject to CFC tax. This should also mean that to the extent that the parent company jurisdiction implements the recommendations in BEPS Action 2 (hybrid mismatches) – these domestic rules should also be followed when calculating the CFC income and this should deal with the concerns raised in relation to hybrid instruments in the discussion draft.

3. Chapter 3

Questions 4 – 5
We agree with the recommendation there should be a low tax threshold based on an effective tax rate calculation.

Based on our practical experience, profits that accrue in different periods, income or expenses that would never be recognised in one or other of the parent company and local jurisdiction are the key items that cause problems in calculating the profits in an effective tax rate calculation. In addition, having to recalculate the profits under the law of the parent company adds complexity but we consider this to be necessary to get an accurate reflection of the effective tax rate for a low tax threshold exemption.

In our view, calculating the profits of the CFC on a company by company basis in accordance with the parent company jurisdiction tax law (allowing for adjustments for the above items - timing differences etc) or using IFRS should be the method of calculating the profits. Groups should be given the choice so that they can apply whichever method is easier for them to apply. However whichever method is chosen should be applied consistently across all entities in the group and in all periods.
In practice, the other problem we have seen arising using an effective tax rate calculation is calculating actual tax paid by a CFC that is a member of a fiscal unity/tax grouping. Often in these scenarios one member of the group pays tax on behalf of all entities in the same jurisdiction, some having losses and some profits. Allocating the share of that tax to the CFC and allocating losses between members of the fiscal unity has been the subject of significant disagreement with parent company tax authorities. We would therefore welcome a recommendation as to how to allocate tax paid by and how to allocate losses to an entity that is part of a fiscal unity.

Based on our practical experience (particularly in the UK), a deminimus and/or white list are also helpful exemptions. These allow groups with entities making small profits/operating in specific territories to quickly and easily eliminate them from their CFC calculations reducing the compliance burden of having to consider entities that pose minimal risk of profit shifting.

**Anti-avoidance rule**

Although it is a subjective test, we strongly believe, as set out in our general comments on policy matters, that an anti-avoidance rule should be included as part of the overall CFC rules. Whilst it is not necessary to have this as an upfront rule, the concepts applied in an anti-avoidance rule should be considered as part of the assessment of what income should be attributed as CFC income. Genuine commercial transactions that result in income earned in a low tax territory with sufficient substance to manage that activity and no tax avoidance motive should not be subject as a policy matter to CFC rules. Groups could be asked to highlight where they have relied on this rule in any tax filings.

**Question 6**

We consider the discussion does correctly address the situation of permanent establishments that are exempt in a CFC jurisdiction. The permanent establishment should be treated as a CFC in its own right and the relevant calculations should be applied to it.

**4. Chapter 4**

**Questions 7 – 8**

We agree with the general recommendations set out in this Chapter. Based on our experience, the practical problems of applying a control test mainly arise where unrelated parties are included in the definition of control. For an entity to try and identify who, or more specifically where, unrelated parties are resident and even what percentage they own can be a significant compliance burden. It may be virtually impossible where the entity having to make the assessment is also a minority shareholder in the CFC.

For example, if a control test just looked at whether an entity was controlled by residents of a country (e.g. more than 50% of its shares were owned by residents which could include individuals) a listed entity could be a CFC. However, if you have a minority interest in the listed entity you are unlikely to be in a position to be able to obtain the information required to determine who the other beneficial shareholders are (particularly where other investors include funds) and where they are resident.
Hence, we would recommend that if unrelated parties are included in the control definition, there should be a minimum percentage that is required to be held. One alternative to this would be to deal with it in the attribution of income from the CFC. For example, if the entity investing in a company held less than x% with related parties there was no attribution of income to it. This would at least allow an entity to make an assessment that if it held less than a certain percentage with related parties, even if the entity it was considering was controlled by residents (because of the unrelated parties holdings), there would be no CFC attribution. Another alternative would be to have an exemption for widely held entities.

5. Chapter 5

Questions 9-10

We agree that the CFC rules should be a more narrowly targeted partial-inclusion system that only attributes income that raises profit shifting concerns. We also agree that if CFC rules are designed to apply only to stripping of the base of the parent jurisdiction (and we think this is how CFC rules should be designed), then income should not be attributed if it arises from value creating activity in any jurisdiction other than the parent jurisdiction.

Our experience of applying substance based analysis in existing CFC rules is there is inevitably a certain level of complexity required. The important point is to try and develop a substance based test that uses information that would generally be available or likely be prepared anyway (ie transfer pricing type information) to help support the substance analysis. A substance based test is necessary to ensure that income that should be subject to CFC rules is identified but also to ensure that genuine commercial activity is not included in attributable income.

Different groups find different types of substance analysis easier, depending on their business model, the industry they are in and the general environment in which they operate. Therefore based on our experience, we would recommend having a combination of factors included in the substance test.

Based on the definitions in the discussion draft, this would mean a combination of the viable independent entity analysis and substantial contribution analysis should be undertaken. In the first instance the significant functions relating to the assets and risks owned by the CFC should be considered (this is consistent with the way the UK CFC rules operate). Note we disagree with the approach where you assess whether the CFC itself is the likely entity that would have owned particular assets or undertaken specific risks as this is very judgmental – the real position should be used in that it does own the assets or undertake specific risks. This should be dealt with in the first instance under transfer pricing principles as transfer priding should properly allocate the profit to where the assets and risks are/should be held. The question should be who, other than the CFC in the group, also contributes to managing those assets and risks and whether this activity is significant in relation to the activity undertaken by the CFC.

There should then be an absolute threshold where if it can be shown that at least X% of the activity is carried out outside the parent company jurisdiction, there is no attribution of CFC
income. To the extent this test is failed, we then recommend a proportionate test is used to calculate the profits that are attributable as CFC income so only the diverted profits are taxable as CFC income.

We appreciate the concern over ensuring certain transactions relating to IP are included in CFC income, but this can be dealt with by ensuring the definition of “management” of the assets and risks owned by the CFC takes account of activity relating to the creation and development of the asset. For example, if the parent company jurisdiction did all the creation and development of the IP and there is only a small amount of passive activity being carried out in the CFC, it is likely that most of the IP income would be attributed as CFC income under the above test.

To the extent there is value added activity being carried on outside the parent company jurisdiction, there would be a comparison of the relative level of activity carried out by the parent company jurisdiction and elsewhere to determine how much of the profit may be taxable. This would also help with the difficulties mentioned later in the discussion draft around defining what IP income is and whether to include sales and services income in that category – this sort of test would cover all these types of income and it is just the relative activity that is carried out in the parent company jurisdiction compared to elsewhere that should be assessed based on the creation, development and ongoing management of the assets or risks.

Questions 11-14
Our view is that if a business is set up in a territory because it has to be set up there for regulatory reasons, this type of entity is likely to be lower risk from a CFC perspective.

Therefore, as mentioned above, if there is a tax avoidance/commercial purpose test in the CFC rules this type of entity should be capable of ensuring it is not subject to a CFC attribution if it has been set up because of regulatory constraints in a low tax territory for the purpose of doing business there.

We think the types of income that should be identified separately and dealt with along the lines set out in the discussion draft are dividends, interest and insurance, with the following additional comments:

- Active financing should be capable of being exempt from CFC attribution, for instance where an entity has a group finance function located in a specific territory
- Interest income earned on amounts incidental to profits that are ultimately exempt from CFC attribution (eg working capital cash held that earns interest where the trade profits are exempt from CFC attribution) should be exempt from attribution (a limit could be set on the amount that could be earned)

As set out in the discussion draft, it is very difficult to specifically identify what is IP income versus sales and services income. There are significant problems with assuming both these categories of income are “bad” income and hence applying the same rules to both categories.
For example a group may hold IP in a jurisdiction where it was developed, and this group company licenses the IP to local entities in the territory where the sales are to be made (this is quite common as most groups have a local presence in the territory in which they want to make sales and in order to sell in that territory those entities need to license the IP to use in their territory). Most of the examples and points raised in the discussion document imply that this activity of the distributors would be bad because it has licensed IP from a group company that has been developed by a group company and it is making sales of products using that IP. This is a normal commercial arrangement and provided the local territory has the sufficient substance/activity in relation to the assets and risks it owns should not mean that its income is attributed as CFC income. Attributing this type of income as CFC income goes far beyond what we would expect from CFC rules and attributes income comparable to arrangements that can be found in third party situations.

This is different to a scenario where the fully developed IP has been transferred out of a high tax territory into a low tax one and then the fully developed IP is exploited.

Grouping together IP income and sales and services income (and, in fact, even trying to specifically identify each separately) is very complex, as set out in the document. If the substance tests were to apply as we set out in the answer to the previous question, the test should not be whether the income is IP or sales or services income but in fact what activity is being carried out in the parent company jurisdiction in relation to the management, including creation and development of the assets and risks held by the CFC, versus what is being carried out elsewhere. Calculation of the attributable income can then be made. This eliminates the need to specifically identify IP income versus sales and services income.

This also means that for IP that has been moved from a parent company jurisdiction to another territory, if there is ongoing development and value added activity being carried out in relation to the IP in a territory outside the parent company jurisdiction, the relative balance of activity that occurred in the parent jurisdiction and elsewhere changes over time, initially giving a larger CFC attribution and gradually decreasing over time. This reflects the commercial reality of what is happening with the IP and should be supported.

The UK uses this type of substance based test and hence it is not necessary to try and define what IP income is versus sales and services income – in practice this seems to be very effective as we do not have difficulties determining what the nature of the income is as it is not necessary to do that. In addition, the UK also defines and taxes financing and insurance income in a similar manner as set out in the discussion document.

**Questions 15 - 20**

We strongly believe that the categorical approach should be used to attribute income under CFC rules. The excess profits approach takes no account of substance or actual activity being undertaken in a jurisdiction versus a parent company jurisdiction in relation to the assets and risks owned and managed by a CFC. It also has no bearing on whether there is any genuine economic substance in a CFC. It is also very complex to carry out the calculations and attribute relevant amounts to identify what the excess profits/returns are.
In a number of territories using the excess profits approach would cause businesses to move their parent company jurisdiction to territories with no CFC rules, as this would be seen as a disproportionate measure that might tax genuine economic activity.

The categorical approach attributes income much more accurately than an excess profits approach. However we do not believe that IP and sales and services income under this approach should be treated as passive income – as set out above we believe the approach for this type of income should be to assess the relative management activity taking place in the parent company jurisdiction compared to elsewhere in relation to the assets and risks held by the CFC.

**Questions 21 – 23**
The issues that arise if an entity approach is taken rather than a transactional approach are as set out in the discussion draft – swamping being the most likely potential outcome. We consider the best and most accurate approach is the transactional approach.

If the substance approach has been taken as we set out above in relation to identifying what the attributable versus non attributable income might be, there should not be any significant additional compliance burden for groups to apply the transactions approach to actually attribute that income as the majority of the work to get to that stage has already been done.

6. Chapter 6

**Questions 24 – 25**
We agree with the recommendations and conclusions in this Chapter and have no further comments to add.

7. Chapter 7

**Questions 26 – 27**
We agree with the recommendations and conclusions in this Chapter in relation to attributing income. In addition, it may be as part of this calculation that our comments on the control definition in Chapter 4 are dealt with where unrelated parties are included in the control definition. If unrelated parties are included in the control definition, there should be a minimum percentage that is required to be held before any attribution should be made.

8. Chapter 8

**Questions 28 – 29**
We agree with the recommendations and conclusions in this Chapter. In addition, the other point we would like to see as a recommendation is how to decide what tax has been paid by a CFC where it is a member of a fiscal unity/tax grouping and another member of the group pays the tax on behalf of the whole group. This is an area that has caused significant uncertainty in the past when applying CFC rules.

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We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further, and to participate in any further discussion on these matters.

More information on how to contact Taxand is provided above. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

Yours faithfully,

Taxand

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April 30, 2015

Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
2 Rue André Pascal
75775 Paris Cedex 16
France

Via e-mail to CTFCFC@oecd.org

Ladies and Gentlemen:

TD appreciates the opportunity to submit comments on the Discussion Draft on BEPS Action 3: Strengthening CFC Rules issued by the OECD on April 3, 2015 (the “Discussion Draft”).

Our key points with respect to BEPS Action 3, described in more detail below, are as follows:

- We believe that the concepts reflected in the Action 3 Discussion Draft are not proportionate to the concerns that are sought to be addressed.

- CFC rules are a departure from countries’ overall international tax policy and such rules should be applied only in narrow circumstances, serving as a backstop rather than a primary approach.

- Making the core recommendations more reasonable would seem likely to reduce the need to layer in anti-abuse rules to protect the overall anti-abuse rule formulation of the proposed CFC rules.

- As there are strong linkages between the work on Action 3 and the work on several other Actions, we recommend delaying the CFC work until the other Actions are completed to better gauge the need for any new measures.
• In light of the strict deadlines associated with the BEPS project, we are concerned that there is not sufficient time for the work that would be needed in order to develop and reach consensus on recommendations with respect to workable and balanced CFC rules.

• The Discussion Draft recommends an approach that focuses on whether the CFC is in a country that has a tax rate that is meaningfully lower than the tax rate in the parent company’s country. Tax rate differentials are the reality for a global business in today’s global economy and should not be considered to be an indication of some inappropriate BEPS activity that needs to be addressed.

• The OECD has long recognized that countries have the sovereign right to set their own tax rates. Using a lower tax rate as the threshold for determining potential applicability of CFC rules risks creating incentives for countries to increase their tax rates to that threshold thereby encouraging a run up in corporate tax rates globally.

• The use of a threshold test that compares the effective tax rate in the CFC jurisdiction with a benchmark that is based on the statutory tax rate in the parent company’s country is inappropriate as the effective tax rate is an accounting concept that can be distorted by issues beyond the control of the company (i.e. losses) and could result in a particular entity flipping in and out of CFC status from year to year.

• Suggesting that countries would have jurisdiction to tax a CFC where the parent company country does not impose “sufficient” tax on a CFC (the so-called “secondary rule” concept) would create a free for all with respect to the taxation of the CFC and is unacceptable from an international tax policy perspective.

• The current recommendations with respect to substance tests, active business requirements and overcapitalization, raise concerns for regulated financial businesses. We encourage the OECD to work closely with the financial services industry to ensure that any recommendations reach appropriate results for financial services businesses.

**Overall concerns about the BEPS Project**

Before turning to the specific issues with respect to this Discussion Draft, we want to express grave concern about the implications of these proposals for CFC rules combined with the other pending BEPS proposals for cross-border trade and investment and the global economy. Changes of the type being contemplated under the rubric of the BEPS project, and the uncertainty that would be created by abandoning clear standards and principles in favor of vague and subjective concepts, would have a profound adverse effect in terms of stifling global business. We of course recognize the need for governments to raise revenue to support essential government functions. However, they must do so efficiently and without having a chilling effect on essential commerce.
We urge the OECD to ensure that the work on all the BEPS Actions includes full consideration of the microeconomic and macroeconomic implications of any changes. The OECD has the world-class resources needed to contribute to the global debate by educating participants about the economic, policy, and revenue dimensions of the issues to be addressed and the solutions to be developed. This should go beyond the corporate income tax system and include the whole range of tax approaches available to governments.

The OECD and the countries involved in the BEPS project must not lose sight of the fact that the role of business in the global economy is not to provide revenue for governments. In imposing tax on business to provide government revenue, governments have both a compelling interest and an obligation to minimize the impact on business. The fact that only some businesses are subject to entity level taxes and others are not heightens the government’s obligation to minimize the impact on those businesses that are subject to tax. In seeking revenue from businesses, governments must weigh both the impact of their proposals on particular businesses and the impact across businesses against other approaches to the generation of revenue.

Overall comments with respect to BEPS Action 3

In contrast to many of the other BEPS focus areas, the design of CFC rules is an aspect of international tax where the OECD has not previously done significant work because it is entirely a matter of countries’ domestic law. In addition, there is significant interaction and overlap between CFC rules and the measures being proposed by the OECD under other Actions. Against this backdrop, the proposals and options in the Action 3 Discussion Draft are both very broad and very complex. We believe that the concepts reflected in the Action 3 Discussion Draft are not an appropriately tailored or proportionate response to the concerns that are sought to be addressed. In light of the 2015 deadlines associated with the BEPS project, we are concerned that there is not sufficient time for the work that would be needed in order to develop and reach consensus on recommendations with respect to workable and balanced CFC rules.

As the Discussion Draft notes, CFC rules have been in existence for more than fifty years and are in place in many different countries. However, as the Draft further notes, the purposes served by CFC rules differ. A CFC regime plays a very different role in the context of a territorial tax system than it does in the context of a worldwide tax system. The decision whether to adopt CFC rules at all and the decision regarding the reach of CFC rules both involve competitiveness considerations for countries. Historically, CFC regimes have been considered to be a domestic law matter, where countries can and do make very different choices. While there may well be a role for the OECD to play in helping countries assess whether and how CFC rules could support their particular tax objectives (and what are the trade-offs to be considered in deciding to deploy a CFC regime), it should be recognized that such a project requires a significant investment of time and resources.

As the Discussion Draft also notes, there are linkages between the work on Action 3 and the work on several other Actions, including in particular Action 1 on the digital economy, Action 2

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on hybrid mismatch arrangements, Action 4 on limitations on interest deductions, Action 5 on harmful tax practices, Actions 8-10 on transfer pricing, Action 11 on economic analysis of BEPS, Action 14 on dispute resolution, and Action 15 on the multilateral instrument. Coordination with the measures being proposed in all these areas is essential. While the Draft indicates that there is a focus on such coordination, it is difficult to see how the outcomes could be properly coordinated at this time while the work on the other Actions is still ongoing.

The proposals and options with respect to CFC rules reflected in the Discussion Draft are extremely ambitious. The rules would have extraordinarily broad reach in part because they reflect a “guilty until proven innocent” approach. The rules also are notable in their complexity. Both of these aspects of the proposals are troubling.

With respect to the “guilty until proven innocent” aspect of the proposals in the Discussion Draft, we are very concerned about the recommendation for use of a low tax rate test as a threshold requirement for determining whether CFC rules should be applied or not. For this purpose, the Discussion Draft recommends an approach that focuses on whether the CFC is in a country that has a tax rate that is meaningfully lower than the tax rate in the parent company’s country. However, any global business that operates in multiple countries necessarily operates in many different tax rate environments, in both lower tax countries and higher tax countries. Tax rate differentials are the reality for a global business in today’s global economy and should not be considered to be an indication of some inappropriate BEPS activity that needs to be addressed.

We would also note the complexity and potential distortions associated with the use of a threshold test that compares the effective tax rate in the CFC jurisdiction with a benchmark that is based on the statutory tax rate in the parent company’s country. Losses in a particular year or years will cause anomalies in the effective tax rate calculation and could push an entity into CFC status for that year or years. The earning of tax exempt income similarly would impact the effective tax rate calculation. We do not believe it is appropriate to structure CFC rules in a manner that could mean a particular entity would flip in and out of CFC status from year to year. We urge the OECD to give further consideration to this issue.

More broadly, we believe that the use of a low tax rate as a kind of “red flag” indicator is bad policy that risks creating the wrong incentives. The OECD has long recognized that countries have the sovereign right to set their own tax rates. This is part of the healthy competition among countries to attract investment. The OECD also has done extensive economic research demonstrating that the corporate income tax is the least efficient way to raise government revenue. Using a low tax rate or a tax rate differential as the threshold for determining potential applicability of CFC rules risks creating incentives for countries to increase their tax rates to that threshold. Encouraging a run up in corporate tax rates around the world is not where the BEPS project should be going. We urge the OECD to reconsider the use of a low tax rate as a CFC threshold measure. More importantly, we urge the OECD not to use the recommendation for a low tax rate threshold test as a justification for CFC rules with very broad reach in situations where a CFC is caught by the low rate threshold test.
Fundamentally, we believe that CFC rules should operate as anti-abuse rules only. Only in narrow circumstances should the parent company’s country be able to impose tax on income that is earned outside that country’s jurisdiction by a CFC of the parent company. CFC rules are a departure from countries’ overall international tax policy and such rules should be applied only in narrow circumstances, serving as a backstop rather than a primary approach. Indeed, for EU member countries, an anti-abuse rule formulation seems to be key to determining that CFC rules are consistent with EU obligations.

We urge the OECD to recraft the recommendations with respect to CFC rules to align with this anti-abuse rule concept. Moreover, we would note that the Discussion Draft’s proposal of several anti-abuse rules to serve the purpose of protecting the CFC rules it proposes really seems to go too far. To name just one example, the Draft proposes a special hybrid mismatch rule, presumably in addition to the general hybrid mismatch rules proposed under Action 2, to be incorporated in the recommended CFC rules to prevent circumvention of the CFC rules. Making the core recommendations more reasonable would seem likely to reduce the need to layer in anti-abuse rules to protect the overall anti-abuse rule formulation of the proposed CFC rules.

We believe that CFC rules should be targeted to identified concerns and necessarily must reflect fundamental tax policy choices by countries. We further believe that the measures being proposed under other BEPS Actions in many cases are better tailored to address particular concerns than would be feasible with CFC rules. Therefore, coordination with the other BEPS Actions and prioritization of the various anti-BEPS measures is essential. To this end, we urge the OECD to defer the work on Action 3 until after the work on other key Actions is completed next fall. This would allow proper coordination among the measures proposed under the BEPS Action Plan. It also would allow the OECD to focus the resources that are necessary to work on the design of CFC rules, a focus that is not possible currently given all of the output that the OECD is committed to deliver in the next several months.

Finally, we want to note our concern about the “secondary rule” concept that is described in the opening of the Discussion Draft as an approach favored by some countries. Under this concept, if the parent company country does not impose “sufficient” tax on a CFC then other countries would have jurisdiction to tax the CFC. While this proposal is not described in much detail, it would appear to create a free for all with respect to the taxation of the CFC. That would seem to be unacceptable from an international tax policy perspective. We urge the OECD not to advance any such “secondary rule” proposal.

Comments with respect to issues for financial services businesses under BEPS Action 3

Our concern about the need for a well-considered approach to the development of CFC rules is heightened because of the risk of inappropriate treatment of an active global financial services business under a CFC regime. Typically some kind of active business or substance based criteria are used to determine whether the CFC rules should apply to a particular entity. Where such criteria focus on physical attributes, they may not appropriately exclude from the reach of a
CFC regime entities that are engaged in global financial services businesses. CFC rules also often focus on income that is considered to be passive, investment type income. However, income that is investment income in the hands of another entity would be income earned in the ordinary course of an active customer-driven business of a financial services entity. Therefore, special provisions and focused tests are needed in order to provide comparable treatment of financial services as an active business.

The Discussion Draft sets forth three alternative approaches for incorporating a substance based analysis into a CFC regime: a substantial contribution analysis, a viable independent entity analysis, and an employees and establishment analysis. Of these alternatives, we believe that the substantial contribution analysis is the most appropriate approach for financial services. This analysis is described as looking to whether employees of the CFC have made a substantial contribution of the income earned by the CFC. This approach still would need to be adapted for a financial services business, including for example ensuring that employees of an affiliated entity could be taken into account in applying such approach. This is important given regulatory and other considerations that increasingly are driving banks to house employees in a separate affiliated entity.

The other two alternative approaches for a CFC regime substance analysis raise concerns for financial services businesses. The viable independent entity analysis looks to the functions performed by the CFC to determine if it is the entity that would be most likely to hold the particular asset or income if it were unrelated. The employees and establishment analysis looks to whether the CFC has the necessary premises and employees to undertake the functions and earn the income. Both of these tests would raise concerns for regulated financial businesses which often are subject to regulation that requires the separation of activities and assets into a separate entity.

With respect to interest and other financing income, the Discussion Draft proposes that such income be considered to be passive unless the CFC is in an active financing business and it is not overcapitalized. In the interest of certainty, a clear definition of active financing businesses would be needed. Given the multi-level regulation with respect to capital requirements to which global financial services businesses are subject, it is hard to see how an “overcapitalization” test would apply. Moreover, any new tax law test related to overcapitalization would be problematic for financial services businesses to the extent it imposes requirements that are different than the regulatory capital requirements.

We encourage the OECD to closely work with the financial services industry to ensure that any substance tests or active business requirements that are included in a CFC recommendation are applied properly to financial services businesses. As noted above, we believe the OECD should defer the work on Action 3 until after the work on other key Actions is completed next fall. Should the OECD not follow that broader recommendation and we hope that the recommendation will be followed, we urge the OECD to defer the necessary work on the CFC issues for active financial services businesses in order to allow time for much needed consultation with the industry.
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We appreciate the opportunity to provide these comments on key issues with respect to the Action 3 Discussion Draft. We would be happy to respond to questions or to provide any further information that would be useful as the OECD continues its work in this area.

Sincerely,

[Signature]

Peter van Dijk
Senior Vice President, Tax
TD Bank
Date: 1 May 2015

Dear Sir/ Madam

OECD discussion draft on BEPS action 3: strengthening CFC rules

The Investment Association\(^1\) welcomes the opportunity to comment on the BEPS Action 3 consultation. We recognise the need to address base erosion and profit shifting by means of using CFCs. We also support the broader objectives of the BEPS Action Plan. However, we are concerned that the general manner in which the proposals for effective CFC rules are drafted may inadvertently capture some arrangements relevant to investment managers that are truly commercial.

Investment funds are an essential savings vehicle, particularly for smaller savers and investors that otherwise lack the scale for cost effective access to the capital markets. The importance of funds as a vehicle for long term saving is all the more relevant today, when citizens are increasingly being called to make their own provision for retirement. Meanwhile the capital raised represents a key source of investment capital to finance economic activity.

Investment managers frequently work in a cross-border environment. An investment manager may manage the assets of funds that are resident in other jurisdictions. Alternatively an investment manager may distribute the funds it manages to investors in other jurisdictions. Some cross border arrangements are in place for regulatory purposes, and/ or for the purposes of being able to access capital markets, invest more freely across borders, and offer savings products to customers throughout the world. For these reasons it is common for investment managers to have branches or subsidiaries in other jurisdictions.

\(^1\) The Investment Association (formerly the Investment Management Association) represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around £5.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.
The recommendations in the discussion draft do not address particular circumstances of some company types, and our concern relates in particular to the impact of CFC rules on fund structures and their investors. Below we outline of examples of circumstances relevant to funds that may result in the application of CFC rules even though they pose no risk of base erosion and profit shifting.

Seeding funds

An example of this is a manager of an offshore fund which meets the specified type and level of control mainly for the purpose of attracting participants to the fund.

Newly launched funds require a minimum size in order to be able to have a sufficiently diversified portfolio and to ensure that the level of administration and dealing costs does not adversely impact performance and deter investors. Therefore, a fund promoter will often ‘seed’ funds by depositing an initial investment in the fund of sufficient size so as to ensure the fund has critical mass on launch. The result of this may be that the fund becomes a CFC if the seed money is invested by a company resident in a different country.

There are various typical sources a fund manager might use to seed their funds. This might be through group companies related to the fund manager (e.g. a group life insurance company), or another fund that is not necessarily part of a group but which is managed by the same manager. Frequently seed investments are made through companies (i.e. the fund manager) that are subject to taxation regimes for holding offshore funds – such as the UK offshore funds rules – and including seeded offshore funds within the CFC rules would increase the compliance burden on fund managers give rise to the risk of double taxation.

The UK CFC rules address this particular situation by means of a specific exemption for fund managers (Taxation (International and Other Provisions) Act 2010 s371BE).

We note that the main focus of BEPS generally, and of any CFC regime is multinational groups. In the case of fund managers seeding funds, the CFC rules would also apply to much smaller businesses. Fund managers of all sizes need to seed their own funds. In fact it is more often the smaller fund managers that are required to seed their funds because they cannot benefit from the support of a large network of distributors and are not established household names.

Funds becoming CFC as a result of investor redemption

A similar problem can arise for participants in offshore funds where a fund is in the process of winding down, or for other reasons a fund has suffered significant investor redemptions. In these cases a remaining investor may find itself in a ‘controlling’ position simply as a result of the actions of other participants in the fund. To address this, the UK rules provide an exemption for company participants in offshore funds where the attribution threshold is met but through no step taken by the company (or any person connected or associated with the company) (Taxation (International and Other Provisions) Act 2010 s371BF).
Funds investing in offshore funds (including UCITS Master-Feeder Funds)

The changes introduced by UCITS IV include allowing Master-Feeder funds as a pooling technique. There are a large number of benefits of the Master-Feeder structures including cost savings and economies of scale which potentially enhance fund performance for investors.

A Master-Feeder fund is a two-tiered fund structure in which investors invest through one of any number of “Feeder” funds, but the assets are held by a separate “Master” fund, whose investors include (or are exclusively) the Feeder funds. Each Feeder fund is established to meet the needs of a particular investor type (e.g. different tax requirements for investors in different countries), and although the Master and the Feeders may be established in the same or in different jurisdictions. Where a Feeder fund established in one jurisdiction has a Master fund in another jurisdiction, the Master fund could be a CFC.

The possible application of CFC rules at the level of the Feeder will prevent Master-Feeder funds from operating effectively by causing tax leakage at the fund level. The viability of investment funds depends on there being a single level of tax at either investor level or at fund level. Most tax regimes provide exemption from tax at the fund level (either explicitly, or by providing broad exemptions from tax on types of income). There is no need, in terms of safeguarding the tax base, for Master-Feeder structures to give rise to the imputation of taxable profits under the CFC rules at the level of the Feeder.

Thank you again for the opportunity to comment on the discussion draft. We hope to continue to be able to contribute to the consultation and I am available at your convenience to discuss anything in this letter at jmorley-smith@theinvestmentassociation.org or on +44 (0)20 7831 0898.

Yours faithfully

Jorge Morley-Smith
Director, Head of Tax
BEPS and anti-abuse rules: The EU law dimension

Introduction
The Organisation for Economic Co-operation and Development (OECD)’s Base Erosion and Profit Shifting (BEPS) project has been creating considerable debate and discussion in the international tax community. This short paper, based on a talk given at the CFE Forum 2014, highlights one aspect of the EU law dimension to the BEPS project; in particular, the jurisprudence of the Court of Justice of the EU (ECJ) in the direct tax (including tax treaties) field.

The jurisprudence of the ECJ clearly shows that certain types of tax planning are acceptable to the ECJ. Moreover, when the principle of proportionality is applied, national anti-abuse rules, such as controlled foreign company (CFC), thin capitalisation and transfer pricing rules, may fail if the taxpayer is able to demonstrate that its CFC is carrying on genuine economic activities or the loans or associated transactions are commercially justified even though they do not meet the arm’s length principle.

Part I examines the ‘Tax Planning Spectrum’ in the EU, which has wholly artificial arrangements (unacceptable tax planning) at one end of the spectrum and genuine economic activities/commercial justification for the transactions at the other end (acceptable tax planning). Part II looks at anti-abuse rules in the EU with a particular emphasis on three types: CFC rules (Cadbury Schweppes), thin capitalisation rules (Thin Cap GLO) and transfer pricing (SGI). Finally Part III offers some conclusions.

Part I
The tax planning spectrum
The BEPS project intersects with the jurisprudence of the ECJ in the area of anti-abuse tax rules of the member states and abuse of EU law. The ECJ has developed a fairly settled jurisprudence whereby the EU member states can maintain anti-abuse rules provided that such rules are aimed at preventing wholly artificial arrangements designed to circumvent the national tax laws of the member states. However, the ECJ has also made it clear that some tax planning is perfectly acceptable. Thus, it is clear from the court's jurisprudence that there is a tax planning spectrum. At one end of that spectrum, transactions involving wholly artificial arrangements are outlawed, whilst at the other extreme the court is willing to accept tax mitigation strategies undertaken by the taxpayer. Understanding this tax planning spectrum is fundamental for tax advisers embarking on tax mitigation strategies for their clients. It is also important for the BEPS
project since all tax planning involving the exercise of the EU freedoms must comply with EU law. Therefore, it is of the utmost importance that the BEPS project takes EU law into account when making changes to the international tax landscape.

**Tax planning in the EU**

The ECJ has accepted that ‘taxpayers may choose to structure their business so as to limit their tax liability’. [1] Moreover, in **RBS Deutschland**, the court highlighted that ‘taxable persons are generally free to choose the organisational structures and the form of transactions which they consider to be most appropriate for their economic activities and for the purposes of limiting their tax burdens’. [2] Thus, in **Batavier**, a pure inheritance tax planning case, the court stressed that an EU national ‘cannot be deprived of the right to rely on provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a member state other than his State of residence’. [3]

However, the court has also pointed out the other side of the coin in **Tunnocht**, stressing that ‘preventing possible tax evasion, avoidance and abuse is an objective recognised and encouraged by the [VAT] directive’ [4] and that the effect of the principle prohibiting abuse of rights is ‘to prohibit wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage’. [5] The court indicated in **Cantor Fitzgerald** that the principle of the neutrality of VAT ‘does not mean that a taxable person with a choice between two transactions may choose one of them and avail himself of the effects of the other’. [6]

The consequences of this mixed case law seem to be clear. Tax planning done within certain parameters is acceptable to the ECJ. However, ‘wholly artificial arrangements’ lacking ‘economic reality’ and set up with the sole aim of securing a tax advantage may be challenged. Moreover, EU nationals cannot use EU law rights (such as the freedom of establishment) to circumvent national tax rules. The court made this clear in **Cadbury Schweppes**, when it stated that EU nationals must not ‘improperly or fraudulently take advantage of provisions of Community law’. [7] However, the court pointed out that the fact that the company was established in a member state for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse of that freedom’. [8]

**Part II**

**Anti-abuse rules and EU Law**

It seems clear from the jurisprudence of the court to date that anti-abuse rules of the EU member states which treat the cross-border situation less favourably than a similar domestic situation may constitute a restriction on the exercise of the freedoms. This reasoning has been applied by the ECJ in relation to CFC rules in **Cadbury Schweppes**; in relation to thin capitalisation rules in **Thin Cap GLO** [9] and in relation to transfer pricing rules in **SGI** [10]

Thus, in **Cadbury Schweppes**, the court focused on the different treatment of an origin state parent company with subsidiaries located in another member state which were subject to a lower level of taxation. The court determined that UK’s CFC rules operating in such circumstances were liable to hinder the exercise of the freedom of establishment. [11] Similarly, in **Thin Cap GLO**, the court highlighted that national thin capitalisation rules gave rise to a difference in tax treatment between resident borrowing companies ‘according to whether or not the related lending company is established in the United Kingdom’. [12] In **SGI**, the court applied similar thinking in relation to Belgian transfer pricing rules, when it noted that ‘the tax position of a company resident in Belgium, which, like SGI, grants unusual or gratuitous advantages to companies with which it has a relationship of interdependence that are established in other member states is less favourable than it would be if it granted such advantages to resident companies with which it has such a relationship’. [13]

Consequently, such anti-abuse rules need to be justified and the rules need to comply with the principle of proportionality. This is clear from an examination of the three cases concerning anti-abuse legislation: **Cadbury Schweppes, Thin Cap GLO** and **SGI**.

**CFC rules**

In **Cadbury Schweppes**, the court was quick to point out that ‘the mere fact that a resident company establishes 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’. [14] Instead, the court indicated that ‘a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the member state concerned’. [15] The court stressed that 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 must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality. [16] The court explained that ‘the type of conduct described in the preceding paragraph is such as to undermine the right of the member states to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardise a balanced allocation between member states of the power to impose taxes’. [17]

The court noted that ‘the intention to obtain tax relief prompted the incorporation of the CFC and the conclusion of the transactions between the latter and the resident company does not suffice to conclude that there is a wholly artificial arrangement intended solely to escape that tax’. [18] The court explained that in order to find that a wholly artificial arrangement exists ‘there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment, as set out in paragraphs 54 and 55 of this judgment, has not been achieved’. [19] Thus, ‘in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality’. [20] In other words, there must be an actual establishment intended to carry on the genuine economic activities in the host member state. If there is, then the CFC rules cannot be applied to that low-taxed entity.

Thus, the court applied the ‘Halifax’ two-prong test: ‘a subjective test consisting in the intention to obtain a tax advantage’ [21] followed by an objective test comprising ‘objective factors which 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’. [22] The court explained that if checking those objective factors ‘leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host member state, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a “letterbox” or “front subsidiary”.’ [23]

On the issue of proportionality, the court indicated 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’. [24]

The ECJ concluded that it was a matter for the national court to determine whether the UK’s CFC legislation could be restricted to wholly artificial arrangements or whether, ‘where none of the exceptions laid down by that legislation applies and the intention to obtain a reduction in UK tax is central to the reasons for incorporating the CFC, the resident parent company comes within the scope of application of that legislation, despite the absence of objective evidence such as to indicate the existence of an arrangement of that nature’. [25] If the former situation applied, then the UK’s CFC regime was compatible with EU law. If the latter situation applied then the CFC rules were incompatible with the freedom of establishment.

Thus, the ECJ held that CFC rules ‘must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that CFC is actually established in the host member state and carries on genuine economic activities there’. [26]

Thin capitalisation rules
The ECJ applied similar thinking in Thin Cap GLO, but in this case it dealt with the UK’s thin capitalisation regime. The court noted that ‘a national measure restricting freedom of establishment may be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the member state concerned’. [27] However, the court pointed out that the ‘mere fact that a resident company is granted a loan by a related company which is established in another member state cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty’. [28]

The court stressed that 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 must be to prevent conduct involving the creation of wholly artificial arrangements which 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’. [29]

The court made a link between the conduct of the taxpayer in Marks & Spencer,[30] ‘which involved arranging transfers of losses incurred within a group of companies to companies established in the member states which applied the highest rates of taxation and in which the tax value of those losses was therefore the greatest’, [31] and the conduct of the taxpayers in Thin Cap GLO, pointing out that this conduct was capable of undermining ‘the right of the member states to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardise a balanced allocation between member states of the power to impose taxes’. [32] The court noted that thin capitalisation legislation was ‘able to prevent practices the sole purpose of which is to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory. It follows that such legislation is an appropriate means of attaining the objective underlying its adoption’. [33] However, the court still had to investigate whether such anti-abuse legislation was compatible with the principle of proportionality.

The court explained that such legislation did not comply with the principle of proportionality where it did not have ‘the specific purpose of preventing wholly artificial arrangements designed to circumvent that legislation, but applies generally to any situation in which the parent company has its seat, for whatever reason, in another member state’. [34] However, such anti-abuse legislation could be justified ‘by the need to combat abusive practices where it provides that interest paid by a resident subsidiary to a non-resident parent company is to be treated as a distribution only if, and in so far as, it exceeds what those companies would have agreed upon on an arm’s-length basis, that is to say, the commercial terms which those parties would have accepted if they had not formed part of the same group of companies’. [35]

The court went on to apply the Halifax formula, discussed above, using the arm’s length test as an objective measure of determining whether a wholly artificial arrangement existed. The court stated that the fact that ‘a resident company has been granted a loan by a non resident company on terms which do not correspond to those which would have been agreed upon at arm’s length constitutes, for the member state in which the borrowing company is resident, an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that member state’. [36] Then, following the opinion of Advocate General Geelhoed, the court set out how the principle of proportionality works in this sphere, highlighting in para 82 that ‘national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement, entered into for tax reasons alone, is to be considered as not going beyond what is necessary to prevent abusive practices where, in the first place, on each occasion on which the existence of such an arrangement cannot be ruled out, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that arrangement’. Thus, the taxpayer must be given the opportunity to rebut the presumption that a wholly artificial arrangement has taken place by providing commercial justification for the loan in question. If the taxpayer satisfies this requirement then the anti-abuse rules fail at this stage. However, if the taxpayer fails to provide the necessary commercial justification for the loan in question then phase two of the proportionality test kicks-in and this requires that ‘the re-characterisation of interest paid as a distribution is limited to the proportion of that interest which exceeds what would have been agreed had the relationship between the parties or between those parties and a third party been one at arm’s length’. [37]

The court noted in para 87 of Thin Cap GLO that it was a matter for the national court to determine ‘whether those provisions allow taxpayers, where the transaction does not satisfy the arm’s-length criterion, to produce evidence of the commercial justifications
for that transaction, under the conditions referred to in the preceding paragraph’. Paragraphs 82 and 83 of the Thin Cap GLO judgment are, therefore, fundamental to understanding the law in this area and, in particular, to understanding how the principle of proportionality operates in the area of thin capitalisation anti-abuse rules.

Transfer pricing rules
In SGI, a Belgian transfer pricing ‘anti-abuse’ case, the court applied similar reasoning to that applied in relation to thin capitalisation anti-abuse legislation. Having determined that the cross-border situation was treated less favourably than a similar domestic one (see para 43 of the SGI judgment), the court quickly determined that such legislation amounted to a restriction on the freedom of establishment. The court stressed that such anti-abuse legislation could deter a resident company from ‘acquiring, creating or maintaining a subsidiary in another member state or from acquiring or maintaining a substantial holding in a company established in that state because of the tax burden imposed, in a cross border situation, on the grant of advantages at which the legislation at issue in the main proceedings is directed’. [38]

The court also noted that the legislation in question could have a restrictive effect on companies established in other member states. Such a company could be deterred from acquiring, creating or maintaining a subsidiary in Belgium or from acquiring or maintaining a substantial holding in a company established in that State because of the tax burden imposed there on the grant of the advantages at which that legislation is directed.

Consequently, the decision in SGI turns on the issue of justification and the application of the principle of proportionality. As regards balanced allocation, the court observed that ‘such a justification may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a member state to exercise its tax jurisdiction in relation to activities carried out in its territory’. [39] Again, the court applied its Marks & Spencer reasoning, pointing out that to give companies ‘the right to elect to have their losses or profits taken into account in the member state in which they are established or in another member state could seriously undermine a balanced allocation of the power to impose taxes between the member states, since the tax base would be increased in one of the states in question, and reduced in the other, by the amount of the losses or profits transferred’. [40]

The court stated that ‘to permit resident companies to transfer their profits in the form of unusual or gratuitous advantages to companies with which they have a relationship of interdependence that are established in other member states may well undermine the balanced allocation of the power to impose taxes between the member states … because, according to the choice made by companies having relationships of interdependence, the member state of the company granting unusual or gratuitous advantages would be forced to renounce its right, in its capacity as the state of residence of that company, to tax its income in favour, possibly of the member state in which the recipient company has its establishment’. [41] Therefore, by having transfer pricing rules to counter this type of tax planning abuse, the Belgian rules at issue achieved the objective of protecting a balanced allocation of taxing powers between the member states.

The court also noted that ‘a national measure restricting freedom of establishment may be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the member state concerned’. [42] In this respect the court again cited Marks & Spencer but, in this instance, referred to para 57 of that judgment. Here, the court underlined that a member state may have anti-abuse rules which ‘specifically’ target wholly artificial arrangements. In such circumstances, the need to prevent tax avoidance is a stand-alone justification for the national anti-abuse rules in question. However, if the national anti-abuse rules are ‘not specifically’ designed to combat whole artificial arrangements they may still be justified by the need to ensure a balanced allocation of taxing powers between the member states taken together with the need to prevent tax avoidance. This becomes clear in the next paragraph of the SGI judgment (para 66) where the ECJ explained that if the member state’s anti-abuse legislation (transfer pricing in this instance) ‘is not specifically designed to exclude from the tax advantage it confers such purely artificial arrangements … [it] 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’. [43]

The court gives a simple explanation for this, stressing that ‘to permit resident companies to grant unusual or gratuitous advantages to companies with which they have a relationship of interdependence that are established in other member states, without making provision for any corrective tax measures, carries the risk that, by means of artificial arrangements, income transfers may be organised within companies having a relationship of interdependence towards those established in member states applying the lowest rates
of taxation or in member states in which such income is not taxed’. [44] Therefore, the Belgian transfer pricing rules at issue were able to prevent these types of abusive practices involving whole artificial arrangements.

The court concluded that in the light of ‘those two considerations, concerning the need to maintain the balanced allocation of the power to tax between the member states and to prevent tax avoidance, taken together, it must be held that legislation such as that at issue in the main proceedings pursues legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest and that it is appropriate for ensuring the attainment of those objectives’. [45] The only matter remaining was for the court to apply the principle of proportionality in this case.

In applying the principle of proportionality in SGI, the court used the same reasoning which it adopted in Thin Cap GLO and Halifax. It accepted that the arm’s length test was an objective criterion to determine whether the conduct of the taxpayer amounted to a whole artificial arrangement but it stressed that the taxpayer must be given an opportunity to provide evidence of commercial justification for the transaction.

The court repeated what it said in Thin Cap GLO para 82, underlining that national legislation ‘which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the member states and to prevent tax avoidance where, first, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction’. [46] If the taxpayer provided such ‘commercial justification’ then the anti-abuse rules in question would fail. However, if the commercial justification was unforthcoming or unsatisfactory in the eyes of the national court, then part two of the proportionality test took effect.

The court stressed that ‘where the consideration of such elements leads to the conclusion that the transaction in question goes beyond what the companies concerned would have agreed under fully competitive conditions, the corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence’. [47]

The court concluded that it was a matter for the national (Belgian) court ‘to verify whether the legislation at issue in the main proceedings goes beyond what is necessary to attain the objectives pursued by the legislation, taken together’. [48]

**Part III**

**Conclusions**

There are a number of important conclusions to be noted from this discussion.

First, the BEPS project needs to take into consideration the views of the ECJ, expressed in its tax avoidance and tax abuse jurisprudence, concerning national anti-abuse rules, because in a European Internal Market environment such anti-abuse rules must comply with EU law. It should also be recalled that the European Internal Market extends beyond the territory of the EU when the EU fundamental freedoms are extended to non-member states. Examples include the free movement of capital which applies generally to all non-member states (subject to numerous derogations) and international agreements where the EU has extended some of its fundamental freedoms to non-member states, such as the European Economic Area (EEA) Agreement and the EU–Switzerland bilateral agreements.

Second, the jurisprudence of the ECJ, discussed above, makes it clear that the emphasis of the court is on the national anti-abuse legislation [49] (CFC, thin capitalisation and transfer pricing) of the member states, not on tax avoidance as such which the ECJ defines as whole artificial arrangements designed to circumvent the national tax system. It is important to recognise that the court sees two types of anti-abuse rules: those which are specifically designed to combat tax avoidance and those which are not specifically designed to combat tax avoidance but operate more generally. The court is satisfied that both types of anti-abuse rules which restrict the exercise of a fundamental freedom may be justified. From SGI and Marks & Spencer, it is clear that the former may be justified by the need to combat tax avoidance. Whereas the latter may be justified by the need to ensure a balanced allocation of taxing rights, taken together with, the need to protect against tax avoidance.

Last, it is important to note for the purposes of the BEPS project that while the ECJ has accepted that the member states can maintain anti-abuse rules which combat wholly artificial arrangements designed to circumvent their national tax systems, such rules must comply with the principle of proportionality. In other words, if the taxpayer can demonstrate that its CFC carries on genuine economic activities then CFC
rules which amount to a restriction on its freedom of establishment may not be applied. Similarly, in transfer pricing and thin capitalisation situations, if the taxpayer can demonstrate commercial justification for its transactions which deviate from the arm’s length principle, then such anti-abuse rules may also fail. Therefore, in a European Internal Market context, the OECD’s BEPS project must take the jurisprudence of the ECJ and EU law into account.

**Final thoughts**

Since writing the above, the ECJ has delivered its judgment in *Ikear* (Case C-282/12), a case which concerned Portuguese thin capitalisation rules and third country situations. The court stressed that ‘where rules are predicated on an assessment of objective and verifiable elements for the purposes of determining whether a transaction represents a wholly artificial arrangement entered into for tax reasons alone, they may be regarded as not going beyond what is necessary to prevent tax evasion and avoidance, if, on each occasion on which the existence of such an arrangement cannot be ruled out, those rules give the taxpayer an opportunity, without subjecting him to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction’.[50]

Similarly, in its more recent *SCA* judgment[51] (Joined Cases C-39/13, 40/13 and 41/13), the ECJ pointed out that ‘although the Netherlands Government sought to justify the restriction at issue … on the ground of the risk of tax avoidance, it is settled case-law that that ground does not constitute, by itself, an autonomous justification for a tax restriction on freedom of establishment if it is not relied on in conjunction with a specific objective of combatting wholly artificial arrangements which do not reflect economic reality and the purpose of which is to escape the tax normally due’.

These recent decisions of the ECJ demonstrate that the court’s jurisprudence is extremely settled and the BEPS project must take this jurisprudence into account in re-designing international tax rules. Otherwise, in an EU environment, the door will be left open to future challenges by taxpayers and the European Commission that such anti-abuse rules are incompatible with EU law.

**Dr Tom O’Shea is a senior lecturer in Tax Law at Queen Mary University of London, Centre for Commercial Law Studies and a chartered tax adviser. Email t.o.shea@qmul.ac.uk. This article is based on a talk given by the author at the CFE Forum 2014. Much of the thinking in this article is based on an article in EC Tax Journal in 2012, entitled ‘CFC Reforms in the UK: Some EU Law Comments’, ECTJ, 13, 1, 65–89 and on Chapter 4 of Tom O’Shea, EU Tax Law and Double Tax Conventions (Avour Fiscal Limited, London, 2008) ISBN 978-0-955916403.

**Endnotes**

5. Tanoarch, para 51.
8. Cadbury Schweppes, para 37.
11. Cadbury Schweppes, para 46.
12. Thin Cap GLO, para 40.
13. SGI, para 43.
15. Cadbury Schweppes, para 51.
17. Cadbury Schweppes, para 56.
18. Cadbury Schweppes, para 63.
19. Cadbury Schweppes, para 64.
21. Cadbury Schweppes, para 64.
22. Cadbury Schweppes, para 67.
23. Cadbury Schweppes, para 68.
24. Cadbury Schweppes, para 70.
26. Cadbury Schweppes, para 75.
27. Thin Cap GLO, para 72.
28. Thin Cap GLO, para 73.
29. Thin Cap GLO, para 74.

31. Thin Cap GLO, para 75.
32. Thin Cap GLO, para 75.
33. Thin Cap GLO, para 77.
34. Thin Cap GLO, para 79.
35. Thin Cap GLO, para 80.
36. Thin Cap GLO, para 81.
37. Thin Cap GLO, para 83.
38. SGL para 44.
39. SGL para 60.
40. SGL para 62.
41. SGL para 63.
42. SGL para 65.
43. SGL para 66.
44. SGL para 67.
45. SGL para 69.
46. SGL para 71.
47. SGL para 72.
48. SGL para 76.
49. For a more detailed explanation of the difference between the two types of anti-abuse legislation and how each may be justified, see Tom O’Shea, ‘CFC Reforms in the UK – Some EU Law Comments’, ECTJ, 13, 1, 65–89.

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Editors: David Salter • david.salter10@virginmedia.com and Tom O’Shea • t.oshea@gmail.com
Marketing: Sally Rodwell • 020 3377 3633 • sally.rodwell@informa.com
Sales: Rhodri Taylor • 020 7017 7787 • rhodri.taylor@informa.com
Renewals: Helen James • 020 7017 5268 • helen.james@informa.com
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CFC REFORMS IN THE UK – SOME EU LAW COMMENTS
Tom O’Shea

In July 2011, the UK Treasury and Revenue issued a second consultation document on the reform of the UK’s CFC rules. In Annex I of the document, the UK Government set out its understanding of the relevant ECJ case law in this area. It highlighted the impact and relevance of the Cadbury Schweppes judgment of the ECJ for these reforms and indicated the importance of the SGI and Thin Cap GLO judgments for understanding the concepts of justification and proportionality. In this article the author makes some comments on the EU law aspects of the proposed CFC reforms.

1 Before articles have been accepted for publication in EC Tax Journal’s peer-reviewed section, they have been subject to double-blind peer-review; that is, two academic reviewers who shall remain anonymous to the author and to each other and neither of whom are from the same country as the author have evaluated the article’s academic merit. Only articles confirmed by the reviewers to show the highest standards of scholarship are accepted for publication in this section.

2 Dr Tom O’Shea is a Lecturer in Tax Law at Queen Mary University of London, Centre for Commercial Law Studies. This article is based on a paper delivered at the 7th Annual Avoir Fiscal EU Tax Conference held at the Institute of Advanced legal Studies on the 27th January 2012. Comments are welcome t.o’shea@qmul.ac.uk. The date of this manuscript is the 17 March 2012.


Introduction

The UK’s CFC rules were challenged in Cadbury Schweppes and the ECJ held that it was a matter for the UK courts to determine whether the so-called “motive test” could be interpreted in such a way that the taxation provided under the UK’s CFC regime could be restricted to “wholly artificial arrangement” situations. The judgment of the ECJ in Cadbury Schweppes was subsequently applied by the UK courts in Vodafone 2, where the Court of Appeal determined that the UK’s CFC rules could be interpreted in a way which ensured EU law was respected by reading into the legislation an additional exception: “if the CFC is, in that accounting period, actually established in another member state of the EEA and carries on genuine economic activities there”. Accordingly, the UK’s rules could be interpreted in a way that ensured the freedom of establishment was guaranteed.

This conforming interpretation approach adopted by the Court of Appeal appears to be correct. The UK legislation, therefore, needed to be amended and with the switch to a more territorial system for taxing foreign profits, the CFC rules were in need of reform. Hence, the current consultation process on the proposed reforms.

Annex I

Annex I of the consultation document sets out a brief, clear, statement of the UK Government’s understanding of the relationship between EU law and CFC rules and of the jurisprudence of the ECJ in the area of anti-avoidance rules (CFC, thin capitalisation and transfer pricing).

The inclusion of Annex I in the consultation document is refreshing and to be welcomed. As is clear from Cadbury Schweppes, the UK CFC rules interact with the freedom of establishment. Therefore, it is important when designing new CFC rules to ensure that they comply with EU law, otherwise, problems are simply being stored-up for the future with further litigation being a distinct possibility. For instance, in May 2011, the European Commission issued a reasoned opinion to the UK indicating that it considers that the UK’s response to the Cadbury Schweppes judgment is inadequate and that further remedial measures are required.


8  See Commission requests UK to further amend its treatment of controlled foreign corporations (CFCs), Case No 2009/4105, IP/11/606 of 19/05/2011. The Commission argues that the UK’s post-Cadbury Schweppes rules continue to breach the freedom of establishment because they “fail to exclude from the CFC regime all subsidiaries established in EU/EEA Member States which are not purely artificial and are not involved in profit-shifting transactions”.

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Therefore, it is imperative to get the new CFC regime right and ensure that it is “EU-proof” and complies fully with EU law and the jurisprudence of the ECJ.

This article is divided into four parts. Part I looks at the improper use of EU law. Part II examines the concept of “wholly artificial arrangements”. Part III analyses in some detail the approach of the Court of Appeal in *Thin Cap GLO CA* and Part IV offers some conclusions.

**Part I - Improper use of EU law**

The discussion of the judgment of the ECJ in *Cadbury Schweppes* is a useful starting point. Paragraph I.4 of the consultation document sets out the understanding of the UK Government on what *Cadbury Schweppes* established. However, it should be highlighted that this paragraph fails to mention a number of key findings of the ECJ that are important for understanding its jurisprudence concerning national anti-avoidance rules, such as CFC regimes.

In *Cadbury Schweppes*, the ECJ pointed out that “nationals of a Member State cannot attempt, under cover of the rights created by the Treaty, improperly to circumvent their national legislation. They must not improperly or fraudulently take advantage of provisions of Community law”.\(^9\) However, the Court explained that “the fact that a Community national, whether a natural or a legal person, sought to profit from tax advantages in force in a Member State other than his State of residence cannot in itself deprive him of the right to rely on the provisions of the Treaty”\(^10\) and that “the fact that the company was established in a Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse of that freedom”.\(^11\) Therefore, there is a difference between a UK company setting up a subsidiary (CFC) in another Member State which conducts genuine economic activities and a UK company setting up a subsidiary (CFC) involving arrangements which artificially divert profits from the UK. In the former situation, the UK cannot tax the UK parent company on the profits of the CFC whereas in the latter situation it can.

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9. *Cadbury Schweppes* paragraph 35. For a detailed analysis of the *Cadbury Schweppes* judgment, see “The UK’s CFC rules and the freedom of establishment: *Cadbury Schweppes plc* and its IFSC subsidiaries – tax avoidance or tax mitigation?” *EC Tax Rev.*, 2007, 1, 13-33.

10. *Cadbury Schweppes* paragraph 36.

11. *Cadbury Schweppes* paragraph 37.
**Thin Cap GLO**

The ECJ repeated these important background comments in *Thin Cap GLO* (paragraph 73) where the Court highlighted that the mere fact that “a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty”.

**RBS Deutschland**

Similarly, in the sphere of VAT, in *RBS Deutschland*, the ECJ has accepted that “taxable persons are generally free to choose the organisational structures and the form of transactions which they consider to be most appropriate for their economic activities and for the purposes of limiting their tax burdens” and that “a trader’s choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations relating to the neutral system of VAT … [and that]… “where it is possible for the taxable person to choose from among a number of transactions, he may choose to structure his business in such a way as to limit his tax liability”.

**Halifax**

In *Halifax*, the ECJ set out its test for abusive practices (in paragraphs 74 and 75), indicating that an abusive practice in the sphere of VAT can be found to exist only if, first, the transactions were contrary to the purpose of the VAT directive and the national legislation transposing it and second, that “it must be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage”. The Court went on to stress that “the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages”.

This approach was followed in *Cadbury Schweppes* where the Court noted 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

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13 *RBS Deutschland* paragraph 53.
14 *RBS Deutschland* paragraph 54.
Some tax avoidance is acceptable to the ECJ

These background comments are important because they show that the ECJ does not outlaw cross-border tax avoidance entirely. Cross-border tax avoidance involving “tax mitigation” is clearly acceptable to the ECJ and forms part of the backdrop to understanding the limitations placed on the design of national anti-avoidance rules when national tax rules come into conflict with EU law, in particular the fundamental freedoms. However, genuine exercise of the freedoms is required.

“Visa planning”

By way of analogy, an example is seen in *Chen* which involved “visa planning” rather than tax planning. This case involved Chinese nationals – a husband and wife - who worked for a business established in China. Mr Chen travelled regularly to the UK. In May 2000, Mrs Chen entered the UK when she was six months pregnant. She went to Belfast, Northern Ireland, in July 2000 where her child, Catherine, was born in September 2000. Claiming citizenship under the then Republic of Ireland nationality law, Catherine applied for an Irish passport because, at that time, anyone born on the island of Ireland was entitled to become an Irish citizen. Catherine was not entitled to British citizenship, even though she was born in Belfast. Consequently, Catherine was issued with an Irish passport. The ECJ noted that it was common ground that “Mrs Chen took up residence in the island of Ireland in order to enable the child she was expecting to acquire Irish nationality and, consequently, to enable her to acquire the right to reside, should the occasion arise, with her child in the United Kingdom”.

The ECJ then dealt with the abuse of the EU freedom of movement arguments put forward by the UK which referred to the “arrangements” put in place by Mrs Chen to secure Irish nationality for her child and, indirectly, a right of residence in the UK for herself as the child’s primary carer. The ECJ examined the motives of the Chen family and noted that Mrs Chen admitted that the purpose of her stay in the UK was to create this situation so that she and her child could access EU law rights. However, as the acquisition and loss of nationality was a matter for each Member State, and as the legality of Catherine’s Irish nationality had never been challenged, it was not “permissible for a Member State to restrict the effects of the grant of nationality of another Member State”. Consequently, Catherine was entitled to reside in the UK as an EU national with sufficient resources to prevent her evasion and justify a measure which compromises the exercise of a fundamental freedom”.

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16 Cadbury Schweppes paragraph 50.
18 Chen paragraph 11.
becoming a burden on the UK. Moreover, a refusal to allow the parent (whatever her nationality) and primary carer to reside with Catherine “would deprive the child’s right of residence of any useful effect”. Catherine was, accordingly, entitled to be accompanied by her primary carer who was also entitled to a right of residence in the UK for the duration of Catherine’s residence.

Motive

The Chen case demonstrates that as long as there is a genuine exercise of the fundamental freedoms, the motives behind the exercise of those freedoms will not necessarily jeopardize their use in order to circumvent national rules. It seems clear that the arrangements put in place in the Chen case were a “pure” scheme (or a series of steps) to achieve residency in the UK for Mrs Chen. In other words, the exercise of the fundamental freedom or acquiring of a right of residency can be carried out for reasons which appear to be inappropriate to a Member State because the Member State’s rules prevent the right of residency. However, all such rules of the EU Member States must be measured against the EU’s internal market rules and the principle of proportionality.

In Cadbury Schweppes, the Court followed this thinking by rejecting the motives of the UK parent company as being abusive when it set up its subsidiaries in Ireland, even though the “arrangements” were put in place to obtain a tax advantage. The Court expressly indicated inCadbury Schweppes 19 that in order for the legislation on CFCs to comply with EU law, “the taxation provided by that legislation must be excluded where, despite the existence of tax motives, the incorporation of the CFC reflects economic reality”. Accordingly, “the extent to which the CFC exists in terms of premises, staff and equipment” 20 becomes important in determining whether the CFC is a real establishment as opposed to a “letterbox” or “front” subsidiary which are seen by the ECJ as wholly artificial arrangements.

19 Cadbury Schweppes paragraph 65.
20 Cadbury Schweppes paragraph 67.
Barbier

A similar approach can be seen in Barbier,\(^{21}\) where the taxpayer took advantage of the favourable Dutch tax rules relating to splitting the legal and financial ownership of immovable property, for tax planning/ tax mitigation/ tax avoidance reasons. The motives behind the transactions and/or the use of the freedoms in both instances were to obtain tax advantages. Yet, the ECJ allowed such practices as long as the actual exercise of the fundamental freedom in question was properly exercised.

Genuine economic activity

These cases demonstrate that “tax planning” or “tax mitigation” can take place using EU law rights as long as the planning involved ensures that the objective of the rules in question are met and as long as there is genuine activity, establishment, capital movement, service, etc. carried out, and “wholly artificial arrangement” situations are avoided. It is also perfectly acceptable in the eyes of the ECJ for a taxpayer to arrange its affairs in such a way as to minimise taxation.

Part II - Wholly artificial arrangements

Paragraphs I.8 - I.14 of the consultation document contain an important discussion concerning the concept of “wholly artificial arrangements”. The view of the UK Government is that the term “wholly artificial arrangements” refers to arrangements that do not relate to genuine economic activities pursued through an actual establishment in the host Member State; that a UK parent company will not have genuinely exercised its freedom of establishment if the CFC is itself a “wholly artificial arrangement” and that CFC rules constitute a justified restriction on the freedom of establishment so long as they only tax those profits that are attributable to “wholly artificial arrangements”. In other words, the view of the UK Government is that the profits of the CFC can be apportioned, with the UK taxing the profits of the UK parent company on any CFC profits that are attributable to artificial diversion of profits from the UK. This appears to be a correct understanding of the jurisprudence.

Thin Cap GLO

Support for this thinking is found in Thin Cap GLO (paragraph 81), where the ECJ accepted that the fact that a resident company has been granted a loan by a non-resident associated company on terms which were not at arm’s length constituted an objective element which can be independently verified in order to determine whether

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the transaction represented, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State. Moreover, in paragraph 83, the Court insisted that the re-characterisation of interest paid as a distribution must be limited to the proportion of that interest which exceeds what would have been agreed at arm’s length.

**SGI**

Paragraph I.13 draws on the ECJ’s judgment in SGI to find further support for the apportionment notion, highlighting that the ECJ held that transfer pricing rules tax profits that relate only to wholly artificial arrangements to the extent that they do not relate to arrangements that would have been made under “fully competitive conditions”. Paragraph I.14 stresses that in both SGI and Thin Cap GLO, the ECJ explicitly noted that the independent enterprise approach to the arm’s length principle as set out by the OECD in, for example, its Transfer Pricing Guidelines, constituted a suitable means of determining “wholly artificial arrangements”. Given that paragraph 72 of SGI applies the same test as that seen in paragraph 81 of Thin Cap GLO, there can be no argument with this approach.

However, the problem arising from Annex I relates to the assumption that a “wholly artificial arrangement” equates simply to that beyond what would have been agreed between the parties acting at arm’s length. This analysis fails to take into account the wording of the ECJ’s judgments in Thin Cap GLO and SGI, in particular, the clear wording of the proportionality test. A comprehensive statement of the law appears to have been set out in point 67 of Advocate General Geelhoed’s Opinion in Thin Cap GLO. His two prong proportionality test appears to have been applied by the ECJ in its judgment in Thin Cap GLO and in its subsequent SGI judgment. Significantly, the ECJ approved the comments of Advocate General Geelhoed in Thin Cap GLO (paragraph 82).

**Two-prong proportionality test**

The analysis adopted in paragraphs I.8 – I.14 of the consultation document focuses mainly on the second part of the two-prong proportionality test set out in paragraphs 71 and 72 of SGI and paragraphs 82 and 83 of Thin Cap GLO respectively. It fails to take into account the first part of that test. This appears to be a significant flaw in the understanding of the EU law in this area. This statement of EU law (and the interpretation of the jurisprudence of the ECJ in this area) seems to be based on the judgment of the English Court of Appeal in Thin
Cap GLO CA,\textsuperscript{22} which represents the law of the UK at this moment in time.\textsuperscript{23} A review of the Thin Cap GLO CA judgment is therefore necessary.

**Acte clair**

After the delivery of the judgment of the ECJ in *Thin Cap GLO*, the matter returned to the High Court and, subsequently, the Court of Appeal for judgment and review respectively. Whilst Henderson J. in the High Court in *Thin Cap GLO HC*,\textsuperscript{24} decided the principal issue in favour of the claimants’ interpretation, the Court of Appeal, by a 2-1 majority, decided in favour of the UK Revenue. Paragraphs I.8-I.14, therefore, express the interpretation of EU law as stated by the majority of the Court of Appeal in *Thin Cap GLO CA*.

Furthermore, an appeal by the claimants was refused by the Supreme Court in an order dated the 28 June 2011 on the grounds that the provision in question had already been interpreted by the ECJ in *SGI* and that “the correct application of Community law is obvious as to leave no scope for any reasonable doubt”. In other words, the matter was acte clair so no further reference to the ECJ was required.

The majority of the Court of Appeal in *Thin Cap GLO CA* made it clear that the arm’s length test was sufficient to determine the concept of wholly artificial arrangement and that no separate test of commercial justification was required by paragraph 71 of *SGI* and paragraph 82 of *Thin Cap GLO*. The decision of the Court of Appeal was by a 2-1 majority. The minority judgment delivered by Arden LJ agreed with the judgment of the High Court judge on the principal issue which concerned the interpretation of the proportionality test in *Thin Cap GLO* and whether a separate “commercial justification” assessment was required following a finding that the arm’s length test had not been met.

It is highly arguable that the majority judgments in *Thin Cap GLO CA* misunderstood the case law of ECJ in this area. Accordingly, these issues are

\textsuperscript{22} Test Claimants in the Thin Cap Group Litigation v Commissioners for Her Majesty’s Revenue and Customs (“Thin Cap GLO CA”), [2011] STC 738.

\textsuperscript{23} The Supreme Court denied the Claimants’ application for permission to appeal the decision of the Court of Appeal to the Supreme Court.

\textsuperscript{24} Test Claimants in the Thin Cap Group Litigation v Commissioners for Her Majesty’s Customs and Excise (“Thin Cap GLO HC”), [2010] STC 301.
discussed in some detail in the following sections because of the impact that this misunderstanding may have on the reform of the CFC rules.\textsuperscript{25}

The Proportionality test in \textit{Thin Cap GLO}

In paragraph 77 of \textit{Thin Cap GLO}, the ECJ made it clear that the UK’s thin capitalisation legislation was able to prevent practices “the \textit{sole purpose} of which is to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory” (emphasis added). The Court went on to explain that the fact that the loan was not granted on arm’s length terms constituted “an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State”.\textsuperscript{26} Thus, the arm’s length test is an objective criterion against which to judge whether or not the transaction in question is a wholly artificial arrangement. However, it is the next paragraph of \textit{Thin Cap GLO} (paragraph 82) that is important. Note the phrase “sole purpose”, (highlighted above in paragraph 77). This is discussed in more detail below in Part III.

In paragraph 82 of \textit{Thin Cap GLO}, the ECJ pointed out that “national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement, \textit{entered into for tax reasons alone}, is to be considered as not going beyond what is necessary to prevent abusive practices where, in the first place, on each occasion on which such an arrangement cannot be ruled out the taxpayer is given an opportunity… \textit{to provide evidence of any commercial justification} that there may have been for that arrangement” (emphasis added). Two particular phrases (highlighted) in this paragraph should be noted: the purely artificial arrangement must be entered into for tax reasons alone and whenever the existence of an artificial arrangement is demonstrated by the tax authorities, the taxpayer must be given an opportunity to provide evidence of any commercial justification for the arrangement.

In paragraph 83 of \textit{Thin Cap GLO}, the Court moved on to the second aspect of the proportionality test, relating to the re-characterisation of the interest payments. The Court specifically referred to the situation where the consideration of the objective

\textsuperscript{25} It has already been pointed out by this author that the UK’s Supreme Court should have been more mindful of the Court’s comments in \textit{CILFIT} paragraph 16, where the ECJ pointed out that before it comes to the conclusion that the matter is acte clair “the national court or tribunal must be convinced that the matter is equally obvious to the courts of the other Member States and to the Court of Justice. Only if those conditions are satisfied, may the national court or tribunal refrain from submitting the question to the Court of Justice and take upon itself the responsibility for resolving it”. The ECJ went on to highlight in \textit{CILFIT} paragraph 20 that “every provision of Community law must be placed in its context and interpreted in the light of the provisions of Community law as a whole, regard being had to the objectives thereof and to its state of evolution at the date on which the provision in question is to be applied”.

\textsuperscript{26} \textit{Thin Cap GLO} paragraph 81.
elements (referred to in the preceding paragraphs) led to the conclusion that the transaction in question represented a purely artificial arrangement without any underlying commercial justification. The highlighted phrase “without any commercial justification” refers back to what had to be shown by the taxpayer in the previous paragraph to rebut the presumption that a wholly artificial arrangement existed (because the arm’s length test had been breached). It is this failure to demonstrate some commercial justification for the arrangements that triggers the second aspect of the proportionality assessment.

Paragraphs 86 and 87 of Thin Cap GLO also contain references to “entered into for tax reasons alone” and “evidence as to any commercial justification”. Interestingly, the opportunity to provide commercial justification comes into play “if their transactions did not satisfy the conditions laid down under the DTC in order to assess their compatibility with the arm’s-length criterion”. In other words, it is clear from the wording of the judgment in Thin Cap GLO, that it was first a matter for the tax authorities to demonstrate that a purely artificial arrangement had taken place. This could be achieved through the use of an objective criterion such as the arm’s length test. If the transaction in question did not comply with the arm’s length principle, then that constituted evidence of a wholly artificial arrangement, entered into for tax reasons alone.

Jobra

Support for this reasoning is found in the Court’s subsequent case law, such as Jobra where the Court indicated that the burden of proof, in establishing a prima facie case that an artificial arrangement existed, rested with the tax authorities and that the taxpayers had to be given the opportunity “to adduce evidence that no abuse is taking place”. The same line of reasoning is adopted by the Court in Tankreederei (Case C-287/10), where the Court pointed out that as regards “the need to prevent abuse, it is true that it is apparent from settled case-law that a restriction on the freedom to provide services can be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and whose only purpose is to obtain a tax advantage”. The Court went on to point out that “the national provision at issue … affects every undertaking which uses capital goods in the territory of a Member State other than … Luxembourg, and does

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28 See Jobra paragraph 38.


30 Tankreederei paragraph 28.
so even where nothing … points towards the existence of such an artificial arrangement.\textsuperscript{31}

\textbf{Lammers and Van Cleeff}

In \textit{Lammers and Van Cleeff},\textsuperscript{32} a case involving German thin capitalisation rules decided after \textit{Thin Cap GLO}, the ECJ recalled that the “mere fact that a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty”.\textsuperscript{33} In dealing with the proportionality issue, the Court stressed that “it is apparent from the order for reference that the interest payments made by the Belgian subsidiary on a loan granted by a non-resident company which is a director were reclassified as dividends because the limit laid down in the second indent of Article 18(1), point 3, of the ITC 1992 had been exceeded, that is to say, at the beginning of the taxable period the total of the interest-bearing loans was higher than the paid-up capital plus taxed reserves”.\textsuperscript{34} However, the Court pointed out that “even if the application of such a limit seeks to combat abusive practices, it goes in any event beyond what is necessary to attain that objective … [because] Article 18(1), point 3, of the ITC 1992 also affects situations in which the transaction concerned cannot be regarded as a purely artificial arrangement. If interest payments made to non-resident companies are reclassified as dividends as soon as they exceed such a limit, it cannot be ruled out that that reclassification will also apply to interest paid on loans granted on an arm’s length basis”.\textsuperscript{35} In other words, if the arrangements in question are not artificial in nature, then the thin cap rules cannot be used to justify the restriction on the freedom of establishment. It seems clear that if such loans are acceptable domestically, then they should also be acceptable cross-border in the absence of wholly artificial arrangements.

\textsuperscript{31} \textit{Tankreederei} paragraph 29.
\textsuperscript{33} \textit{Lammers and van Cleeff} paragraph 27. Interestingly, this case is not discussed in \textit{Thin Cap GLO CA}.
\textsuperscript{34} \textit{Lammers and van Cleeff} paragraph 31.
\textsuperscript{35} \textit{Lammers and van Cleeff} paragraph 32.
\textsuperscript{36} \textit{Lammers and van Cleeff} paragraph 33.
Commercial justification

In order for the UK rules in *Thin Cap GLO* to comply with EU law, however, they still had to comply with the principle of proportionality. According to the Advocate General and the ECJ in *Thin Cap GLO*, this meant that the taxpayer had to be given an opportunity to provide evidence of any commercial justification for the arrangement in question. Commercial justification for the arrangements would take the matter out of the realm of “wholly artificial arrangements”, designed with the sole purpose to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory and would rebut the presumption that a wholly artificial arrangement existed. Such arrangements clearly would not be arrangements “entered into for tax reasons alone” because a commercial rationale for them beyond that of tax advantages would have been shown to exist. Moreover, the demonstration of some commercial justification for the arrangements in question would take such arrangements outside the scope of the justification for the national rules in combating abusive practices. This seems clear from the wording of paragraph 83 of *Thin Cap GLO*.

There is also support for this thinking in the *CFC and Dividend GLO*, 37 decided by the ECJ subsequent to *Thin Cap GLO* by way of a reasoned Order, where the Court highlighted that in relation to the UK’s CFC rules that “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 must be to prevent conduct involving the creation of wholly artificial arrangements, which 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”. 38 Here, again, the Court refers to artificial arrangements “which do not reflect economic reality”, indicating that if they reflect economic reality then they are not wholly artificial arrangements and, as such, the national anti-abuse rules are incapable of justifying a restriction on a fundamental freedom in such circumstances. In paragraph 79 of *CFC and Dividend GLO*, this is confirmed by the Court when it states that “in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality. That finding must be based on objective factors which 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”. This was the ECJ simply applying its *Cadbury Schweppes’* reasoning outlined above.

The crux of the issue in these thin cap cases appears to be a failure to accept a genuine loan (or the establishment of a legitimate subsidiary in a CFC rule situation)


38  *CFC and Dividend GLO* paragraph 77.
in a cross-border situation, which is perfectly acceptable in a domestic environment. The jurisprudence of the ECJ indicates that a Member State is entitled to have national anti-avoidance rules that protect against tax avoidance involving wholly artificial arrangements or which involves some artificial diversion of profits / taxable income from that Member State which affect the balanced allocation of taxing rights between the Member States. But the national rules may not go beyond preventing such “wholly artificial arrangements”. If such rules do not meet both prongs of the Thin Cap GLO proportionality test, then they cannot constitute a justification acceptable to the ECJ.

In Thin Cap GLO, the Court highlighted that “the fact that a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty” (paragraph 73 of Thin Cap GLO) but explained that 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 must be to prevent conduct involving the creation of wholly artificial arrangements which 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” (paragraph 74 of Thin Cap GLO). The fact that commercial justification has been shown takes the arrangements out of the “do not reflect economic reality” category and, therefore, outside the scope of the justification.

Transfer Pricing - SGI

The ECJ’s decision in SGI does not appear to change matters.

SGI involved transfer pricing rather than thin capitalisation rules. The Court again noted that in relation to the prevention of tax avoidance, a national rule restricting the freedom of establishment may be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned (paragraph 65 of SGI). Further, the Court accepted that “to permit resident companies to transfer their profits in the form of unusual or gratuitous advantages to companies with which they have a relationship of interdependence that are established in other Member States may well undermine the balanced allocation of the power to impose taxes between the Member States” (paragraph 63 of SGI). The Court went on to explain that “national legislation which 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” (paragraph 66 of SGI).
The Court pointed out that these corrective tax measures were necessary because otherwise there was a risk that “by means of artificial arrangements, income transfers may be organised within companies having a relationship of interdependence towards those established in Member States applying the lowest rates of taxation or in Member States in which such income is not taxed” (paragraph 67 of SGI). By providing that the resident company is to be taxed in respect of any unusual or gratuitous advantages granted to an associated company established in another Member State, the Belgian rules at issue were able to combat such practices which the Court noted were “designed only to avoid the tax normally due in the Member State in which the company granting the advantage has its seat” (paragraph 68 of SGI). Note the focus of the Court is on “artificial arrangements” and the fact that granting of the unusual or gratuitous advantages to the connected company was “designed only to avoid the tax normally due”. The Court concluded that such anti-avoidance rules were appropriate for achieving their objective. However, whether such rules were proportionate was the next matter to be decided.

Proportionality - SGI

The Court sets out its proportionality requirements in paragraphs 71 and 72 of SGI. Significantly, these paragraphs are worded in almost the same terms as paragraphs 82 and 83 of Thin Cap GLO.

In paragraph 71 of SGI, the Court applied the first prong of the Thin Cap GLO proportionality test, indicating that national legislation which provides for a consideration of “objective and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance where, first, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction” (emphasis added). Again, the focus of the Court is on “artificial arrangement” and “entered into for tax reasons” and the provision of “evidence of any commercial justification” once the arm’s length test has not been met.

The second prong of the proportionality test in paragraph 72 of SGI echoes paragraph 83 of Thin Cap GLO but differs to a certain extent. The Court points out that “where the consideration of such elements leads to the conclusion that the transaction in question goes beyond what the companies concerned would have agreed under fully competitive conditions, the corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence”. In other words, where the
The transaction in question goes beyond what would have been agreed at arm’s length, the corrective tax measure must be limited to what would have been agreed at arm’s length.

In the following paragraph (73) of SGI, the Court sets out how the Belgian rules at issue are applied by the tax authorities and notes that the taxpayer is given a month to demonstrate that no unusual or gratuitous advantage is involved. If the tax authorities reject the taxpayer’s arguments, the taxpayer can challenge the assessment before the national courts. The ECJ made it clear that it was a matter for the Belgian national court to verify whether the two legs of the proportionality principle were respected by the Belgian regime.

It seems clear from paragraphs 71 and 72 of SGI that the Court is applying the same proportionality test in SGI that it applied in Thin Cap GLO. Clearly, different national anti-avoidance rules are at stake. However, in both SGI and Thin Cap GLO, the Court insisted that “the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that arrangement” (paragraph 71 of SGI and paragraph 82 of Thin Cap GLO). Indeed, the same phrase is used in paragraph 84 of the CFC and Dividend GLO that was decided by way of a reasoned order. Given that the majority judgments of the English Court of Appeal did not follow this line of reasoning, the next Part examines in detail the judgments in Thin Cap GLO CA in which the Court of Appeal applied the guidance given by the ECJ in Thin Cap GLO and interpreted, for the first time, the SGI decision.

Part III – The judgments in the Thin Cap GLO CA – an analysis

Lord Justice Stanley Burnton delivered the main judgment of the majority in the Court of Appeal. He pointed out that the ECJ had delivered two significant judgments since Henderson J. gave his judgment in the Thin Cap GLO (High Court) which would have affected his decision, namely, Oy AA39 (this had not been cited) and SGI. An analysis of this judgment is, therefore, of the greatest importance.

The judgment starts to unravel in paragraph 40 when Stanley Burnton LJ links “purely artificial arrangements” to “sham transactions” (in paragraph 42) because this led to a discussion that the UK’s thin cap rules should be able to deal with a loan which does not involve an “artificial arrangement” in circumstances where “the corporation tax rate applicable to the profits of the parent is significantly lower than the rate applicable to the UK subsidiary’s profits”. This is a flaw in the understanding of the ECJ’s case law concerning tax avoidance, in particular, the

notion of “wholly artificial arrangements designed to circumvent the national tax system” which is the ECJ’s understanding of the concept of “tax avoidance”. 40

Stanley Burnton LJ continued in paragraph 40: “The loan is not “a purely artificial arrangement”, yet surely it is a legitimate, and should be a permissible, object of thin cap legislation?” The answer to this question is yes, if the UK is operating outside the constraints of EU law. However, the answer is no if EU law is applicable. This can be explained by the “migrant/non-migrant” (or national treatment) test applied by the ECJ which all EU Member States must respect.

**National treatment test**

The national treatment test is clearly set out in De Groot paragraph 94, where the ECJ highlighted that “as far as the exercise of the power of taxation so allocated is concerned, the Member States must comply with the Community rules … and, more particularly, respect the principle of national treatment of nationals of other Member States and of their own nationals who exercise the freedoms guaranteed by the Treaty”. 41

The Thin Cap GLO case concerned the different treatment of two UK companies, one of which exercised the freedom of establishment and, as a consequence, suffered detrimental tax treatment amounting to a restriction on the freedom of establishment. 42 In other words, the UK’s thin cap legislation breached the national treatment principle in respect of a UK company with an establishment in another EU Member State. The ECJ explained that such a restriction was permissible if it was justified by overriding reasons of public interest. The UK argued that its thin cap rules were justified by the need to prevent tax avoidance, in particular, tax avoidance consisting of artificial arrangements designed to circumvent the UK’s tax system.

**Justification**

40 See paragraph 26 of ICI v Colmer where the Court stated that “[a]s regards the justification based on the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group’s subsidiaries are established, for whatever reason, outside the United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment.” The Court applies this understanding of “tax avoidance” in subsequent cases. ECJ, 16 Nov. 1998, Case C-264/96, Imperial Chemical Industries (ICI) v Kenneth Hall Colmer (Inspector of Taxes), [1998] ECR I-4695.

41 De Groot paragraph 94.

42 See Thin Cap GLO paragraph 63.
Whilst the ECJ accepted in Thin Cap GLO that a restriction on the freedom of establishment could be justified where it specifically targeted wholly artificial arrangements designed to circumvent the legislation of the Member State concerned, it pointed out that the mere fact that a resident company was granted a loan by an associated company established in another Member State “cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty”. In other words, in an EU context, thin capitalisation rules amount to a restriction on the freedom of establishment in an EU context unless they fall within an acceptable justification.

Conduct

The ECJ went on to explain that in order for such a restriction to be justified on the ground of preventing abusive practices, “the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on the national territory.” This type of “conduct” was such as to undermine “the right of the Member States to exercise their tax jurisdiction in relation to activities carried out in their territory and thus jeopardise a balanced allocation between Member States of the power to impose taxes.” It is important to note that the conduct in question relates to “wholly artificial arrangements which do not reflect economic reality”. This is highlighted again by the Court in the proportionality segment of the Thin Cap GLO judgment discussed above.

Balance in the allocation of taxing rights

Stanley Burnton LJ in Thin Cap GLO CA focused on paragraph 62 of Oy AA, where the ECJ noted that “[c]onduct involving the creation of wholly artificial arrangements which 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 is such as to undermine the right of the member states to exercise their tax jurisdiction in relation to those activities and jeopardise a balanced allocation between member states of the power to impose taxes.” He argued that it was difficult to reconcile the judgment in Oy AA with that delivered in Thin Cap GLO. He commented that the Finnish legislation did not target purely artificial arrangements.

Stanley Burnton LJ then went on to analyse the SGI judgment of the ECJ and pointed out that the Belgian legislation was upheld even though it was not limited to

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43 Thin Cap GLO paragraph 73.
44 Thin Cap GLO paragraph 74.
45 Thin Cap GLO paragraph 75.
46 See paragraph 44 of Thin Cap GLO CA.
purely artificial arrangements. In paragraph 57 of *Thin Cap GLO CA*, he concluded that “[l]egislation that involves the application of the arm’s length test, as embodied in Article 9 of the OECD Model Convention, does not unlawfully interfere with Article 43 EC, provided the taxpayer is given an adequate opportunity to present his case to the tax authority that the transaction in question was on arm’s length terms, and may challenge the decision of the tax authority before the national court, and, secondly, that the effect of the legislation is limited to those aspects of the advantage conferred by the taxpayer company that do not satisfy that test.” This important finding ignored the clear language of the proportionality test in *Thin Cap GLO*, in particular the first prong of the test seen in paragraph 81 of the judgment. Moreover, it ignored the clear language set out in paragraph 71 of *SGI*.

Rimer LJ delivered the second judgment of the Court of Appeal and agreed with Stanley Burnton LJ. Arden LJ dissented.

**Some general remarks on the Thin Cap GLO CA judgment**

The interpretation of the jurisprudence of the ECJ by the majority in the *Thin Cap GLO CA* may be strongly criticised.

The majority judgments failed to correctly identify the process used by the ECJ in coming to its decisions in *Thin Cap GLO* and *SGI*. The starting point should have been the two-pronged “subjective” and “objective” tests seen in the *Halifax* judgment. This test for abuse was subsequently adopted by the ECJ in *Cadbury Schweppes* in the direct tax field. The *Thin Cap GLO* judgment was based on similar reasoning in relation to the test for abuse. Indeed, the main paragraphs of the *Thin Cap GLO* judgment concerning the justification of the thin cap rules on grounds based on the need to prevent abusive practices were in the main based on the reasoning of the ECJ in *Cadbury Schweppes*. 47

The judgment in *Cadbury Schweppes* demonstrates that CFC rules are only compatible with the freedom of establishment in situations where they deal with the problem of wholly artificial arrangements designed to circumvent the national tax system in question. In paragraph 77 of *Thin Cap GLO*, the ECJ clearly states that “by providing that that interest is to be treated as a distribution, such legislation is able to prevent practices the sole purpose of which is to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory. It follows that such legislation is an appropriate means of attaining the objective underlying its adoption.” Therefore, thin cap rules can be justified where they prevent practices “the sole purpose of which is to avoid tax” that would normally be payable in the national territory. In other words, they protect against artificial diversion of profits. However, it is important to note that this statement is clearly qualified by the principle of proportionality.

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47 See *Thin Cap GLO* paragraphs 72-75.
The ECJ goes on to explain in paragraph 81 of *Thin Cap GLO* that “[t]he fact that a resident company has been granted a loan by a non-resident company on terms which do not correspond to those which would have been agreed upon at arm’s length constitutes, for the Member State in which the borrowing company is resident, an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State. In that regard, the question is whether, had there been an arm’s-length relationship between the companies concerned, the loan would not have been granted or would have been granted for a different amount or at a different rate of interest.” It continues in paragraph 82 by stating that “national legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement, entered into for tax reasons alone, is to be considered as not going beyond what is necessary to prevent abusive practices where, in the first place, on each occasion on which the existence of such an arrangement cannot be ruled out, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that arrangement.” If such evidence of commercial justification is produced then clearly the arrangement at hand is not a wholly artificial arrangement and the second leg of the proportionality test is unnecessary. The second leg of the proportionality test only kicks-in where the taxpayer does not demonstrate commercial justification for the arrangements in question.

It is argued that the majority judgments of the Court of Appeal in *Thin Cap GLO CA* misunderstood the importance and purpose of the proportionality test. The UK’s thin cap rules amounted to a restriction on the freedom of establishment unless they were justified by a mandatory reason in the general interest. Therefore, it was not sufficient for the UK to simply demonstrate that a wholly artificial arrangement might have existed through the breach of the arm’s length principle, it also had to meet the proportionality test which required the taxpayer to be given the opportunity to rebut that presumption that an artificial arrangement existed through the production of some evidence of commercial justification.

The High Court in *Thin Cap GLO HC* accepted that such evidence of commercial justification had been provided by the taxpayers. As such, the UK failed to demonstrate that a wholly artificial arrangement existed and, therefore, the loans in question were not artificial in nature. Consequently, the interest payments on such loans should be allowed in the same way as the interest payments on similar domestic loans.

It should be recalled that thin capitalisation rules are anti-avoidance rules that amount to a restriction on the freedom of establishment in the absence of justification. Controlled foreign company rules (CFC) (seen in *Cadbury Schweppes*) and transfer pricing rules (seen in *SGI*) are similar anti-avoidance rules. In the
absence of a wholly artificial arrangement situation such rules cannot be justified in
an internal market because they amount to a restriction on the freedom of
establishment. In situations where domestic rules allow the establishment of a
subsidiary where the CFC rules do not apply, similar situations must be allowed to
occur cross-border when the freedom of establishment is involved. The same
thinking applies when thin capitalisation rules are at play and when transfer-pricing
rules are in operation. The proportionality test seen in Cadbury Schweppes, Thin
Cap GLO and SGI is the same. It makes it clear that in the absence of a wholly
artificial arrangement situation where the taxpayer has shown that the CFC reflects
economic reality or that the loan was not entered into purely for tax reasons and that
evidence of commercial justification has been produced or that there was some
commercial reasons why the arm’s length test was not met.

Strong support for this line of reasoning is found in the judgments of Henderson J. in
his Thin Cap GLO HC decision and in the dissenting judgment of Arden LJ. In Thin
cap GLO CA.

Henderson J. in Thin Cap GLO HC

Mr Justice Henderson stressed in paragraph 65 of his Thin Cap GLO HC decision
that he was “unable to accept the Revenue’s submission that the ECJ regarded the
question of commercial justification as no more than an aspect of the arm’s length
test”. He commented that it was “abundantly clear that the ECJ regarded them as
separate tests, each of which had to be satisfied if the thin cap rules of the UK or any
other member state were to meet the criterion of proportionality. The proposition
that the ECJ regarded the arm’s length test alone as sufficient for this
purpose, or as a complete “proxy” for determining whether there was abusive tax
avoidance, is in my opinion impossible to reconcile with the clear terms of the
Court’s judgment, in particular at paragraphs 82, 83, 86, 87 and 92.” Henderson J.
went on to point out that the ECJ “must be taken to have known that the UK thin cap
rules contained no test apart from the arm’s length test”. He concluded that “the
only issue of fact which I strictly need to resolve is whether any of the relevant
transactions entered into by the test claimants were, either wholly or in part, purely
artificial arrangements devoid of any commercial justification. If that is the right
question to ask, there can be no doubt about the answer. I am satisfied that none of
the relevant transactions was, even remotely, of such a character, and to be fair the
Revenue have never sought to argue that they were”.

Arden LJ in Thin Cap GLO CA

48 See Thin Cap GLO HC paragraph 70.
49 See Thin Cap GLO HC paragraph 100.
The dissenting judgment of Lady Justice Arden in *Thin Cap GLO CA* also provides strong support for the line of reasoning outlined above. In paragraph 104 she highlighted that an abusive transaction “is to be found by the tax authorities first asking, by reference to objective and verifiable elements, whether the transaction is on arm’s length terms, or as it is from time to time put, on fully competitive terms. It follows that the Revenue does not have to go further at this stage than consider whether the loans were on a fully competitive basis. If it is not on such terms, the taxpayer must be given an opportunity to show that the terms were nonetheless commercial, as in *Lankhorst-Hohorst*, and for that reason not abusive. It is for the national court to determine whether the ground that the taxpayer asserts is sufficient commercial justification for this purpose”. She went on to indicate that “the Revenue have accepted that, in the case of the claimants’ test claims, there was some commercial reason for the non-resident parent company providing the money to its resident subsidiary, and that, if the judge was right on the test, it was satisfied in all these cases”.

In relation to *SGI*, Arden LJ pointed out that “[p]aragraph 82 of the judgment of the Court of Justice in [*Thin Cap GLO*] expressly refers to paragraph 67 of the Opinion of the Advocate General and would thus appear to be placing the same meaning on commercial justification as the Advocate General did in the first indent to that paragraph”. She noted that “it seems to me unlikely to be the correct interpretation of paragraph 72 of the judgment in *SGI* that it was intended to depart from the judgment of the Grand Chamber. Paragraph 72 of the judgment is only a partial replication of paragraph 83 of the judgment in [*Thin Cap GLO*]. It can be seen from paragraph 79 of the Opinion of the Advocate General in *SGI* that the Court of Justice only had to deal with the corrective tax measure when a transaction was not at arm’s length since it was not alleged that there was commercial justification in that case…” She concluded that “in paragraphs 73 and 74 of its judgment in *SGI* … the Court of Justice noted the submission of the Belgian government that under Belgian law the national legislation permitted a taxpayer to resist its application if he could establish that the transaction had a commercial justification, and that the national legislation only led to disallowance of interest exceeding the commercial amount. The Court of Justice accordingly appear to have attached significance to the taxpayer having the ability to provide commercial justification and did not repeat the view, apparently taken by Advocate General Kokott in paragraph 78 of her Opinion in *SGI*, that the taxpayer was required to show that the transaction was on arm’s length terms”.

**Part IV - Conclusion**

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50  See *Thin Cap GLO CA* paragraph 108.
51  See *Thin Cap GLO CA* paragraph 99.
52  See *Thin Cap GLO CA* paragraph 100.
53  See *Thin Cap GLO CA* paragraph 101.
In conclusion, perhaps three key points can be made. First, Her Majesty’s Treasury and Her Majesty’s Revenue and Customs are to be praised for producing Annex I of the CFC Reform Consultation Document. This, in itself, is a big step forward in the design and implementation of new tax rules in the UK because it recognises the supremacy of EU law even in the direct taxation area. By including such a clear statement of the law in Annex I the Consultation Document provides a snapshot of the EU law backdrop against which the UK’s CFC reforms are taking place. The consultation process includes the possibility of analysing that understanding and this makes the whole consultation process more meaningful. This paper has endeavoured to challenge some of this understanding and hopefully contributes to the debate on this very important area of law reform.

Second, the author has been extremely critical of the judgments of the majority in the Court of Appeal in *Thin Cap GLO CA*. Clearly, there are significant questions concerning the proportionality test in *SGI* to be reconsidered, particularly because of the impact that the views of the majority in that case had on the drafting of Annex I. It seems clear to the author that the drafters of Annex I were entitled to base their understanding of the law of the UK as set out in the *Thin Cap GLO CA* judgment when they included the statement of EU law in Annex I. However, it is highly arguable that the interpretation of the jurisprudence of the ECJ adopted by the majority in the Court of Appeal in that case (in relation to anti-avoidance rules such as thin cap and transfer pricing) was defective. In any event, the issues in the case were so novel in nature that a further reference to the ECJ would have been a more appropriate outcome. The judges in the Court of Appeal interpreted the *SGI* decision despite the fact that the ECJ has not done so to date. Clearly, the partnership between the national courts in the UK and the ECJ was weakened by this approach because there is a strong possibility that the majority judgments in the Court of Appeal misunderstood the jurisprudence of the ECJ.

Lastly, given the significance of getting the law in this crucial area of UK business law correct, it is extremely surprising that the UK’s Supreme Court did not grant the Claimants an appeal and, consequently, make a further reference to the ECJ to determine the law in this area from an EU perspective. The fact that the Supreme Court declared that the matter was acte clair was even more surprising given the fact that two senior judges (Arden LJ and Henderson J) has held in favour of the taxpayers and delivered judgments on the EU law aspects more in keeping with the jurisprudence of the ECJ in this author’s opinion. The 2-1 split in the Court of Appeal should have triggered an appeal to the Supreme Court and a further reference to the ECJ to determine this highly sensitive EU law issue. The consequence of getting it wrong simply stores up problems for the future and, of course, further ECJ litigation.

In 2011, the ECJ reminded the Member States that “[i]t should also be recalled that Article 267 TFEU, which is essential for the preservation of the Community
character of the law established by the Treaties, aims to ensure that, in all circumstances, that law has the same effect in all Member States. The preliminary ruling mechanism thus established aims to avoid divergences in the interpretation of European Union law which the national courts have to apply and tends to ensure this application by making available to national judges a means of eliminating difficulties which may be occasioned by the requirement of giving European Union law its full effect within the framework of the judicial systems of the Member States. Further, the national courts have the most extensive power, or even the obligation, to make a reference to the Court if they consider that a case pending before them raises issues involving an interpretation or assessment of the validity of the provisions of European Union law and requiring a decision by them”.

The Court went on in paragraph 84 to state that “[t]he system set up by Article 267 TFEU therefore establishes between the Court of Justice and the national courts direct cooperation as part of which the latter are closely involved in the correct application and uniform interpretation of European Union law and also in the protection of individual rights conferred by that legal order.”

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54 See ECJ, 8 Mar. 2011, Opinion 1/09 of the Court (Full Court), [2011] ECR I-0000, paragraph 83 (not yet reported).
The Court concluded in paragraph 85 that “[i]t follows from all of the foregoing that the tasks attributed to the national courts and to the Court of Justice respectively are indispensable to the preservation of the very nature of the law established by the Treaties”.

These statements should act as a reminder to national courts to use the preliminary ruling procedure when critical EU law issues appear in cases before them.
To,
Achim Pross
Head, International Co-operation and Tax Administration Division
Organisation for Economic Co-operation and Development
Paris, France

Dated: April 29, 2015

Sent via E-mail: CTPCFC@oecd.org

Re: Public Discussion Draft on BEPS Action 3: Strengthening CFC Rules

Dear Mr Pross,

On April 3, 2015, the Organisation for Economic Co-operation and Development (OECD) invited stakeholders’ comments on the discussion draft on base erosion and profit shifting (BEPS) Action 3, which seeks to strengthen the controlled foreign corporation (CFC) regime.

We note that, through BEPS Action 3, the OECD is seeking to formulate CFC rules with a view to preventing erosion of a country’s tax base. We appreciate and support the OECD in this regard. However, we would like to submit that any changes must be certain and unambiguous so as to balance the objectives behind BEPS Action 3 while at the same time preserving the rights of taxpayers.

As part of the transparent and inclusive consultation process mandated by the BEPS Action Plan, the OECD has invited interested parties to send comments on this discussion draft. We are pleased to submit our comments as below.

About Trinity Law Partners

Trinity Law Partners (TLP) is an Indian legal and tax consultancy firm representing primarily companies from start-ups to transnational corporations operating in various sectors.

Comments

TLP welcomes the OECD’s efforts in designing ‘building blocks’ to assist tax administrations without CFC measures in place to implement recommended rules directly and countries with existing CFC rules to modify their rules to align more closely with the recommendations. However, we would like to submit our comments which are specific to some of the changes proposed in the discussion draft.

First, in relation to the control threshold proposed in the discussion draft, TLP shares the OECD’s understanding that control may be an indication that resident shareholders had sufficient influence over the foreign company and its tax policy to use it to shift profits. We note that a control requirement can also be used to reduce the scope of CFC rules and limit the compliance costs for minority shareholders where they have no real ability to influence the foreign company.

However, we feel that the OECD must provide more detailed and specific guidance as to when a CFC should be treated as ‘controlled’. Currently, the draft lacks vision as it on the one hand recommends tax administrations to use a 50 percent control threshold while on the other hand provides them the leeway to set their own control threshold at a lower level. A lack of uniformity in the implementation of the rules will lead to taxpayer uncertainties and compliance costs.
The OECD has itself acknowledged that one of the fundamental policy considerations raised by CFC rules is double taxation. The discussion draft highlights three specific situations where double taxation may arise in relation to a CFC, and provides recommendations to address these situations. For instance, in situations where CFC rules in more than one jurisdiction apply to the same CFC income, the discussion draft proposes to allow a credit for foreign taxes actually paid, including CFC tax assessed on intermediate companies.

However, in our opinion, the discussion draft, which although is clear in its identification of the problems giving rise to double taxation, provides little guidance for tax administrations to prevent double taxation to take place in the first place. We note that although Chapter 8 is titled “Rules to prevent or eliminate double taxation,” the Chapter only discusses methods to eliminate double taxation and does not recommend adequate solutions to prevent double taxation from taking place. While eliminating double taxation is certainly in line with the objectives of international tax law, we believe that preventing double taxation will mean nipping the problems in the bud, reducing taxpayer hassle to a much larger extent.

Finally, we consider it necessary for the OECD to formulate a set of uniform rules for countries to follow while implementing the proposed changes into their domestic legal system. Needless to say, some countries still do not have a CFC regime in place and it will be difficult for these countries to adapt to the sudden changes required under BEPS Action 3. Also noting that the OECD’s work under BEPS Action 3 is being carried on alongside its work on other BEPS Action Items, we believe that the final BEPS deliverables on other relevant Action Items will invariably inform the contents of BEPS Action 3 and must precede finalization of any work under BEPS Action 3.

Conclusion

Once again, we extend our sincere appreciation to the OECD for inviting us to comment on the discussion draft regarding strengthening CFC rules under BEPS Action 3. In the hope that the OECD will take into account the above comments in carrying out further policy work under this Action Item, we remain:

Yours sincerely,

Trinity Law Partners, India

Kumar Madan, Tax Head
madan@trinitylawpartners.com
www.trinitylawpartners.com
April 30, 2015

VIA EMAIL
Mr. Achim Pross
Head, International Cooperation and Tax Administration Division
Center for Tax Policy and Administration (CTPA)
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(Achim.Pross@oecd.org / CTPCFC@oecd.org)

Re: USCIB Comment Letter on the OECD discussion draft on BEPS Action 3: Strengthening CFC Rules

Dear Mr. Pross,

General Comments

USCIB appreciates the opportunity to provide comments on the OECD discussion draft on Action 3: Strengthening CFC Rules. USCIB believes that additional work is needed to create a proposal that effectively facilitates public discussion of these important issues. This is the case for two reasons: first, the discussion draft does not have a coherent framework from a policy perspective; and second, because of the absence of a coherent policy framework, the mechanics are either missing, unclear or potentially in conflict. We believe that CFC rules can and should be a critical component of dealing with BEPS, particularly when part of a coherent plan which includes other BEPS actions. This is why any draft has to establish a consistent approach with clear principles and recommendations. Before adopting any recommendations on CFC rules, USCIB believes it would be necessary to publish a new comprehensive draft with a coherent framework with detailed mechanics and permit an extended period of stakeholder input into those new comprehensive proposals.
Because of the extremely short comment period (less than 30 days on a lengthy document on a topic that the OECD has never dealt with before), USCIB has focused its comments on a few high-level issues. The lack of comments on other sections of the discussion draft should not be considered an endorsement of the proposals contained therein. USCIB is aware of the pressure to complete the Action Items within the self-imposed two-year deadline. This time pressure is leading to poorly thought out proposals and inadequate time to solicit or consider stakeholder input and resolve issues that are raised. Rather than adopting poorly thought out CFC recommendations, the OECD/G20 should consider, at this point, providing a summary of the various types of CFC rules and the context in which they are adopted. That would be more helpful than the proposals contained in this draft.

In our view, the lack of a coherent framework is broadly attributable to lack of agreement on the purpose of CFC rules and the difference between territorial systems and worldwide systems. No country has a pure territorial or worldwide system and it is unlikely that such a system would be adopted. There are, however, important distinctions that should be addressed. At its core a territorial system would permit an exemption for active business income regardless of the tax rate. At its core a worldwide system would collect residual tax on all lower-tax earnings. If the countries involved in the BEPS process are to reach agreement on “best practices” for CFC regimes, they need to resolve these core issues. Are countries intending to allow an exemption for income earned in a low-tax jurisdiction\(^1\), are they intending to tax it, or something in between? It is primarily the lack of agreement on this goal that in our view causes the discussion draft to lack direction. Clarity on this point is essential given that the recommendations are intended to serve as building blocks for countries. The building blocks that countries will select will depend on what it is they want to “build”.

A secondary reason for the lack of coherent policy framework seems to be the inability to reject any country’s existing standards. That is, rather than reflecting “best practices” the discussion draft seems to endorse – at least as an acceptable alternative – anything that any country currently does. Recommendations ought to be based on “best practices” or at least good ideas and therefore non-best practices/bad ideas should be rejected. If the OECD/G20 cannot reject bad ideas because of political constraints, they should simply describe what countries currently do and why. Countries are and will be free to make their own sovereign choices based on their view of what may work best for them, but the OECD should not put a tax policy stamp of approval on bad ideas.

Although Chapter 5 does not currently include recommendations on the definition of CFC income, the draft asserts that the 2015 Report on Action Item 3 will include such

\(^1\) “No or low taxation per se is not a cause of concern,” BEPS Action Plan, page 10.
recommendations. Given that the approaches set forth in the discussion draft are so far apart, it is difficult to see how agreement could be reached other than by the expedient of blessing all of the alternatives, which is not a recommendation with respect to “best practices”.

Finally, throughout this letter we use the word “seems”. The reason for this is that the operation of the proposed recommendations is not clear, particularly in those cases where different sections interact with each other.

**Specific Comments**

**Policy considerations**

- As a representative of US-based business, it is important to us and our members that the OECD not make recommendations that set up a two-tier system\(^2\) that disadvantages US headquartered business and effectively exempts European business because of self-imposed European restrictions on the ability to tax CFC income within the EU. That is, if the OECD accepts that CFC rules which only apply to “wholly artificial arrangements which do not reflect economic reality and whose only purpose would be to obtain a tax advantage” are a “best practice” and therefore adequate, then the OECD/G20 should not be recommending a different more onerous standard for others. If the EU’s standard is not a “best practice” and is inadequate, then the OECD/G20 should not endorse its use by anyone.

- USCIB has pointed out in prior comment letters (including its letter on permanent establishments) that the OECD/G20 should be considering the impact of the BEPS proposals on trade and investment. Tightening of CFC rules in ways that require more substance in a particular jurisdiction may well result in shifting of substance, including jobs, to jurisdictions with more competitive tax systems.

**Definition of control**

- Concerning the level of control required to create a CFC, the discussion draft says that the majority of rules require more than 50% control. Nevertheless, jurisdictions are free to lower their threshold below 50%.\(^3\) Either more than 50% control is a “best practice” or it is not. USCIB believes that the more than 50% standard is appropriate for a variety of reasons, including the difficulty of obtaining information to apply the rules for

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\(^2\) Discussion draft paragraph 13.

\(^3\) Discussion draft paragraph 65.
determining and attributing income and taxes if the enterprise controls 50% or less of a CFC.

Definition of CFC income

*Categorical approach*

- It is not at all clear that the operation of the categorical approach\(^4\) has been well thought out in that it appears to suggest that a given category of income will always give rise to CFC income regardless of whether substantial business activity gives rise to that income.
- Alternatively, the draft can also be read so that under the categorical approach passive income would be defined as includable income,\(^5\) but subject to a “kick-out” if the CFC engaged in sufficient substantive activities under one of three tests.\(^6\) It also seems that active income would be initially excluded but included or “kicked-in” if the CFC did not meet one of the substance tests.\(^7\) Thus, the categorical approach seems to boil down to a substance approach in all cases. (It seems dividends from active income cannot be “kicked-in”; presumably this is because the substance approach is applied to the underlying active income to make it active to begin with and it retains that character as it comes up through the tiers.)
- The rules for defining dividend and interest income as active or passive differ. At least in the case of financial services businesses, both types of income will generally be active and the standard for determining whether this income should be active should be the same. This also illustrates the potential need for rules that distinguish and apply different CFC rules to different industries.
- It may be difficult to distinguish sales and services income from IP income particularly in the technology sector. By lumping sales, services, royalties and IP income together the discussion draft essentially abandons any attempt to define IP income.\(^8\) All of this income would be treated as passive and includable unless the CFC had the required substance to earn the income itself, including the development of the IP.\(^9\) This approach is overbroad. Companies can earn active income from sales and services that should not be subject to tax merely because they do not engage in IP development.

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\(^4\) Discussion draft paragraphs 112 through 116.
\(^5\) Discussion draft paragraph 113.
\(^6\) Discussion draft paragraph 114.
\(^7\) Discussion draft paragraph 114.
\(^8\) Discussion draft paragraph 113.
\(^9\) Does this mean that all of the IP that contributes value to a product would have to be developed by the entity claiming exemption from the CFC rules? If so, this standard is unlikely to ever be satisfied.
• Under this standard, would any company with a valuable global brand necessarily earn passive income for all of its sales through subsidiaries anywhere in the world regardless of the level of local country activity? For example, an MNE resident in Country A operates globally-recognized branded restaurants in Country B both through franchise arrangements and locally owned subsidiaries. Both franchisees and subsidiaries pay royalties for the use of MNEs intellectual property. Both franchisees and subsidiaries operate the branded restaurant in Country B. Neither the franchisees nor the subsidiaries contribute to the development of the IP including the global brand. Under the proposed rule, the income from operating the subsidiaries would be includable as passive and would not be able to kicked-out because the subsidiaries did not develop the IP.

• Similarly, it seems that any sales of any product that includes the results of research, development or engineering could not be sold outside of the country in which that research, etc. took place without the income being treated as passive and included under the proposed rule.

• These situations are extremely common and taxing what are clearly local activities (the sales and services income earned locally) will distort competition between locally-owned business (the franchisee in the above example) and the foreign-owned business (the subsidiaries in the above example). There is no justification for this distortion.

• The substance tests are problematic. The “viable independent entity analysis”\textsuperscript{10} and “employees and establishment analysis”\textsuperscript{11} seem to undercut the arm’s length standard (ALS). The “viable independent entity analysis” attempts to determine whether the CFC is the entity which would be most likely to own particular assets, or undertake particular risks, if the business relationship was between independent enterprises. If not, the income should be included as CFC income. It is fundamental to the ALS that related parties do not have to structure their arrangements in the same manner as unrelated parties. Basing CFC inclusion on this standard therefore undercuts the ALS. The “viable independent entity analysis” also seems contrary to the ALS because it would apply after an appropriate transfer price has been determined, presumably after the transaction has been properly delineated and subjected to non-recognition rules. So even though the transaction has been properly delineated, recognized, and priced, this rule would effectively tax that income on the basis that assets would not have been owned or the risks assumed by the CFC. If this were the case, then the transaction should not have been recognized under the transfer pricing guidelines and therefore the income would not be earned by this entity.

\textsuperscript{10} Discussion draft paragraph 89.
\textsuperscript{11} Discussion draft paragraph 89.
The “employees and establishment analysis” does not require “an analysis of risks or asset ownership.” In particular this test does not identify IP assets, ignores ownership of those assets, and ignores management and control of risk. The OECD has published multiple transfer pricing discussion drafts attempting to take those items into account for transfer pricing purposes. Adopting CFC rules that ignore that those activities have substance and are entitled to a profit is fundamentally inconsistent with the proposals on intangibles and risk. Adoption of such an approach would move the OECD to a formulary approach to determining entitlement to tax income.

If the OECD/G20 wish to abandon the ALS, they may do so. However, continuing to espouse the ALS, while at the same time undercutting it in fundamental ways is inappropriate. Therefore, neither the “viable independent entity analysis” nor the “employees and establishment analysis” should be used to determine whether a CFC has substance.

**Excess profits approach**

- Whether one would support or oppose the use of an excess profits approach depends on the fundamental structure of a country’s tax system and the purpose of its CFC rules. In our view, an excess profits approach would never be appropriate in the context of a territorial system of taxation. USCIB and its members support a territorial approach to taxation and thus oppose any recommendations that would encourage the adoption of a worldwide system combined with an excess profits approach.

- Even in the context of a worldwide system, USCIB opposes the adoption of an excess profits approach. The excess profits approach essentially ends deferral. It is USCIB’s view that under a worldwide system deferral is appropriate. Therefore, an MNE parent should not be subject to tax on the properly defined active income of its subsidiaries. Further, although the excess profits approach is described as simpler and mechanical, the discussion draft sets forth a number of complex, first-impression issues that would need to be resolved in order to make the excess profits approach work appropriately. These rules would need to cover all industries, including those where IP is generally thought not to be a material driver of profits. The questions raised by the excess profits proposal have not been adequately addressed in the discussion draft and there is not

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12 Discussion draft paragraph 89.
13 As described above, at its core a territorial system would permit an exemption for active business income regardless of the rate. At its core a worldwide system would collect residual tax on low-tax active earnings. So "exempting" high tax active business income and currently taxing low active business income is at its core a worldwide system without deferral. A territorial system would allow an exemption regardless of the rate of tax if the income were earned from activities within the other country.
14 Discussion draft paragraph 117.
15 These include the rate of return, the risk-free rate of return, the equity premium, and eligible equity.
enough time to develop detailed proposals, consult with stakeholders and reach consensus on the proposals.

Foreign tax credit/double taxation

- The draft raises complicated foreign tax issues such as how to relieve double taxation on the distribution of previously included CFC income\(^\text{16}\) and adjust foreign taxes when there is additional withholding tax on income that was previously included as CFC income\(^\text{17}\), but provides essentially no guidance on how those rules ought to operate. If the purpose of the report is to provide “building blocks” for countries wishing to adopt CFC rules, then more detailed proposals on the operation of the foreign tax credit ought to be provided.

- This lack of direction again seems to be the result of the divide between territorial systems and worldwide systems. The discussion draft seems to assume that if a country operates a territorial system, then it will exempt the dividend coming out of CFC income and that additional foreign tax credits or adjustments to previously claimed FTC will not be required. The discussion draft, however, suggests an effective rate threshold to get into a CFC regime\(^\text{18}\) and recommends a foreign tax credit as the appropriate method for relieving double taxation on CFC inclusions.\(^\text{19}\) If adopted, these will require rules for determining how taxes are associated with income and issues relating to the computation of indirect FTCs.

- The discussion draft requires companies to determine effective rates taking into account rebates or refunds of foreign taxes, presumably this requires some form of tracking of taxes to income and years.\(^\text{20}\) Further, taxpayers should be entitled to a credit against the tax paid under a CFC regime for additional taxes, such as withholding taxes, paid on that included income, otherwise double taxation will result from that failure. Therefore, even exemption systems should track earnings, taxes, and adjustments to taxes through tiers of ownership.

- Paragraph 166 of the discussion draft states: “it may be appropriate to provide a refund for CFC taxes paid equal to the amount of the withholding tax, if the dividend was paid out of profits that were subject to CFC tax, since this would essentially be equal to a credit had the CFC jurisdiction imposed tax on the income itself.” The OECD should take

\(^{16}\) Discussion draft paragraph 164.

\(^{17}\) Discussion draft paragraph 166.

\(^{18}\) Discussion draft paragraphs 53 through 63.

\(^{19}\) Discussion draft paragraph 158.

\(^{20}\) Can income become CFC income in a later year if a foreign tax previously paid is refunded? Or would the refund be reflected with respect to the current year taxes and affect whether there is an inclusion in the year of the refund?
a stronger position on this issue and recommend that a refund be provided. Failure to provide a refund in this case will result in double taxation. USCIB believes there is no recommendation on this point because the tracking and tracing required by this is simply too difficult. Given the complexity that the BEPS proposals will impose on taxpayers to create a single level of taxation, countries should not shy away from relieving double taxation simply because it is complex.

- Unless appropriate guidance is provided on these complex issues and foreign taxes are properly accounted for there will be double taxation.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business (USCIB)

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21 See for example the proposals on hybrids, interest deductibility and harmful tax competition.
DISCUSSION DRAFT “BEPS ACTION 3: STRENGTHENING CFC RULES”

Valente Associati GEB Partners
(www.gebpartners.it)

Submitted by Piergiorgio Valente
(p.valente@gebnetwork.it)

To the kind attention of: Committee on Fiscal Affairs
(CTPCFC@oecd.org)

1 May 2015

[Privileged]
Summary

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1 General Comments

The Discussion Draft “BEPS ACTION 3: STRENGTHENING CFC RULES”, released on April 3, 2015, intends to provide guidelines on the designing of CFC rules. It “considers all the constituent elements of CFC rules and breaks them down into the «building blocks» that are necessary for effective CFC rules. These building blocks would allow countries without CFC rules to implement recommended rules directly and countries with existing CFC rules to modify their rules to align more closely with the recommendations (...)” (OECD Discussion Draft on Action 3, p. 6).

CFC rules require increased coordination. Consistency of such rules might enhance their reliability which would, in turn, produce innumerable benefits for both, enterprises and Tax Authorities alike. Levying foreign income tax has been regarded historically as a most useful tool, generally adopted by national tax legislations of the various countries, to enhance investments and the resulting economic growth.

Each country generally adopts varying taxation principles relating to the above issue and this is also true for CFC rules and regulations. Not all countries have adopted CFC rules and, since methodologies to foster national economy vary from country to country, aligning and regulating CFC rules and achieving a standardized position on the latter by all countries concerned is far from being a simple matter.

In designing CFC rules, a balance must be achieved between taxing foreign income and the competitiveness concerns inherent in it. CFC rules arise some competitiveness issues. Countries with CFC rules that apply broadly may find themselves at a competitive disadvantage if compared with countries without CFC rules. This is because foreign subsidiaries owned by resident companies will be taxed more heavily than locally owned companies in the foreign jurisdiction. This disadvantage may impact on where groups choose to locate their head office as well as on ownership or capital structures where groups attempt to avoid the impact of CFC rules.

Moreover, multinational enterprises resident in countries with sound CFC rules may find themselves at a disadvantage if compared with
multinational enterprises resident in countries without such rules. This occurs because the foreign subsidiaries of the former will be subject to a higher effective tax rate on the income of those subsidiaries than the foreign subsidiaries of the latter due to the application of CFC rules, even when both subsidiaries are operating in the same country.

Therefore, Valente Associati GEB Partners (VAGP) is most appreciative of the OECD’s endeavours to offer some guidance in order to design a proper, effective and coordinated CFC regime.

The above mentioned balance may be reached if some requirements are met when designing CFC rules. Including a substance analysis that would only subject taxpayers to CFC rules if the CFC did not engage in genuine economic activities would be consistent with the “wholly artificial arrangements” limitation set forth by the European Court of Justice (ECJ).

With the aim to not discriminate against non-residents, and in compliance with the freedom of establishment, CFC rules should apply equally to both domestic subsidiaries and cross-border subsidiaries. An arrangement could be artificial only in part. CFC rules could be applied to transactions that are “partly wholly artificial”.

CFC rules should ensure a balanced allocation of taxing power. In that case, the rules in question could be justified notwithstanding the fact that they were not restricted to wholly artificial arrangements because of the need to maintain a balanced allocation of taxing rights.

In VAGP’s view, in designing effective CFC rules, increasing the compliance burden faced by businesses, and bringing into scope legitimate transactions that ought not be subject to CFC rules are risks that should be avoided.

Rules – in order to be effective – need not raise compliance costs excessively, nor administrative burdens for either taxpayers and/or Tax Authorities; as stated by the OECD, “CFC rules must strike a balance between the reduced complexity inherent in mechanical rules and the effectiveness of more subjective rules” (Paragraph 15 of the Discussion Draft). Taking the foregoing into due account, there is
special concern regarding the fact that numerous recommendations and options provided by the Discussion Draft are inclined towards more subjective tests which would significantly increase application-related difficulties.

2 Special Observations

CFC identification

Appropriate consideration should be given to the treatment of the entity in the foreign jurisdiction as well as in the parent’s jurisdiction. Rules providing for the treatment of transparent entities as separate entities should be interpreted and applied across all countries in a consistent manner.

When CFC rules apply on an entity basis, they rely on the calculation of profits and taxes paid or payable in that entity. If the entity is transparent and is not required to prepare separate accounts, obtaining the information necessary to make CFC calculations could not be easy, from an administrative and compliance standpoint. The same applies when the entity concerned is a branch and there is no separate accounting.

In VAGP’s view, the compliance with CFC requirements should involve some flexibility when accounts are not available.

Thresholds requirements

Information on current thresholds in CFC rules is provided under Annex 1 of the Discussion Draft, and the OECD should consider the various advantages and disadvantages of the same in order to provide recommendation on the matter. The aim is to enhance the likelihood of more consistent rules, which would – in turn – contribute to ease any potential compliance burden deriving from dissimilar regimes.

The recommendation provided under Paragraph 58 of the Discussion Draft is that the effective tax rate ought to be determined on the
basis of the national rules set forth by the parent company. In case of MNEs working with numerous subsidiaries, which might even be owned by parent companies in various jurisdictions, applying different regulations would essentially result in increased costs for the purpose of complying with CFC rules. Also dissimilar income definitions may occasion significant difficulties and irregularities.

According to VAGP, to eliminate as many low-risk entities as possible well-defined and working threshold rules would be most helpful and desirable.

Definition of control

Since objective legal and economic tests may be useful in determining control, such tests should be established as best practice. The combination of legal and economic control tests should successfully and appropriately identify CFCs.

According to the OECD, de facto tests are generally more subjective and more burdensome as far as their application.

With reference to the statement according to which “a CFC should be treated as controlled where residents hold, at a minimum, more than 50% control”, VAGP thinks that the OECD should provide a clear-cut and well-defined best practice with regard to the foregoing; to such effect 50% might seemingly constitute a reasonable threshold. Thanks to consistent key measures such as control, any compliance burden for businesses would be reduced to a certain extent.

Definition of CFC income

The outcome of a minimum standard with the possibility of various options set forth under BEPS Action 3 might involve the implementation of new CFC rules by a given number of countries. Ensuing CFC rules might require more expenditures than might be needed to counter BEPS. Before proceeding to an extensive adoption of broad rules, further economic analyses should be carried out, in order to better understand the effects of such rules on investment
and trade. The recapturing of any avoided tax through such rules should not be counterbalanced by the cost engendered through friction to international trade.

According to VAGP, CFC rules should not assign income to a parent entity, when it is linked to substantial activities carried out elsewhere. Developing Countries are clearly under focus here; in fact, the Discussion Draft provides comments on the positive spill-over effects potential on source countries, most probably due to the distinctive that adequate CFC rules may add to the cause of tax avoidance.

As suggested by Paragraphs 83 and 89 of the Discussion Draft, substance-based tests might need to be included in CFC rules for the purpose of addressing EU Law restrictions. The OECD’s standard should constitute a minimum standard for all jurisdictions involved, without creating a two-tier system for such MNEs that operate within an EU or non-EU framework.

Although substance-based tests may be an essential addition, it is just as necessary to bear in mind the kind of compliance burden that such subjective requirements would engender. Therefore, “threshold tests” could be applied prior to any detailed substance-based tests, in order to decrease the volume of entities/activities to which more onerous requirements would apply. Thus, further analyses – to ascertain to which income portion the rules should be applied – would strictly be carried out in connection with activities involving the CFC risk.

There are five (5) general income categories under Paragraph 96 of the Discussion Draft to which CFC rules might be applicable, although countries may wish to implement broader rules. In case of optionality, according to VAGP some further investigations as to the countries’ underlying motivations for wishing to implement broader rules – including the impact of such rules on the economic scenario – would be appropriate.
Attribution of income

A range of approaches might be potentially generated by the recommendation under Paragraph 146 of the Discussion Draft; in view of the above, establishing a definite and clear-cut best practice to be implemented by a comprehensive range of jurisdictions is strongly suggested. Any methods to establish whether minority interests affect CFCs might entail a compliance burden that is far too disproportionate to the benefit.

According to VAGP, a best practice in order to establish the amount of attributable income should be set forth. Applying a proportionate approach would be the most appropriate solution.

CFC rules set forth under the BEPS Action Plan will be most successful if recommended best practices are explicit and clear-cut. Allocated income should be comprised in taxpayer's taxable income for the relevant taxable year during which the CFC’s accounting period closes.

A most effective means to target BEPS issues is to apply to CFC income the tax rate of the parent’s country. Including active income is bound to have a harmful effect on trade and competition, and therefore – as a matter of policy – should be entirely avoided.

Elimination of double taxation

At the state of play, an OECD minimum standard with considerable flexibility runs the risk of generating numerous CFC rules that would not only conflict, but also entail special administrative difficulties for all parties involved, namely for Tax Authorities and taxpayers (as Paragraph 159 of the Discussion Draft points out). As a rule, conflicting norms generally produce a rise in double taxation.

Pursuant to the Discussion Draft, several double taxation issues may be treated by a tax credit be recognized for foreign taxes payments; this would include CFC tax assessed in relation to intermediate companies. If multiple versions of OECD recommendations are adopted, the concern is that should there not be any consistency, the
outcome might be that – by reason of competing rules - some countries might not acknowledge credits for foreign taxes that have been collected.

According to Paragraph 159 of the Discussion Draft, “in order to provide such a credit countries may need to change their double taxation relief provisions in order for CFC tax paid in an intermediate country to qualify as a foreign tax eligible for relief”. An issue that raises concern is that the proposed “minimum standard” may result in several CFC regimes that are significantly dissimilar among themselves. It is rather unrealistic to surmise that countries may coordinate their double tax relief efforts vis-à-vis rules that are inconsistently applied. In VAGP’s view, solely where consistent rules are recommended and applied, may such relief become a reality.

Application of mechanical reliefs may be expected to grow once again more complicated, as countries implement conflicting rules. Such areas also involve procedures on how to apply relief to double taxation on the distribution of CFC income that had been previously included, and how to adjust foreign taxes in case of additional withholding tax on such income that had been previously included as CFC income. The OECD should provide specific recommendations on the matter.

Companies establish effective rates by considering foreign tax refunds and rebates; this would apparently require some kind of procedure in order to trace taxes back to the relevant tax periods and income. Additional difficulties may result where there is a system in which multiple rules/regulations overlap; as a rule, further double taxation risks are generated by such kinds of complications.

According to VAGP, further and more exhaustive evaluations and studies on tools, means and procedures to reduce double taxation risks would be essential and of the utmost urgency; it would be just as important to delve into any potentially negative consequences that might derive from trade and investment proposals.
Interaction with transfer pricing issues

There is a need for further debates on CFC rules and Transfer Pricing, as it concurs that both regimes may co-exist and interact accordingly. According to VAGP, the Discussion Draft should also take into consideration – within a broader perspective – what impact may be expected from the Transfer Pricing proposals (via BEPS Actions 8-10), and how any further work in that area may affect the need for more extensive CFC rules. Some of the OECD proposals on CFC might essentially undercut substantive and legitimate transactions, priced and supported pursuant to Article 9 of the OECD Model and OECD Transfer Pricing Guidelines.

According to the OECD (Paragraph 24 of the Discussion Draft), CFC rules “only restore (or transfer) taxing rights to parent jurisdictions, which are not necessarily the jurisdictions which have suffered the profit shifting”. Such statement could be especially significant in connection with Developing Countries, as income may have been shifted to a CFC by artificial means, to be later “collected” by a parent company in a Developed Country, instead of being repatriated to the effective location in which the substantive economic activity was actually carried out. A special thought should be given to any effects that might derive from the various interpretations of the OECD's minimum standard and its likely impact on profit with substance alignment, while also considering whether implementing potentially conflicting CFC rules may actually produce positive spill-over effects.

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