Comments received on Public Discussion draft

BEPS ACTION 3: STRENGTHENING CFC RULES

5 May 2015

Part 1
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1 May 2015

By email to: CTPCFC@oecd.org

Dr. Achim Pross
Head, International Co-operation and Tax Administration Division
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Dear Achim,

BEPS Action 3: Strengthening CFC rules

General comments

AFME¹ and the BBA² welcome the opportunity to respond to the OECD’s discussion draft entitled “BEPS Action 3: Strengthening CFC rules”.

We wish to make clear that while AFME and the BBA have separate and distinct memberships, both organisations have decided to submit a single, combined response since our respective members share the same concerns with the OECD’s proposals in the discussion draft.

We welcome that the OECD is consulting with business on its proposals. We believe that this approach is to the benefit of both policymakers and business and helps to avoid any unintended consequences arising from the OECD’s proposals. We believe that it is also

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¹ The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

² The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Our associate membership includes over 80 of the world’s leading financial and professional services organisations.
valuable for the OECD to take account of the views of business on the practical aspects of operating the intended policy.

The relatively short time available to consider the discussion draft poses a challenge for all businesses and the OECD secretariat. Should it be of assistance we would be pleased to meet with the OECD Secretariat to discuss these matters in greater detail or provide further information upon request.

Branches

Paragraph 33 states that “many transparent entities such as partnerships should not be treated as CFCs to the extent that their income is already taxed in the parent jurisdiction on a current basis”. We welcome that statement. However, we note that the discussion draft suggests that branches whose income is not taxed in the jurisdiction of the principal potentially should be treated as CFCs. It is a natural feature of branch exemption systems that low tax branches are – in principle – exempt. Those countries which wish to prevent potential base erosion due to that feature typically address it by means of simple, but effective, restrictions within the branch exemption. We believe that that is the appropriate approach to address the risk, and would be concerned if more complex CFC regimes were modified to attempt to address the same feature, as this seems likely to be an unduly complicated way to address it.

Control

Control definitions which include economic control need to recognise that banks could, at times, have economic control of an independent third party simply as a result of the financial relationships between the bank and its customer. These are not situations within the scope of CFC regimes, are not designed to avoid other control definitions such as legal control and, therefore, we believe should be excluded from the definition of control. An example is where a bank has advanced a significant loan to a customer, in the normal course of its banking business, which may mean that it is entitled to a significant part of profits, capital and/or assets upon a liquidation. The control definition should exclude all financial relationships, not just lending, between a bank and a third party customer where the bank’s return from those financial relationships is included, and taxed, as part of its ordinary income.

Defining CFC income – Substance analysis

Paragraphs 89 to 94 set out three options for a substance analysis. We believe that the "substantial contribution analysis" or the "employees-and-establishment analysis" would be preferable to the "viable independent entity analysis" which would be subject to a high degree of uncertainty, and difficult to apply in practice given that it seems to
require speculation as to which other entities in the group “should” be carrying out the functions of the controlled company.

We believe that the primary focus of CFC rules should be to address base erosion of the controlling entity, i.e. the parent or, more broadly, the parent jurisdiction. That suggests a more straightforward approach to defining CFC income, which is to consider whether ‘significant people functions’ – in an OECD transfer pricing sense – are provided to the CFC from the parent jurisdiction.

We believe that any approach to the substance analysis which involves considering the location of people needs to take account of a common feature of international business, which is that there may be specific service companies within a multi-national enterprise that employ the group’s staff and provide their services to the other companies in the group under service agreements. The approach to financial services should also recognise that a relatively small number of skilled staff may be required to undertake some activities. We should be grateful if the OECD would take these considerations into account its final recommendations, as it has done previously in its 2010 report on the attribution of profits to permanent establishments.

We also note that the highly regulated nature of the banking and financial services sector means that a regulated financial services entity should have qualified employees, albeit potentially provided to it by a service company, and adequate capital to support its business and therefore should satisfy the ”substantial-contribution analysis” or an ”employees-and-establishment analysis”, and thus, not be within the scope of the CFC rules.

**Interest and other financing income**

We note that Paragraphs 100 and 101 suggest that interest and other financing income should be within the scope of the CFC rules unless the CFC is engaged in an active trade or business such as banking or financial services and it is not overcapitalised. Paragraph 101 notes that such an approach would require the application of one of the substance analyses to determine whether the CFC was in fact engaged in activities required to earn the financing income.

We welcome the recognition of the importance of this issue for active financial businesses and believe that a banking or financial services sector business that meets a substance analysis test should not also have to meet further tests that qualify particular types of income.

When determining whether a business which involves the earning of interest or dividends is active, CFC regimes should recognise and support the commercial and regulatory realities of the banking and financial services sector. We believe that such
commercial and regulatory factors should significantly address any opportunities for BEPS behaviour. For example, where a CFC regime considers the capital level in a banking subsidiary, the capital level should be considered acceptable when it is consistent with local market conditions. It should be recognised that non-tax related, commercial requirements dictate that capital levels will be above the regulatory minimum.

**Excess profits approach**

We note that in Paragraphs 111 to 125, the OECD sets out two different approaches - the categorical approach and excess profits approach - that jurisdictions could use to define what constitutes income subject to CFC rules.

We note the disadvantages of the excess profits approach set out in Paragraph 125 - in particular the uncertainty involved in calculating the value of the excess profits - and we believe that the categorical approach is therefore more likely to attribute income more accurately and is more consistent with the policy objectives. In addition, we believe that the relative volatility of earnings from risk bearing activities could present significant challenges to the use of an excess profits approach.

**Secondary rule**

The Executive Summary states that:

“some countries have proposed that in addition to CFC rules (which for the purposes of the proposal is described as the “primary rule”), countries could introduce further rules (the “secondary rule”) that applied to income earned by CFCs that did not give rise to sufficient CFC taxation in the parent jurisdiction. Such secondary rules would introduce a secondary form of taxation in another jurisdiction (for example the source country of the income earned by the CFC).

Working Party 6 is currently considering several options for special measures in the area of transfer pricing as part of Action Items 8-10, which could be implemented as possible secondary rules. Possible future work on the options to address the tax challenges of the digital economy could also be adapted to be applied as secondary rules. There is a question as to whether any of these options might form the basis for a secondary rule.”

We note that a secondary rule could lead to double taxation and would create additional and potentially complex administrative obligations for taxpayers and tax authorities. Furthermore, we believe that a secondary rule would be inconsistent with international tax policy objectives, as it would attribute profits to the parent which should properly be taxed in another jurisdiction. We consider that the concerns which a secondary rule
seeks to address would be more effectively addressed by appropriate transfer pricing rules which are supported by the approach to risk set out in the work on BEPS action items 8 to 10.

**Double taxation and dispute resolution**

We note that consensus has not been reached in respect of the proposals set out in the discussion draft and that the flexibility afforded by the proposals has the potential to result in a broad range of varying CFC rules across jurisdictions. Such an approach could result in double taxation. We welcome that Paragraph 155 sets out some recommendations to address concerns with double taxation. However, we believe that further work is necessary in this regard. We encourage the OECD to make a clear commitment in the final OECD guidance to effective double taxation relief and the development of effective dispute resolution mechanisms.

We are grateful for the opportunity to share our comments with the OECD on the discussion draft. We would be happy to discuss any of the above in greater detail with the OECD and would be pleased to contribute further as the OECD’s work develops.

Yours sincerely,

Richard Middleton
Managing Director
Tax and Accounting Policy
AFME

Sarah Wulff-Cochrane
Director of Policy
Taxation
BBA
Dear Sirs

OECD discussion draft 3 April 2015
BEPS Action 3: Strengthening CFC rules

The Alternative Investment Management Association¹ (AIMA) welcomes the opportunity to respond to the Organisation for Economic Co-operation and Development (OECD) consultation on strengthening the controlled foreign company (CFC) rules, released on 3 April 2015.

AIMA supports the OECD's policy on ensuring the coherence of corporate income taxation at international level. AIMA welcomes the proposed framework for national CFC regimes under which rules are designed as recommendations for jurisdictions implementing a CFC regime. However, the priority must be to guarantee a sufficient degree of consistency among the different national regimes, as international tax competition can create uncertainty if jurisdictions consider it appropriate to make unilateral change to tax rules, cause greater complexity through inconsistent reform proposals in different countries, and remove clarity from the future roadmap of corporate taxation.

We have concerns about a number of aspects of the proposed CFC rules. While accepting that the intended targets of the CFC rules are large multinational businesses which seek to use abusive methods to divert income away from the parent or other affected jurisdiction, we would like to point out that the recommendations under the draft CFC rules are likely to apply much more widely. CFC rules based on the recommendations would potentially capture arrangements which are not contrived and do not amount to abusive or aggressive tax avoidance, but constitute legitimate longstanding commercial structures and activities.

In particular, little account is taken of the position of other entities such as investment funds which may fall to be treated as CFCs. As a consequence AIMA considers the proposals to be inconsistent with the work previously undertaken by the OECD which identified the special nature of collective investment vehicles (CIVs) that are widely held, and hold a diversified portfolio of securities². The OECD has also recognised that aspects of the BEPS Project should take account of the position of the larger universe of collective investment schemes, including alternative investment funds³, and not only CIVs. These collective investment schemes have singular characteristics, and face practical difficulties in demonstrating that they meet requirements such as the control test, and as a result the proposed CFC rules would have a direct impact on collective investment schemes⁴.

Collective investment schemes generally exist to receive investment monies from a range of investors and to deploy that capital in order to generate investment returns. They are not designed or promoted as vehicles for tax avoidance. Many investors are not liable to tax, being pension funds, sovereign wealth funds, not for profit organisations, charities and other entities that would be entitled to tax exemptions in their own right if they invested directly in the underlying investments.

¹ AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector including hedge fund managers, funds of hedge fund managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.
² The granting of treaty benefits with respect to income of collective investment vehicles (OECD 2010)
³ OECD discussion draft 21 November 2014 - BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances
⁴ In this letter the term “collective investment schemes” refers to such larger universe and is not limited to CIVs.
One of the policy objectives of the OECD, as stated in its 2006 publication the Policy Framework for Investment - is to mobilise private investment that supports economic growth and sustainable development. The fund management industry is an important provider of international private investment, both as a primary investor and as a provider of liquidity in the secondary markets. The OECD’s work should recognise the role of collective investment schemes, consistent with the objective of the BEPS Project to facilitate cross border investment. The OECD should ensure that its proposals for national CFC rules do not, through inappropriate application, stifle private investment or increase the costs of its provision.

AIMA therefore proposes that CFC rules should either contemplate a general exemption for collective investment schemes (on the basis that investors should be taxed instead under targeted offshore funds rules) or should provide exclusions for investors who satisfy an ownership or voting power threshold which investors can determine from the information available to them.

We comment on aspects of the draft CFC rules in the annex to this letter.

Yours faithfully,

Paul Hale
Director, Head of Tax Affairs
Annex

OECD discussion draft 3 April 2015
BEPS Action 3: Strengthening CFC rules

We comment below and respond to a number of the questions asked in the discussion draft, by reference to the chapter headings.

Definition of a CFC

We consider that an entity which is treated as transparent for tax purposes should generally not be classed as a CFC, where residents of the jurisdiction applying the CFC rules are subject to tax on their share of the CFC’s income as it arises for tax purposes.

Threshold Requirements

What practical problems, if any, arise when applying a low-tax threshold based on an effective tax rate calculation? How could these problems be addressed or mitigated? (Questions 4 & 5)

We agree that thresholds can both help make CFC rules more targeted and effective and also reduce the overall level of administrative burden by ensuring that certain companies are not affected by the rules. However, a threshold based on the amount of tax for which a company is liable does not take into account, in the case of a company that is a collective investment scheme, that tax neutrality is a feature of collective investment of all kinds and that a comparable entity in the jurisdiction applying the CFC rules would almost invariably also have little or no tax liability on the same profits.

Therefore, either an additional threshold requirement is required - such as an anti-avoidance requirement, although the discussion draft believes this to be undesirable and unnecessary, while noting that this is not intended to imply that an anti-avoidance requirement can never play a role in CFC rules that tackle base erosion and profit shifting - or other provisions of the CFC rules must provide an appropriate and practical means of exclusion. An anti-avoidance requirement would also provide an exclusion for collective investment schemes which may at points in their life cycle (such as initial seeding, significant investor redemptions and winding up) become controlled for a limited period but without any tax avoidance.

Definition of control

What practical problems, if any, arise when applying a control test? 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? (Questions 7 & 8)

Legal control, economic control and de facto control will all be relevant in determining whether a collective investment scheme would be a CFC. While investors will hold the economic interests in the collective investment scheme and perhaps voting rights, in some instances all or certain voting rights may be exercisable by the fund management business that sponsors the collective investment scheme, and day to day management may lie with an investment management business. Control of a collective investment scheme may therefore exist separately in several jurisdictions simultaneously and bring it within the scope of multiple CFC regimes.

Investors will rarely be able to determine whether the collective investment scheme is a CFC under the tax law of their jurisdiction. The fund sponsor also may not be able to determine the position, as it will not have full knowledge of the identity of all investors (e.g. where their investment is made through a fund of funds or by a financial intermediary on behalf of its discretionary investment clients) - anti-money laundering rules and reporting regimes such as FATCA will not provide sufficient information for this purpose.

Jurisdictions where CFC rules have been implemented for many years have further thresholds that restrict the scope of CFC rules. For instance, the US Subpart F regulations generally only apply to a “controlled foreign corporation”, where US persons each owning directly, indirectly or constructively at least 10% of the voting stock of the foreign corporation together own more than 50% of the voting power or value of the foreign corporation’s outstanding shares. Under the UK’s CFC rules, a non-resident company will be a CFC if it is controlled by UK resident persons, but apportionment of its profits is made only to UK resident corporate investors who with connected persons have a beneficial interest in its profits of at least 25%.
US and UK investors in non-resident companies that are collective investment schemes are therefore generally not subject to the US and UK CFC rules (though instead targeted offshore fund regimes may apply). These examples demonstrate the need for CFC rules to contain collective investment scheme gateways.

There are also legal considerations. We understand that the OECD takes the view that the judgments of the CJEU in the Cadbury Schweppes and Thin Cap GLO cases demonstrate the establishing principles by reference to which a CFC regime may be considered EU law compliant, on the basis that they provide precedent for circumstances in which tax rules directed at preventing the artificial redirection of profits from one country to another may constitute a proportionately justified restriction on the freedom of establishment. We note also cases such as Eurowings and CFC GLO (which is particularly relevant to the application of CFC rules to offshore collective investment schemes). The Cadbury Schweppes case primarily concerned a cross border differential in tax rates within CFCs, but in its judgment the CJEU stated that the UK’s CFC rules would only be EU law compliant if they targeted solely “wholly artificial arrangements”. This case law raises doubts over the proportionality and compatibility with EU law of any CFC regime which, without suitable thresholds or exclusions, will in practice extend to collective investment schemes that clearly constitute arrangements that are not wholly artificial and have commercial, non-tax purposes.

There may also be other possible breaches of international law, such as whether action under a CFC regime to counter the accumulation of income offshore and the consequent deferral of tax liability might constitute an illegitimate or ultra vires exercise of tax jurisdiction by the country of residence of the controlling shareholders. Such action may be contrary to the provisions of double tax treaties, whether explicitly under the business profits article or within the scope of the non-discrimination principle.

**Definition of CFC income; Rules for computing income**

We note that these chapters take no account of the position of collective investment schemes which typically receive only passive income and do not meet tests of substance in their jurisdictions of residence. There must therefore be adequate thresholds or exemptions elsewhere in the CFC rules to provide certainty to investors about their liability to or exclusion from tax.

**Rules for attributing income**

The important element of the proposals on attribution of income of the CFC is the identification of the persons to whom it should be allocated for tax purposes. We consider that CFC rules should contain a high threshold participation level so that investors are not uncertain about their position, which may fall to be determined on the basis of factual information to which they have no access. A jurisdiction which wishes to counter any tax advantages perceived to be obtained by investors in non-resident collective investment schemes should adopt targeted offshore fund rules.

**Rules to prevent or eliminate double taxation**

We have no comments on this chapter.
The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK’s total net worth and contributing £11.8 billion in taxes to the Government. Employing over 315,000 people in the UK alone, the insurance industry is also one of this country’s major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to protect themselves, their families, their homes and assets, provide for a financially secure future and manage the risks faced in their businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed.

The ABI

The Association of British Insurers (ABI) is the voice of the UK insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI’s role is to:
- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

Introduction

1. The ABI welcomes the opportunity to comment on the discussion draft. We support the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment. We therefore support the objectives of the discussion draft in tackling BEPS activity, provided any rules are appropriately targeted and do not bring in non-BEPS activity. Our comments reflect our desire to ensure that any measures are workable, well targeted, and proportionate in the context of the efficiency of commercial insurance operations. In the spirit of working constructively with the OECD and member governments, we offer information and suggestions as to how the proposals could be improved to help achieve objectives whilst at the same time avoiding inadvertent consequences that impact on the normal conduct of insurance business models.

1 Discussion draft on OECD BEPS Action 3 (Strengthening CFC Rules) released 3 April 2015.
2. There are three overarching points in the discussion draft. The first is the reference to countries introducing a “secondary rule”. This would introduce a secondary form of taxation in a territory other than the territory of the parent of a CFC. This would create uncertainty for business, the potential for double taxation and substantial compliance burdens. It is also difficult to see how it would function in practice.

3. The second is that although we support the aim of developing recommendations for CFC rules that are effective in dealing with BEPS issues, we do not believe CFC rules should go wider. As identified in paragraph 5 of the discussion draft there are a number of closely related BEPS Actions, some (e.g. Actions 2 and 4) have the potential to impact on commercial insurance operations. How these other Actions interrelate with Action 3 needs to be understood. So the recommendations in the discussion draft are difficult to consider in isolation. Risk and capital is the heart of the insurance business and therefore any concerns about related party reinsurance should in our view be more appropriately dealt with through the OECD BEPS Action 8 – 10 and not through CFC rules.

4. Finally we note that the discussion draft is silent concerning the application of CFC rules in the asset management sector more generally. The application of CFC rules to offshore funds may cause a number of issues that governments will need to consider if implementing or when amending CFC rules. As global insurance groups often have an investment management arm we have in this response addressed some of the issues experienced when the UK most recently reviewed their CFC rules.

Executive Summary

5. Chapter 5 of the discussion draft suggests one of the forms of income that CFC rules should be capable of dealing with is insurance income. This overlooks the fact that reinsurance contracts can and do give rise to losses as well as profits. Whether there will be a loss or a profit is not known at the outset of a reinsurance contract.

6. We believe the viable independent entity analysis is the analysis that seems to more accurately identify whether there is real substance in a territory. It will also ensure that

a. reinsurance operations where few but appropriately qualified staff (such as actuaries, underwriters etc.) are required to assume and manage insurance risk, and

b. where staff performing key entrepreneurial risk-taking (KERT) functions are employed by a service company of the insurance group in the territory of the CFC, which may be for regulatory reasons,

do not inappropriately fail any substance test. As currently drafted the employees and establishment analysis would not appear to regard an insurer as having sufficient presence if the features at a. and b. are present. Those features would be present irrespective of whether an issuer was assuming risks from just 3rd parties, risks just from related parties or risks from a combination of 3rd parties and related parties.
7. Where insurance operations have many of the following features our view is that there should be no income attributed in respect of the CFC as there will be economic and value creating activity and no BEPS activity:
   a) The reinsurance contract is priced on arms-length terms.
   b) There would be diversification and pooling of risk in the reinsurer.
   c) There would be a demonstrable and quantifiable capital benefit – the economic capital position of the group has improved as a result of diversification and therefore there is a real economic impact for the group as a whole.
   d) Both the insurer and reinsurer would be regulated entities with broadly similar regulatory regimes applying with regulators that required evidence of risk transfer and appropriate capital levels. Additionally, rating agencies’ capital requirements may be relevant.
   e) The original insurance involves third party risks outside the (re) insurers group.
   f) In addition to having the risk and appropriate capital levels the entity would have the requisite skills and experience at its disposal. This would likely involve having employees (or those of a related service company) with senior underwriting expertise sufficient to accept the risk and/or an actuary. Although some non-KERT work could be outsourced, the decision makers would be likely to be officers of the company with suitable experience and authority.
   g) The entity would have a real possibility of suffering losses as well as making profits.

8. Our view is that the UK CFC rules achieve the right balance between ensuring that any insurance income that relates to BEPS activity is within the CFC rules, but insurance operations that generate economic and value creating activity are outside the rules. We therefore suggest that the UK’s CFC rules should be regarded as good practice when considering CFC rules for insurance income.

9. Insurance results are volatile which means that either profit or loss can arise and whether there will be a profit or loss will not be known at the outset of the reinsurance contract. As such an excess profit approach is completely inappropriate for insurance income.

10. Insurance operating subsidiaries are generally not overcapitalised because of the regulatory and commercial operating environment which leads groups to hold surplus capital at the parent company level to maximise their ability to redeploy capital quickly and efficiently when required. Insurers should therefore be able to demonstrate that the capital they hold is required to support the business written.

11. The primary question should always be whether or not an entity should be subject to attribution of its profits under CFC rules. However, transactional based thresholds can be useful in ensuring CFC rules are targeted at BEPS activity. This approach is that used in the UK CFC rules, which we believe achieve the right balance between ensuring that any income that relates to BEPS activity is within their CFC rules, not capturing non BEPS activity and keeping the compliance burden to the minimum possible.

12. The recommendations should include the ability to set off losses either against other CFC profits in the same territory in the same year or to carry forward in the CFC against profits in later years.
13. We believe the suggestion in paragraph 33 that a partnership should not be a CFC to the extent that its income is taxed in the territory of the parent, should go further for funds. The use of a fund vehicle, whether a company or partnership, to make investments for policyholders does not relate to BEPS activity. We do not therefore believe that income should be attributed under CFC rules in respect of these vehicles. One way of achieving this would be that where fund managers can demonstrate that the investments are made on behalf of third parties (policyholders and 3rd party investors) and that the income is brought into charge to tax no income would be attributed under CFC rules.

14. The recommendations should include a de-minimis threshold for profit and that there should be “white lists”. This would still enable BEPS activity to be tackled, but it will also keep the compliance burden on business to the minimum possible.

15. Timing difference can arise in insurance companies as a result of differing tax rules in different territories relating to investments and/or reserves. This could result in a loss in the territory in which the CFC is located, but a profit under the territory applying CFC rules. We believe that these timing differences should be recognised as part of any CFC rules and if the final recommendation is that the low-tax threshold should be based on an effective tax rate then this rate should be computed as an average rate over several years - footnote 26 (paragraph 57) of the discussion draft refers.

16. There can be difficulties in establishing whether there is control where funds are involved. We suggest the test of control for funds should be based solely on whether the results of the fund are consolidated in the parents' financial statements.

17. In addition to our comments in paragraphs 5-17 the overarching issues covered in paragraphs 2 - 4 of the Introduction are also relevant.

**Detailed Response**

**Chapter 2 Questions: 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?
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?

18. Life insurance companies in the UK often have asset management entities within their groups. These entities make investments on behalf of policyholders of the life company within the group and also unrelated third parties. Investment fund structures, particularly for property investment, can be complex, to accommodate a wide range of issues and investment
requirements. It is quite common for the vehicles used to be partnerships. Changing the treatment of partnership structures that are transparent for tax purposes in a number of territories and treating them as entities would cut across the rationale for many of these structures, where currently the investor is taxed directly on their share of profit. This facilitates, for example, pension fund investors being able to benefit from treaty benefits that would be available to them if the investment was made direct.

19. The use of a fund vehicle, whether a company or partnership is not driven by BEPS activity, but is a means of making investments for policyholders/third parties. We do not therefore believe that where insurers control fund vehicles (whether they are companies or partnerships) income should be attributed under CFC rules, where there are already arrangements in place to tax the profits arising in the insurers’ territory of residence. We therefore support the suggestion in paragraph 33 that a partnership should not be a CFC to the extent that its income is taxed in the territory of the parent, but believe in the case of funds it should go further. We suggest that even though investments will be held in the name of the fund vehicle, if the fund manager can demonstrate that the investments in the fund vehicle (whether a company or a partnership) are made primarily on behalf of third parties (policyholders and 3rd party investors) and that the income of the fund vehicle is subject to an appropriate level of taxation no income should be attributed under CFC rules.

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

20. In view of the number of entities in international groups the administrative burden of complying with CFC rules is high. This can be mitigated by having a de-minimis profit threshold and “white lists” as identified in paragraph 54 of the discussion draft. The ABI therefore strongly recommends that there should be additional recommendations in Chapter 3 that CFC regimes should include an appropriate de-minimis profit threshold and “white lists” where there is no scope for BEPS activity so as to mitigate against a disproportionate administration burden from compliance with CFC regimes. In the case of the de-minimis profit threshold we believe that as funds pose a low BEPS risk the threshold should be set an appropriate level. The UK CFC rules, for instance, effectively have a £500,000 threshold.

21. Paragraph 43 of the discussion draft recommends that CFC regimes should include a low-tax threshold based on the effective tax rate or a rate that is meaningfully lower than the rate in the country applying the rules. However, tax rate thresholds can be complex to use given differences between territories tax rules.
22. In the insurance sector timing differences can arise as a result of differing tax rules in different territories relating to investments. Investments in some territories are taxed on a mark to mark basis and in others on an accruals basis. There can also be differences in the tax treatment of insurance reserves between territories. For example in some territories tax relief is available for equalisation provisions, whilst in others no relief is allowed. As a consequence timing differences could result in there being a loss in in the CFC territory, but a profit in the territory applying the CFC rules. So, using a threshold based on effective tax rates is difficult to apply in practice and could potentially lead to uncertainty with the final filing position not being known for some years i.e. losses might be carried back that would change the result. A statutory tax rate would be easier to apply. If the final recommendation is that the low-tax threshold should be based on an effective tax rate we suggest that this rate should be computed as an average rate over several years as noted in footnote 26 (paragraph 57) of the discussion draft.

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?

23. As indicated in paragraphs 18 - 19 global life company groups could have numerous fund vehicles of varying types in multiple territories in which they have 50% holdings. It would therefore be a huge compliance burden if the insurance group had to carry out a number of different control tests to identify whether an entity is a CFC. Where the fund vehicle invests in other fund vehicles (i.e. third party funds/umbrella funds/Master Feeder funds) it can be difficult to identify if there is control of these other fund vehicles. In these circumstances we would suggest the control test being applied at fund level rather than on an entity by entity basis for the underlying vehicles of the investing fund.

24. As these fund vehicles do not relate to BEPS activity, but are a means of making investments for policyholders/3rd parties we believe the compliance burden should be kept to a minimum possible, whilst still meeting the objectives of nullifying BEPS activity. One way of achieving this would be to apply the GAAP consolidation requirement to identify whether there is control. An example of a standard is IFRS 10 (“Consolidated Financial Statements”) where the key principles are that control exists, and consolidation is required, only if the investor has power over the investee, exposure to variable returns from its involvement with the investee and the ability to use its power over the investee to affect its returns. Insurance groups already need to identify entities that meet these conditions as part of the preparation of their financial statements. Therefore using such a definition of control for funds would keep the compliance burden to a minimum possible, whilst still meeting the objectives of nullifying BEPS activity.

25. If there is control of a fund vehicle under the test suggested in paragraph 24 above, then as stated in paragraph 19, we believe that income should not be attributed under CFC rules in respect of these vehicles if the fund manager can demonstrate that the investments in the fund
vehicle (whether a company or a partnership) are made primarily on behalf of third parties (policyholders and 3rd party investors) and that the income of the fund is subject to an appropriate level of taxation. The parent territory of the life company would generally have a regime in place to tax life companies in a manner considered appropriate to that territory.

Chapter 5: Definition of CFC Income

I. General approaches to defining 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?

26. We agree with the suggestion in paragraph 85 of the discussion draft that not all income (which would include insurance income) in the CFC should be attributed under CFC rules. If insurance income is a category of income within CFC rules then to the extent that insurance income raises BEPS issues it should be attributed. Income that arises from economic and value creating activities should not be attributed. The principle should in our view be that the profits should follow the economic activity and that the viable independent entity is the most likely approach to meet this requirement.

27. We believe that there are disadvantages to the employees and establishment analysis that relate to insurance operations in addition to those set out in paragraph 92 of the discussion draft.

28. In the third bullet of paragraph 89 of the discussion draft the suggestion is that for the employees and establishment analysis the necessary substance could only be achieved if employees are employed in the CFC in the CFC’s territory. Although insurance groups employ staff performing KERT activities in the territories in which they operate, these employees, sometimes because of regulatory requirements are often not employed by the insurance operating company in the territory. They are employed by a service company of the insurance group. As such if the employees and establishment analysis is the preferred approach then it will need to cover the situation where employees are employed by an insurance group’s service company in the territory.

29. Furthermore with the employment and establishment analysis, it should be noted that KERT functions can be undertaken by a relatively small number of appropriately qualified staff. This is particularly so with reinsurance business where, given the relatively higher value and smaller number of contracts entered into compared to an insurance companies, a limited number of actuaries and/or underwriters can assume and manage a substantial quantum of insurance risk.

2 For example Article 6 of the third non-life directive (92/49/EEC) which amended (amongst other things) Article 8 of the previous directive 72/239/EEC.
This is irrespective whether of 3rd party or related party risks are accepted. It should therefore not be assumed by tax authorities that if few staff are employed in a territory then the substance test cannot be met.

30. The reasons why few but appropriately qualified staff are required is explained further in Appendix 3 – Role of Risk and Capital in Insurance. Furthermore the insurance supply chain and value drivers are explained in detail in the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) (“Part IV”) and we believe these should be referred to when consideration is given to whether an insurance company has the necessary substance in a territory irrespective of whether the insurer is in a low or high tax territory.

31. It is not unusual for an insurance group to set up a shared service company to deal with non-KERT functions such as claims handling for the worldwide group. The same functions are undertaken by the service company for insurers in both low and high tax territories. The shared service company may not therefore be located in the same territory as the insurance company and will be remunerated on an arm’s length basis commensurate with the services being supplied. The fact these activities are not carried out in a territory should not result in tax authorities concluding that there is not the necessary substance in the territory of the insurer. As explained in Part IV the assumption and management of the insurance risk is the KERT function and therefore the value creating activity is with the insurance company. Shared service companies are often located in territories with lower labour and other costs (more likely to be relatively less-developed countries) thereby contributing to improving the cost efficiency of insurance products for consumers. Any CFC recommendations should not place an over-emphasis on the location of employees in general rather than those actually assuming and managing insurance risk. Otherwise, there could be, in our view, an inappropriate impact on insurers that locate their non-KERT functions and employees in the most efficient locations from an operational perspective.

32. Although the viable independent entity analysis requires a fact intensive analysis we believe the advantages as set out in the second bullet of paragraph 92 of the discussion draft more than outweigh this disadvantage. Furthermore, a similar approach is used in the UK CFC legislation and the analysis seems to more accurately identify whether there is real substance in a territory. It also overcomes the difficulties for insurers as identified in paragraphs 28 - 31 above.

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

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?

33. The discussion draft, at paragraph 102, expresses concern that income from the insurance of risks can be shifted away from the territory in which the risk is located to another territory. It seems to follow that there is a view that the income from the insurance risk should be in the same territory as the risk. This ignores the fact that insurance is written on a global basis and as part of managing the insurance risks assumed an insurer will undertake both internal and external reinsurance. The key principle is that the profits should be aligned with the economic activity of the enterprise not the risk being covered.

34. Furthermore, in the European Union regulated insurers are permitted to write business on an EU Freedom of Services basis - Appendix 1 includes a brief description of EU Freedom of Services and EU Freedom of Establishment. Under Freedom of Services an EU regulated insurer is able to write insurance policies in its home territory which cover risks written in another EU member State. This is a further and important example of where the income from the insurance risk is in a different territory to where the risk is located.

35. So it does not follow that if insurance income is in a different territory to the risk that there is BEPS activity. Rather it is a consequence of insurers managing risks on a global basis. Furthermore, it is also worth noting that a number of territories have introduced Insurance Premium Tax which is payable on the gross premiums for risks insured that are situated in their country.

36. The ability for an insurance entity to assume risk is governed by regulation. This regulation is there to protect consumers, so that in the event of a claim the insurer has the funds to pay the claim.

37. Every insurance entity is regulated in the territory in which it operates locally (or in the parent territory with EU Freedom of services business) and is required to have sufficient capability and capital in the territory to support risk. In the EU insurers are regulated at both entity and group level and when Solvency II comes into force in 2016 EU insurers will only be able reinsure risks with reinsurers in territories that have Solvency II equivalent regimes.

38. Similarly, there are regulatory constraints on the movement of capital within groups and therefore the location of risk and capital will generally have to reflect the economic and value creating activities carried out.
39. Insurers undertake reinsurance with related parties for a number of commercial reasons. These include:
   a. Management of capital and obtaining efficiencies. By reinsuring and obtaining diversification (see below) the amount of capital an insurance group needs to hold is reduced. This enables more business to be written and keeps the cost of insurance for consumers down. Appendix 2 includes an example of how capital efficiencies.
   b. Diversification of risks. This could involve pooling the risks from say US storm risk, New Zealand earthquake risks and European flood risks. By pooling these risks the individual risks become less concentrated and therefore less capital is required to back the risks. Some reinsurers seek to diversify the risk further by accepting insurance risks from 3rd parties.
   c. Pooling the risks in a group reinsurance vehicle can also enable cheaper rates for external reinsurance to be obtained by “pre-packaging” a pool of diverse risks.
   d. Where there is a political and economic risk to the capital in a particular country.
   e. Where smaller countries may not have sufficient volume or scale to efficiently pool risk.
   f. Improved credit ratings.

40. The decision on whether to reinsure with a related party or with a third party would include the following considerations:
   a. Competitive prices in the market – insurers have different views of risk and therefore the pricing of reinsurance may be different.
   b. Whether there is a need to reduce group exposure overall.
   c. Whether the local regulator permits all of the risk to be retained in the local territory.
   d. The improvement of the capital position of the group. Decisions to use a related party reinsurer would generally be driven by the capital benefits, which might include additional benefits from onwards reinsurance in the market subject to a and b above.

41. Reinsurance of risks in a regulated insurance context involves a genuine transfer of risk from the insurer to a reinsurer of a risk that originates from outside the insurance group. The regulator for the insurer will only agree to risks being transferred and the capital reduction that arises from the reinsurance if it is satisfied that the reinsurer has the capital and capability to assume and manage the risks. Equally, the regulator of the reinsurer will only allow the reinsurer to accept the risk if it is satisfied the reinsurer has the capital and capability to assume and manage the risks. Therefore there are two independent regulators who have to be satisfied that the risks have been transferred. So in the context of regulated insurers, although the regulators would not generally consider the tax consequences of the transfer of risks, they would be satisfied that the risks had been genuinely transferred. Appendix 3 includes a detailed explanation of the Role of Risk and Capital in Insurance.

42. When risks are transferred under reinsurance contracts the liability to meet the claims passes to the reinsurer. Reinsurers have funded a large percentage of the claims relating to catastrophes (cats). The table below summarises the territory, the insured and reinsured amounts and the proportion of risk reinsured outside the territory in which the risk was located for the material events in 2011. The data is taken from publicly available sources and is based on liabilities assumed and not necessarily claims that have been paid to date.
### Territory Summary

<table>
<thead>
<tr>
<th>Territory</th>
<th>Insured Losses (Mega Cats)</th>
<th>Reinsured Losses (Mega Cats)</th>
<th>Estimated Reinsured Share</th>
<th>Non-Domestic Reinsured Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia³</td>
<td>$ 8 B</td>
<td>$ 3.5 B</td>
<td>44%</td>
<td>90%</td>
</tr>
<tr>
<td>New Zealand⁴</td>
<td>$17 B</td>
<td>$12.5 B</td>
<td>73%</td>
<td>100%</td>
</tr>
<tr>
<td>Japan⁵</td>
<td>$35 to $40 B</td>
<td>$12 to $14 B</td>
<td>40%</td>
<td>98%</td>
</tr>
<tr>
<td>Thailand⁶</td>
<td>$15 to $20 B</td>
<td>$12 B</td>
<td>60%</td>
<td>95%</td>
</tr>
<tr>
<td>Chile⁷</td>
<td>$8.5 B</td>
<td>$8 B</td>
<td>95%</td>
<td>100%</td>
</tr>
<tr>
<td>2011 Summary</td>
<td>$75 to 85 B</td>
<td>$40 to 42 B</td>
<td>54% average</td>
<td>96% average</td>
</tr>
<tr>
<td>Summary (with Chile 2010)</td>
<td>$83.5 to 93.5B</td>
<td>$48 to 50 B</td>
<td>62% average</td>
<td>97% average</td>
</tr>
</tbody>
</table>

43. The table above also highlights a further important point. When an insurance or reinsurance contract is entered into it is not known whether there will be a profit or loss relating to the risks undertaken.

44. So, insurance income is dissimilar to the other income identified in Chapter 5 of the discussion draft in that the results can be volatile and substantial losses can arise. The ultimate profitability of a line of business may not be known for several years.

45. The conclusions from our response on part II of Chapter 5 are that the identifying features of insurance operations that generate economic and value creating activity and which do not give rise to BEPS activity are:
   a. The reinsurance contract is priced on arms-length terms.
   b. There would be diversification and pooling of risk in the reinsurer.
   c. There would be a demonstrable and quantifiable capital benefit – the economic capital position of the group has improved as a result of diversification and therefore there is a real economic impact for the group as a whole.
   d. Both the insurer and reinsurer would be regulated entities with broadly similar regulatory regimes applying with regulators that required evidence of risk transfer and appropriate capital levels. Additionally, rating agencies’ capital requirements may be relevant.
   e. The original insurance involves third party risks outside of the (re)insurer’s group.
   f. In addition to having the risk and appropriate capital levels the entity would have the requisite skills and experience at its disposal. This would likely involve having employees (or those of a related service company) with senior underwriting expertise sufficient to accept

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³ Holborn, 2012 Reinsurance Market Outlook, January 2012; Australian flooding in Queensland and Victoria; Cyclone Yasi; other loss events included in aggregate global cat loss total but not in this table
⁸ Aon Benfield Reinsurance Market Outlook, Sept. 2011; Insurance Insider Chilean Loos Tracker Report
the risk and/or an actuary. Although some non-KERT work could be outsourced, the decision
makers would likely to be officers of the company with suitable experience and authority.
g. The entity would have a real possibility of suffering losses as well as making profits.

Whilst insurance group business models will vary from group to group we believe that where
insurance income that has many of the features above there should be no income attributed in
respect of the CFC as there is no BEPS activity and economic and value activity is created.

46. Our view is that the UK CFC rules effectively achieve this by having the right balance between
ensuring any insurance income that relates to BEPS activity is within their CFC rules, whilst
insurance operations that generate economic and value creating activity are outside the rules.
We therefore suggest that the UK’s CFC rules should be regarded as good practice when
considering CFC rules for insurance income.

III. Possible approaches

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?

47. The discussion draft at paragraph 112 suggests that income from insurance will generally be
treated as active (and therefore excluded) unless (1) the income was derived from contracts or
policies with a related party or (2) the parties to the insurance contract or the risks insured were
located outside the CFC territory. However, income from insurance that falls under these two
exceptions will only be treated as passive (and therefore included) if the CFC were
overcapitalised or did not have sufficient substance to assume and manage the risks on its own
accord.

48. We have explained in our response to part II of Chapter 5 why we consider there are other
factors relevant to the simplistic approach of making all related party reinsurance income as
passive and therefore bad. We have also provided comments on sufficient substance.

49. Insurance operating subsidiaries are generally not overcapitalised. It makes no commercial sense
for a subsidiary of an insurance group to hold excess capital even where the subsidiary is in a low
tax territory. Any capital above what is needed in a territory to undertake the insurance
operations will always be distributed up to the parent company. This is to ensure that capital can
be deployed quickly if needed in another territory for example in the event of a significant loss. If the surplus capital were not distributed to the parent then an insurance group parent could find itself in a position that when it needed to deploy capital quickly the group’s surplus capital would be in a regulated insurance subsidiary in another territory. As regulatory approval would be required for the subsidiary to pay capital to its parent there would be a substantial time delay between the capital being needed and the parent receiving it. This could lead to severe operation difficulties in the territory that need the capital which could lead to reputational issues for the insurance group. We believe that insurers should therefore be able to demonstrate that the capital they hold is required to support the business written.

50. As explained in paragraphs 43 and 44 above there is volatility in insurance results which means that either profit or loss can arise and whether there will be a profit or loss will not be known at the outset of the reinsurance contract and the ultimate profitability of a line of business may not be known for several years. As such an excess profit approach is completely inappropriate for insurance income.

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

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?

51. The primary question should always be whether or not an entity should be subject to attribution of its profits under CFC rules. However, transactional based thresholds, such as a de-minimis passive income threshold, can be useful in ensuring CFC rules are targeted at BEPS activity. This approach is that used in the UK CFC rules, which we believe achieves the right balance between ensuring that any income that relates to BEPS activity is within their CFC rules, not capturing non BEPS activity and keeping the compliance burden to the minimum possible.

Chapter 6: Rules for computing income

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?

52. As mentioned above insurance results can be volatile and substantial losses can arise. These losses will be genuine and therefore we believe that relief should be available to be set off either against other CFC profits in the same territory in the same year or to carry forward in the CFC against profits in later years. We believe that the ability to allow these set offs should form part of the recommendations.
Chapter 7: Rules for attributing income

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?

53. We have no comments.

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

34. We have no comments.

Association of British Insurers
1 May 2015
Appendix 1 - EU law Freedom of Establishment (‘FoE’) and Freedom of Services (‘FoS’).

In the EU there is a single market for insurance – see the EU Life Insurance and Non-Life Insurance Directives. These Directives effectively provide for insurers in one EU member state to be able to sell in or into other EU member states either under FoE or FoS.

FoE is typically where an insurer resident in one EU member state sells “in” another EU member state through a branch, i.e. has a physical presence. Despite this physical presence the insurers’ capital requirement will be regulated by its home regulator and not the regulator in the EU member state where it has the branch. For tax purposes we would expect the insurer to have a PE in the EU member state in which it is selling that business as a result of its physical presence.

Under FoS, the insurance policy issued is written in the insurer’s home EU territory but covers a risk located in the other EU member state. All Key Entrepreneurial Risk-Taking functions (e.g., assessment, assumption and management of risk) would be in the home EU member state and the insurers’ capital requirement would be regulated by the home regulator.
Appendix 2 – management of capital to achieve efficiencies

The Excel spreadsheet below is a simple example of the capital efficiency calculation showing the impact of a proportional reinsurance (40% Quota Share\(^9\)) on the cedant and the reinsurer. The example is based on an internal training course of an insurance group and can be summarised as:

**Starting position**

Capital requirement of insurer for 1 in 200 event before reinsurance (based on 10 policies, average claim £2000): £12567  
Capital requirement reinsurer for 1 in 200 event before reinsurance (based on 50 existing policies, average claim £800): £11240

Intra group 40 % quota share reinsurance undertaken  
Capital requirement of insurer for 1 in 200 event after reinsurance (10 policies, average claim now £1200): £7540  
Capital requirement of reinsurer for 1 in 200 event after reinsurance (now with 60 policies, average claim still £800): £12313

Capital reduction for insurer: £12567-£7540 = £5027  
Capital increase for reinsurer: £12313-£11240 = £1073  
Capital saving for group: £3954

The example uses illustrative figures and is of course highly simplified. However it demonstrates that there is a non-linear relationship between the number of policies (re)insured and the capital required to support them. In a normal distribution, the range of possible claims outcomes increases at a slower rate than the number of risks (re)insured, hence proportionally less capital is required for incremental increases in the number of policies. Pooling risk within a group by means of intra-group reinsurance can therefore release capital across the group overall.

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\(^9\) Quota Share reinsurance is where the reinsurer reinsures a certain percentage of each of the policies written by the ceding company. Once the reinsurance treaty is entered into, the reinsurance is automatic.
Appendix 3 – Role of Risk and Capital in Insurance

Executive Summary

Through the Base Erosion and Profit Shifting (BEPS) Project, G20 and OECD countries are more closely aligning taxation with economic activity and value creation. A key action of the BEPS project relates to risks and capital, where the concern is that ‘inappropriate returns will accrue to an entity solely because it has contractually assumed risks or has provided capital.’ This concern arises because tax authorities have encountered situations where a multi-national group’s profits have been shifted between jurisdictions through artificial risk transfer (i.e. where actual risk does not follow contractual risk); where capital is moved to where it is not needed; and where contractual risk is divorced from the functions which manage risk.

For insurers, risk and capital cannot be separated; there can be no assumption of risk without the provision of appropriate capital in an insurance context because the regulatory capital rules which (re)insurers are subject to are designed to ensure that the person bearing the risk of loss has the capital available to meet such losses. Inevitably, the assumption of risk can lead to loss as well as profit and it is the capital provider to which both arise. This is why this function is rewarded. The insurance industry is concerned that any new rules which seek to limit the allocation of returns to an entity ‘solely because it has contractually assumed risks or has provided capital’ could inadvertently impact legitimate insurance business models where both these things go hand in hand.

As a contribution to the BEPS project, this paper is offered as an explanation of the unique role that risk and capital play in the insurance industry, in order to demonstrate that insurance risk transfers are by their nature real transfers of risk (even where intra group), that insurance companies have strong commercial reasons not to hold excessive capital or move it to where it is not needed, and that the management of insurance capital (which is analogous to the raw materials used by other industries) can be done by comparatively few but appropriately qualified staff. Insurance is a highly-regulated industry, and these regulations, along with existing transfer pricing guidelines, give tax authorities and governments wide powers to challenge or disregard any intra-group insurance transactions which result in profits or losses that are not aligned with economic activity.

Intra-group reinsurance contracts perform the same role as external reinsurance contracts, and should be priced in the same way, i.e. on the basis that residual profits and losses are returned to the key entrepreneurial risk-taking (‘KERT’) function/capital provider after remunerating other functions (such as brokers or sales agents), as there is simply no other party that bears the insurance losses.

This note applies to groups where the main or one of the main activities is the conduct of insurance business. It does not consider captive insurance companies of groups whose main activity is not insurance.
the global economy, protecting individuals, businesses, and governments against financial loss from risks ranging from natural catastrophes to poor health and unemployment.

The essence of insurance is the transfer of risk between the insured party and the insurance company. In exchange for the payment of a premium, an insured party can transfer to an insurer the risk of loss from a particular source. By pooling the risks of multiple insured parties, the insurer can spread the risk of loss. To ensure it will be able to pay any claims that arise beyond those expected, the insurer holds an appropriate amount of capital. The first risk in the insurance supply chain that an insurance company takes on is by definition from an independent third party.

An insurer assumes a variety of risks in relation to the business it writes:

- The main risk is insurance (or underwriting) risk, i.e. that factors beyond the insurer’s control result in claims that exceed premiums and other income and the insurer makes a net loss. Examples of these factors include severe or frequent natural disasters such as earthquakes, storms and floods, or people falling ill and / or living longer or not as long.
- Other insurance specific risks exist, e.g.:
  - Reserve risk: the risk that original estimates of claims are ultimately too low due to changes in inflation, court decisions on damages etc
  - Market risk: the risk that the investment assets held to support both the claims reserves and the solvency capital of the insurer fall in value due to underlying market conditions
- Insurers must also manage general business risks such as credit risk, expense risk, and operational risk.

Risk management is at the heart of the insurance business; insurers cannot eliminate risk and volatility but their objective is to understand and manage it. The key decisions an insurer makes relate to which risks to take on and what premiums to - in order to make profits, an insurance company must get the correct balance between these two factors. Accordingly, the understanding and management of insurance risk is at the heart of an insurer’s ability to create value.

One of the key methods for managing risks is through diversification of risk, or in other words reducing the concentration of one type of risk by writing many different types of policies. Diversification of risk can be achieved by writing business in different geographical locations (because there is little correlation between losses in different locations e.g. earthquakes in Japan versus Wind/Winter storm in Europe), or it can be achieved by writing products that partly offset each other (such as whole-of-life assurance and annuity contracts because there is a negative correlation between claims for these types of risks). “Diversification, particularly geographic, is fundamental to the insurance business”.\(^\text{10}\) It reduces the overall risk of unexpected loss to the portfolio as a whole and therefore reduces the need for capital. As the cost of capital is a key factor in setting premiums, the efficient management of capital is critical to competition between insurers.

Insurers hold reserves to cover all expected risks and, as regulated entities, the (minimum) size of these reserves is determined by local regulatory rules. These rules can vary widely, though from

\(^{10}\) Insurers Rating Methodology: Standard & Poor’s, 7 May 2013
2016, the Solvency II regime will govern all European Union insurers and many other governments are developing new regulatory rules that follow the same fundamental concepts as Solvency II. Whilst Solvency II does not apply outside the EU, EU insurance companies who reinsure to locations outside the EU will need to demonstrate that the local regulations are ‘equivalent’ to Solvency II, or be sufficiently capitalised under Solvency II rules, in order to get regulatory credit for the reinsurance (more about reinsurance later). One of the main changes in moving from Solvency I to Solvency II is that Solvency II requires more accurate modelling of the underlying economic risks. Solvency II rules are outlined further in Annex A.

A real loss can and often does arise from the risks insurers manage as the underwriting results from the Association of British Insurers (‘ABI’) members for the 17 years to 2012 below demonstrate.

Furthermore, a single large natural catastrophe or other unexpected event or mismanaged financial risk can wipe out several years’ worth of earnings.

Recent examples of large unforeseen events include the impact the recession and the consequential fall in global markets had on life insurers providing variable annuity products in 2008/2009, and the general insurance market in 2001 after the terrorist attacks of September 11th, and in 2005 after Hurricane Katrina. In each of these cases, substantial underwriting losses occurred.

Insurers are able to bear losses arising from insurance risk as they hold capital reserves against such events. For this reason, in insurance transactions (whether between related or unrelated parties), the capital provider receives the residual profits and losses after remunerating other functions (such as brokers or sales agents), as the reward for the capital it has placed at stake. The capital provider is the entity that bears the risk of an insurance loss, and earns the return on the capital at stake should no loss arise in the period.
For most companies, capital is simply defined as the excess of assets over liabilities. The position is more complicated for insurance companies, with multiple capital requirements arising from regulators and ratings agencies. The capital position of an insurer is regulated by local regulators (government bodies), who set a minimum amount of capital which must be held by an insurer to cover expected liabilities plus a margin for additional security, in order to ensure that policyholder claims will be met even where these are greater than anticipated. (See Appendix I)

Insurance entities must be approved and licensed by the relevant country regulator before they are permitted to write local insurance business in the territory. Regulators will not allow the risk of insurance loss (and therefore of profit) to sit with any party except the capital provider as a safeguard for local policyholders; for example an insurance broker or a sales agent would not be allowed by the regulator to accept insurance risk on their own account (without being regulated as an insurance company) as they may not have the financial reserves to cover the potential losses under the contract. Only the (authorised) party which holds the required capital may accept insurance risk.

Regulators also set limits around the amount and type of capital and debt an insurance company can utilise to meet its regulatory capital requirements. Because of this restriction, as the table to the right illustrates, insurers tend to hold a much greater proportion of equity capital in relation to debt than other industries. The S&P 500 column shows the debt/equity ratio for all companies listed on the S&P 500 versus their credit rating, whereas the A.M. Best (as a specialty insurance credit rating agency) column shows their expected debt/equity ratio for an insurance group for the same credit rating. This demonstrates that any losses that arise must be borne by the insurers out of their equity reserves, making the possibility of financial loss to the equity holders a very real one.

Equity capital is expensive in every industry, as tax rules in most jurisdictions allow deductions for interest payments, but not dividends, and shareholders require a higher rate of return than debt holders in exchange for the higher risk they take on as owners of the business. Capital is particularly expensive for insurers, as regulators, and effectively Rating Agencies, and corporate customers and their brokers, force insurers to hold high quality capital in excess of expected liabilities, and limit the amount and type of debt that may be included in regulatory capital.

<table>
<thead>
<tr>
<th>Rating</th>
<th>Debt/Equity Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>S&amp;P 500 (actual)</td>
</tr>
<tr>
<td>AAA</td>
<td>6%</td>
</tr>
<tr>
<td>AA</td>
<td>40%</td>
</tr>
<tr>
<td>A</td>
<td>84%</td>
</tr>
<tr>
<td>BBB</td>
<td>45%</td>
</tr>
<tr>
<td>BB</td>
<td>75%</td>
</tr>
<tr>
<td>B and below</td>
<td>193%</td>
</tr>
</tbody>
</table>

Source: Standard & Poor’s and AM Best

There is a natural tension between the minimum amount of capital required by regulators and ratings agencies, and the maximum amount of capital an insurance group can use effectively.
Ratings agencies provide opinions, such as the Financial Strength Rating, based on an insurer’s ability to meet its senior financial obligations, which are its obligations to policyholders. Many corporate customers will only contract with insurance groups which have high credit ratings (for example A or above) as this provides more security that the insurer will be able to pay claims even where losses are unexpectedly high.

However, there is a strong incentive not to hold too much capital. Being over-capitalised means that the insurer will not be able to earn an acceptable return on capital, which will damage its ability to attract and retain investors. If an insurer cannot earn an acceptable return on capital (e.g. by expanding into new markets or writing new lines of business) it will often return the capital to shareholders. There are many recent examples of general insurers returning capital to shareholders after a string of good years in which there have been few natural disasters, but no additional appetite in the market for increased levels of business.

For insurers, capital is analogous to the raw materials used by other industries, and insurance risk cannot be accepted without holding the required level of capital. Unlike using other raw materials, however, we will show below that that putting capital to work in insurance and, in particular, reinsurance does not necessarily require a large workforce.

Managing risk and capital through reinsurance

One of the most important ways that insurers balance risk and capital requirements is via reinsurance agreements, or in other words insurance for insurers. A reinsurance agreement takes a single large risk or a collection of risks written by the original insurer and transfers them to a reinsurer, in return for a premium. The result is that risk is removed from the liabilities of the original insurer and the insurer is freed from the requirement to hold capital against the risk. This requirement is instead passed to the reinsurer who now bears the risk of loss.
Examples of reinsurance treaties are an excess-of-loss treaty where a reinsurance company agrees to cover losses that go above a certain limit, and a quota-share treaty where a reinsurance company receives a percentage of the premiums that an insurance company writes in return for paying the same percentage of claims. Please see Annex B for a more detailed discussion of types of reinsurance business. Reinsurance is simply a type of insurance, and many insurance companies write both direct insurance business and reinsurance business.

Reinsurance is a common market transaction, used by insurers all over the globe to remove risks from their balance sheets in order to manage capital and solvency requirements more effectively and reduce earnings volatility. As noted above, insurers cannot eliminate risk and volatility but they can understand and manage risks (partly through reinsurance) in order to balance the ability to pay claims with the ability to make profits for their investors.

The table below shows the gross and net reinsurance premiums written by the largest reinsurance groups- the difference between the gross and net premiums written shows that even large reinsurance groups reinsurance some of their risks to other reinsurers.

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Company</th>
<th>Gross</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Munich Reinsurance Co</td>
<td>38,333</td>
<td>36,638</td>
</tr>
<tr>
<td>2</td>
<td>Swiss Re Ltd</td>
<td>32,934</td>
<td>30,478</td>
</tr>
<tr>
<td>3</td>
<td>Hannover Re AG</td>
<td>19,225</td>
<td>16,833</td>
</tr>
<tr>
<td>4</td>
<td>Lloyd's</td>
<td>15,614</td>
<td>11,329</td>
</tr>
<tr>
<td>5</td>
<td>SCOR S.E.</td>
<td>14,116</td>
<td>12,570</td>
</tr>
<tr>
<td>6</td>
<td>Berkshire Hathaway Inc</td>
<td>12,776</td>
<td>12,776</td>
</tr>
<tr>
<td>7</td>
<td>Reinsurance Group of America Inc</td>
<td>8,573</td>
<td>8,254</td>
</tr>
<tr>
<td>8</td>
<td>China Reinsurance (Group) Corp.</td>
<td>7,936</td>
<td>7,523</td>
</tr>
<tr>
<td>9</td>
<td>Korean Reinsurance Co.</td>
<td>5,623</td>
<td>3,635</td>
</tr>
<tr>
<td>10</td>
<td>PartnerRe Ltd</td>
<td>5,562</td>
<td>5,391</td>
</tr>
</tbody>
</table>

Top 10 Global Reinsurance Groups
Ranked by unaffiliated gross premium written in 2013
(USD millions)

source: A.M. Best

Reinsurers, like insurers, take on risk in order to make profit, so the key decisions a reinsurer makes are the same as those of an insurer, namely which risks to take on and what premiums to charge.

By selectively ceding or taking on risks, both insurers and reinsurers can achieve a better balanced book of risks which will not only reduce capital requirements by reducing volatility of earnings as excessive losses may be avoided, but also because losses from one line of business should be offset by profits from another.
Commercial drivers for insurers to reinsure risks

**Protection from large losses**
- They can protect themselves from especially large losses, e.g. through excess of loss or stop loss treaties

**Transfer risk from balance sheets**
- Transferring risks from their balance sheets enables insurers to write an increased volume of business, enhancing ability to earn ancillary income from a broader policyholder base, and/or larger risks which are more profitable without being required to find more capital

**Improve solvency and capital ratios**
- Removing risks also improves insurers’ solvency ratios and other capital ratios - these can be driven by regulatory, rating agency capital, or group internal guidelines

**Benefit from diversification of risk**
- By reinsuring large one-off risks or an unbalanced portfolio, the insurer can achieve a better balance of risks and benefit from diversification of risk which will also result in lower capital requirements (more on diversification below)

Consumers benefit from reinsurance in the form of more competitive premium prices, a stronger capital base for the insurer (making it more likely that their claims will be paid) and a wider range of risks that can be underwritten (making it less likely that they will be denied coverage for larger or more complex risks). In particular, as natural disasters have been increasing in frequency and severity and as individuals have been enjoying longer lifespans and are increasingly responsible for their own retirement incomes, consumers need well-priced solutions in order to achieve financial security.

It is important to remember that in order to obtain the desired solvency and capital effects, a reinsurance contract must be of a type recognised by regulators and accounting rules with a sufficiently capitalised counterparty, and must genuinely transfer risk from one insurance entity to another. Neither regulators nor accounting standards would recognise a reinsurance treaty that did not actually transfer risk, nor would it be recognised in law as insurance, so there would be no purpose in such a contract.

Reinsurance contracts are written both domestically and cross-border, depending on the circumstances of the parties and the types of risks being reinsured. As a result, reinsurance business is not concentrated in any particular location, but is written in many jurisdictions around the world, as
demonstrated by the chart to the left (note: A.M. Best treats the domicile of the group as the location of the reinsurance). This is important to enable better diversification of risks.

Source: A.M. Best

Differences in business models of insurers and reinsurers

There are important differences in the business models of insurers and reinsurers which mean that the numbers and types of staff required to manage the business are very different.

Most insurers tend to write a large number of relatively small policies, which means that they need significant numbers of staff to develop and sell products, administer policies, and handle claims. Even where an insurer reinsures a risk, the insurer remains contractually responsible to the insured party for the administration of the policy and the payment of any claims, and so needs to maintain staff to carry out these functions.

In contrast, reinsurers write a relatively small number of policies for large amounts, and so have significant benefits of scale. In addition, reinsurers do not deal directly with consumers (as the insurer retains that responsibility) so do not have significant sales or administrative staff and are able to maintain a lower operating expense ratio than is the case for insurers. This is the reason why a reinsurer often pays a ceding commission or other contribution to the original insurer’s operating expenses.

Model of insurance staff allocation

Model of reinsurance staff allocation

A high-level look at two of the largest insurers and reinsurers demonstrates the different scale of staff required to support each. As the table below demonstrates, the reinsurers are able to write a
large amount of business with relatively few staff, whereas the business of the insurers is much more staff-intensive:

### Ratio of Staff to Gross Written Premiums (GWP)

(USD millions)

<table>
<thead>
<tr>
<th></th>
<th>GWP $m</th>
<th>Staff $m</th>
<th>Staff per $m GWP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reinsurers</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Munich Reinsurance Co</td>
<td>38,333</td>
<td>11,315</td>
<td>0.3</td>
</tr>
<tr>
<td>Swiss Re Ltd</td>
<td>24,509</td>
<td>7,151</td>
<td>0.3</td>
</tr>
<tr>
<td><strong>Insurers</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AXA Group</td>
<td>117,732</td>
<td>93,146</td>
<td>0.8</td>
</tr>
<tr>
<td>Allianz Group</td>
<td>99,203</td>
<td>147,627</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Source: Annual Reports

1 Reinsurance business only- direct business excluded
2 Staff numbers for reinsurance estimated from annual report

It is important to note that for both insurers and reinsurers, the **key decision makers are those who select and price risks**, as these decisions have the largest impact on the profitability of the insurer. Transfer pricing guidelines describe this function (‘the assumption of insurance risk’) as the KERT function in insurance business, which means that the profits and losses relating to that assumption of risk should accrue to the location where these decisions are made. As capital is required to be held against the risks taken on by an insurance entity, the location in which the KERT function takes place is also the location where the capital relating to the business is held (or attributed in the case of an insurance branch).

The underwriters and actuaries that make the decision to assume insurance risk will be highly skilled but the requirement for such staff will be driven by the volume of decisions to assume insurance risk taken by the company; so for a typical reinsurer, who writes a smaller number of policies than an insurer, there will be a need for fewer underwriting and actuarial staff, and indeed for a smaller number of staff in general. The result is that in a reinsurance context, **relatively few highly-skilled staff make the decisions** about how to use the capital of the company.

**Intra-Group Reinsurance**

Regulatory and other rules prevent insurance groups from operating as a single entity. Therefore, in many countries, insurers need to operate via locally regulated and authorised subsidiaries or via permanent establishments, which often have to hold assets to back potential claims to policyholders in regulated ringfenced funds. However, such separation is commercially problematic and intra-group reinsurance is used to counter those problems.

11 Part IV, paragraph 69, of 2010 OECD Report on the Attribution of Profits to Permanent Establishments
The first risk in the insurance supply chain that an insurance company takes on is by definition from an independent third party; however, many groups manage their risks and capital via a programme of internal and external reinsurance contracts. There is no distinction from a regulatory perspective between internal and external reinsurance and the same requirements must be met from a risk transfer perspective in order to obtain the capital benefit from the reinsurance. There is a real impact to the cedant and the reinsurer in terms of de-risking and diversification.

The commercial drivers for insurers and reinsurers are exactly the same for intra-group reinsurance, namely to manage capital and solvency requirements more effectively and reduce earnings volatility. These drivers apply equally to intra-country reinsurance and cross-border reinsurance. However both the group and consumers may derive further commercial benefits from internal reinsurance.

By centralising capital the group and consumers will benefit from:

- **Lower capital requirements and hence higher Return on Equity** – the diversification of risk via intra-group reinsurance reduces the total capital the insurance group needs to hold as the combined underlying risks have a reduced aggregate payout in a stress (i.e. large loss) scenario. This avoids a reduction in Return on Equity that would deter investors.

- **Flexibility of capital use** - reinsuring business is usually faster and cheaper than carrying out a full legal transfer of business around the group, especially cross-border, which:
  - avoids the need to put excess capital into jurisdictions where it is difficult to remove at a later date and
  - allows groups to write insurance in locations where political or economic instability would otherwise make investing unattractive.

- **Improved liquidity** - reinsurance gives groups the ability to move cash around the group to where it is needed (via premiums) or raise funds (for example through the securitisation of a particular book of business which can be assembled via reinsurance), ensuring funds exist to pay claims following large losses, and also reducing third party borrowing.

- **Reducing localised problems** - the group as a whole can write business that the local insurance company does not want to keep on its books, e.g. due to risk concentration levels in a subsidiary or insufficient capital, and centralise risks to achieve balance and diversification of risk.

- **Centres of excellence** - by concentrating one line of business in one location, groups can develop teams with deep expertise in particular types of risk, and by sharing information from different transactions, the group can build valuable commercial information.

- **Improved bargaining power** with external reinsurers - by bundling risks the group does not want to keep into one larger package, the group is able to more effectively structure its reinsurance coverage and negotiate a better price from an external reinsurer.

These features promote competition in the market by allowing insurers to write business at lower premium levels, which drives down prices for consumers. They also mean that insurance groups are better able to manage their capital and liquidity, so they are more likely to have the financial strength to pay claims even after unusually high levels of loss. By making insurance more reliable, affordable and available to the widest possible market, more consumers can benefit from the financial stability offered by insurance and from lower premium rates.
Regulators will review internal reinsurance contracts, often prior to inception, to ensure that the terms and conditions, often including the price, and the credit-worthiness of the reinsurer are sufficient to ensure that the policyholders are protected, and not adversely impacted by the reinsurance. If regulators do not permit the reinsurance treaty to be factored into the determination of solvency capital or claims reserves for the insurer, then the insurer does not obtain the required capital benefit.

Internal reinsurance contracts are required by transfer pricing rules to be on the same terms and conditions as external reinsurance contracts, and take the same legal form (please refer to Annex B for examples). Existing transfer pricing guidelines already require that a ‘purported allocation of risk is consistent with the economic substance of the transaction’ for a controlled transaction; if the contractual risk is not consistent with the economic substance, tax authorities may challenge or disregard the transaction, which protects tax authorities from artificial transfers of risks between group entities.

In addition to existing transfer pricing guidance, the new transfer pricing documentation guidelines which will be adopted as part of the BEPS project (Action 13) will give tax authorities an increased amount of information with which to assess transfer pricing risks. For example, the Local File will require groups to set out explicitly the amounts a local entity has paid or received for each category of controlled transactions, along with copies of material intercompany agreements. The Country-by-Country template will show tax authorities how profits and losses are spread across jurisdictions, and how these figures relate to tax paid and capital. With these tools, tax authorities will be able to ensure that profits and losses arising in each jurisdiction are aligned with economic activity and value creation.

**Conclusion**

Insurance and reinsurance transactions, whether internal or external, are governed by regulators and are genuine, legitimate transactions. Regulators set rules about who can write insurance, what reserves and capital must be held, and (in some cases) what governance and other processes an insurer must have, and these rules encompass the effective use of reinsurance.

For insurers (including reinsurers), the decision to assume insurance risk is the KERT function, as it is this decision that puts capital at risk, though this function can be performed by a relatively small number of appropriately qualified staff. Existing transfer pricing guidance ensures that in an internal reinsurance contract, groups should be able to demonstrate that there are:

- Clear commercial benefits (such as capital benefits)
- Real transfers of risk
- Appropriate staff making the decision to assume insurance risk in the territory.

Providing these criteria are satisfied, intra-group reinsurance contracts perform the same role as external reinsurance contracts, and should be priced in the same way, i.e. that residual profits and

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Paragraph 1.48, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, dated July 2010
losses are returned to the KERT function/capital provider after remunerating other functions (such as brokers or sales agents), as there is simply no other party that bears the insurance losses.

There is a strong incentive not to hold too much capital. If an insurer cannot earn an acceptable return on capital (e.g. by expanding into new markets or writing new lines of business) it will often return the capital to shareholders. Being over-capitalised means that the insurer will not be able to earn an acceptable return on capital, which will damage its ability to attract and retain investors.
Insurance groups must hold sufficient regulatory capital to cover the risk of their assets not being sufficient to cover their insurance liabilities. Capital adequacy standards define the amount of capital which an insurance company must hold and detail the characteristics which regulatory capital must meet in order to qualify as such. Debt instruments, which form an integral part of the regulatory capital of insurers, have certain equity-like features (relating to loss absorbency and interest deferral) which are mandated by regulators for the protection of policyholders. This means that these debt instruments can fall within some definitions of a hybrid instrument for tax purposes. However, these equity-like features which are mandated by legislation are not designed to give a tax mismatch and are essential in supporting the trading operations of the insurance industry.

The Solvency II Directive\(^\text{13}\) codifies and harmonises insurance regulation in the EU and is scheduled to come into effect on 1 January 2016. Capital adequacy standards will become more stringent under Solvency II for EU (re)insurance companies, to reduce the risk of insolvency. The regime is intended to be more sophisticated and risk sensitive than the current insurance regulatory regime.

Under Solvency II, the required regulatory capital of an insurance company is be divided into 3 'tiers'\(^\text{14}\) (Tier 1 to Tier 3) based on both its 'permanence' and its 'loss absorbency' characteristics. The “tier” of capital in which an instrument falls will be determined by factors such as its quality, liquidity, duration, permanence and the obligations of the insurer under its terms to pay distributions or interest. Tier 1 is the capital of the highest quality and the majority of an insurer’s regulatory capital must be Tier 1 capital. The majority of regulatory debt instruments are designed to fall within either Tier 1 or Tier 2.

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\(^{13}\) 2009/138/EC

\(^{14}\) Under Solvency II, the regulatory capital of an insurer is called ‘own funds’. However, the term “regulatory capital” is used in this paper. The requirements for the “tiers” of capital apply equally to insurance companies and the “regulated” EU holding company.
Solvency II sets limits on the amount of Tier 1, Tier 2 and Tier 3 capital that can be held to cover an insurance company’s capital requirements, to ensure that the insurer has sufficient capital to absorb any losses that might arise. As with all companies, there is an optimum capital structure under which insurance companies aim to operate. Although more expensive than senior debt, regulatory debt instruments are significantly cheaper than equity. Using too much equity increases the overall cost of capital while using too much debt increases the risk profile of the business due to the obligation on the business to service the debt.

**Purpose of Capital Requirements under Solvency II**

The regulation of insurance companies is similar in principle to that of the banking sector. The solvency capital requirement of an insurer has the following purposes:

- To reduce the risk that an insurer would be unable to meet any claims;
- To reduce the losses suffered by policyholders in the event that a firm is unable to meet all claims fully;
- To provide an early warning to supervisors so that they can intervene promptly if an insurer’s capital falls below the required level; and
- To promote confidence in the financial stability of the insurance sector.

Under Solvency II, there are two principle capital requirements of an insurer.

- The main capital requirement is the Solvency Capital Requirement (“SCR”). The SCR is the capital required to ensure that the (re)insurance company will be able to meet its obligations over the next 12 months with a probability of at least 99.5%.
- In addition to the SCR capital, a Minimum Capital Requirement (“MCR”) must be calculated which represents the threshold below which the national insurance regulator would intervene. The MCR is intended to correspond to an 85% probability of adequacy over a one year period.

The limits for capital instruments covering the MCR are the most restrictive. The MCR must be made up of Tier 1 and Tier 2 capital only and at least 80% of the capital used to cover the MCR must be Tier 1 capital. For the SCR, at least 50% per cent of the capital making up the SCR must be Tier 1.

It is also expected that at least 80% of Tier 1 items should be “unrestricted” Tier 1; with no more than 20% being “restricted” Tier 1. Tier 2 can be up to 50% and Tier 3 can be no more than 15% of eligible capital. If the limit for one tier is exceeded, the item may still be capable of being counted in a lower tier (i.e. restricted tier 1 capital may count as Tier 2 capital if the 20% cap is reached).

In practice, (re)insurance companies will hold an additional capital “buffer” over and above the MCR and SCR for prudence (and this is generally required in practice by insurance regulators and the rating agencies). For supervisory purposes, the SCR and MCR act as regulatory triggers. The insurance regulator would intervene once the capital holding of the (re)insurance company (or
holding company) falls below the SCR, with the intervention becoming progressively more intense as the amount of regulatory capital held approaches the MCR.

The Solvency II capital requirements apply equally to each active insurance company in a group of companies and also to the ultimate EU holding company of an insurance group. Each insurance entity and group holding company must hold sufficient regulatory capital which meets the Solvency II capital requirements. Where the parent company of a group of companies is located outside of the EU, the Solvency II requirements will apply to the “top” EU holding company.

The Solvency II Directive provides regional supervisors with a number of discretions to address breaches of the MCR, including the withdrawal of authorisation from selling new insurance business and, in extreme cases, the winding up of the company.

**Detailed requirements for regulatory capital instruments**

It is a requirement under Solvency II that all capital instruments should not:

- rank before policyholder or non-subordinated creditors on insolvency;
- include encumbrances or connected transactions (e.g. guarantees or reciprocal financing arrangements);
- pay distributions/coupons whilst in breach of the SCR; and
- be redeemed without prior approval by the insurance regulator.

Under Solvency II, regulatory capital instruments must be “loss absorbing” on an ongoing and/or on a winding up basis. The ability of an instrument to permanently absorb losses on a “going concern” basis or only in the event of a winding up (a “gone” concern) is key in determining which tier of capital an instrument will fall within. It is also a requirement that such instruments should not include terms which could cause or accelerate the insurer’s insolvency. The rules also have duration requirements which apply to each ‘tier’ of capital in order to satisfy the permanence requirements. In addition, insurers need to ensure that the duration of instruments is consistent with the duration of their liabilities. The detailed implications of these requirements for the tiers of capital are as follows:

**Tier 1**

Tier 1 capital instruments include ordinary share capital, non-cumulative preference shares and certain sub-ordinated liabilities. All distributions on Tier 1 items must be cancelled in the event of a breach of the SCR and repayment of principal must be suspended. Preference shares and subordinated debt are subject to the ‘loss absorption’ requirement (described below) which could involve writing-off all amounts owed by the insurer to the holders of the instruments. Under Solvency II, “unrestricted” Tier 1 capital must make up at least 80% of total Tier 1 funds. Unrestricted Tier 1 will be made up of ordinary shares plus share premium. It will also include surplus funds meeting the full requirements for subordination and permanence.
“Restricted” Tier 1 items include paid in subordinated preference shares and certain subordinated liabilities. This type of capital is limited to a maximum of 20% of the Tier 1 capital of an insurer.

The 'Tier 1' loss absorption requirement applies where:

- where an insurer holds less than 75% of its SCR;
- where it breaches its MCR; or
- where it breaches its SCR for more than 3 months.

In these circumstances, there must be an automatic writing down of the liability of the insurer (principal and dividend/coupon), a conversion to ordinary shares or use of an 'equivalent mechanism' (i.e. similar to writing down or conversion).

**Tier 2**
Tier 2 'capital' is likely to include cumulative preference shares, and sub-ordinated liabilities with a shorter duration. Unlike Tier 1 instruments, the principal need not be written down or converted following a serious breach of the solvency requirements. Tier 2 may therefore also include shares or long term debt which does not comply with the loss absorption requirement described above. All distributions on Tier 2 shares must be suspended following a breach of the SCR whereas coupon and other amounts owing on debt and capital instruments must be cancelled. Therefore, debt to be included within Tier 2 can encompass both debt with hybrid characteristics (though of shorter duration that Tier 1 instruments) as well as other sub-ordinated liabilities.

**Tier 3**
Tier 3 capital is all capital items which do not satisfy the Tier 1 or Tier 2 requirements. Tier 3 items must have an original maturity of at least 3 years and need only suspend distributions (not interest/coupons on debt) on breach of the MCR (and not the SCR). However, breach of the SCR would still trigger a suspension of repayment of principal amounts. Certain net deferred tax assets also count towards Tier 3 capital.

**Incentives to redeem**
Tier 1 and Tier 2 capital can only be redeemed at the option of the insurer. Tier 1 items cannot include incentives to redeem. Tier 2 own funds may include 'limited' incentives to redeem provided this does not happen in the first 10 years. Tier 3 instruments can be redeemed by either party after 3 years. All redemptions, conversions and exchanges of all capital instruments require the prior approval of the supervisor.
Reinsurance is a form of insurance coverage intended for insurance providers, and can be provided by other insurers or specialist reinsurers. Reinsurance business is subject to regulation in the same way that insurance business is, and can be provided by third parties or by other insurance group members. Policies can be of a number of types:

### Facultative Coverage

This type of policy protects an insurance provider only for an individual, or specified risk, or contract. If there are several risks or contracts that needed to be reinsured, terms for each one must be negotiated separately, therefore this type of reinsurance is administratively intensive and tends to be used for single large risks. The reinsurer has the right to accept or deny a facultative reinsurance proposal.

Facultative coverage can be:

- **Proportional**: the reinsurer assumes a share of all claims relating to the risk, regardless of the amount, or
- **Non-proportional**: the reinsurer pays claims above a certain amount retained by the insurer.

**Example:**

An insured ship has a collision and makes a claim for 100m.

<table>
<thead>
<tr>
<th>Type of Contract</th>
<th>Proportional: 40% cessation (i.e. reinsurer pays 40% of any claim, insurer pays 60%)</th>
<th>Non-proportional: Net retention of 20m (i.e. insurer retains 20m of any claim, reinsurer pays the remainder)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurer pays</td>
<td>60m</td>
<td>20m</td>
</tr>
<tr>
<td>Reinsurer pays</td>
<td>40m</td>
<td>80m</td>
</tr>
</tbody>
</table>
Facultative coverage is often documented with a ‘cover note’ which sets out essential information such as the parties to the contract, the amounts and risks reinsured, and premium amounts. Apart from the cover note, the rest of the terms are often undocumented, and parties rely on common reinsurance custom and usage to govern the contract.

**Treaty coverage**

Unlike a facultative policy, which reinsures a single risk, a reinsurance treaty covers a variety of risks. Under a reinsurance treaty, an insurer must cede all risks that fall within the treaty, and a reinsurer must accept all ceded business. A treaty is generally set up for a year, and can cover a particular line of business (for example cargo) or cover a wider range (for example all aviation lines), or even cover the whole book of business an insurer writes in a year (called ‘whole account’).

Like facultative policies, reinsurance treaties can be proportional or non-proportional. There are a couple of well-known types of each:

- **Proportional**- where the reinsurer assumes a share of all claims relating to the risk, regardless of the amount. This can include
  - Quota share treaties, where the reinsurer takes a percentage of premiums (usually less a commission to the insurer) and pays the same percentage of claims
  - Surplus treaties, where the reinsurer takes a set amount of business written by the insurer in excess of what they wish to retain for themselves; premiums will vary by the level of risk inherent in the reinsured business (e.g. higher premiums for assumption of higher risks)

- **Non-proportional**- where the reinsurer pays claims above a certain amount retained by the insurer, the insurer can be certain about what its maximum losses can be. The insurer must pay a premium to the reinsurer even if no claims are made. These treaties can include
  - Excess of loss treaties, where the reinsurer pays claims in excess of those retained by the insurer on a particular line of business or a particular event
  - Stop loss treaties, where the reinsurer reimburses the insurer when an insurer’s overall losses reach a certain amount
Example of an Excess of Loss (‘XL’) stack

An insurer might purchase a ‘stack’ of XL treaties to cover losses (i.e. claims) from earthquake risk as illustrated below:

An insurer may do this to provide additional protection against very large losses and it is likely that purchasing a number of reinsurance policies with different levels of cover will be cheaper than purchasing a single reinsurance contract from one reinsurer. This is because a claim would only be made against Z if an unusually large loss arises and this low probability would be reflected in the premium pricing.

If earthquake claims are 2800, they will be paid as follows:

<table>
<thead>
<tr>
<th>Insurer Pays</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurer</td>
<td>500</td>
</tr>
<tr>
<td>X</td>
<td>500</td>
</tr>
<tr>
<td>Y</td>
<td>1000</td>
</tr>
<tr>
<td>Z</td>
<td>800</td>
</tr>
</tbody>
</table>
OECD Discussion Draft under BEPS Action 3 on Strengthening CFC rules (the “Discussion Draft”)

We welcome the opportunity to comment on the OECD’s discussion draft on strengthening CFC rules, as issued on 3 April 2015. We are pleased to contribute our comments below.

Before offering our comments on the respective chapters of the Discussion Draft, we would first like to take the opportunity to provide some general observations on the document as a whole.

First of all, it is not clear from the Discussion Draft how the work under Action 3 is being co-ordinated with the other relevant Actions (e.g. anti-hybrid rules, transfer pricing rules etc) as part of a holistic reconciliation. We recommend that any further Action 3 analysis takes into account the extent to which measures resulting from other Actions might affect policy decisions about CFC rules, and further clarity around this interaction and the expected timing of the various outputs would also be welcomed.

Additionally, the breadth of recommendations included within the Discussion Draft provides tax authorities with significant scope to interpret and implement CFC rules in many differing forms. A wide variation of CFC regimes would only serve to add significant complexity and uncertainty to already complicated sets of CFC rules, with an associated increase in administrative and compliance burden for taxpayers. Consideration should therefore be given as to the precise final output of the Action 3 deliverable i.e. whether it is to represent a minimum standard for countries to adopt or specific recommendations/best practice guidelines.

General comments on Policy Considerations

Whilst there are not any specific questions on this section within the Discussion Draft we would like to take the opportunity to provide comments on some of the points raised.

We strongly support targeted, substance-based CFC rules, developed alongside other relevant BEPS Actions, which contain suitably targeted entity level exemptions that can be applied with sufficient flexibility in order to strike the right balance between preventing tax avoidance in the parent country and limiting the administrative and compliance burden associated with operating such rules in practice.

We consider that the recommendations made under Action 3 should focus purely on preventing base erosion and profit shifting from the parent jurisdiction which, as a result, leads to double non-taxation that cannot be taxed under the parent jurisdiction’s transfer pricing rules. In this way, a parent jurisdiction’s CFC and Transfer Pricing regimes complement each other in a coherent manner.
Other policy considerations, such as foreign-to-foreign stripping, should be outside the scope of these recommendations on the basis that there are other, superior, and directly effective targeted methods of protecting source countries from BEPS which should be addressed in the work on the other relevant BEPS Actions (e.g. Actions 8-10 and Action 2 respectively). Accordingly, we do not think it is necessary for a parent company’s CFC rules to target foreign-to-foreign stripping in order to supplement, or even replace, its own transfer pricing rules.

In addition, the risk of double (or triple) taxation is greater where CFC rules target both foreign-to-foreign and parent jurisdiction stripping rather than only parent jurisdiction stripping that causes double non-taxation. For example, if the CFC country, parent country and source country each claim taxing rights to the same item of profit, the determination of which country has the primary taxing rights and how the double tax relief rules operate would be difficult to manage in practice.

We strongly support the development of a single global common standard for a ‘BEPS compliant’ CFC regime, which has a sufficient degree of flexibility to deal with a particular parent jurisdiction’s economy and tax system as well as, for example, EU law. The adoption of materially different CFC regimes – such as one for EU territories and one for Rest of World territories, or one for parent territories with worldwide tax systems vs territorial tax systems - would be unduly complex and extremely burdensome.

Furthermore, we would not support a primary CFC rule combined with a secondary rule which introduced a form of taxation in a third jurisdiction where there is insufficient CFC taxation in the parent country. Such a regime would be very complex and incredibly difficult to operate. In addition, it may not result in a fair allocation of the CFC’s profits to the respective country where the value-creating activities occur.

**General comments on Definition of a CFC**

We agree in principle with the recommendation to include non-corporate transparent entities, which are either owned by a CFC or treated in the parent country as taxable entities separate from their owners, within the definition of a CFC. This will, however, result in additional complexity and increase the compliance burden for taxpayers.

From a practical perspective, the re-determination of a transparent entity’s profits under the parent jurisdiction’s rules may not be straightforward therefore detailed deeming rules would be required in order to ensure the correct calculation of profits for CFC purposes.

Furthermore, as an example, a partnership is not a taxpayer itself; the respective partners each pay tax on their share of the partnership profits. Consideration would therefore need to be given as to how credit for tax paid would be given, particularly in cases where that tax is paid in a third territory.

**General comments on Threshold Requirements**

We agree that the principle of using a low-tax threshold based on an effective tax rate (“ETR”) calculation, and a benchmark of 75% or less of the statutory corporate tax of the parent jurisdiction seems sensible.
From a practical viewpoint, the main challenge of adopting an ETR approach is that it requires the profits of a CFC to be calculated under the parent company’s tax rules, which necessitates adjustments by the parent company to locally prepared accounting and tax return information potentially across a number of entities. In a group the size of AZ, this would create a significant compliance burden if we were required to undertake this calculation for every foreign entity to determine whether or not it was a potential CFC.

In order to mitigate this burden, and enable companies to allocate resources appropriately, we would support the inclusion of targeted entity level exemptions including but not limited to:

i) a de minimis exemption, supplemented with an anti-fragmentation rule, for CFCs with low income as based on financial statements prepared under an acceptable accounting practice;
ii) an exemption, such as a white list, for CFCs located in territories which meet specified high-tax criteria; and
iii) a main purpose test (whilst noting that this is not considered further in the Discussion Draft) which provides for an exemption where the avoidance of parent jurisdiction tax is not one of the main purposes of arrangements associated with the CFC.

Additionally, the CFC rules should have a sufficient degree of flexibility such that companies can pragmatically apply the exemptions in order of preference or appropriateness to simplify the administrative process, rather than following mandatory steps for low value, low risk CFCs which will be excluded in the final analysis. The UK’s existing CFC rules allow this approach and this is welcome as it enables companies to focus their resources accordingly.

Consideration should also be given to the impact of timing differences and the variation between parent country and CFC country tax rules on the calculation of a CFC’s ETR. In order to smooth the effect of timing differences the inclusion of the option to use, for example, a 3 year rolling average ETR and/or a grace period for a CFC’s first year with an ETR below the threshold is recommended.

We also recommend that consideration should be given as to whether, in order to simplify the process, any leverage could be gained from the information that will be required to be provided following implementation of the country-by-country reporting obligations being developed under Action 13.

**General comments on Definition of Control**

We support a legal and economic control test where residents of a parent country hold more than 50% control.

A supplementary de facto control test based on a subjective assessment of facts and circumstances would only serve to increase complexity and costs and would appear to be unnecessary if the legal and economic tests are robust.

With regard to determining whether minority shareholders are acting together to control a CFC, we consider that an ‘acting in concert’ test would pose a significant administrative and compliance burden as it requires a fact based analysis. Therefore, in our view, the test
should be where the shareholders are related parties, or where the shareholders hold a minimum percentage interest in the CFC.

**General comments on Definition of CFC Income**

We agree that Action 3 should focus on narrowly targeted partial inclusion rules that only attribute income that raises BEPS concerns. On the basis that we consider that CFC rules should only apply to parent jurisdiction stripping, it is our view that CFC rules should not attribute income to a parent country that arises from value-creating activity in either the CFC territory or any source/third territory.

We agree that a method of substance analysis is more appropriate in the modern business environment than that of a form-based analysis. It is also necessary in order to comply with existing EU law.

Each of the 3 proposed substance analyses has their relative merits and disadvantages. The substantial contribution analysis is the more objective, however, it could be over (or under) inclusive and therefore not well aligned with the focus of BEPS. The remaining options are better targeted at BEPS, however, we have a concern that these options provide scope for tax authorities to substitute their own more formulaic view as to the location of value creation. Additionally, the viable independent entity analysis presumes that multinational businesses can and do operate on a standalone basis in each country whereas, in practice, many are now increasingly integrated such that it may be difficult to satisfy this requirement. We would recommend that, as is the case under the UK’s rules, companies should be able to obtain advanced clearance from their respective tax authority in order to obtain certainty of treatment should this be desired.

We strongly prefer a categorical approach over an excess profits approach to determine the CFC profits that should be apportioned to the parent country.

With regard to the categorical approach, we consider that the default treatment of dividend, interest, royalty and IP income as passive is only a reasonable starting point provided there are adequate exclusions available to reclassify such income as active where the value creation is outside the parent country.

However, we consider that there is a risk of significant over-inclusion, additional complexity and therefore increased compliance burden where sales and services income is treated as passive if it includes any IP derived income, unless the CFC is engaged in substantial local activities (including the development of the IP) required to earn the income. We would recommend that, as an alternative approach which is adopted under the existing UK CFC rules, sales and services income should be treated as active unless it is derived from a related party in the parent company territory and arises to a CFC which has insufficient substance and resources located or managed in the CFC country to manage its income generating activities.

We strongly disagree with the excess profits approach and consider that it should not be included within the OECD’s recommendations. As a more mechanical approach, it is over-inclusive and therefore not necessarily focussed on BEPS. Additionally, it does not provide any principles as to where income is actually created and where profits should belong. Without a substance-based exclusion, this approach may include income arising from
genuine economic activity of the CFC and where the CFC has sufficient substance in its own territory, which conflicts with BEPS principles.

We believe that the excess profits approach is unduly complex and would create a significant compliance burden in order to operate in practice. As an example, we feel that it would be very difficult to quantify a ‘normal return’ that is appropriate for a very broad range of fact patterns across the entire business population and which reflects year-on-year business fluctuations within a particular group.

We also consider that the ‘excess return’ may pick up income that is stripped from a third country to the CFC. Such cases should be dealt with by applying robust transfer pricing rules, and this approach risks overriding such established principles. Accordingly, we consider that transfer pricing rules should apply in priority. We therefore recommend that the interaction of this approach with the work being carried out as part of Actions 8 to 10 is considered.

If the excess profits approach was targeted at specific income, such as IP income only, then (in addition to the comments made above regarding a required substance exemption and the prioritisation of transfer pricing rules), we consider that the definition of ‘eligible equity’ should include expensed off-balance sheet IP.

Furthermore, we consider that the rules should only apply to IP which has been transferred to the CFC within a relevant period, such as the ten years preceding the accounting period in question, as any period of time much greater than this can cause significant administrative burden and unreliable conclusions to be drawn in the absence of appropriate company records etc.

We support a transactional approach to determine whether or not a particular stream of CFC income is potentially attributable under the categorical approach. To ease the compliance burden for parent countries, we recommend that a threshold requirement is considered to ensure that active CFCs which happen to have an incidental amount, say 5% of the CFC’s income, of passive income are not treated as CFCs in respect of that income.

**General comments on Rules for Computing Income**

We agree with the recommendations that:

i) The tax rules of the parent country should apply to determine attributable CFC income;  
ii) CFC losses may be used against profits of the CFC or other CFC’s in the same jurisdiction (however, please refer to comments below with regard to utilisation of CFC losses in the parent country);  
iii) The parent company’s losses may be used against attributable CFC profits; and  
iv) CFC losses may be carried forward or backwards for use against profits within ii) and iii) above.

We note that it would be difficult to justify the offset of CFC losses against the profits of the parent company in the situation where those losses arise as part of arrangements to artificially divert profits from the parent. However, we consider that the rules should not prevent the offset of other losses arising to a CFC against the profits of its parent company, effectively mirroring the treatment at recommendation iii) above.
General comments on Rules for Attributing Income

We agree with the recommendations that:

i) The attribution threshold should be tied to the minimum control threshold;

ii) The amount of income to be attributed should be calculated by reference to both a shareholder’s proportion of ownership and actual period of ownership;

iii) Parent countries can determine when CFC income should be included and how it should be treated in the tax return such that it is coherent with domestic provisions; and

iv) The tax rate of the parent jurisdiction should be applied to the CFC income (however, please refer to comments below with regard to applicability of incentive rates e.g. patent box).

We do, however, consider that detailed rules will need to be developed to address the mechanics and tax implications of the attribution of CFC income where the CFC is held indirectly through a number of foreign intermediate entities – whether direct apportionment or deemed dividend flowing through the chain.

Furthermore, we recommend that consideration be given to the ability of parent companies to apply incentive tax rates (such as the patent box) to relevant attributable CFC income, where such income would have qualified for the reduced rate had it been generated in the parent country, and therefore the reduced rate would have been ‘the rate that would apply to the parent company in the parent jurisdiction’. The interaction with the work being carried out under Action 5 should therefore be considered.

General comments on Rules to Prevent or Eliminate Double Taxation

We strongly believe that taxpayers should not be taxed more than once on the same item of profit. Therefore, CFC rules need to contain a mechanism to eliminate double taxation.

We agree with the recommendation that the parent jurisdiction should give credit relief for foreign taxes paid in the CFC territory and foreign CFC charges paid by intermediate companies on the same CFC income.

However, where there are intermediate companies we consider that the recommended rule which assigns priority CFC taxation rights to the shareholder closest to the CFC should not be compulsory; rather this intermediate territory should have the option to give credit relief for CFC charges in the ultimate parent company on the same income. This ensures that the CFC charge resides in the parent country, which aligns with the concept that BEPS should focus only on shifting from the parent jurisdiction.

In general, we feel that significantly more guidance should be provided in relation to the mechanics of an effective system of double tax relief, perhaps taking into account the experience of countries with worldwide tax systems with credit relief rules.

We appreciate the opportunity to contribute to the discussion on Action 3 and would be willing to offer any other assistance or further explanation of the above as required.
Yours sincerely

Ian Brimicombe
Vice President Corporate Finance
AstraZeneca
May 1, 2015

BEPS Action 3 Discussion Draft (“Strengthening CFC Rules”)

Comments by the Banking and Finance Company Working Group on BEPS

Introduction and summary

These comments are being submitted to the OECD by the Banking and Finance Company Working Group on Base Erosion and Profit Shifting (BEPS) 1, a group of global banks and finance companies, in response to the public Discussion Draft released on 3 April 2015 by the OECD entitled “BEPS Action 3: Strengthening CFC Rules” (the Draft).

The Draft proposes “building blocks” for constructing CFC rules in the form of draft recommendations. But the OECD also acknowledges that critical areas lack consensus, particularly relating to defining CFC income, so that Chapter 5, regarding the definition of CFC income, contains options relating to different types of income, including dividends, interest and other financing income, and sales and services income. The Working Group has several recommendations relating to the building blocks or basic framework for constructing CFC rules. But more importantly, some of the observations and options in Chapter 5 raise particular concerns for regulated global financial institutions.

We welcome the statements in paragraphs 85, 86, and 98-101 of the Draft that income earned by a CFC in the course of an active business, including an active financing or securities dealing business, does not give rise to BEPS concerns and

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1 The Banking and Finance Company Working Group is comprised of members of the Securities Industry and Financial Markets Association (including Citigroup, T.D. Bank, JPMorgan Chase & Co., Bank of America, State Street, BNY Mellon, and Goldman Sachs), Barclays, and General Electric and American Express. The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to develop policies and practices which strengthen financial markets and which encourage capital availability, job creation and economic growth while building trust and confidence in the financial industry. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information and a complete list of SIFMA members, visit www.sifma.org
therefore should not be included in the CFC income that is attributed to controlling shareholders under CFC rules.

It is critically important that the OECD develop a practical and realistic ‘best practices’ approach to defining an active financing or securities business that recognizes the important role of the substantial and evolving post-financial crisis regulatory environment. This submission discusses such an approach, based on the regulated nature of global financial services groups and their CFCs, which we believe should be embodied in the analysis as to whether the CFC has adequate substance to be engaged in the active banking, financing or broker dealer business. If such a substance test is met, a CFC’s income should be treated as having been earned in its banking, financing, or broker dealer business and should not be subject to CFC inclusion.

We note that the Draft does not reflect a consensus of the Working Party 11 delegates regarding several issues. Because CFC rules should inherently be tailored based on the home country’s domestic tax law, a “best practices” approach is the course the OECD should take under this Action. The Draft also discusses the special constraints that EU law places on EU member states in designing CFC rules. This raises the question of whether the OECD will recommend different “best practices” regarding CFCs for EU countries, on the one hand, and non-EU countries, on the other hand. In our view, this would be a mistake, insofar as it could result in competitive advantages or disadvantages depending on whether a company is headquartered in an EU member state or elsewhere. Any “best practice” recommendations should, therefore, be the same for all OECD and G20 countries.

**Definition of a CFC and the treatment of branches**

The Draft recommends an extremely broad definition of the entities to which CFC rules should apply, including certain Permanent Establishments (PEs). The draft acknowledges that CFC rules should not apply to entities that are taxed currently by the home jurisdiction. However, the Draft suggests that branches whose income is not taxed currently by the home jurisdiction potentially should be treated as CFCs under an exemption system.

Banks are one of the few industries that continue to operate through true branches. The distinguishing characteristic of a true branch is that it is an integrated and interdependent part of a larger corporation. This integration has real and meaningful business, financial and regulatory consequences that create
fundamental differences (wholly apart from the differences in tax treatment) between true branches and subsidiaries. Therefore, a key design issue for countries implementing an international tax regime that partially or fully exempts foreign-source income is whether the income of true branches of home country entities should be treated as exempt. This is not a BEPS issue; some countries in adopting exemption systems have opted to exempt income of branches and some have not.

Taxation of foreign branch income should be dealt with under the home-country tax rules regarding exemption of foreign-source income. There is no need for CFC rules to come into play in this regard. The integrated and interdependent nature of a true branch makes it very difficult to apply CFC rules to such an entity. That is precisely why there is no globally consistent standard among exemption systems for applying CFC rules (or income tax rules generally) to foreign branches, and why it makes more sense to address the tax treatment of branches through each country’s own rules relating to the design of an exemption system itself.

Among other key issues, determining the taxable income of the branch can be extremely difficult when local country banking regulators do not require banking branches to have their own capital (which is the case in many jurisdictions). Countries have not adopted consistent tax rules for allocating group-wide regulatory capital to a branch in these cases, despite the recommendations in the OECD’s 2010 paper relating to the attribution of profit to a PE.

**Threshold requirements**

The Draft recommends in paragraph 43 a low-tax threshold requirement to limit the application of CFC rules in those situations in which there is little risk of BEPS. Specifically, the Draft indicates in paragraph 56 that CFC rules should only apply when the effective tax rate (ETR) of the CFC is less than 75% of the home country tax rate. This low-tax threshold raises several concerns that suggest such a threshold warrants further consideration.

Due to the relatively high U.S. tax rate, the low-tax threshold effectively would mean that CFC rules would apply to subsidiaries operating in many jurisdictions in the OECD and G20 where the subsidiaries in question are serving local customers in the course of an active business carried on locally. The threshold thus would not act as a meaningful filter limiting the application of CFC rules to low-taxed entities giving rise to BEPS concerns.
Therefore, the OECD should consider recommending a “white list” of countries that could act as an override to the low-tax threshold. Alternatively, the OECD should consider using a lower percentage for the low-tax threshold (e.g., 50% of the home-country tax rate).

The Working Group appreciates the acknowledgment in the Draft that calculating a CFC’s effective tax rate using the CFC’s home country tax regime as a base could cause anomalies in the ETR calculation. We believe these anomalies could be quite severe and could cause entities operating in relatively high-tax jurisdictions to be pushed into a CFC regime due to business losses that arise in several years but that are not accommodated by an ETR calculation or due to timing differences between the local country tax regime and the home country tax regime. This is a significant issue for many companies and thus requires further consideration before an ETR-based test could be implemented.

**Definition of CFC income – Substance analysis**

Chapter 5 of the Draft discusses in paragraphs 89-94 the use of a substance analysis to determine whether a CFC earned its income from its own substantial activities. In our view, such an analysis is the key element in determining whether a banking, financing, or similar business that earns a substantial portion of its income in the form of interest and/or dividends should be subject to CFC rules.

The nature of the financial services industry’s business and the existing and evolving regulatory requirements surrounding capital and risk provide considerable safeguards against the concerns that are driving BEPS Action 3. Regulators closely monitor financial institutions’ activities and closely monitor the capitalization and leverage ratios of each material entity, whether or not it is a regulated entity. Regulators also monitor the transfer of equity or equity-like capital to foreign subsidiaries. The ability, if any, to capitalize an entity in a low tax foreign jurisdiction that might not have actual customer functions but that is utilized to fund operating entities in other jurisdictions is very limited. All material funding structures are monitored and questioned by home country regulators. Financial groups are also restricted in their ability to recognize income in an entity that does not in substance conduct the business that generates the income.

Regulators are imposing new capital standards, including mandates on the amount of capital and loss-absorbing debt and on how that additional capital and certain other loss-absorbing instruments should be positioned at the holding company...
level and in affiliates. A key focus here is the potential resolution of a regulated financial services group in the event of another serious financial crisis, and the ability of a parent company to access capital immediately. These new rules will create additional capital requirements, and will impose further restrictions on where global financial institutions must maintain capital, including certain types of debt.

Given that financial regulations typically require a licensed financial services entity to have qualified staff as well as adequate capital to support its business, we believe that a licensed entity should normally satisfy either a substantial-contribution analysis or an employees-and-establishment analysis, and thus should not be within the scope of CFC rules.

We recommend, therefore, that a CFC whose parent is subject to prudential regulation by its home country banking regulator and that itself has a banking license and thus is subject to home country and local country regulation and capital requirements should be presumptively viewed as meeting a substance test and therefore should not be considered within the scope of CFC rules. Such a test would operate as an all or nothing test, and we believe the regulatory requirements that now apply to global banks, broker dealers and finance companies justify this type of approach.

Of the three options discussed in this section of the Draft, either the substantial contribution approach or the employees-and-establishment approach would be preferable, as a policy matter, to the use of the viable independent entity approach, which would involve a high degree of uncertainty (“Whether or not profits are included in CFC income depends on the balance of activities between entities and how unrelated parties would have been most likely to allocate assets and risks.”). This risk of uncertainty is acknowledged in paragraph 92 of the Draft (“The main disadvantage is that [the viable independent entity analysis] requires a fact-intensive analysis involving an element of judgment, which would increase administrative complexity and compliance costs and may lead to uncertainty.”)

Both the substantial contribution approach and the employees and establishment approach refer to local employees, either of the CFC or the CFC jurisdiction. It is common business practice for multinational enterprises to employ staff through specific employing entities or service companies, so a CFC’s staff may be legally employed by another company, possibly in another territory, with their services provided to the CFC under a service arrangement. Any assessment of the
employees of a CFC or a CFC territory needs to include employees provided under
genuine service arrangements.

**Definition of CFC income - Interest and other financing income**

The Working Group believes, as recommended above, that a banking, financing or
similar business that meets a prudential regulation test should not also have to meet
tests that qualify particular types of income. In paragraphs 100 and 101 of Chapter
5, the Draft raises several troubling issues for regulated financial institutions. The
Draft suggests that interest and other financing income should be within the scope
of CFC rules unless “the CFC was in the active trade or business of banking or
financing and it was not overcapitalized.” The Draft notes that such a rule would
require the application of one of the three substance requirement options identified
in the draft in order to determine whether the CFC was in fact engaged in activities
required to earn the financing income. We believe we have addressed this analysis
in our recommendation, above. However, this recommended approach should be
supplemented by allowing the taxpayer alternative substance approaches in order
to confirm the existence of an active financial trade or business if the entity is not
subject to home country prudential and local country regulation.

The Draft goes on to require some method of determining whether the CFC was
overcapitalized, a test that would not have to be applied if the “all or nothing” test
we recommend above is met.

As an initial matter, it should be understood that most global banking groups and
finance company groups are relatively highly taxed. The ability of regulated banks
and finance companies to use BEPS strategies is limited by the fact that the
business is inherently a local business serving local customers, and that financial
regulation makes it difficult to separate risk and capital functions.

We do not believe that an overcapitalization test is advisable for determining
whether CFC rules should apply to interest and other financing income of a CFC
engaged in an active financing business. The use of a necessarily subjective
overcapitalization test is a disproportionate response to the perceived problem the
Draft seeks to address given all the regulation, including layers of new, post-
financial crisis regulation, that exists at both the home country and local country
level, and other safeguards that prevent banks from inappropriately capitalizing
CFCs. Specifically, such a test is not advisable because:
Current regulatory and capital requirements imposed on global banks by home country regulators reflect the home country regulators’ desire to have as little capital as possible “stranded” in foreign affiliates. Overcapitalization of a foreign affiliate is simply not a practical concern under post-financial crisis banking regulation. Determining whether a subsidiary is overcapitalized would be subjective -- there is no accurate measure for tax purposes that could be consistent with capital requirements imposed by the regulators. The Draft references the UK’s overcapitalization standard, but this standard is actually a safe harbor rather than a definitive test for determining whether CFC rules should apply to such entities.

As a business matter, banks and finance companies engaged in active business aim to make the most efficient use of capital, which is an expensive, carefully managed resource. The cost of holding more capital than necessary to support an active financing business cannot be justified from a business perspective. Moreover, if the subsidiary is fully engaged in an active financing business, its capital will be deployed in that activity and the profits earned will be attributable to the CFC and not to its parent.

Finally, such a CFC rule would effectively mandate a capitalization standard for non-home country subsidiaries that would not apply to locally based banks that are subject to local banking regulatory and capitalization requirements. Thus, such a rule would create a competitiveness issue for global banks seeking to compete in local markets.

**Definition of CFC income – Excess profits approach**

We have several comments regarding this section of the draft. First and foremost, we do not believe that an attribution approach is necessary if the OECD adopts our recommendations relating to determining the substance of an active bank, broker dealer or financing entity, above.

Moreover, we do not favor the excess profits approach for determining the attributable income of a CFC when such determination is necessary. This approach requires the determination of a “normal return” as discussed in paragraphs 122-125 of the Draft, which is a novel and extremely uncertain concept. Consequently, we believe that the answer to question #18 on page 53 of the Draft is that the categorical approach is more likely to accurately attribute income that gives rise to BEPS concerns.

It appears that the excess profits approach is aimed at CFCs earning high returns related to intellectual property. IP does not play an important role in the earning of
financial services income. Therefore it is difficult to see how an excess profits approach could be sensibly used in relation to CFCs engaged in the provision of financial services.

**Control**

Economic tests of control need to recognize that, on occasion, a bank which is party to an arm’s length transaction with a third party customer may inadvertently meet economic tests of control. For example, a bank may have advanced a loan to a borrower, and that borrower may subsequently have financial difficulties due to an unexpected downturn in its business. An economic test of control which, for example, focuses on the entitlement to assets on a winding up might determine that technically the bank has economic control of the borrower at that point in time. Such economic interests, which arise only as a result of a normal financial services transaction between third parties in the ordinary course of the bank’s business, should be ignored in determining whether there is control for CFC purposes.

**Secondary rule**

On page 3 of the Draft, the OECD notes that some countries have proposed a “secondary rule” that would apply to income of a CFC when CFC rules in the home country of the CFC’s parent company do not impose sufficient home-country tax on the income. It is noted that Working Party 6 is considering options for special measures under Action Items 8-10 that could operate as such a secondary rule.

The Working Group is very concerned about the proposal to have a secondary rule allowing source countries to impose tax on a CFC’s income in the event that the income is not taxed in the parent country’s jurisdiction under CFC rules of that jurisdiction. In the absence of more details regarding the proposal, it is difficult to provide a specific critique, but as a concept it strikes us as a radical departure from international income tax norms. The Working Group submitted comments on the OECD’s discussion draft regarding the transfer pricing aspects of risk and capital under Action Items 8-10. In those comments, we expressed our concerns about the special measures options described in that discussion draft. We urge the OECD to adhere to international norms of taxation such as the arm’s length principle, rather than introducing novel concepts that may have unintended consequences (such as increased double taxation) and produce unnecessary compliance burdens for taxpayers.
Conclusion

We would be happy to work with the OECD on evaluating any BEPS risks in the banking and finance sector that are identified in the future and on developing appropriately targeted rules to address any such specific concerns. In the specific context of Action 3 and the development of CFC rules, we believe that a substance analysis based on the regulated status of both the parent company and the local business entity should determine whether CFC rules should be applied to banking, broker dealer, and finance entities.
Public Discussion Draft dated April 3, 2015
BEPS Action 3: Strengthening CFC Rules
Comments on the consultation document

Dear Mr. Pross,

We appreciate the opportunity to provide the OECD with comments on the Discussion Draft on Action 3 “Strengthening CFC Rules” as published on April 3, 2015.

BASF is a multinational group operating in more than 80 countries with business activities comprising 14 operating divisions and almost 400 production sites and with high volumes of complex transaction flows within the group, including several joint ventures with third parties.

Generally, we support the OECD BEPS initiative related to CFC rules with the intended goal to avoid abusive shifting of income to affiliates located in low-tax countries.

The Discussion Draft on Action Point 3 at its current state indicates that the OECD’s BEPS initiative has broadened its scope in comparison to what was aimed to achieve with it in the beginning. It does not limit its recommendations to what is needed to avoid artificial shifts of profits to where little or no economic activities are performed, but rather appears to be a “catch-all” for income which has not been caught by other measures. An implementation of the other BEPS Action Plan recommendations would mean that there is no need to issue such a broad range of recommendations regarding CFC rules. We recommend to reconsider narrowing the scope of recommendations on CFC rules to comply with the original objective aimed at artificial shifts of profits.
Our comments focus on the most fundamental issues of the Discussion Draft and are subdivided into general comments on the scope of the measures, EU considerations and specific statements on selected aspects.

1. General comments

According to the OECD the BEPS project aims at the prevention of artificial shifts of profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. With the proposed set of tools the Action Points are supposed to deliver it shall be ensured that profits are taxed where economic activities generating profits are performed and where value is created. CFC rules are intended to counter tax avoidance by the artificial transfer of profits from the country in which they were generated to a low-tax jurisdiction by means of the establishment of a subsidiary in that country. This intention – to counter tax avoidance by the artificial transfer of profits – should be the focus of the OECDs recommendations. Instead, the Discussion Draft seems to be based on a significant number of (contradictory) objectives and political considerations. Considering the differing tax systems in different countries it appears to be impossible to provide recommendations that meet the above objective without extending the scope substantially and without imposing an avoidable administrative and compliance burden on tax authorities and tax payers.

The OECD’s goal to maintain competitiveness by implementing similar CFC rules in more countries ignores the fact that the desired impact only occurs to the extent that there are no fundamental differences in the underlying tax systems which is not the case. If for example the competitive advantage granted to US based MNCs by a deferral of non-US income was considered to be BEPS, it would be doubtful that harmonized CFC rules applying to all jurisdictions may effectively improve competitiveness in that respect.

Even assuming that similar CFC rules with a broader scope would be implemented in more countries, the effectiveness of these rules is not only based on the qualification of a CFC with harmful income but mainly depends on the applicable tax rates. However, it is agreed that the BEPS initiative is not targeting the fair competition between countries based on different tax rates. Therefore, setting a respective income tax rate continues to be a measure for countries to attract and encourage investment. According to the recommendation in the Discussion Draft a harmful low taxation should be determined based on a certain percentage of the tax theoretically paid in the parent jurisdiction. However, this correlation of tax rates set by the parent jurisdiction and the potential CFC jurisdiction should per se lead to a kind of ‘market balance’ (as it already does today) irrespective of the harmonization of the CFC rules. We thereby recommend to narrow the scope of CFC rules to abusive shifting. This implies a significantly lower tax rate than the parental companies should be applied as definition for low taxation. And it means a limitation to such income that is generated by activities generated by wholly artificial structures.

Combining the recommendations on Action Item 3 with a ‘secondary rule’ in order to include low taxed income not covered by CFC rules in the parent company’s jurisdiction in the tax base of another jurisdiction contradicts the objective of BEPS and would include income only because of the applicable low tax rate. CFC rules should therefore not be supplemented by a secondary rule. Furthermore, substance in the low taxing country should be sufficient to prove that such in principle mobile activities have not been transferred in an artificial manner.
In summary, the OECD recommendations may impose a substantial administrative and compliance burden on both tax payers and authorities ignoring that CFC rules need to align with the basic principles of different tax systems to be effective in dealing with BEPS. The impacts of amended harmonized CFC rules considering the rather limited intersection between the different tax systems may be limited as well. Therefore, it is crucial to evaluate the breakeven of the administrative costs vs. the impact in combating abusive tax structures before issuing final OECD recommendations. The OECD should accurately take care that CFC rules do not degenerate into a catch tray taxing low taxed parts of income that have not already been caught by other BEPS measures (in particular hybrid mismatch rules and transfer pricing).

2. EU considerations

We appreciate that the Working Party is aware that CFC rules within EU Member States have to comply with EU law. However, in our opinion EU law requires more restrictions than the Discussion Draft acknowledges. Since the Cadbury Schweppes decision of the ECJ it is without doubt that the prevention of abusive practices is not sufficient to justify a breach of the freedom of establishment. CFC rules can only be in accordance with the freedom of establishment where they cover wholly artificial arrangements aimed at circumventing the legislation of the respective state in a proportionate manner. CFC rules cannot be applied in cases where a CFC is actually established in the host Member State and carries on genuine economic activities there, even if the establishment is tax motivated. Premises, staff and equipment are indicators of genuine economic activities. With the help of these pillars CFC rules in EU Member States have to be designed in so far as they apply to CFCs in other EU Member States. In case the participation threshold is too low to fall under the scope of the freedom of establishment those limitations are valid as well for CFCs in non EU Member States.

In contrast to what the Discussion Draft suggests it is no alternative for EU Member States to apply CFC rules to domestic subsidiaries as well. Either the rules would as a matter of fact not be applicable in domestic cases as low taxation would never arise which contradicts the fundamental freedoms of EU law. Or - if low taxation is not taken into consideration for the application of CFC rules - this would lead to a complete change of national tax principles as subsidiaries would depending on their kind of income either be subject to tax or taxed transparently. The administrative burdens for both taxpayers and tax administration would be unbearable.

Neither the inclusion of “partly wholly artificial” transactions/income nor the balanced allocation of taxing powers as sole justification reason lead to lower EU law requirements for CFC rules. The balanced allocation of taxing powers is by itself not sufficient to justify a breach of the freedom of establishment. It has only been considered by the ECJ in conjunction with the need to prevent tax avoidance and/or the need to prevent that losses will be taken into account twice. It is unclear what partly purely artificial shall mean in the context of CFC rules. Even if one of these reasons could be sufficient as a justification this would not permit to apply CFC rules more broadly. Still the CFC rules would have to be applied in a proportionate manner in relation to the objective of the rules. They cannot go beyond what is necessary to achieve that purpose which leads to the same requirements that are to be applied as regards the prevention of tax avoidance by wholly artificial transactions.

EU law therefore brings more limitations to CFC rules than the Discussion Draft recognizes:

- The proportionality has to be preserved by allowing the taxpayer to prove the substance of a transaction. This is the central aspect to design CFC rules in accordance with EU law.
• The tax rate that defines low taxation has to be considerably lower than the tax rate in the parental jurisdiction in order to hit only artificial circumventions.
• The level of standardization of the excessive profits approach is not suitable to limit the scope of CFC rules to artificial behavior.
• Only such income can be subject of artificial avoidance which is mobile and therefore easy to transfer. CFC rules have to be limited in their scope to cover only such categories of income.
• The CFC rules would go beyond what is necessary to prevent artificial arrangements aimed at circumventing the legislation if the avoidance of double taxation is not secured.

As a certain degree of harmonization and standardization is one of the objectives of Action Point 3 the restrictions of EU law should be used to mark the maximum scope of CFC rules. This would not only avoid that non-EU Member States with a broader scope suffer from a competitive disadvantage but would also help to restrict the CFC rules to cases of artificial tax avoidance schemes and therefore to focus on the original purpose of the OECD’s BEPS initiative. To define the lowest common denominator even other countries regulatory limits have to be taken into account such as the US Subpart F provisions.

3. Specific comments

3.1. Chapter 2: DEFINITION OF A CFC

According to the OECD recommendation, a payment should be included in CFC income to the extent the parent jurisdiction would have included this payment if the parent jurisdiction had classified the entities and arrangements in the same way as the payer or payee jurisdiction (see example in Para 39). We are concerned about the application of such recommendation in practice. In the first place this would mean that tax administrations in the parent jurisdiction need to have knowledge about the tax systems of not only their own country, but also about the tax systems in two or even more other countries involved. This in itself appears to be an unrealistic expectation of, and burden on, the tax administrations (or the tax payer in jurisdictions where the burden of proof lies initially with the tax payer). Secondly, according to Chapter 6 ‘Rules for Computing Income’ the rules of the parent jurisdiction should apply when calculating the respective CFC income. This is contrary to the approach in Chapter 2 (partly) importing the classification of entities of third countries leading to a mixed approach when calculating potential CFC income. Furthermore, it is not clear how this would impact the calculation of the effective tax rate for CFC purposes which is also based on the income computation according to the tax law of the parent jurisdiction. We believe that a consistent approach referring to the parent jurisdiction’s tax law when calculating the income and the effective tax rate should also include the entity classification according to respective tax law.

However, if the OECD sticks to the imported entity classification a narrow approach would be preferred, i.e. an inclusion into CFC income should only apply to the extent a payment is deductible in one jurisdiction and subject to no or low taxation in the jurisdiction of the receipt. Otherwise, if a deduction was denied e.g. due to thin cap rules and the nil or low taxed income of the recipient was still included into CFC income, this would lead to or at least increase an already existing double taxation.
3.2. Chapter 3: THRESHOLD REQUIREMENTS

We support the approach of the OECD to determine 'low taxation' based on a certain percentage of the tax that would have been paid in the parent jurisdiction. However, it needs to be ensured that only income taxes in the parent jurisdiction that allow a foreign CFC tax credit are considered in this calculation. Otherwise CFC rules lead to double taxation as currently the case in Germany.

Example:
- CFC income in the amount of 100 was originally taxed in the low tax jurisdiction at a rate of 24%
- CFC income of 100 is included in the German tax base and therefore taxed at 30%
- However, the foreign tax credit is limited to 15% (German corporate income tax rate)
  → Overall effective tax rate: 39%, i.e. double taxation in the amount of 9.

We further agree that CFC income should only be considered 'low taxed' if the tax rate is meaningfully lower than the tax rate in the country applying the CFC rules. The Discussion Draft states that most CFC rules apply benchmarks that are the most 75% of the statutory tax rate. However, in order to better reflect CFC rules as anti-abuse measures the benchmark could be set lower. Compared to other anti-abuse rules in different jurisdictions a percentage of 50%-60% seems to be reasonable (e.g. France: non-deductibility of expenses if the corresponding income is taxed in the hands of the foreign recipient at 50% or less of the expected French taxation; Art. 28 Para 5 of the US-German Double Tax Treaty: triangular provision within the limitation on benefits clause allowing the source jurisdiction to levy withholding tax on deductible payments if the corresponding income is taxed at less than 60% of the expected taxation in the country of the recipient).

3.3. Chapter 5: DEFINITION OF CFC INCOME

The definition of CFC income seems to be one of the most important parts when it comes to accuracy and to practical application of CFC rules. We are concerned that the discussion draft does not include recommendations yet but only discusses several possible options with respect to the definition of CFC income.

However, please find the following general comments with respect to the different options:

- With respect to the different substance tests it is crucial that the final recommendations are in line with the ECJ case law. We refer to our comments provided above under section 2.
- The OECD seems to prefer a broad definition of passive income in the categorical approach. However, we are concerned that this broad approach leads to an unnecessary additional administrative burden for taxpayers. Instead of a broad definition of passive income allowing the taxpayer to proof the contrary it should be the function of the OECD and the legislative bodies to precisely differentiate between clearly active income (without additional requirements) and potentially passive income still allowing the tax payer an escape by a substance test.
In particular, it remains unclear to what extent the distinction between sales and services income and IP income shall be eliminated. We believe that sales and service income should generally be treated as active income unless certain thresholds are breached or related party transactions are concerned. Furthermore, dividends of distributed passive income should have already been included in CFC income when generated and therefore, dividends should be considered active income.

Considering the key objective of the OECD recommendations being the mitigation of BEPS the excess profits approach seems to be significantly off target. Besides the fact that the excess profits approach would put a tremendous administrative and compliance burden on taxpayers to determine the fundamentals of the calculations it would unavoidably include income into CFC taxation that has little relation to abusive tax planning with artificial structures. We therefore object against the excess profits approach.

3.4. Chapter 6: RULES FOR COMPUTING INCOME

We support the OECD recommendation to compute CFC income based on the rules of the parent jurisdiction. However, to reduce an additional administrative burden as well as in order to mitigate the risk of double taxation any income (actual or deemed) arising within a foreign tax group with a corresponding expense (actual or deemed) within the same foreign tax group should not give rise to CFC income as an abusive shift of profits can be excluded in such cases.

3.5. Chapter 8: RULES TO PREVENT OR ELIMINATE DOUBLE TAXATION

In addition to the risk of double taxation mentioned above related to Chapter 2 and Chapter 3, a tax credit systems in the country applying CFC rules should allow a tax credit without limitation to item, country or fiscal year to mitigate the risk of double taxation. Furthermore, a double taxation could arise in cases where CFC income is taxed in the parent jurisdiction whereas the corresponding expense is considered non-deductible in the country of the payee (e.g. based on thin cap rules or due to anti-abuse rules). A general escape clause should enable taxpayers to avoid a double or multiple taxation in these cases.

We hope that our comments are useful. Please feel free to contact us with any questions you may have on the above.

Yours sincerely,

BASF SE

Eva Brücher Alexander Just
Dear Mr. Pross,

BDI\(^1\) refers to the OECD Discussion Draft “Strengthening CFC Rules (BEPS Action 3)” issued on 3 April 2015. We would like to thank you for the possibility to provide our comments that allow us to engage with you on these important issues. We focus our feedback on the most fundamental issues raised in the draft.

**General comments**

*Need for a Clear Policy Objective*

Chapter 1 of the Draft discusses several policy considerations which according to the Draft must be considered in order to develop recommendations for CFC rules. However, we believe that the Draft lacks a clearly articulated policy objective, which would be essential for the development of coherent, targeted and proportionate tax standards. On the contrary, the Draft at present reads as an attempt to satisfy multiple competing objectives and differing views of Member States. This results in a “toolkit”, a set of complicated and at times conflicting proposals. Also, even if political consensus over a minimum standard would be reached, there would still be a much more detailed analytical framework so that countries can actually understand which rules would be most appropriate for them, and how such rules should be implemented. Finally, given the fundamental differences in national tax systems, even a harmonized im-

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\(^{1}\) BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 36 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.
plementation of CFC rules throughout the G20/OECD countries would result in significant discrepancies.

Transfer Pricing vs. CFC rules: Lack of Coordination

We believe that some of the proposed rules are coming close to transfer pricing rules. However, in our view well drafted Transfer Pricing guidance should be capable of realigning profits with substance (which is one of the primary objectives of the BEPS Action Plan) and thus there would be no need for additional rules (and associated compliance burdens). We believe that both set of rules need be kept apart. Both have a different conceptual core and they are certainly not complementary. The relevance of CFC rules should not be reduced to a mechanism for (secondary) adjustments in cases where transfer pricing rules are inapplicable. We would appreciate a more fundamental discussion of the purpose of CFC rules. Furthermore, we see a risk of double taxation going along with changing the character of CFC rules into a methodological supplement of transfer pricing rules. CFC income is included on a current basis. However, transfer pricing adjustments often take place later in time e.g. in the course of a tax audit. Hence, if one purpose of CFC rules is to capture any mispricing of intercompany transactions but this mispricing will be adjusted due to transfer pricing rules in later tax audit as well, this will lead to a double taxation.

Against this background we fear that overly broad rules could also implicatie commercial transactions with appropriate substance, simply because the tax rate is low compared to the parent country.

Furthermore, besides the overlap with Action 8-10 (transfer pricing), we are concerned about the lack of interaction and coordination with other Action Items, especially Action 2 (hybrid mismatch arrangements), Action Item 4 (interest deductions) and Action Item 5 (countering harmful tax practices). In general, we perceive an overlap and also a confusion between many of these proposals and Action Item 3.

“Secondary rules”

We are 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 Items 8-10. We are extremely troubled that deliberations on possible “secondary rules” in connection with CFC rules are dealt with outside the scope of the Discussion Draft. Also, we are concerned that such a proposal would allocate taxing rights purely based on the level of taxation imposed in a particular country and thus run counter to the original intention of the BEPS Action Plan. If these proposals are taken forward it needs to be
ensured that there will also be an opportunity to comment for stakeholders.

"CFC Minimum Standard": Risk of Treaty Override

If the OECD is going to deliver a „minimum standard“ of common CFC rules to be implemented in all countries the question arises of how to deal with possible treaty overrides that would most certainly occur. The Draft offers no further guidance on how the OECD or the countries respectively would be expected to deal with this situation.

Specific comments

Chapter 3: Threshold Requirements

A low tax threshold based on an effective tax rate causes significant problems, such as:

- Administrative/compliance burden: The computation of the effective tax rate based on the rules of the parent/shareholders country (or according to an international accounting standard such as IFRS) would give rise to additional administrative and compliance burden since reconciliation is needed for adjustments between the Tax GAAP of the CFC and either the Tax GAAP of the parent/shareholder or IFRS.

- Low taxation due to differences in the Tax GAAP Rules: Further, an effective high tax CFC – based on the local Tax GAAP rules – can be deemed low taxed just as a consequence that the effective tax rate is calculated according to the Tax GAAP rules of the parent/shareholders country or according to IFRS. By way of example, the following elements are causing problems for the computation of the effective tax rate and could lead to an inclusion of income that should actually not be captured by CFC rules:

  - Timing differences in depreciations for assets between CFC-jurisdiction and parent jurisdiction
  - Different periods for the tax effectiveness of accruals and related costs (for example in connection with actions against parent and CFC company)
  - Different periods for tax loss carry backs and tax loss carry forwards
  - Technical tax exemptions, which lead to deferrals (for example in connection with restructurings)
  - Different definitions of tax groups with the consequence that a transaction in a tax group in the CFC jurisdiction would be disregarded (consolidated for tax reasons) but not disregarded in the parent jurisdiction
- General costs have to be allocated when CFC-rules apply only to a stream of income

- Transfer price corrections lead to lower or higher profits in later years

Therefore we believe that only tax free or non deductible income with a permanent effect should be considered for the computation of the effective tax rate according to the definition of the low tax threshold.

- Collection/Availability of data: Further, depending on the design of the level of control, the calculation of the effective tax rate based in the rules might be problematic in certain cases. E.g. if the proposed threshold requirement of more than 50% control in a CFC also applies if the aggregated amount of shareholdings exceeds the 50% threshold. In such a case an (unrelated) minority shareholder would face the problem that access to the detailed general ledger data and other financial data of the CFC, which is however required to reconcile CFCs financial/tax figures to the local Tax GAAP rules of the shareholders for the calculation of the effective tax rate, might be restricted.

These problems could be mitigated if control would be deemed only in cases if one resident shareholder – together with resident related parties – owns more than 50% of the shareholding in the CFC.

With regard to the situation of permanent establishments that are subject to a different tax rate than CFCs it is important to note the Authorized OECD Approach (AOA) for the income allocation to a permanent establishment as proposed by the OECD. Hence, there is already a common rule available for the computation of the effective tax rate. In the context of harmonizing rules the AOA should be used for the computation of the effective tax rate of a permanent establishment. According to the AOA principles – treating a permanent establishment as a separate entity – we agree that the effective tax rate of permanent establishments should be calculated separately from that of the CFC to ensure that the tax rate of the PE and CFC cannot be blended to avoid the low-tax threshold.

Chapter 4: Definition of Control

Practical problems that arise when applying a control test would be:

- Guidance on the definition of “economic control”: We generally agree that the type of control should cover a legal and economic test. However, CFC rules should provide guidance on how economic control can be objectively assessed. Further guidance is needed on how economic control impacts the level of control; i.e. what level of economic control should represent the respective level of control in percentages for the determination of the “more than 50% threshold”?
• More of 50% of related parties only: We further agree that only situations should be captured by CFC rules if resident taxpayers – excluding unrelated parties – have legal or economic interest in the CFC of more than 50%. Only with a certain degree of control the taxpayer would be able to shift profits into low tax jurisdictions and would be in a position to retrieve all further requested data/information necessary to determine whether the taxpayer has to include CFC income in its tax base or not.

• Lack of information for the economic control test: With regard to interests held by unrelated or non-resident parties there would be a lack of information. As regards the legal control test, public information should be available. However, in respect to the economic control or de facto control test, an unrelated party would not be in a position to retrieve the respective information that are needed for the determination of the required level of economic control.

Chapter 5: Definition of CFC Income

General comments

As set out in the note for consultation this chapter 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 whole system of CFC rules. We are concerned that the Draft in this regard reflects a very early stage of discussions between countries with many different views as to how to best proceed with this point. Chapter 5 seems to be nowhere near a political consensus, with a menu of options for individual domestic issues instead of recommendations being the most likely result. With regard to the different approaches to defining CFC income and the individual options pointed out in the Draft we are worried that it is not entirely clear how these different rules are meant to interact. We therefore believe that clearly more technical guidance is needed, even if countries should agree on common recommendations in the 2015 report on Action Item 3, as envisaged in the introductory note for consultation.

Also, as already pointed out above, the mixture of transfer pricing rules and CFC rules is critical. The amalgamation of CFC rules and transfer pricing rules is inappropriate, as ‘at arm’s length’ is not a synonym for ‘active’ and ‘not at arm’s length’ not for ‘passive’, respectively. For example, a CFC whose transfer pricing is inappropriate (according to the arm’s length principle) may well be ‘active’ for CFC purposes (et vice versa). Both attributes – arm’s length and active (and their respective complements) – might come to the same conclusion, but this is not true in any constellation. Consequently, the required substance of a CFC should not be measured against the appropriateness of its transfer prices.
We are concerned that especially the proposals made on the different forms of substance analyses do not conform to EU law requirements. As already indicated by the Discussion Draft EU Member States would need to modify the suggestions made in order to bring them in line with ECJ jurisdiction. Following the ECJ in its case C-196/04 - Cadbury Schweppes the purpose of preventing tax avoidance may only be justified if it specifically relates to wholly artificial arrangements that do not reflect any economic activity. CFC legislation must ensure that the CFC rules are not applied if the incorporation of a subsidiary reflects economic reality; i.e. the extent to which the CFC exists in terms of premises, staff, and equipment. Hence, CFC rules must allow the taxpayer to produce evidence that the CFC is actually established and that its activities are genuine. We believe that none of the substance tests suggested by the Draft is actually limited to the “wholly artificial” criterion and therefore, as it stands, would hardly be in line with EU law requirements.

Further, other ECJ judgements suggested by the Draft as possible justifications for not restricting tax provisions to wholly artificial arrangements (e.g. C-311/08 - SGI, and C-231/05 – Oy AA) did not especially refer to CFC rules. It would be highly questionable whether they could be reliably consulted in a CFC context.

**Possible Forms of Substance Analyses**

Stated that we believe that none of the substance tests proposed would *per se* be in line with EU law requirements, we would nevertheless point out the following aspects:

**Viable independent entity analysis**

- General remark: Regarding the three ‘general approaches to defining CFC income’ as presented in Chapter 5, Subsection I. (substantial contribution analysis, viable independent entity analysis and employees and establishment analysis), we consider the viable independent entity analysis as the most critical one. Under this approach, the substance of a CFC would be linked to its functions, risks and assets, but this CFC would only be regarded to have ‘active’ income if it performs the ‘significant functions’ following the Authorized OECD Approach (par. 89, second bullet in conjunction with par. 92, second bullet). Hence, the viable independent entity analysis is an attempt to adopt transfer pricing allocation rules, as proposed under action item 8-10 of the OECD/G20’s action plan, for testing the substance/activity level of a CFC. It should be widely acknowledged, however, that both sets of rules have completely different conceptual backgrounds.

- Practical problems: Significant functions are a too strict indicator for activity. Apart from these rather conceptual considerations, the viable

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2 Discussion Draft, paragraph 13.
independent entity analysis appears overly strict in its practical application, especially for those CFCs which are receiving IP income. The issue is that only the IP-owner (-s) of a group, i.e. those entity (-ies) which are managing and controlling the development, enhancement, maintenance, protection, and exploitation of intangibles (Par. 89), could demonstrate the required substance/activity, while all other entities could not. To show the rigidity of this approach by referring to this ‘significant functions’, it may be assumed that a group is consisting of one single IP-owner and several hundred distributors. Due the reference to the ‘significant functions’ or ‘key functions’ the viable independent entity analysis would reclassify all distributors, namely non-IP-owners, into ‘passive’ entities, which is obviously not in line with modern business reality, as a participation of all group entities to all ‘significant functions’ connected to an intangible (e.g. development) is simply impossible and should not be required. Even if the viable independent analysis would be applied as a ‘proportionate test’ (instead of a ‘threshold test’) this negative consequence could not be mitigated significantly. Although we certainly agree that some kind of activity needs to be performed, we believe that the ‘significant functions’ requirement is a too strict indicator for the activity level of a CFC.

Substantial contribution analysis

- Missing guidance: With regard to the substantial contribution analysis, the reader of the Draft is missing a clear definition of the term ‘substantial contribution’.

Categorical vs. Excess Profits Approach

The categorical approach has some disadvantages as mentioned in the Discussion Draft, e.g. more administrative and compliance burden, but the problems arising from it should not be more difficult to deal with than in many already existing CFC systems. Therefore, we believe that a categorical approach to attributing income is preferable to an excess profits approach. In general, we welcome 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”\(^3\). It is important to strike the balance between this objective and the risk of over-inclusion. This means not to include income when the CFC engaged in substance.

Also, with regard to dividend income, there is a risk of double taxation that needs to be tackled. According to the Discussion Draft dividends should be treated as passive income unless the dividends were paid out of

\(^3\) Discussion Draft, paragraph 16.
active income or if the CFC is in the active trade or business of dealing in securities (par. 98, 112).

- Majority shareholding: However, from our perspective, dividend income should be active income in any case since dividends are either (i) paid out of passive income but the passive income will be subject to inclusion at the shareholders level on a current basis, or (ii) dividends are paid out of active income which is not captured by CFC rules at all. Hence, if dividends are paid out of passive income and the passive income was subject to CFC taxation already a further qualification of dividend income as CFC income will lead to double taxation. This applies to shareholding structures where on each shareholder level there is a majority shareholding available.

- Minority shareholding: In case the CFC holds a minority shareholding in a subsidiary which is distributing its profits it might be not in a position to collect the necessary information to determine whether the dividend was paid out of active or passive income. Hence, CFC rules should only apply if there is a majority shareholding (> 50%) at each chain available.

If, however, dividend income would nevertheless be generally treated as passive as suggested by the Draft, there must be an effective way of addressing the risk of double taxation. This means that crediting the taxes paid must fully and effectively be ensured in the jurisdiction of the parent company (see also below, Comments on Chapter 8).

With regard to sales and services income the Draft shows concerns that profits are shifted into a low tax CFC country where the goods are sold, IP is exploited and the services are provided to which the CFC has added little or no value, but a high profit margin might remain in the CFC country. Such a result must be tackled by way of transfer pricing rules instead of CFC rules. If an unreasonable high margin remains in the CFC country considering the risks and functions of the CFC, then the transfer price set for the purchase of goods or IP is not assessed correctly. Hence, such issues must be solved via transfer pricing rules.

In general, we do not agree with the proposed rule which is to “treat all sales, services, royalty, and other IP income as passive unless the CFC had engaged in the substantial activities required to earn the income” (par. 110 etc.). If CFC rules are to be appropriately targeted, we believe it is essential to recognise that not all IP income is passive in nature. IP can often have a relatively short life and requires significant on-going cost and active management to continuously maintain, update and replace it. We are concerned that, if income from sales, services and IP are to be conflated and assumed passive, that this could substantially increase the compliance burden faced by taxpayers in situations that do not represent a BEPS risk. More targeted proposals would be welcomed, to better include BEPS related income.

We oppose the excessive profits approach. The complexity of an excess profits approach obviously lies in the determination of the several parameters of the calculation formula, i.e. ‘normal return’, ‘rate of return’, ‘eli-
gible equity’, which are, by nature, highly disputable. 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. Also, it is not clear how fluctuations in the market would be considered appropriately by assessing the correct rate of return. In cases where a consensus between the involved fiscal authorities cannot be reached, double taxation risks for the taxpayers might occur.

Further, we agree 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 (e.g. especially with regard to intangibles). The excess profits approach therefore would not only target BEPS situations. According to the BEPS Action Plan no or low taxation is not per se a cause of concern, but it 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. Also, it would cause a high degree of legal uncertainty.

Chapter 7: Rules for Attributing Income

Difficulties that arise under existing CFC provisions for attributing income arise for example with regard to the aggregation of shareholdings. Pursuant to different CFC rules (also the German) any CFC income will be included in the tax base of the resident taxpayer if the aggregated amount of shares or the voting rights in the CFC exceed 50%. This means that CFC taxation will be triggered even if the aggregate amount of voting rights of unrelated parties exceed the 50% threshold. The determination whether in total more than 50% of voting rights in the CFC owned by unrelated resident shareholders are fulfilled might cause problems due to a lack of information about the level of control of the other unrelated party (see also above, Chapter 3).

Chapter 8: Rules to Prevent or Eliminate Double Taxation

Preventing double taxation is a very important issue. It therefore needs to be ensured that the national credit potential is high enough to actually and effectively avoid double taxation. This means that the CFC tax rate must be lower than the countries nominal corporation tax rate. For the same reason of eliminating double taxation effectively we believe that countries should refrain from any limitation of the creditable amount, such as per year or per country limitations.

Please do not hesitate to contact us if you have any questions.

Sincerely,
ACTION 3: Strengthen CFC rules - Comments

Dear Dr. Pross,

We, the undersigned, refer to the OECD Public Discussion Draft "BEPS Action 3: Strengthening CFC Rules" issued on 3 April 2015. We welcome the opportunity to comment and to support your consultative development approach.

The comment letter represents the view of the undersigned which work for BEITEN BURKHARDT. BEITEN BURKHARDT is a corporate law firm founded in Germany and operates worldwide, with a range of expertise that covers all areas of commercial law relevant to our clients, including listed companies, large medium-sized companies, multinational corporations, the public sector and foundations.

We understand that the OECD has and will receive several comments on this and other public discussion drafts. Therefore, we have decided to comment on selected question for consultation.

1. Chapter 3: Threshold requirements (Questions 4 and 5)

1.1. General

At first, we support the OECD approach that the low-tax threshold should use a tax rate that is meaningfully lower than the tax rate in the country applying the CFC rules.

A higher tax rate would not be consistent with the drafted policy considerations of CFC rules. The drafted policy considerations include the recommendation that CFC rules are designed
to prevent taxpayers from shifting income into CFCs.\footnote{OECD, Public Discussion Draft "BEPS Action 3: Strengthening CFC Rules", issued on 3 April 2015, Chapter 1, point IV.} If the domestic tax rate is below the foreign tax rate, the taxpayer has not an incentive to shift the income to the foreign corporation.

As described in point 56 of the Public Discussion Draft "BEPS Action 3: Strengthening CFC Rules" issued on April 3 April 2015, the German CFC rules define the level of taxation below 25 \% as low taxation. We would like to add some comments to the description of the draft:

The German business income taxes for corporations consist of the corporate income tax ("CIT", 15 \%), the solidarity surcharge ("SO", 5.5 \% of the CIT) and the trade tax ("TT", 7 - 17.15\%). As a result, the minimum aggregated tax rate amounts to 22.83\%. The German CFC rules could cover non-profit shifting cases since a tax payer has not an incentive to shift income to a foreign corporation in case of a tax rate between the German minimum aggregated tax rate and the level of taxation below 25 \%.

Therefore, among constitutional concerns and concerns based on European law, the described German low-tax threshold does not fulfill the drafted OECD approach and the drafted policy considerations.

\textbf{Petition:} We would appreciate if BEPS Action 3 maintains its opinion that low-tax threshold should use a tax rate that is meaningfully lower than the tax rate in the country applying the CFC rules.

1.2. Group taxation systems

According to the prevailing opinion in German tax expert literature, the determination of the effective tax rate also includes taxes paid within a group taxation system.

We support and recommend this approach since it is not relevant for the avoidance of profit-shifting which (legal) person is obligated to pay the taxes on the foreign income. A group of corporations would only have an incentive to shift income if the total tax burden in a profit-shifting scenario is below the total tax burden in a scenario where no profit shifting is applied. Therefore, the determination of the effective tax rate on foreign income should take into consideration the tax effects of a group taxation system.

\textbf{Petition:} We would appreciate if BEPS Action 3 clarifies that tax effects of a group taxation system shall be considered for the determination of the effective tax rate.
2. Chapter 8: Rules to prevent or eliminate double taxation – Issues with respect to relief for foreign corporate taxes (Question 28)

2.1. General

We support the OECD approach to prevent or eliminate double taxation with the tax credit method. In most cases, it is favourable to set off the foreign tax against residence tax but the deduction method could be advantageous in case of an excess foreign tax credit. The basic German tax principle is to deduct the foreign tax from the attributed CFC income ("deduction method"). Alternatively, the taxpayer is entitled to apply for the credit method.

2.2. Excess foreign tax credit: Limited scope of the credit method

There is one double taxation issue in Germany resulting from the scope of the credit method.

It is controversially discussed in Germany whether the attributed CFC income is subject to TT and whether the domestic corporation is entitled to credit the foreign taxes against the TT. We have decided to restrict our statements on this issue.

The attributed CFC income is subject to CIT and TT but the credit method is not applicable to TT. In other words, the attributed CFC income increases the TT but it is not possible to credit the foreign taxes against the TT. As a consequence, it is not possible to credit foreign taxes against all German business taxes if the effective foreign tax is above 15 % and below 25 %. Corporations which own only German subsidiaries ("domestic case") could be in a better tax position than corporations owning foreign subsidiaries.

Aside from constitutional concerns, historical aspects of the TT and concerns based on European law, the presented practice would not be consistent with the drafted policy considerations of CFC rules. On the one hand, the drafted policy considerations include the recommendation that CFC rules are designed to prevent taxpayers from shifting income into CFCs and are not designed to raise significant revenue in the form of additional corporate taxation. But the described limited tax credit generates tax revenues since the tax payer is not entitled to credit the foreign taxes against all business taxes which are triggered by the attributed CFC income. The mechanism is also not in line with the consideration to avoid double taxation.

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2 The German CFC rules only apply if the effective foreign tax rate for the respective income is below 25 %.
3 OECD, Public Discussion Draft "BEPS Action 3: Strengthening CFC Rules", issued on 3 April 2015, Chapter 1, point IV.
4 OECD, Public Discussion Draft "BEPS Action 3: Strengthening CFC Rules", issued on 3 April 2015, Chapter 1, point VI.
Petition: We would appreciate if BEPS Action 3 clarifies that the policy considerations are only fulfilled when the taxpayer is entitled to credit the foreign taxes against all taxes whose tax base includes the attributed CFC income.

2.3. Excess foreign tax credit: Negative total income

Another economic double taxation issue could arise if the taxpayer is not entitled to carry forward an excess foreign tax credit. This could especially arise from a negative total income.

On the one hand, the positive attributed CFC income decreases current losses and the tax loss carry forward. Therefore, it results in lower tax savings due to a reduced offsetting of tax losses with future tax profits. On the other hand, it is not possible to credit the foreign taxes against current and/or future domestic taxes since the negative income does not lead to domestic income taxes and it is not possible to carry forward the foreign taxes.

The result would be a final excess foreign tax credit.

Petition: We would appreciate if BEPS Action 3 clarifies that economic double taxation is only avoided in case of negative total income if the taxpayer is entitled to carry forward an excess foreign tax credit.

2.4. Excess foreign tax credit: Interaction between foreign income attribution date and foreign tax payment date

According to the German CFC rules, a taxpayer is only entitled to consider foreign taxes for the deduction or credit method in case of attributed CFC income if these taxes are actually paid in the moment of the attribution of CFC income.

The attributed CFC income is deemed to have been received immediately after the closing date of the CFC's relevant fiscal year. Therefore, it is not possible to consider foreign taxes for the deduction or credit method in the year of the attribution if the CFC has not actually paid the foreign income taxes before its closing date.

For this reason, the German CFC rules allow to deduct or credit the actually paid foreign taxes only in the year in which they are paid. If CFC does not generate CFC income in this period, it is only possible to deduct the foreign taxes for generating a carry forward. But it is not possible to credit the foreign taxes against domestic taxes of the controlling person.

The credit method eliminates double taxation more effectively than the deduction method, but economic double taxation is only comprehensively avoided in case of an "actually-paid-requirement" for the credit method if the taxpayer is entitled to carry forward an excess
foreign tax credit which results from the interaction between foreign income attribution date and foreign tax payment date.

**Petition:** We would appreciate if BEPS Action 3 clarifies that economic double taxation is only effectively avoided in the case of an "actually-paid requirement" for the credit method when the taxpayer is entitled to carry forward an excess foreign tax credit which results from the interaction between foreign income attribution date and foreign tax payment date.

We trust that this letter contains useful comments. If you would like to discuss any points of the OECD Public Discussion Draft "BEPS Action 3: Strengthening CFC Rules" or other BEPS issues in more detail, please do not hesitate to contact us.

Yours sincerely,

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Comments on BEPS Action 3:
Strengthening the Rules on Controlled Foreign Corporations (CFCs)

This report is published by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This paper has been prepared by Sol Picciotto and Jeffery Kadet, with comments and input from Martina Neuwirth, Markus Henn, and other members of the Group.

We welcome this opportunity to comment on the Discussion Draft, and would also be willing to speak at the public consultation on the subject.

SUMMARY

Rules on controlled foreign corporations (CFCs) override the ‘separate entity’ principle by providing that, in defined circumstances, profits channelled to an affiliate of a Multinational Enterprise (MNE) in a low-tax country can be attributed to its parent and taxed by the home country of the MNE. In effect, CFC rules give the primary right to tax business profits to the source country (where the activities take place), thus ensuring neutrality between domestic and foreign-owned firms, but a secondary right to the country of residence of the foreign owner, to ensure neutrality between home and overseas investments. CFC rules should act as a deterrent removing the incentive for MNEs to shift profits out of source countries. To achieve this however, they must be set at a high standard and coordinated. A weak standard which is left to states to implement would be counter-productive, as it would encourage source states to reduce their tax rates, and hence worsen the race to the bottom in corporate tax.

We therefore support adoption of full inclusion approach, under which the home country would tax all CFC income, with a credit for foreign taxes paid. An acceptable alternative would be a substance test based on the proportion of profit to employees, determined by payroll costs. It should apply if the effective tax rate in the CFC’s country of residence is below 95% of that of the home country, since a high threshold is essential both to remove pressures on source countries to reduce their tax rate, and to ensure competitive equality between MNEs from different home countries. We urge rejection of a ‘top-up tax’ as an inadequate alternative which would give unfair advantages to MNEs which continue to engage in BEPS behaviour.

Such strong CFC rules could give the BEPS project some chance of success, but weak rules would mean its failure. The inability to coordinate CFC rules until now has led to their weakening, due to economic globalization allowing MNEs to play states off against each other. Strong and coordinated international action is now needed in order to ensure that MNEs are taxed ‘where economic activities take place and value is created’. In our view the most effective response to BEPS would be to adopt a more explicitly unitary approach to MNEs, for example by systematizing and regularizing the profit split method with defined concrete allocation factors and weightings for all commonly used business models. Apportioning profits according to appropriate measures of real economic activity would leave states free to set their corporate tax rates, balancing encouragement of investment in real
activities with optimizing tax revenues. The BEPS Project has preferred a different approach, including CFC rules, but it remains to be seen whether it can achieve agreement on the high standards necessary to make them effective.

1. **General Remarks**

A. **Status of the Proposals**

1. Measures on controlled foreign corporations (CFCs) date back to the adoption by the USA of Subpart F in 1962 to deal with deferral by US-based MNEs of US tax on foreign income by structuring corporate groups to route investments through intermediaries in convenient jurisdictions. The US at the same time referred the general issue of treaty abuse to the OECD, but for over half a century no effective action has been taken on this broader issue. Subpart F introduced the principle that, in specified circumstances, the income of a foreign subsidiary would be treated as having been distributed to and hence taxed directly in the parent entity’s country of residence. Gradually some other countries also introduced CFC rules, but consensus has not been possible on this principle through the OECD, due to the insistence of many on the principle that affiliates should be treated as separate entities even if they form part of a single enterprise. The CFA in 1986 approved two reports on the use of Base and Conduit companies, but doubts were cast by some states on the compatibility of CFC rules with the separate entity principle in tax treaties, and the Committee suggested that CFC rules should be guided by an international consensus, to be formulated by the CFA. This has not been done formally, but language was included in the Commentary to article 1 of the model convention from 1995 which in effect provided criteria to validate such measures, and these were amended in 2003 and 2010. The CFA returned to the issue in 1996 with a report whose purposes included consideration of ‘whether uniformity should or can be reached in the design of a CFC regime’, but which in the event resulted in a purely descriptive analytical and comparative study. As this brief account shows, agreement on this issue has eluded the OECD, so CFC rules have been left for each state to formulate.

2. The present Discussion Draft (DD) remains unclear about the extent or form of coordination envisaged. It includes draft ‘recommendations’, but nothing is said about the form these might take, i.e. whether they are intended simply as a basis for national legislation, or for inclusion in the model convention, or indeed in the proposed multilateral convention. The intention seems to be to leave it to states to legislate as they wish, guided by the recommendations. These will inevitably establish an international standard, but one which will be more likely to constrain the extent of national legislation than empower countries to enact strong and effective CFC rules. The DD states at various points that some states may wish to go beyond its recommendations, which aim to deal only with BEPS aspects. States may nevertheless feel inhibited in doing so, particularly if they wish to diverge from specific recommendations, especially as the Commentary to Article 1 (para.26) still states that

‘States that adopt controlled foreign companies provisions or the antiabuse rules referred to above in their domestic tax laws seek to maintain the equity and neutrality

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1 The OECD Fiscal Committee in early 1962 created Working Party 21 on Tax Avoidance through the Improper Use or Abuse of Tax Treaties, consisting of the US and Denmark; it produced reports in 1963, 1965 and 1967, was expanded to include Germany, and reported again in 1975 as Working Group 21 of WP 1.

2 Beginning with Germany’s Aussensteuergesetz of 1972.

3 Published a year later in *International Tax Avoidance and Evasion. Four Related Studies*; they are now included as R(5) and R(6) of the ‘Full Version’ of the 2010 Model Convention (OECD 2010).

4 *Controlled Foreign Company Legislation*, (OECD Fiscal Committee, 1996).
of these laws in an international environment characterised by very different tax burdens, but such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer. The issue of when taxation is ‘comparable’ is at the heart of CFC rules, so retaining this broad and vague statement in the Commentaries is clearly unsatisfactory. It seems unlikely that agreement can be reached on common standards for CFC rules. In our view therefore this paragraph should be replaced by a clear statement that states are free to adopt any CFC provisions they consider appropriate.

B. Competition and Coordination

1. CFC rules are central to balancing residence and source tax rights, or reconciling capital export and capital import neutrality. They may be applied by countries which in principle assert tax rights over worldwide income, with a credit for foreign taxes paid, or those with an essentially territorial tax system, but which wish to limit the exemption of foreign-source income to that which derives from active business which has not shifted income from the home-country tax base. In effect CFC rules give the primary right to tax business profits to the source country (where the activities take place), thus ensuring neutrality between domestic and foreign-owned firms, but a secondary right to the country of residence of the foreign owner, to ensure neutrality between home and overseas investments. If capital-exporting countries adopt strong CFC rules, capital-importing countries can be insulated from pressures to offer incentives or reduce their tax rates. On the other hand weak CFC rules, which apply a low threshold to define CFC income, retain the incentive for MNEs to shift income from operating affiliates in high-tax source countries into intermediary jurisdictions with lower tax rates (through above the CFC threshold), thus continuing the race to the bottom in corporate tax rates.

2. We do not agree with the suggestion in the DD (para. 8) that subsidiaries of parent companies which are subject to broad CFC rules are at a competitive disadvantage compared to local companies. This is a red-herring that MNEs have repeated so often that some politicians believe it. Rather, the aim is to ensure competitive equality by depriving such foreign-owned affiliates of opportunities for profit-stripping, which gives them an unfair advantage over their competitors which have less opportunity or inclination to engage in such practices. Hence, we agree with the characterization in the DD of CFC rules as a deterrent (para. 16), and with the suggestion that effectively taxing CFC income at a high rate would protect the source country tax base (para. 17). Source countries should support strong CFC rules. We also support the implication (paras. 18 and 19) that, to be effective against BEPS behaviour, CFC rules should not protect only the home country tax base but extend to foreign-to-foreign profit stripping. As the DD states, this is particularly important for developing countries, which the G20 has stated should also benefit from the BEPS project.

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1 The distinction between worldwide and territorial systems is much less clear in practice than in theory, and the weakening of CFC rules in effect has moved worldwide towards territorial systems. Indeed, it has been pointed out that the weakening of Subpart F by the US, combined with generous foreign tax credits, is more generous than an exemption system: Fleming, Peroni and Shay, ‘Worse than Exemption’, Emory Law Journal 59: 79-149 (2009). For an empirical comparison of effective tax rates of US MNEs with those based in EU countries (many of which have exemption systems) see Avi-Yonah and Lahav, ‘The Effective Tax Rate of the Largest US and EU Multinationals’, U of Michigan Public Law Working Paper No. 255 (2011).

3. The weakening of CFC rules in recent years has resulted from several factors due to growing economic globalization: (i) competition between countries to attract MNE headquarters leading to regionalization and head office relocation or ‘inversions’; (ii) increased difficulty of defining ‘active’ income due to the growing importance of services (including financial services) and intangibles, and (iii) the trend to reduction of corporate tax rates and offering tax breaks, making it hard to distinguish between a ‘low’ and ‘normal’ tax rate. In our view, as made clear in our previous submissions, the most effective response to these trends, in order to ensure that MNEs are taxed ‘where economic activities take place’, would be to adopt a unitary approach to MNEs, for example by systematizing and regularizing the profit split method with defined concrete allocation factors and weightings for all commonly used business models. Apportioning profits according to appropriate measures of real economic activity would leave states free to set their corporate tax rates, balancing encouragement of investment in real activities with optimizing tax revenues. The presumption in the present rules that affiliates should be treated as separate entities facilitates and indeed encourages BEPS behaviour.

4. To the extent that they effectively override the independent entity assumption, CFC rules could also counteract BEPS behaviour. To be effective, however, they would need to be either (i) targeted and coordinated multilaterally, or (ii) adopted by all or most home countries of MNEs on a full-inclusion basis.

5. Under a targeted and coordinated system, CFC rules would apply to any income which has benefited from tax advantages which are considered illegitimate, for example due to hybrid mismatch arrangements (HMAs), or harmful tax practices (HTPs). The DD recognises that there is an interaction between this action point and those on HMAs and HTPs. However, although it includes proposals aiming to link CFC rules to HMAs, nothing is said about HTPs. This is understandable in view of the form taken by the proposals on HTPs. These have not established clear rules which are easy to apply but broad principles, particularly the ‘substantial activities’ requirement, which has now been supplemented by detailed provisions attempting to define ‘nexus’ in relation to IP regimes. As we pointed out in our comments on the Agreement on the Modified Nexus Approach, these are complex and would require careful monitoring to be effective, including intrusive auditing of company expenditures under ‘track and trace’ regulations. Yet it seems that compliance will be left to the countries introducing the measures themselves, perhaps subject to general oversight through the Forum on HTPs. This would be toothless unless backed by counter-measures, which could be provided by the application of CFC rules. However, unless such counter-measures were properly coordinated it would be a tit-for-tat system at best; even with such coordination it would likely be ineffective in stemming the race to the bottom in providing corporate tax breaks.

6. In our opinion, therefore, if the CFC proposals are to be effective they must be designed on a broad full-inclusion basis, and be applied by all countries in which MNEs have resident parent companies. If the BEPS project is to stand any chance of success within the framework laid down in the Action Plan, such strong CFC rules are absolutely essential. It is also important that they be applied by all relevant countries. Achieving such collective action will not be easy, especially in view of the unfounded concerns for ‘competitiveness’ articulated by some politicians. In our view this ‘competitiveness’ focus only leads to beggar-thy-neighbour policies, and we are very sad to see some of these arguments expressed in the DD (paras. 8-9). Although it correctly points out that collective action can overcome those concerns (para.10), in our view there is no need to adopt minimal standards to ensure this, as suggested there. In practice, there is rarely much scope for a MNE to choose where to locate its true headquarters. Choice of head office may be possible where there is a joint venture set up
from several existing large otherwise unrelated companies, or a cross-border merger or acquisition, but there will very seldom be any choice when a truly new business is being formed, and still less to change location of the head office when a firm has been long established in its home base. Artificial relocation of the head office can be dealt with by combining place of incorporation with place of effective management to determine residence.

7. All states could benefit from strong, well designed CFC rules which are widely adopted. When the UK weakened its CFC rules in 2012 the government estimated that the measures would cost the UK £1b a year in revenues, while charity Action Aid estimated that the cost to developing countries would be £4b. The BEPS project offers a unique opportunity to establish strong tax rules on a coordinated basis. If it results instead in weak rules which are left to states to apply individually it would be worse than ineffective, it could be a recipe for further encouraging the race to the bottom in corporate tax. The main losers would be developing countries, since they cannot easily resist pressures to offer tax incentives to attract investment, and they are more highly dependent on corporate tax revenues. However, developed countries would also lose, as their tax bases continue to be eroded by profit-shifting. Our comments in the next section, answering the specific questions posed, attempt to spell out in more detail the design implications of these considerations.

C. The Issue of EU Law

8. In our view, the BEPS project should aim at devising the best global solution, without concerning itself with compatibility with EU law. It should be recalled that at the root of the EU’s difficulties is the principle, dating back to the Treaty of Rome of 1957, that direct taxes are a matter for national states, which has become increasingly incompatible with increased economic integration and the creation of a single market. The jurisprudence of the European Court of Justice (ECJ), briefly discussed in the DD, aims generally to push states away from unilateral solutions and towards a more joint approach to corporate taxation, the need for which has been accepted by the European Commission since the Rudden report in 1992. The difficulty has been reaching agreement among the member states, especially with continued enlargement of the EU now to 28 states. Although there are considerable political and institutional difficulties, a number of strategies are available, and the EU has much stronger legislative powers than other regional organizations. A comprehensive technical solution already exists with the proposed Common Consolidated Corporate Tax Base (CCCTB); although this can certainly be refined and improved, the main obstacles to its adoption are clearly political. The European Commission is preparing an Action Plan, which it has said will include a re-launch of the CCCTB and ideas for integrating the OECD/G20 actions on BEPS at EU level. The BEPS project should aim at strong and coordinated CFC rules, and the EU should work constructively to ensure their implementation compatibly with EU law. It would be inappropriate and unfortunate if discussion of the niceties of ECJ jurisprudence were used to weaken proposals on CFCs in the BEPS project. A well designed global approach to CFCs should pose no significant technical problem for adoption in the EU. Since almost all EU member states are also members of the OECD, such coordination should be possible.

2. RESPONSES TO SPECIFIC QUESTIONS

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?

One practical issue could arise where a transparent partnership (or other transparent vehicle such as a transparent LLC) has one or more minority CFC partners. Any such minority
partners might not have full access to the details of the partnership’s operations and its accounting and tax information. As such, the parent of such a minority CFC partner might be unable to access the information necessary to apply its home country CFC rules to their CFC’s partnership share.

To deal with this issue, perhaps the final BEPS proposals for domestic BEPS legislation could include a requirement for controlling owners of transparent vehicles treated as CFCs to provide information reasonably required by all other owners to comply with any CFC rules applicable to them. It seems doubtful that such a requirement would cause any release of trade or financially sensitive information.

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

We suggest a broad definition which is not limited to a parent-subsidiary relationship, but includes any entity under common control. This would be a better way of dealing with structures aimed at avoiding CFC rules than a general anti-avoidance rule. It would also help encourage all relevant countries to introduce strong CFC rules.

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

No serious practical problems noted. Applying the wider approach would seem simpler since there would be no need to examine the tax effect on country C of any payment made by C Co. Also, we agree with the point in para. 38 that the broad rule helps ensure the coherence of CFC rules by taking account of all rather than specific income of a CFC.

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?

We see no need for a *de minimis* threshold, which would be an unnecessary complication. There could be a danger of setting it too high, while the claimed advantage of ease of administration seems to be negated by the need for refinement by the addition of dual thresholds such as in the UK, or an anti-fragmentation or anti-abuse provision as in the US.

We agree with the reasons in para. 52 for not including an anti-avoidance requirement.

Low-tax threshold

As argued in section 1 above, CFC rules should be designed as a deterrent to BEPS behaviour and hence be designed primarily to protect the tax base of the source country, by removing the incentive to shift profits from the source country, since they would anyway be subject to full and current taxation by the home country. From this perspective, there is no reason for a low-tax threshold, and some commentators have indeed proposed even a unilateral total-inclusion approach as a more practical alternative to worldwide formulary apportionment. If it is not possible to achieve agreement on either high CFC standards or our suggestion outlined above that the profit split method be significantly expanded, then we strongly

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suggest that the benefits of countries changing from their present territorial and deferral taxing models to a worldwide current taxation approach (with a narrow country-by-country foreign tax credit mechanism) be brought into the discussion. Both the territorial and deferral systems strongly motivate MNEs toward BEPS behaviour. On the contrary, where an MNE knows that all its income, wherever earned in the world, will be subjected to current home country taxation, that BEPS motivation is eliminated. If just a relatively small number of countries that are the home-countries of MNE groups were to adopt such an overall approach, BEPS behaviour would significantly fall with greater tax revenues for all countries and a much more level playing field for all MNEs.

The reluctance towards this approach would seem to be because of a perception that it restricts the power of the source state to exercise its tax rights to lower its tax rate to attract investment, since the profits would anyway be taxed at the home country tax rate if it is higher. This would indeed be the likely consequence, given the concern of governments especially of capital importing countries to attract investments. Equally, the deterrent effect on MNEs to shift profits from source countries is seriously reduced if the home country threshold on CFC income is significantly lower than the source country tax rate. As explained above, we regard this dissuasive effect on source country base erosion to be an important and perhaps primary objective of CFC rules. For all these reasons we advocate a threshold of 95% of the home country rate.\(^8\) This leaves some small leeway for source countries to reduce their rate to attract investment, perhaps to compensate for other impediments to cross-border investment, but to an extent that would not significantly distort neutrality. Further, if a source country desires to use tax incentives to attract investment, it can attempt to negotiate tax sparing provisions in its treaties with important investor countries. While this would allow some tax competition, at least it would reflect the agreement of both the source and residence countries that this is economically desirable.

Another motive for adopting a lower threshold is that MNEs may threaten to relocate their headquarters (corporate inversion) away from countries applying CFC rules based on a high threshold. Indeed, this type of threat has been a major motive for the weakening of CFC rules in recent years, notably by the UK. However, as we argued in section 1 above, a central aim of the BEPS project is precisely to adopt a more coordinated approach, to help states withstand the very inappropriate pressures they are under from MNEs that make unilateral action so difficult. Any tax rate threshold proposed under the BEPS project will in practice establish an international standard for an acceptable minimum tax rate for MNE income. Even if the proposals do not take the form of binding treaty rules (which seems likely) they would carry considerable weight, given governments’ concerns about the effects on investment. Furthermore, such a strong approach for a high international standard should counter the competitiveness objections since all MNEs would be subject to the same rules.

Hence, we should also make it clear that we do not advocate a threshold based on a percentage of the home country rate unless that percentage is close to 100%, i.e. 95% as we suggest. Significant disparities have developed between tax rates of OECD countries, even those which are in principle considered to be high-tax. A threshold based on a percentage significantly less than 100%, such as 75% as suggested in the DD (para. 56), would create a strong incentive for countries anxious to attract inward investment to reduce their tax rates to undesirably low levels. Countries which have reduced their tax rates for ‘competitiveness’ reasons, such as the UK, should have no valid reason to apply a significantly lower threshold than their own in defining CFCs, since it would encourage others to out-compete them.

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\(^8\) We also advocated this threshold in our submission on BEPS Action 8-9-10 on Special Measures.
Adopting a high threshold would also avoid the need for ‘white’ or ‘black’ lists. Further, at least for countries applying a foreign tax credit, there would be no need to calculate 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?

As the DD mentions (paras. 34 and 63), the issue of treatment of PEs only arises for countries applying the exemption method. In such cases, we support the proposals for a broad approach to this calculation set out in para. 63. However, we suggest that this could be on a country-by-country basis, since the country-by-country reports which will be required (at least for large MNEs) under AP13 will include aggregate data for each country. We consider it undesirable for countries to exclude the income of a PE from this calculation.

Chapter 4: Definition of control

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

In our view, inclusion of a de facto control test is necessary, essentially as a targeted anti-avoidance rule. We do not accept that this would involve ‘added costs, complexity and uncertainty for taxpayers’, since where de facto control is an issue, it will virtually always be the result of contractual, legal, and operational structures created by the taxpayers themselves that are meant to achieve tax objectives which could not be accomplished more directly. As a simple example, there are accounting rules for variable interest entities that will apply to many situations that would not be caught by either the legal or economic control tests. There is clearly a need for a de facto control test. It must be included either by adding it as a separate test or, alternatively, by expanding the economic test to include not only legally enforceable economic results, but also resulting from other contractual or relationship factors. For example, where a key local individual, who for all practical purposes acts as an employee or representative of an overseas company, owns the shares of a local company which conducts the local business of the overseas company, only a de facto or expanded economic test would treat such a local company as a CFC.

We would also support inclusion of financial statement consolidation as another test. However, we see consolidation rules and how a company is treated under consolidation rules as a factor that would be relevant in applying other tests, including a de facto 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?

In our view, related parties should be presumed to act in concert. Hence, attribution rules should be positively recommended and not just treated as an acceptable add-on. They are clearly not difficult to apply. All groups maintain organization charts that show the total of common ownership for all group investments. If a country's CFC law requires attribution rules to be applied, it's simply not correct to say that it adds to complexity and expense of compliance.

Hence, we see no difficulty with respect to related nonresident parties. We also see no practical issue in requiring all residents who have some minimum ownership percentage to report those ownership interests. The only practical issue is where an under 50% or over 10% owner does not know if there are other resident 10% or greater owners. All 10% or greater owners, directors, officers, etc of such foreign companies could be required to provide to the tax authorities robust information on such foreign companies to the extent known to them.
Usually this is information that will be known to such persons who act as directors or officers.

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?

For the reasons outlined in section 1 above, we advocate a full-inclusion approach. As we explain in that section, it should not be limited to protection of the home country’s tax base. It must be made clear throughout the BEPS process that this is an international effort to combat profit shifting with respect to all countries. Hence, any suggestion such as that in para. 85 that it is acceptable for a country to enact CFC or other rules that protect solely its own tax base and that would specifically allow BEPS-motivated structures to beggar other countries is simply not acceptable. This must be removed from the Report. In addition to the policy reasons discussed above, we see many practical difficulties in applying criteria to define the specific income that raise BEPS concerns. This is certainly the case if a formal approach is adopted. This is clear from the discussion in para. 88, which suggests that attributing royalties, interest and dividends may be problematic because they may be considered in some circumstances to result from an ‘active business’ (the example of ‘active financing’ is given). It adds indeed that this may not involve BEPS concerns, whereas the structuring of finance within an integrated corporate group is a major technique for BEPS. As we stated above, adoption of weak recommendations on CFCs would fatally weaken the BEPS project, by encouraging a race to the bottom, instead of stronger coordination to strengthen all countries’ tax systems.

However, a viable alternative to full-inclusion could be a substance test based on an employee and establishment analysis, applied on a proportionate basis. This could be quantified on the basis of payroll costs. It is suggested in para. 92 that this could be difficult to apply because it would ‘require a comparison of the employees and establishment in the CFC to the employees and establishment that would be required to earn the overall income, which may be a difficult comparison to undertake’. However, the data which will be made available through the Country-by-Country reports and Transfer Pricing Documentation Master File should facilitate such a comparison. The aim of this new reporting standard is precisely to enable a BEPS risk analysis, so using it to guide the application of CFC rules would be entirely appropriate. One difficulty is that these reports are at present to be required only for MNEs with a turnover of 750m euros, however similar documentation requirements could be introduced for all groups identified as potentially falling within CFC legislation.

We see both principled and practical problems with both the substantial contribution analysis and the viable independent entity concept, especially as they are both essentially threshold tests. Many MNEs have now developed highly sophisticated structures based on functional fragmentation. This makes it difficult or impossible to decide whether or when an entity makes a ‘substantial contribution’ or is ‘viable’. Hence, a threshold test is inadequate. In addition, these tests would require detailed facts-and-circumstances analysis which is resource-intensive and subjective, so as recognized in para. 92 ‘would increase administrative complexity and compliance costs and may lead to uncertainty’. That paragraph also suggests, however, that an advantage would be the similarity of this approach to transfer pricing methods which also apply such a facts-and-circumstances analysis. In our view this is a disadvantage. As we have stressed in our submission on the transfer pricing proposals, these
methods are totally unsuitable, especially for developing countries. The aim of the BEPS project is to ensure that MNEs can be taxed 'where economic activities take place and value is created'. This is not a binary choice, but requires a proportionate test. In our view, the relative objectivity of the ‘employees and establishment test’ on a proportionate basis is the only practical approach that can provide a meaningful result. It analyzes limited, objective and easy-to-determine factors that are administrable and will provide fair results.

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

As stated above, our preference is for a full inclusion approach, or alternatively inclusion based on a substance test applied proportionately using employee payroll costs. In our view, transactional approaches are particularly inappropriate. However, we will add some comments in relation to these questions for the sake of completeness, especially to deal with exceptional cases.

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?

Banks and other regulated financial enterprises are among those who most make use of BEPS structures. In order to provide a ‘bright-line’ rule but with flexibility, we suggest for (i) a rebuttable presumption for inclusion in CFC income of all such income. If a bank, financial institution, or other regulated CFC can establish to the satisfaction of the appropriate home country tax authority that it does have substantive operations in the CFC country that in fact earned the relevant income, then the earnings would be excluded from CFC income.

Considering the mobile nature of reinsurance and captive insurance companies, we recommend blanket coverage for both (ii) and (iii) that all such income earned by a CFC will be CFC income.

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

We strongly agree with the broad approach suggested. The subjectivity of the distinction between sales and services on the one hand and IP on the other creates a total inability for tax authorities to deal with this issue. A broad approach like this is the only practical answer. There should be no practical problems, especially considering that this broad treatment eliminates so many subjective judgments from any analysis.

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

Nothing to add.

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

Generally yes. We believe, though, that the rents, leasing fees, and capital gains mentioned in paragraph 97 should be included in CFC income as well. As a result, we suggest that addition guidance be given and that they be added to the final recommendations for a definition of CFC income.

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III Possible Approaches.

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

While the discussion draft is sufficiently clear for its purposes, we suggest that future recommendations include suggested draft statutory or regulatory language that individual countries could then tailor to their needs.

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 generally recommend approaches that provide broad coverage based on objectively determined factors; these will best minimize any practical problems. Where there is an exception available based on a facts and circumstances analysis, applying that is at the option of the taxpayer. As a result, such additional work is limited to those taxpayers who wish to establish their qualification for such an exception.

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 believe that either could provide an administrable approach that gives fair results. However, we believe the use of the excess profits approach to be better since we see that as being overall more inclusive, less susceptible to abuse, and easier to apply by taxpayers and monitor and examine by tax authorities. It is also the more appropriate approach to apply in relation to our preferred broad definition of CFC income using a substance test based on an employee and establishment analysis, applied on a proportionate basis.

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

Even where IP might be a lesser issue, there are synergies that exist in most MNEs that allow higher profits on a group-wide basis. For this reason, it is very reasonable for the home country of the parent to apply CFC rules that do not allow such excess profits to be placed in low- or zero-taxed CFCs.

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

No suggestions.

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

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 discussion in the DD accurately outlines the varying efforts and costs by taxpayers to comply and for tax authorities to administer and audit these approaches, and it seems that neither of the two possibilities outlined has any insurmountable difficulties or practical
problems. On balance, our preference is for the entity approach, which would be simpler and easier to administer.

**Chapter 6: Rules for computing income**

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?

We agree with the recommendation in para. 133 that the income should be calculated according to the legal requirements of the parent company’s jurisdiction, based on the explanation in para. 132. Use of financial accounting standards such as IFRS would be inappropriate, as they are unsuitable for tax purposes and not accepted by tax authorities. As we have suggested in other submissions, especially in relation to the use of the profit split method in transfer pricing, we recommend that the OECD should work on developing a harmonised tax accounting standard, which could build on the methodology and standards in the CCCTB.

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

Yes. We have nothing to add to the discussion in the chapter.

**Chapter 7: Rules for attributing income**

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

We agree with the recommendations outlined in para. 143, and the reasons given in the subsequent discussion.

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

The description is broadly accurate, and we not only agree with the conclusion that a top-up tax is undesirable, but recommend that it should be firmly rejected. Its only justification is the purely pragmatic one of perhaps making it easier for a country with a significantly higher corporate tax rate than other countries to adopt proper CFC rules. However, in our view it is essential for any such country to grasp the nettle and introduce whatever changes are necessary to bring its tax rates and international tax rules more in line with other countries and with the package of proposals from the BEPS project. As the discussion in the DD points out, adopting a top-up tax would eliminate the deterrent effect that in our view is a key element in CFC rules, to eliminate BEPS behaviour and protect both source and residence country taxation. Finally, a top-up tax would give those MNEs which benefit from it a wholly undeserved competitive advantage over other MNEs which have not engaged in BEPS behaviour. A top-up tax would be wrong in principle, damaging in practice, and should be rejected.

**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?

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

The discussion in the DD seems comprehensive to us. We agree with the recommendations outlined in para. 155, for a credit if the CFC has been taxed where it is resident or in another country with CFC rules, and for exemption of dividends and gains from income which has been taxed, to be determined by the CFC rules of the country concerned. The rule hierarchy
proposed in paras. 159-160 seems appropriate. It is clearly especially important to eliminate double taxation via these methods if a broad full-inclusion approach is adopted as we have recommended.
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May 1st, 2015

Ref: OECD DISCUSSION DRAFT: STRENGTHENING CFC RULES (BEPS ACTION 3)

Dear Achim

BIAC 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 3 April 2015 (the “Discussion Draft”).

However, we do believe that the Discussion Draft represents an important opportunity missed. Controlled Foreign Company/Corporation (CFC) rules can play a very important role in preventing base erosion and profit shifting. They can, by effectively imposing home-country taxation on foreign subsidiaries, discourage inappropriate base-eroding transactions. And they can, by complementing the Transfer Pricing rules, discourage certain forms of inappropriate profit shifting transactions. As mechanical rules, they can provide certainty for government and taxpayers alike, as well as relief from certain time-consuming, fact-specific transfer pricing enquiries. They can facilitate greater equity between countries by restricting certain hidden forms of tax competition. And, they can encourage certain types of “virtuous” economic behaviour – for example, true value-creating activity – and discourage other, less productive, activity.

Unfortunately, the Discussion Draft does not advance any of these goals. Because of – we assume – fundamental disagreements between member governments, there is no clear initial articulation of what CFC rules are meant to achieve. This lack of articulation is followed by a myriad of suggestions to create a “minimum standard” (although with many options within that standard), which do not, in the end, hold together. The net result is that the Discussion Draft does not effectively target artificial base erosion and profit shifting.

1 It is important to note, of course, that not every deductible payment is “base-eroding” in the BEPS sense; nor does every inter-company transaction result in “profit-shifting” as understood in BEPS. Both deductible payments and intercompany pricing are allowed by law, and as applied by taxpayers will generally reflect the economics and substance of the transaction. However, that will not always be the case, and in those circumstances well-focussed, clearly-articulated CFC rules are appropriately applied.
The confusion surfaces early on with the expression of the hope that a solution can be found to balance capital export neutrality with capital import neutrality. As the principles are diametrically opposed, this, of course, is hard. But without suggesting where a new balance might lie, the Discussion Draft then seems to reject the long-standing balance previously struck between the two, of imposing current taxation on “passive” income while not currently taxing “active” income until repatriation to the parent jurisdiction (also known as “deferral”).

The Discussion Draft departs from this foundational active/passive distinction of CFC taxation with proposed models that look at new concepts such as “excess returns”. That potential rule would reallocate taxing rights over genuine economic activity to the parent jurisdiction, regardless of the level and nature of the activity which generated the income. BIAC has objected to proposals in other discussion drafts that might inappropriately shift taxing rights to what are often (if, perhaps, imprecisely) called “source” countries. It seems only right that, by the same token, BIAC object to proposals that inappropriately shift taxing rights to “residence” countries, as the routine application of the “excess profits” approach would do.

Further suggestions that fact-based determinations should be much more widely used in CFC rules would diminish the advantage of the objective, mechanical aspect of those rules. As a result, rather than complementing Transfer Pricing rules, they would fulfil a similar (and quite possibly duplicative) role, where everything is subjective, and, thus, almost always, more complicated. This would clearly be another burden on business – but just as much on revenue authorities, many of whom, in a resource-constrained environment, are already being asked to do “more with less”. Surely there must be a limit to how far that maxim can be stretched before it breaks?

Despite our disappointment at this missed opportunity to clarify (and even simplify) CFC rules, we have, of course, and as requested, responded in detail to the Discussion Draft. Nevertheless, in light of such clear lack of agreement on even the fundamentals, we do suggest that a better way forward might be to survey existing national CFC regimes. This process might truly identify best practices, rather than seeking to come up with “minimum standard” recommendations which – especially given the very short amount of time left – can only be agreed to at the very highest of levels (and with the potential, below that very high level consensus, for a completely uncoordinated set of legislative responses by different countries).

As always, we acknowledge the amount of time and effort that member governments (and the Secretariat) have put into this project, and we are very grateful for the opportunity to comment on these proposals while still in draft. However, we do, in this case, believe that it might be better to set less lofty goals and a slightly longer time horizon in order that – at the end of the process – a broader, more detailed consensus can be reached on this critical area of international tax policy.

Sincerely,

Will Morris
Chair, BIAC Tax Committee
General Comments

Establishing a Clear Policy Objective

BIAC is concerned that the OECD’s Discussion Draft on CFCs lacks the clearly articulated policy objectives that are necessary to develop the coherent, targeted and proportionate CFC measures called for in the 2013 Action Plan on BEPS. At present, it seems that the Discussion Draft is attempting to satisfy multiple competing objectives. In other areas, for example the rules on permanent establishments, there is general agreement on the purpose of the PE rules, even if there is disagreement on, say, the appropriate thresholds to be applied. In the area of CFCs, however, there seems to be no broad consensus on what CFC rules are even meant to achieve. Before refining the existing recommendations, therefore, it is critical to determine exactly what the purpose of CFC rules should be: for example, is the concern about passive income diverted away from a parent entity; or is it that there should be a more mechanical and objective backstop to transfer pricing rules; or is only protection of the home country tax base important/justified or are foreign-to-foreign transactions implicated; or is the system theoretically underpinned by capital export neutrality? If these fundamental design questions are not agreed upon, then this project will, almost inevitably, result in confused and problematic recommendations.

Given the apparent difficulties on reaching a consensus on the purpose of the rules, we believe that a more useful approach, at least as an initial matter, and pending further work, might be to review the effectiveness of different existing CFC rules (based on the setting in which they are applied), to determine what best practices might look like for countries operating substantially different tax systems. A more thorough analytical examination of the options available to countries under each ‘building block’ could help countries to understand how rules might i) help to tackle BEPS related activity and ii) impact the competitiveness of a country, including as it relates to inbound and outbound investment. In addition, delivering narrowly focused ‘best practice’ options could contribute to more consistent international rules.

One of the dangers inherent in a number of the BEPS items is recommendations that are unintentionally broader than is necessary to prevent the harm being aimed at. BIAC believes that, the most basic principle of any CFC regime must be that it is not intended to tax “active” income. We are also concerned that the proposals could fundamentally alter the allocation of taxing rights in certain situations and undermine legitimate sovereign tax policy choices made by countries.

Although BIAC supports the development of “best practice” recommendations, rather than a minimum standard, if the OECD does propose a minimum standard for income inclusion, it should be developed 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 to 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. A method to ensure proper and effective relief for such double taxation will be critical for the success of this Action and the wider BEPS project. In relation to Action 3, the establishment of a clear common hierarchy of rules that would apply across different CFC regimes and between CFC and Transfer Pricing rules should be developed. This would be required in addition to clear ordering rules to ensure that, for example, credit for foreign taxes paid is properly provided. Effective dispute resolution continues to be important to ensure that any failure of such an ordering rule would still be rectified. There must be a clear commitment to effective double taxation relief and dispute resolution mechanisms.

In addition, we are concerned about the lack of any impact assessment to determine the expected effect that the proposals might have on trade and investment. For example, tightening of CFC rules in ways that require more substance in a particular jurisdiction may well result in the perhaps unintended consequence of the shifting of substance, including jobs, to jurisdictions with low tax rates.

The BEPS Action Plan will deliver a range of recommendations 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 all the recommendations are taken together, taxpayers will be presented with a massively increased compliance burden, which diverts resources from real commercial activity. And this should be of concern to tax authorities as well, who will be presented with huge volumes of new filings that could risk muddying the water, rather than providing clear and effective tools to target real risks.

Indeed, 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). Although BIAC fully understands the time pressures of the project, we continue to be concerned about the apparent lack of ongoing coordination between the OECD Working Parties and Focus Groups developing proposals under these Action Items. Due to the overlapping nature of the Action Plan, specific abuses may be targeted (and addressed) through multiple recommendations. A detailed review process which looks at the project in its entirety 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, overlaps and compliance costs. BIAC looks forward to opportunities to work with the OECD to address these concerns.

**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. Although we agree with much of that analysis, we are concerned 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, where the target is passive income, 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 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.

We believe that it would be helpful to restate that CFC rules can help support Transfer Pricing rules, by removing the requirement for fact-intensive development in cases where it is clear that passive income is, for example, being shifted from a home country. The role of mechanical, (relatively) simple to use CFC rules, however, is not to provide an alternative fact-based, case-specific route to allocating tax between various related parties based up respective economic contributions. It is to remove certain, quite narrow, classes of intercompany transactions from the (in these narrow classes, unnecessary) subjective enquiries required under the Transfer Pricing rules.

An Excess Profits Approach
BIAC believes that the Excess Profits Approach should not be included in the OECD’s recommendations. It seems to drift very far from commonly understood CFC principles, especially as related to the distinction between active and passive income. It runs counter to the OECD’s core mission of removing impediments to facilitating cross-border trade and investment. The implication of this, were it to be adopted, could be wide-ranging and highly detrimental to economic growth.

We are particularly concerned about:

- **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 may 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 identifies 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. Absent broad multilateral adoption, 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’.
We are also concerned that this approach would place MNEs headquartered in higher tax rate jurisdictions at a disadvantage. For example, the (excess) profits of a subsidiary of such an MNE, owning and exploiting IP and operating in a lower tax jurisdiction, may be subject to tax in the headquarter jurisdiction, whereas a domestic entity, owning and exploiting comparable IP in the lower tax jurisdiction would pay a lower rate of tax on all of its profits, potentially putting it at a competitive advantage.

Although we strongly disagree with the Excess Profits Approach, if governments did decide to develop it further, any taxable inclusion should be computed on an aggregate basis (taking into account all income, losses and taxes of an affiliated group of CFCs). Such an approach would better reflect the largely integrated nature of many global supply chains, which commonly cut across multiple jurisdictions. An aggregate approach would take account of the total taxation of supply chain (and intangibles), help to mitigate distortions created by timing differences in particular countries and would help to reduce some of the complexity (for example, the need for separate accounting per-country). That being said, we would reiterate that such an approach would still represent an entirely new standard, and would create substantial difficulties in application, and would risk overriding other important international tax rules (including the application of the Arm’s Length Principle through Article 9). We fully believe that this would be a mistake.

A 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. Tax rate differentials – as opposed to double non-taxation – was never meant to be the primary focus of the BEPS project. We do 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 impact on competition and cross-border trade.

Restricted Timeframe
The timeframe to provide comments has been exceptionally short. BIAC has attempted to gather comments from its members to respond to the OECD’s Discussion Draft, but we note that it has not been possible to fully consider all of the proposals made and their impact. As the OECD develops its recommendations, we hope there will be opportunity for more extensive stakeholder feedback and engagement, so that the full impact of the proposals can be explored. The comments provided below are based on our initial review of the Discussion Draft, and do not necessarily represent all of our feedback or concerns. We look forward to having further opportunities to provide our input.

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2 OECD BEPS Action Plan: “No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it” (emphasis added).
CHAPTER 1: POLICY CONSIDERATIONS

1. BIAC understands the key principle of the BEPS project to be the realigning of taxation with economic activity. We are, therefore, particularly concerned about several proposals that suggest including “active” income unless threshold tests are met. The BEPS project was not meant to be about protecting high-cost jurisdictions against low-cost jurisdictions, and preventing or discouraging the relocation of economic activity to the latter. We strongly encourage the OECD to undertake an economic impact analysis of its final minimum standard proposals to understand how they might impact trade and investment patterns.

2. To expand on the concern expressed in the last paragraph a little more, we are very concerned about the example in paragraphs 123 and 124. This asks nothing about the correctness of the pricing of the intangible sale; asks nothing about the other elements of the cost base in Country B (wages, burden of regulation, productivity, etc.); asks nothing about the activity going on in Country B. It simply assumes a rate of return, deems anything above that to be “excess”, and then returns that to the – quite possibly much less productive – parent country. In economics terms this is quite remarkable. Carried to its logical extreme this would greatly disadvantage lower-tax economies – including most developing countries – in the short-term and higher cost countries in the medium term as productivity languishes, and over the longer terms as businesses decide not to locate their headquarters there.

3. Turning to other issues, we welcome 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. That being said, 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.

4. From a policy perspective, if CFC regimes are intended to target BEPS activities, we believe that only one set of CFC rules should apply at any one time to any entity (i.e. if a number of countries adopt new CFC rules, there should be clear guidance to avoid multiple CFC rules applying to the same entities at the same time). This highlights the import of establishing a clear order of how and when different jurisdictions’ CFC rules should apply. Clarifying which rules should apply (for example only applying the rules of the ultimate parent jurisdiction) may well be easier in a European context, but we should strive for clarity and cohesion in the way new rules apply to avoid double taxation and dispute over who has taxing rights over CFC income. BIAC reiterates here that we do not believe that further secondary rules should be pursued as part of this project. In addition to cutting against the purpose of the BEPS Action Plan, such secondary rules would further increase the complexity of application.

5. BIAC 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.

6. BIAC believes that a fundamental feature of good CFC regimes is an appropriate number of simple or low-compliance threshold tests to exclude entities presenting an acceptably low CFC risk. Using such an approach would ensure that more extensive compliance work can be focused on higher risk entities, reducing the burden for taxpayers and tax administrations. Adequate flexibility in the ordering of the threshold tests would be necessary, so if one test would exclude an entity from a CFC charge, then that test should be applied first, rather than having to follow a pre-determined order. Whether a threshold test is easy or difficult to apply will depend on the profile of a particular business model and entity in question. This means that more subjective (e.g. substance) tests might be more easily applied by some taxpayers, whereas mechanical options could work better for others.

7. BIAC supports the need for a discussion on the interaction between CFC rules and Transfer Pricing (Paras 21-28), and, as noted above, it would be helpful to restate that CFC rules can help support Transfer Pricing rules, by clearly targeting where passive income is, for example, being shifted from a home country. We also believe, that the Discussion Draft should more broadly consider the expected impact of the Transfer Pricing proposals (through BEPS Actions 8-10), and how work in that area may impact CFC rules. 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.

8. Paragraph 24 identifies an important limitation of CFC rules, in that they “only restore (or transfer) taxing rights to parent jurisdictions, which are not necessarily the jurisdictions which have suffered the profit shifting”. We believe this is a particularly important consideration for Developing Countries, where income may have been artificially shifted to a CFC, but then be picked up by a Developed Country parent, rather than being repatriated to the real location of substantive economic activity (which is the intended purpose of the project). Particular consideration should be given to how different interpretations of the OECD’s minimum standard across Developing and Developed Countries could impact on the alignment of profit with substance, and whether the implementation of potentially conflicting CFC rules are indeed likely to have positive spill-over affects. This again highlights the importance of clearly establishing the purpose of CFC rules, and how such rules should interact with Transfer Pricing principles. Transfer Pricing rules ought to be the tool used by countries to align taxation with substance, with CFC rules applied to clearly targeted cases where passive income is diverted away from a parent entity.

CHAPTER 2: DEFINITION OF A CFC

9. Chapter 2 considers a modified hybrid mismatch rule to address “differences in the way the parent and CFC jurisdiction characterise instruments and entities” (Paragraph 35) to bring certain payments into the scope of CFC rules. The broader approach is considered (in
Paragraph 38) to “be more consistent with existing CFC rules since CFC rules typically do not require a payment to be base eroding in order to take account of the payment.” Earlier in the Discussion Draft, Paragraph 1 notes 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 are recommended that clearly target BEPS related issues.

CHAPTER 3: THRESHOLD REQUIREMENTS

10. Paragraph 51 states that there is no general recommendation for or against de minimis thresholds, but that anti-fragmentation rules should be considered best practice if jurisdictions choose to have such a threshold. Annex 1 of the Discussion Draft includes information on existing thresholds, and we encourage the OECD to consider the benefits and disadvantages of those to make a clear best practice recommendation. Making such a recommendation will increase the prospect of having more consistent rules, mitigating some of the potential compliance burden of differing regimes. Even if countries cannot agree to a best practice monetary threshold, agreeing to the principle of how such a limit should be determined would be beneficial.

11. In addition to monetary thresholds, we also encourage the OECD to consider alternative options, such as time thresholds. Due to differences in threshold requirements between CFC regimes, and/or the impact of calculating an effective tax rate using the parent jurisdiction tax laws, a newly acquired company, which may not have been treated as a CFC under its previous owner, may be treated as a CFC under the new parent jurisdiction regardless of the existence of BEPS activities or risk. An exemption/transitional period would be welcomed following such transactions (as, for example, is provided for in the UK rules) for MNEs to properly integrate activities and undertake any necessary reorganizations after an acquisition. As we have indicated earlier in this response, appropriate simple threshold tests are critical to the success of the OECD’s recommendations.

12. As noted above, the purpose of CFC rules has not been clearly articulated in the Discussion Draft. This fact makes it very difficult to suggest clear and appropriate thresholds. The BIAC recommendations that follow, however, are intended to ensure that CFC rules do not interfere with efficient structures, creating unnecessary compliance burdens for taxpayers.

13. In paragraph 52, the Discussion Draft disregards the use of an anti-avoidance threshold requirement as it would increase the administrative burden. CFC rules were initially designed as anti-avoidance legislation, and BIAC believes that an anti-avoidance threshold could be a useful compliment to the rules. This would help to target the rules at actual abuse, rather than potentially bringing into scope a number of non-abusive transactions.

14. Paragraph 57 recommends the use of the effective tax rate (ETR) of a CFC to determine the low-tax threshold. Paragraph 58 goes onto 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 intermediary holding companies in different jurisdictions, the application of different rules
and accounting standards would substantially increase the cost of complying with CFC Rules – as we have identified in previous discussions on Country-by-Country Reporting, 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.

15. In determining the 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).” Although the policy objective here may be clear, there are a number of practical issues that would need to be considered before such an approach could be applied – clear guidance would be required to deal with timing differences, and other legitimate reasons why a CFC’s ETR may fluctuate significantly from one year to the next (for example, many countries offer reduced tax rates for natural resource exploration activities, after which the applicable tax rate increases substantially). One solution could be to adopt a rolling average approach to smooth the ETR, although careful consideration would be required to determine an appropriate rolling period. Such a rolling period may not work for all industries (for example, extractives), and further detailed work would be necessary to determine how such an approach could be effectively implemented without causing substantial compliance difficulties for taxpayers.

16. As Paragraph 61 notes, there will also be substantial complications in determining the denominator under different standards. If an ETR approach is adopted, we would recommend flexibility to permit the use of local GAAP.

17. Paragraph 63 goes on to explore the ‘unit’ of the calculation, considering an income stream, entity, or country based approach. Calculating an ETR per income stream would appear to create an almost impossible compliance burden for MNEs, and should be avoided. Although and entity approach may be considered preferable by some countries from a policy perspective, we would welcome further consideration of how other reporting requirements could be used to help determine CFC risk in an efficient way, ruling out lower-risk entities.

18. CFC rules are used to override foreign tax rules (specifically those that apply low rates of taxation) through domestic legislation. This is understandable in cases of wholly artificial structures. However, the OECD’s proposals go beyond this objective. For example, where a source country permits a tax neutral reorganization, the parent jurisdiction could still tax any locally non/low taxed reserves. CFC rules should be targeted at abusive transactions, not legitimate commercial arrangements.

CHAPTER 4: DEFINITION OF CONTROL

19. 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 (including control based on consolidation) can be effective in determining control, but we would encourage the OECD 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. An approach based on consolidated accounts may also be appropriate for
some taxpayers, but could also produce unusual results for others that are required to consolidate minority owned entities (over which they have little actual control).

20. As the Discussion Draft notes, de facto tests tend to be more subjective in nature and burdensome to apply – the OECD also states in Paragraph 67 that “If a de facto control test could be designed to arrive at accurate results without these significant administrative and compliance burdens, it could also be included in a recommendation,” but does not identify such tests that would satisfy this requirement. Such a recommendation should only be made if reasonable options are identified for countries to adopt. The potential approaches set out in Paragraph 67 would require substantial work to determine control, which would also require monitoring on an ongoing basis.

21. Paragraph 65 states that “a CFC should be treated as 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.” Again we believe that the OECD should establish a clear best practice in this regard, and that more than 50% would appear to represent a reasonable threshold. Through having consistency in key measures like control, the compliance burden for business will be somewhat reduced.

22. The Discussion Draft also recommends that rules be adopted to target taxpayers “acting-in-concert,” either using a fact based approach (Paragraph 71), by looking the relationship of the parties (Paragraph 73), or by using a concentrated ownership requirement (Paragraph 75).

23. We are concerned that the application of “acting in concert” tests could add complexity to the rules, and could be open to subjective interpretation, potentially bringing into scope unintended entities.

24. As suggested by paragraph 71 of the Discussion Draft, the “acting-in-concert” approach is heavily reliant on fact-based analysis and would create significant administrative and compliance burdens for taxpayers. We believe that any benefits of a more fact based approach would be outweighed by the substantial cost of its application. In contrast, the application of the “relationship of the parties” approach (as set out in Paragraph 73) to determine joint control of a CFC seems reasonable.

25. Although we understand the motive behind the “concentrated ownership” approach, the Discussion Draft doesn’t consider cases where a listed company intermediary exists 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.
26. Under the CFC rule of Country A, a control test is imposed based on a ‘more than 50%’ ownership threshold, alongside a concentrated ownership requirement. Under the general rule, C Co would not appear to be a CFC or A Co or B Co, but it is understandable that a concentrated ownership requirement could be appropriate to deal with cases of artificial fragmentation. Although we agree that artificial cases should be targeted, such rules should not bring into scope where there is no real relationship between the owning parties. In the above example, A Co and B Co each has a 50% interest in C Co. Both A Co and B Co are listed companies. The shareholders of B Co are not disclosed except large shareholders owning more than certain percentage of shares. None of the disclosed shareholders are resident in Country A. Although there may be a small number of individual shareholders of B Co resident in Country A, A Co is unable to obtain such shareholder information from generally available public sources.

27. Since it is very unlikely that A Co would be “acting-in-concert” with individual shareholders of B Co, and considering the practical difficulties of application, we believe it would be appropriate not to consider the shareholders of such a listed company to determine whether the concentrated ownership requirement is met. Therefore, in the above example, C Co should not be treated as a CFC under the CFC regime of Country A. Clear guidance would be required to deal with such cases where listed companies intermediate in the ownership structure.

CHAPTER 5: DEFINITION OF CFC INCOME

28. BIAC is concerned by the note added at the start of Chapter 5, emphasising that the approaches to defining CFC income do not reflect a consensus view. We are concerned that the options identified in this Chapter represent substantially different perspectives and underlying theories regarding the purpose of CFC rules, and that there is not sufficient time remaining in the BEPS process to arrive at a consensus position with broad stakeholder input on the specifics of the proposals. The differences in proposals appear to stem from fundamental differences in tax regimes (e.g., territorial vs. worldwide systems) and opposing views as to what the role of CFC rules should be, including how such rules should interact with Transfer Pricing.

29. As already noted, the result of a minimum standard with substantial optionality delivered under BEPS Action 3 could be the adoption of new CFC rules by a number of countries. Based on the Discussion Draft’s recommendations, we believe there is a substantial risk that
resulting CFC rules could include more income than would be required to combat BEPS. Prior to widespread adoption of broad rules, BIAC would recommend further economic analysis (perhaps conducted as part of BEPS Action 11), to understand how such rules might impact trade and investment. Any avoided tax recovered by such rules should not be outweighed by the cost created through friction to international trade. We support the OECD’s focus on “more narrowly targeted partial-inclusion systems that only attribute income that raises profit shifting concerns” (Paragraph 83).

30. We agree with the statement in Paragraph 85 that “If CFC rules are designed to apply only to stripping of the base of the parent jurisdiction, then income should not be attributed if it arises from value-creating activity in any jurisdiction other than the parent jurisdiction.” We believe that this should indeed be the focus of CFC rules, and such rules should not attribute income to a parent entity that relates to substantive activities undertaken elsewhere. It is clear that Developing Countries are in focus here, and the Discussion Draft does comment on the potential for positive spill over effects on source countries, potentially due to the disincentive that appropriate CFC rules can create for tax avoidance. In this regard, we worry that the use of broadly crafted CFC rules to address such concerns would be an indirect approach, and such issues would be better targeted through more direct measures, for example, improvements to the Transfer Pricing Guidance and expanding capacity-building work.

31. Paragraphs 83 and 89 suggest that substance-based tests may need to be incorporated into CFC rules applying between member states to address EU Law restrictions. As noted earlier in these comments, we believe that the OECD’s minimum standard should represent a minimum standard for all jurisdictions, and should not create a two-tier system for MNEs operating inside and outside the EU.

32. BIAC agrees that using only-form based tests to determine income inclusion would be overly-broad. Substance-based tests are a necessary addition, but it is important to consider the compliance burden that such subjective requirements create. In this regard, we would encourage the use of practical ‘threshold tests’ that could be applied prior to detailed substance-based tests, to reduce the population of entities/activities that more burdensome requirements would apply to. In this way, only activities presenting a CFC risk would be subject to further analysis to determine what portion of its income should be subject to the rules.

33. In this regard, we are concerned that the “viable independent entity analysis” and “employees and establishment analysis” would likely override the application of the Arm’s Length Principle. The “viable independent entity analysis” assessing income for CFC purposes after transactions have been rigorously assessed and priced based on the OECD’s new Guidelines. If there is inadequate substance, the transaction should have already been either re-priced or recharacterised to reflect an Arm’s Length Result. Of the three approaches suggested, the “substantial contribution analysis” may represent a more reasonable balance between the intended outcome of the application of Transfer Pricing principles and an approach that can be applied in practice (so long as there is sufficient clarity over what “level” of activity is considered sufficient in different circumstances).
34. Although the “employees and establishment analysis” may be more mechanical and objective in its application, BIAC is concerned that it would ignore ownership of intangible assets and the management and control of risk. Again, this is fundamentally inconsistent with the proposals on intangibles and risk and moves to a formulary approach to determining income.

35. These issues speak directly to the overlaps of BEPS Actions, and the challenges of delivering multiple recommendations at the same time. If the OECD chooses to move away from the Arm’s Length Principle, then that should be done in a clear and deliberate way, rather than indirectly eroding its application through conflicting recommendations.

36. Paragraph 96 sets out five broad categories of income that CFC rules could apply to, but Paragraph 97 suggests that countries may wish to implement broader rules. Where optionality is identified, we would welcome some exploration of the reasons why countries might want to implement broader rules, and what the economic impact could be.

37. Paragraphs 98 and 99 establish possible rules for dividend income, and suggest that such income should generally be treated as passive unless certain tests are satisfied. Germany is an example of a country that begins by treating dividend income as active. We would encourage further analysis of the benefits and disadvantages of active and passive assumptions, including the additional burden that a passive assumption places on taxpayers, and to what extent specific BEPS issues are likely to be targeted through a negative vs. positive presumption.

38. Paragraph 101 states that “interest and other financing income could therefore be attributed by categorising this income first as passive but excluding it from CFC income if the CFC was in the active trade or business of financing and it was not overcapitalised.” We believe it is important that active financial services businesses should be treated in the same way as any other active business (subject to suitable safeguards) – in this regard, interest income earned by regulated banking entities should not generally be considered passive. We do also believe that clear guidance is required to assess when a CFC should be considered to be engaged in such an “active trade or business”. Without clear guidance, different countries may interpret this proposal in different ways. In addition, we would welcome further guidance on what should be considered interest income for the purpose of best practice CFC rules. Banks have many forms of income, and clarity will be required to understand its proper treatment.

39. BIAC also believes that footnote 48 of the Discussion Draft would benefit from clarification. This footnote states that “the UK CFC rules include a safe harbour for banking income under which a CFC is not considered to be overcapitalised if the tier one capital ratio (i.e., tier one capital over the total risk weighted assets) of the CFC does not exceed 125% of its UK banking group’s capital ratio.” We believe that this sentence is misleading, as the 125% ratio is just one part of an over-capitalisation safe harbour applied in the UK rules. The OECD’s explanation should be extended to consider the different aspects of that safe harbour.

40. Paragraph 102 goes on to express concerns that profits of insurance companies might be easily shifted to low-tax jurisdictions and away from jurisdictions where the insured risks are located, and that CFC rules can play a role in preventing BEPS in this context. We are concerned that such a generalised view does not reflect the real structure of many insurance operations which are heavily influenced by regulation and efficient capital management. In
addition, the insurance industry is one of the world’s oldest and, in general, should not be described as overly complex. Therefore, we believe the following sentence in paragraph 102 of the Discussion Draft should be deleted: “Further, due to the complexity of the insurance of risks generally, taxing authorities may not have the capacity or ability to successfully challenge the extent to which companies have actually transferred the risks to related CFCs.”

41. We believe it should be clarified what “overcapitalization” means in an insurance context, and which capital should be considered – for example, would the focus be on Solvency I regulatory capital of the country of residence, solvency II risk capital, a comparable average capital of competitors in the market or another formulation?

42. We are concerned about the option suggested in Paragraph 106 and 110 that “CFC rules may therefore be more effective if they eliminate the distinction between sales and services income and IP income and treat all sales and services income as passive unless the CFC had engaged in the substantial activities (including the development of the IP) required to earn the income.” Although we understand that there are concerns about the use of invoicing companies and the recharacterisation of IP income, applying such a broad approach risks bringing into scope a huge spectrum of legitimate transactions that should not be subject to CFC inclusion. Having such a negative assumption of abuse would create a disproportionate compliance burden for many taxpayers. More pragmatic threshold approaches to identifying risky entities and would be preferable – therefore we support an active presumption for services and sales income, unless specific thresholds are breached.

43. In many sectors, services represent the totality of the activity performed, and for these to be presumptively passive seems troubling. Furthermore, services are often an integrated part (or, at least, adjunct) to manufacturing activity. To treat such income as presumptively passive is to ignore the economic and commercial reality of much of modern business.

44. Following our comments above, we note that Paragraph 110 states that “CFC rules may therefore be more effective if they apply just one rule to sales and services income and IP income that would treat all sales, services, royalty, and other IP income as passive unless the CFC had engaged in the substantial activities required to earn the income.” If CFC rules are to be appropriately targeted, we believe it is essential to recognise that not all IP income is passive in nature. IP can often have a relatively short life and requires significant on-going cost and active management to continuously maintain, update and replace it. We are concerned that, if income from sales, services and IP are to be conflated and assumed passive, that this could substantially increase the compliance burden faced by taxpayers in situations that do not represent a BEPS risk. More targeted proposals would be welcomed, to better include BEPS related income.

45. Noting our concerns about the categorisation of income above, we do believe that a Categorical Approach to attributing income is preferable to and Excess Profits Approach. Businesses have experience in applying categorical type approaches that adopt form and substance based analyses – in this regard, it should be possible to identify a number of best practice approaches that can be used to develop substance tests that are both administrable and effective in identifying income that should be attributed. We would like to reiterate here
that income from operational activities should clearly be prevented from CFC inclusion, so a
categorical approach should include sufficiently robust and easy to apply filters to exclude
substantive activity and active income.

46. We are concerned that an Excess Profits Approach, through its mechanical application, risks
bringing into scope a substantial amount of active income, and undermining the application of
Article 9 and the Arm’s Length Principle. Paragraph 117 suggest that this approach could be
used as an add-on to more traditional CFC rules, but we are concerned about the substantial
compliance burden that this could create.

47. We are also concerned that the excess profits approach goes beyond targeting BEPS, and
would bring into scope income solely based on the tax rate applied by particular jurisdiction.
The BEPS Action Plan stated that “no or low taxation is not per se a cause of concern, but it
becomes so when it is associated with practices that artificially segregate taxable income from
the activities that generate it,” which suggests that a low tax rate should only be concerning
when it is accompanied by BEPS activity. The Discussion Draft (Paragraph 118) states that “an
excess profits approach is intended to target situations that give rise to BEPS by
characterising as CFC income excess profits in low tax jurisdictions,” suggesting excess profits
in low tax jurisdictions is, by itself, a BEPS issue. The Discussion Draft goes on to suggests that
an Excess Profits Approach might be appropriate as “intangibles and risk-shifting transactions
among related parties could be susceptible to systematic mispricing, leading to a profit in
excess of the normal returns that would not occur if the same transactions were undertaken
with unrelated parties.” In this regard, we are concerned that identifying a ‘normal’ return for
intangible related transactions is an incredibly difficult task given the unique nature of IP.
Indeed, the OECD has explored the difficulties in pricing returns to such assets (and identifying
appropriate comparables) in its work on the Transfer Pricing of intangibles.

48. BIAC agrees with the statement in Paragraph 121 that “an excess profits approach will include
income irrespective of whether it arises from genuine economic activity of the CFC and where
there is appropriate substance,” therefore going beyond the traditional scope of CFC rules.
The mispricing of intangible related transactions would be better addressed through the
OECD’s work on Transfer Pricing, and perhaps even through Special Measures if they are
considered necessary, for example, through the commensurate with income proposal. That
being said, we note that the Discussion Draft states (in Paragraph 122) that “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,” suggesting that
certain countries believe that the Transfer Pricing Guidelines and potential Special Measures
will be incapable of addressing BEPS concerns. Although that may prove to be the case over
time, we would encourage the adoption of one approach before the other, to avoid targeting
the same issue with multiple solutions. In this regard, we are concerned that the approach
discussed in Paragraph 122 would make adjustments without reference to economic reality
and proper allocation of value. Transfer Pricing should be considered a preferable option as it
would rectify pricing issues between two parties, regardless of whether there is a parent-
subsidiary relationship.
49. In addition to the policy concerns associated with an excess profits approach, there will also be substantial administrative difficulties in determining eligible equity and the rate of return. In particular, from a taxpayer perspective, determining eligible equity could be complicated by the broad definition (paragraph 119) where “intangible property would be defined broadly to mean something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and which increases the value received by the company, over and above normal returns. Under this definition, intangible property should include intangibles that are not legally protected, such as trade secrets, know-how, customer lists, management systems, networks, data, goodwill, and other similar items.” This approach would potentially require the assessment of eligible equity based on assets that “not recognised on the balance sheet at all,” creating further substantial difficulties.

50. It may be that an Excess Profits Approach is largely being considered as an appropriate tool for countries operating worldwide tax systems with deferral. We believe that such an approach would be extremely problematic in any type of tax system, not only due to the inherent complexity, but also due to the substantial economic distortions it could create.

51. If such an approach is pursued, a substance based exclusion would be critical to i) ensure that the issues targeted do relate to BEPS, and ii) increase the likelihood of compliance with EU Law.

52. In terms of determining whether an entity or transactional approach should be pursued, we believe that a narrowly targeted partial inclusion system could be achieved through an entity or transactional approach, so long as adequate filters and thresholds are available to exclude lower risk entities from further assessment. This would focus the administrative burden on the activities/entities that pose the greatest risk.

CHAPTER 6: RULES FOR COMPUTING INCOME

53. Paragraph 131 of the Discussion Draft recommends the use of parent jurisdiction rules to calculate a CFC’s income. It should be clarified that this applies only to passive income.

54. Although BIAC believes that CFC loss restrictions may be appropriate, we believe that explicit recommendations should be included in the Discussion Draft so that losses continue to be available following a change in ownership of a CFC. We do recognise that this is a complicated issue, and further work will be needed to determine an appropriate best practice response.

CHAPTER 7: RULES FOR ATTRIBUTING INCOME

55. Paragraph 143 of the Discussion Draft recommends that the tax rate of the parent jurisdiction should be applied to the income. It should be clarified for each jurisdiction which tax rate should be applied, and whether other trade taxes should be included.

56. Paragraph 146 suggests a best practice that either ties “the attribution threshold to the control threshold” the use of “another attribution threshold that attributed income to, at a minimum, taxpayers who could influence the CFC”. We are concerned by the potential range of approaches that could result from this recommendation, and would encourage the establishment of a clear best practice that could be adopted by a broad range of jurisdictions.
In this regard, methods to determine whether minority interests could influence a CFC could represent a compliance burden that is disproportionate to the benefit. BIAC recommends tying attribution to the broader control threshold.

57. Although BIAC agrees that the parent country tax rate should apply to appropriately attributed CFC income as the most effective way to target BEPS issues, we do not believe that CFC rules should automatically apply simply because the parent country tax rate is higher than a subsidiary. We understand that a lower ‘top-up tax’ may have been proposed to counter some of the other recommendations that could result in the inclusion of active income. As noted previously, the inclusion of active income will have a damaging impact on competition and trade, and should be avoided as a matter of policy. Seeking to rectify the over-inclusion of income through the application of a lower tax-rate should be avoided, and could even lead to separate issues of further tax competition.

CHAPTER 8: RULES TO PREVENT OR ELIMINATE DOUBLE TAXATION

58. As discussed previously, as it stands, an OECD minimum standard that permits substantial flexibility risks creating a myriad of different conflicting CFC rules that will be difficult to administer for taxpayers and tax administrations alike (as is noted in Paragraph 159). One natural outcome of conflicting rules is an increase in double taxation. The issues identified in Paragraph 154 are expected to be exacerbated by these proposals.

59. The Discussion Draft states that a number of double tax concerns could be addressed by allowing a credit for foreign taxes actually paid, including CFC tax assessed on intermediate companies. However, if multiple different versions of the OECD’s recommendations are enacted in different countries, we are concerned that a lack of uniformity will result in some of those countries not recognising credits for foreign taxes collected by virtue of competing rules. The same issue could easily also be faced in relation to the exemption of dividends and gains on disposition of CFC shares. In addition, we believe that the Discussion Draft that foreign tax credits should include both corporate income tax and trade taxes.

60. Paragraph 159 recommends that “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,” and that “there should also be a hierarchy of rules to determine which countries should have priority,” which could “prioritise the CFC rules of the jurisdiction whose resident shareholder is closer to the CFC in the chain of ownership”. As noted already, we are concerned that the proposed ‘minimum standard’ will result in a number of CFC regimes that bear little resemblance to each other. Expecting countries to coordinate their double tax relief efforts in relation to rules that are applied in an inconsistent manner is likely unrealistic, and the prospect for double taxation is significant. Only through the recommendation of consistent rules would such relief be realistic.

61. Paragraphs 164 – 168 identify other complex areas where double taxation might arise, and the application of mechanical reliefs will once again become more difficult here as countries adopt different and conflicting rules. Those areas include how to relieve double taxation on the distribution of previously included CFC income and adjust foreign taxes when there is additional withholding tax on income that was previously included as CFC income. Although
issues are raised, no clear recommendations are provided. Much more work is required to develop effective solutions to these issues. Double taxation can also be caused by other timing differences not mentioned in the Discussion Draft, for example, through dividend add-back rules (similar to those operated by France), and through thin capitalisation restrictions (where a deduction may be restricted at the payor level but full income may be subject to CFC inclusion).

62. In addition, the Discussion Draft requires companies to determine effective tax rates taking into account rebates or refunds of foreign taxes, which would seem to require a form of tracking of taxes to income and years. Such complications, especially in the context of multiple overlapping rules, create additional double taxation risk.

63. BIAC believes that a much more comprehensive assessment of how the risk of double taxation risk can be mitigated, and to fully understand the potential negative implications of the proposals on trade and investment.
Annex 1: Non-Consensus responses by individual BIAC members to OECD Questions for Consultation

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?

This is unlikely to be an issue where there are no transparent entities other than partnerships and trusts, and where the legal and tax frameworks interact well.

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

PEs should not be included in the CFC definition, a similar and far less complex result can be achieved by denying the exemption for PEs where the PE income is passive or derived via related services/sales income without any real work being added. For example, Australia has an exemption that works in this way.

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

Hybrid mismatch rules should be counted by ensuring all CFCs income is recalculated under the resident countries tax rules removing any influence of hybrids from the CFC regime unless the resident country chooses to allow hybrid entity and the relevant tax outcomes that might prevail.

For example, Australia’s CFC rules contain specific foreign hybrid limited partnership measures, designed to provide certainty and remove unintended consequences for taxpayers that would otherwise result from the taxation treatment of foreign hybrids under the CFC regime.

CHAPTER 4: DEFINITION OF CONTROL

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

Some control tests currently used are broad enough to include most foreign companies that can be controlled as CFCs. There is no look through and watering down from the parent company. Once it is a CFC, the entities below it are considered in isolation assuming the CFC is wholly owned. Inclusion in the system should, by its nature, be wide, as long as further exclusions ensure easier compliance when you get to attributable income. Control should only be a gateway into the regime.

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?

Australia’s current regime indicates a combined control test as a gateway. For instance it includes as a CFC, a foreign company that is held 50% or more by 5 or fewer Australian residents, therefore it is controlled from Australia. It also includes if any Australian shareholder owns 40% -50% and no other controller exists within the shareholders and an effective control test. These are only gateway tests. There is a further exemption in assessing the level of attributed income, and then what owners
should attribute (normally having to have an attributable (equity) interest of 10% or more). The Australian tests are more than robust in determining the right outcomes.

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?

In a practical sense, a higher threshold activity test reduces the effectiveness of any CFC regime and therefore a lower threshold regime is more likely to get the results trying to be achieved. However, the lower the test the more compliance work that will need to be done, and the large amount of taxpayers actually get caught up in the system.

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?

This could be done in two ways. 1. As a CFC if owned from the domestic country, and 2. They have an insurance tax levied on the payer of insurance premiums and assume a 10% net income at 30% tax. 3% on the premiums paid. This seems to be the best way to capture insurance sold into a country from a foreign insurer regardless of if they are captives or just a MNE insurer with no presence in country. It reduces the overall impact of captive insurance initiatives in terms of tax anyway. Of course further to this tax if the revenue authority can determine the full profit of the foreign insurer it could have the ability to take that full profit.

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

There are no practical problems in applying CFC rules to services sales or IP related income, other than the additional compliance cost to determine what is or isn’t included in the CFC income calculations.

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

An excess profits approach does not seem appropriate or necessary. Limiting the categories of income included in attributable income is important in saving compliance costs and keeping most immaterial amounts out of the system.

CHAPTER 6: RULES FOR COMPUTING INCOME

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, a significant compliance burden would be placed on taxpayers. In this regard, the second half of Option 1
mentions that “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 for 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.
Dear Mr. Pross:

The Brazilian National Confederation of Industry (CNI) 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 3 April 2015 (the “Discussion Draft”). The comments offered by CNI in the attached report focuses on technical and policy issues which are particularly sensitive to Brazilian Industry yet which are relevant to all nations.

CNI is the largest and highest-level representation of industry in Brazil with a mission to promote a favorable business environment, enhance competitiveness and promote sustainable development. CNI represents 27 state federations of industry, over 700,000 manufacturing companies and 2,000 sectorial associations, encompassing issues such as economic policy, infrastructure, environment, SME development, labor relations, and international negotiations. CNI develops an active process of dialogue and influence with the National Congress and the Executive. With the Judiciary, the organization has the power to propose measures to ensure that laws are empowered by the Constitution in any respect that affects the industry’s interest. CNI also operates a vast high quality network of professional qualification, education, management training and promotion of entrepreneurship through three entities it oversees: the National Industrial Training Service (SENAI), the Industrial Social Service (SESI) and the Euvaldo Lodi Institute (IEL).

CNI will remain engaged in the BEPS Project and hopes to contribute further with the OECD and the G20 in the discussion of this and all other Action items.
Brazilian-headquartered multinational enterprises (MNEs) that are members of CNI have significantly expanded their global presence and footprint in the recent past, and operate complex global value chains with massive presence in Europe, Asia, Africa and the Middle East, and North America, and substantial trade across such regions. The potential ramifications from the proposed changes under the BEPS Project might differ in different areas of the world as, we fear, different nations will tend to interpret or enforce the proposed changes according to their national tax policies and traditions.

In the area of CFC rules, nonetheless, the Brazilian standard of full annual inclusion of all foreign-source income each year (even of active trade or business income earned and reinvested by uncontrolled entities, and in spite of bilateral treaties) is a harmful rule, which could benefit from a positive influence stemming from the OECD and the G20 in the context of the BEPS Project. The discussion draft, however, appears to be lenient towards such standard in spite of its harmful effect on global welfare, international investment, and employment growth.

The OECD/G20 coalition in the context of the BEPS Project represents an opportunity for enhanced global cooperation regarding international tax matters, and Brazilian Industry believes the discussion of stronger and consistent CFC standards can serve as an avenue for Brazil to improve its position and reduce barriers to the foreign direct investment of Brazilian headquartered MNEs. The international CFC standards adopted by other countries and cited in the discussion draft are more conducive to economic growth, to employment growth, and to investment growth, than the current Brazilian standard. Therefore, if in the context of BEPS the world embraces a common standard (or set of principles) which viewed as curbing abuse and protecting the tax base, Brazil would have a unique opportunity to reform its current rule seeking to secure its stance as a home-country of MNEs and

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increase its competitiveness and attractiveness vis-à-vis the rest of the world.

We offer our comments in this report using the following structure:

I. General Commentary on the Proposed Changes under Action 3;
II. Enforcement and Interpretation Issues Affecting Industry within Brazil;
III. Enforcement and Interpretation Issues Affecting Brazilian Industry in China, India, and in Developing Countries;
IV. Enforcement and Interpretation Issues Affecting Brazilian Industry in Europe and North America.

I. General Commentary on the Proposed Changes under Action 3

Foreword on Brazilian Anti-Deferral Rules

Brazil remains as a significant exporter of commodities, and also of diverse manufactured goods, and Brazilian MNEs that expanded globally represent very diverse sectors of industry (e.g., oil and gas, mining, steel, food and beverage, aviation, engineering services, etc.). The expansion of Brazilian MNEs occurred most markedly in the last two decades, a period during which international tax concepts and standards were well established, tried and tested by MNEs that originated in the U.S. and in Western Europe. Accordingly, many Brazilian headquartered MNEs established regional headquarters or global “super-holding” structures particularly within Europe in order to benefit from wider networks of tax and investment treaties, and from a more stable and sophisticated environment as it pertains to international tax law.

Brazilian rules dealing with the taxation of income earned abroad by MNEs headquartered in Brazil lags behind international standards. And such rules changed significantly over time – often for the worse. Prior to 1995, Brazil operated a territorial system. From 1996 through 2001, Brazil introduced a worldwide tax system with foreign tax credits (direct and indirect) wherein
foreign source income earned by Brazilian headquartered MNEs would be taxed in Brazil when distributed or “made available” to Brazilian investors (“claim of right” doctrine). Brazil experimented with (quasi-CFC) “deemed distribution” rules between 1997 and 2000, but never properly developed legislation to address mobile income, or passive income earned or accumulated abroad within Brazilian MNE groups, through CFCs. Quite to the contrary, since 1997 Brazilian transfer pricing rules were enacted and export “safe harbors” served as an incentive for Brazilian exporters to establish foreign-based sales entities and accumulate earnings at such entities which would otherwise be recorded within Brazil, if Brazil had adopted OECD Guidelines for transfer pricing, or proper anti-deferral (CFC) rules to address mobile income.

Instead of fixing design flaws of its transfer pricing rules, Brazil adopted a “full-inclusion” method as from 2001, requiring all foreign earnings (no matter if active or passive, no matter if reinvested at source, no matter if redeployed as working capital, or kept in treasury portfolios) to be recorded as taxable in Brazil. Effectively, Brazil introduced a barrier to capital exports, and misconceives such barrier as a representation of “capital export neutrality”. As a response, Brazilian MNEs had to become even more international and off-shored significant functions and activities to their “super-holding” structures (management and operations) in order to secure treaty entitlement for their global value chains, and engaged in substantial litigation in Brazil seeking the deferral (or minimization) of Brazilian tax on foreign source income.

The entire discussion under Action 3 of the BEPS Project, thus, is very relevant to Brazilian headquartered MNEs particularly for two main reasons: (a) international structures established by such Brazilian MNEs operate super-holding or headquarter entities which rely on the application of current CFC standards within Europe, the U.S., and worldwide; and, hopefully, (b) strengthened standards developed in the context of the OECD/G20 BEPS Project may encourage Brazil’s policymakers to adopt a new standard which might be deemed sufficiently effective to curb abuse yet which would replace current anti-deferral rules – as such, Brazilian MNEs would no longer be at a significant competitive disadvantage versus all other MNEs from around the globe.

In this sense any and all standards discussed in the current draft, if adopted in Brazil in lieu of current anti-deferral rules, would be welcomed by Brazilian
Industry. Such development would not only foster the competitiveness of Brazilian MNEs, but enable greater investment through such MNEs that would generate employment, wealth, and welfare not only in Brazil but worldwide.

General Comments on the Policy Statements of the Discussion Draft

In its first page, the discussion draft states as follows:

“Action 3 of this plan stresses the need to address base erosion and profit shifting using controlled foreign company (CFC) rules. Many countries already have CFC rules, but these rules do not always counter BEPS in a comprehensive manner. While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spillover effects in source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.

Working Party No. 11 (WP11) has considered many options for the design of CFC rules that would prevent base erosion and profit shifting. This discussion draft considers all the constituent elements of CFC rules and breaks them down into the “building blocks” that are necessary for effective CFC rules. Most of these building blocks include draft recommendations. The exception to this is Chapter 5, which deals with the definition of CFC income and which does not include recommendations but instead discusses several possible options. The building blocks include:

- Definition of a CFC
- Threshold requirements
- Definition of control
- Definition of CFC income
- Rules for computing income
- Rules for attributing income
- Rules to prevent or eliminate double taxation”

The statements above would appear to be aligned with the overall purpose of the BEPS Project, as one would expect the refinement of the
The aforementioned “building blocks” to be considered strictly in the context of BEPS. However, after reviewing the entire document, Brazilian Industry cannot see a clear and coherent policy orientation, which represents a “missed opportunity” (or lack of leadership), as reflected in several statements which are conflicting and confused and can serve to condone multiple incoherent practices around the world which are detrimental to foreign direct investment and to international cooperation.

As the draft continues, its true nature become more and more apparent:

“This document does not necessarily reflect consensus views of either the Committee of Fiscal Affairs (CFA) or of WP11 regarding the issues it addresses. Rather it reflects preliminary consideration of the issues since the publication of the Action Plan and seeks to identify issues for public comment. (…)

Some countries have proposed that in addition to CFC rules (which for the purposes of the proposal is described as the “primary rule”), countries could introduce further rules (the “secondary rule”) that applied to income earned by CFCs that did not give rise to sufficient CFC taxation in the parent jurisdiction. Such secondary rules would introduce a secondary form of taxation in another jurisdiction (for example the source country of the income earned by the CFC).

Working Party 6 is currently considering several options for special measures in the area of transfer pricing as part of Action Items 8-10, which could be implemented as possible secondary rules. Possible future work on the options to address the tax challenges of the digital economy could also be adapted to be applied as secondary rules. There is a question as to whether any of these options might form the basis for a secondary rule.

The CFA has not yet considered whether this high level proposal should be taken forward.”

The aforementioned statements seem to demonstrate that there is absolutely no concerted effort, far from no consensus; there seems to be no common thread of anti-BEPS policy in the discussions that occur within the working groups. And no coherence whatsoever between the discussions and the mandate arising from the BEPS Action Plan of 2013. Instead, there appears to be a significant conflict of adversarial views between countries (and between certain countries and the CFA/OECD itself), regarding the
meaning of international investment and international trade, and regarding the role of MNEs in promoting economic growth and welfare. Apparently, the discussions are no longer focused on global base erosion through profit shifting (i.e., through abuse, stateless income, hybridity) and harmful tax competition, but instead in a distorted sense national base protection from foreign investment.

What is the meaning of “sufficient taxation at the Parent” which would justify “secondary rules” for supplemental tax outside of CFC regimes? What jurisdictions would impose such supplemental tax? The draft notes transfer pricing and its “special measures”, of course, but merely as an example. These vague statements create an environment of uncertainty and risk, and may incite incoherent, unilateral actions by countries outside any common standard, and outside transfer pricing, such as Brazil’s full-inclusion of active and passive income which discriminates against any foreign investment of any kind in any country which maintains a rate of corporate income tax that is lower than Brazil’s. Again Brazil’s policy is not at all what is “recommended” in the discussion draft, yet the language of the draft is so broad that may mislead readers (including authorities and policymakers) to interpret that “anything goes” with the excuse of protecting the national tax base in the context of international investments and operations of MNEs, which is an extremely negative tax policy “context” for the OECD to condone or encourage, and in fact one that is simply contrary to the mission and the Charter of the OECD itself.

Still, the discussion draft moves on to provide a collection of potential rules some of which used by multiple countries from around the world, some of which informed by national standards and based upon national policies which serve multiple different purposes, often inconsistent and incoherent across countries. Again, a common thread and objective is simply missing, and as the draft continues it quite often distances itself from the BEPS debate.

In its introduction, the discussion draft outlines quite properly its mandate, and it lists the general features (i.e., “building blocks”) of CFC rules, as follows:

"1. Action Item 3 of the BEPS Action Plan recognises that groups can create low-taxed non-resident affiliates to which they shift income and that these affiliates may be established in low-tax countries wholly or partly for tax reasons rather than for non-tax business reasons. Controlled foreign company (“CFC”) rules combat this by enabling
jurisdictions to tax income earned by foreign subsidiaries where certain conditions are met. However, some countries do not currently have CFC rules and others have rules that do not always counter BEPS situations in a comprehensive manner. Action Item 3 mandates Working Party 11 (WP 11) to “develop recommendations regarding the design of controlled foreign company rules”. The objective is to develop recommendations for CFC rules that are effective in dealing with base erosion and profit shifting.

2. CFC rules have existed in the international tax context for over five decades, and dozens of countries have implemented these rules. This discussion draft 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, and they include:

I. Definition of a CFC
II. Threshold requirements
III. Definition of control
IV. Definition of CFC income
V. Rules for computing income
VI. Rules for attributing income
VII. Rules to prevent or eliminate double taxation

3. Before discussing these seven building blocks, this discussion draft first addresses the policy considerations to be considered in the context of Action Item 3. These include some fundamental policy considerations that need to be considered when designing CFC rules such as how to strike a balance between the need to tax foreign income and the need to maintain competitiveness, how to limit administrative and compliance burdens while ensuring that CFC rules are effective, and the avoidance of double taxation. It also considers the role of CFC rules; that is their role as preventative measures, the scope of base stripping prevented by CFC rules, and the interaction between transfer pricing rules and CFC rules. These are all briefly
considered in Chapter 1. The following chapters then set out the building blocks. There are also three annexes with tables outlining how existing CFC rules currently address several of the issues addressed in this discussion draft, including how countries de minimis and low-tax thresholds work, and how they define attributable income from insurance.

However, the discussion draft overlooks the serious problems in terms of tax barriers to international investment that do exist in certain countries (and most strikingly in Brazil), and makes the following statement (which is reflected in later sections):

"4. The recommendations discussed in this discussion draft are designed to combat base erosion and profit shifting. It is recognised that some countries design their CFC rules to achieve wider policy objectives. Jurisdictions can choose to adopt CFC rules that apply more broadly than the recommendations as long as these are consistent with other international legal obligations. However, such wider aims are not within the scope of the BEPS Action Plan for CFCs."

What “wider policy objectives” could justify broader CFC rules that apply even more “broadly” than those cited in the discussion draft, and still remain consistent with “other international legal obligations” of countries? This statement can be used as a context to imply that Brazil’s and/or other country’s “broader” anti-deferral rules can serve “wider policy objectives”, and any such country can argue that its rules are consistent with international legal obligations in spite of what other countries (or the OECD) may understand. A proper statement of the OECD, therefore would have to be in the sense that rules which are “broader” than those recited and recommended in discussion draft would be inconsistent with the rules, object and purpose of the OECD Model Convention (and hence most likely inconsistent with the international legal obligations of countries that use such broader rules).

In its Chapter 1, on policy considerations, the OECD again forgets its mission and reproduces what may be the “allegation” or “justification” of countries that apply broader rules:

"I. Purpose of CFC rules
7. CFC rules tax the income of controlled foreign subsidiaries in the hands of resident shareholders. For most countries, they are used to prevent shifting of income either from the parent jurisdiction or from the parent and other tax jurisdictions. Some countries which give more importance to the principle of territoriality do not currently apply CFC rules. For those countries CFC rules would have to be limited to targeting profit shifting. However, where countries have worldwide tax systems, they may also be concerned about long-term deferral and therefore their rules may have broader policy objectives (for example, preventing long-term base erosion rather than only preventing profit shifting).

What does “preventing long-term base erosion rather than only profit shifting” through CFC rules mean, particularly in the context of the OECD Model Convention? Not having an answer in the discussion draft creates ample room for incoherence and misconduct, and for the imposition of unilateral barriers to foreign direct investment or reinvestment in active trade or businesses.

Some of the policy statements embedded in the first chapter of the discussion draft, nonetheless, deserves attention from Brazilian policymakers, as these statements alone would justify revisions to Brazil’s current rules:

"II. Striking a balance between taxing foreign income and maintaining competitiveness

8. In designing CFC rules, a balance must be struck between taxing foreign income and the competitiveness concerns inherent in rules that tax the income of foreign subsidiaries. CFC rules raise two primary types of competitiveness concerns. First, jurisdictions with CFC rules that apply broadly may find themselves at a competitive disadvantage relative to jurisdictions without CFC rules (or with narrower CFC rules) because foreign subsidiaries owned by resident companies will be taxed more heavily than locally owned companies in the foreign jurisdiction. This competitive disadvantage may in turn lead to distortions, for instance it may impact on where groups choose to locate their head office or increase the risk of inversions, and it may also impact on ownership or capital structures where groups attempt to avoid the impact of CFC rules. CFC rules can therefore run the risk of restricting or distorting real economic activity. Second, multinational
enterprises resident in countries with robust CFC rules may find themselves at a competitive disadvantage relative to multinational enterprises resident in countries without such rules (or with CFC rules that apply to a significantly lower rate or narrower base). This competitiveness concern arises because the foreign subsidiaries of the first MNEs will be subject to a higher effective tax rate on the income of those subsidiaries than the foreign subsidiaries of the second MNEs due to the application of CFC rules, even when both subsidiaries are operating in the same country.

9. The balance between taxing foreign income and maintaining competitiveness is often discussed in the tax policy literature by referring to the impossibility of achieving both capital export neutrality (CEN) and capital import neutrality (CIN) in the absence of harmonised tax rates. CEN, under which taxes do not distort a domestic taxpayer’s decision to invest capital domestically or internationally, requires taxing foreign income at the same rate as domestically earned income. CIN, under which taxes do not favour domestic over foreign investments of capital, requires that income earned from investments in a particular country is taxed at the same rate regardless of the investor’s residence.

10. To address these concerns, CFC rules typically exempt so-called “active” income that is, or is more likely to be, linked to real economic activity in the foreign subsidiary and has not been, or is less likely to have been, shifted from the parent company. This approach may not be entirely effective in combatting BEPS, but, in developing recommendations for the design of CFC rules, the balance between taxing foreign income and maintaining competitiveness needs to be kept in mind. Another way to maintain competitiveness would be to ensure that more countries implement similar CFC rules. This is therefore a space where countries working collectively and adopting similar rules could reduce the competitiveness concerns that individual countries may have when considering whether to implement CFC rules. This discussion suggests that competitiveness concerns could be reduced either by designing the output under Action Item 3 as a minimum standard or combining this output with a secondary rule.”

Although the literature cited is very much dated (as other “neutrality” standards have been developed over time), it is clear that the OECD
understands CFC regimes as “specific anti-abuse rules” in the form of anti-deferral regimes, and that a distinction of “active” versus “passive” income is highly recommended to preserve “competitiveness” and to preserve foreign direct investments across countries which promotes welfare to all. Such distinction would only be revised if it is perceived that it would not be sophisticated enough to combat BEPS, to fight abuse, which is rather reasonable. A “secondary rule” would have to be equally specific, be it transfer pricing and its special measures (the object of Actions 8, 9 and 10), or mechanisms to confront and curb “harmful tax practices”.

The OECD should leave no room for other interpretation in its statements, as it would be contrary to the OECD mission and Charter for an OECD-led project to condone unilateral barriers to international capital flows related to active trade and active businesses.

In fact the OECD appears to advocate in favor of “softer rules” within the EU, as the discussion draft makes an effort to reconcile newly proposed CFC rules with an interpretation of EU Law and jurisprudence dealing with “wholly” or “partly” artificial arrangements. Again, a greater problem resides not with “artificial arrangements” in the context of CFC rules (except in very specific areas such as entity classification, particularly under U.S. rules), but in the over-implementation of anti-deferral rules which equate to barriers to international trade and international investment.

In this sense, the common CFC standards that are being developed under the G20/OECD Project should not be viewed as “minimum standards” but instead as exhaustive OECD-recommended standards that are compliant with the terms, object and purpose of the OECD Model Convention. As such, stricter standards would only be acceptable by the OECD if, through bilateral or multilateral MAP procedures, profit shifting and abuse are ascertained (and not if “wider national policy goals” are pursued).

On the other hand, aside from developing such definitive OECD-recommended CFC standard, it is indeed positive to pursue and achieve greater international consistency proper CFC regimes. The benefits to governments of coherently curbing abuse through consistent rules and enforcement practices would match the benefit for MNEs stemming from greater consistency of compliance practices and procedures worldwide.

Still in the “policy” chapter of the discussion draft, the following statements should warrant the reflection of Brazilian policymakers:
“16. CFC rules are designed to act as a deterrent. In other words, CFC rules are not designed to raise significant revenue in the form of additional corporate taxation. Instead, they are designed to prevent taxpayers from shifting income into CFCs in the first place, and they therefore protect revenue by preventing tax avoidance rather than subjecting parent companies to tax on their CFCs. CFC rules will, of course, raise some revenue by taxing the income of CFCs, but there is likely to be a reduction in the income shifted to CFCs after the implementation of CFC rules.

17. Because CFC rules are designed to change taxpayer behaviour, they may not have the effect that their design suggests. For example, the design of CFC rules suggests that they grant secondary taxing rights to the residence jurisdiction. In reality, however, if CFC rules effectively tax profits at a sufficiently high rate, they may also increase taxing opportunities in source jurisdictions by reducing or eliminating the tax incentives for MNEs to shift income into subsidiaries in low-tax jurisdictions.”

In this sense, CFC rules should not serve the primary purpose of equating the effective tax rate on all (controlled and uncontrolled, active and passive) foreign-source income to the home-country rate on a current basis. Such all-encompassing rule is not a policy suitable to tackle abuse, or to curb BEPS. Instead, such all-encompassing rule simply reduces foreign direct investment, under the delusion that such policy would “substitute” foreign direct investment with domestic investment. This should be made clear by the OECD, in its role as an organization that promotes international cooperation for development and growth.

Finally, in the general policy section one commentary on “base stripping” might be misleading. In discussing whether CFC rules should tackle “parent-to-foreign” versus “foreign-to-foreign” base stripping, the discussion draft emphasizes that CFC rules which do not reach “foreign-to-foreign base stripping” are not as effective to curb BEPS. One may argue that such “foreign-to-foreign base stripping” standard would be less suitable for inclusion in CFC regimes and would instead be the precise object of enhanced transfer pricing rules (i.e., “foreign-to-foreign base stripping” would be a synonym to “profit shifting” in this sense). A more appropriate view would be to ascertain that there are failures to existing CFC regimes
(such as that of the U.S. entity classification rules, i.e., “check-the-box”) under which what is in essence mobile “passive income” or “tainted income” that should be deemed distributed to the parent country in a foreign-to-foreign scenario is instead “disregarded” through hybrid mismatches or other similar practices that raise BEPS concerns. In this sense, again the failure is indeed the lack of a deemed inclusion at the parent-company tax base, as opposed to a foreign-to-foreign base difference.

Preliminary Comments in the Discussion Draft on CFC vs Transfer Pricing

The discussion draft brings some rather unfortunate general policy statements regarding the interrelation of CFC rules and transfer pricing. It starts by properly reproducing a general academic recognition of a BEPS-“backstop” effect arising from CFC rules (a deterrent against transfer pricing manipulation), as follows:

"21. Transfer pricing rules are intended to adjust the taxable profits of associated enterprises to eliminate distortions arising whenever the prices or other conditions of transactions between those enterprises differ from what they would have been if the enterprises had been unrelated. If transfer pricing rules were to fully achieve this objective, they would restore the taxing rights of all jurisdictions involved. As with CFC rules, transfer pricing rules often achieve this objective by deterring business from entering into certain arrangements. Because controlled foreign company rules by definition address related parties (as the companies that are captured by such rules are controlled by another party), jurisdictions often also use these rules to combat the adjusted prices charged between related parties. In other words, CFC rules are seen as a way for a parent jurisdiction to capture income earned by a foreign subsidiary that may not have been earned had the original pricing of the income-creating asset been set correctly. CFC rules are thus often referred to as “backstops” to transfer pricing rules."

But it then misinterprets that same definition, as follows:

"That terminology, however, is misleading, in that CFC rules generally do not complement transfer pricing rules in a coherent manner."
Instead, **CFC regimes applying a sufficiently high rate of tax may make certain transfer pricing outcomes irrelevant to the MNE by removing the benefit of engaging in transfer pricing manipulation.** It is generally therefore not that the principle of CFC rules is to capture income from transfer pricing manipulation but that certain CFC provisions may sometimes have this effect.”

In other words, insofar as an effective CFC regime is a deterrent SAAR that complements another deterrent SAAR (as it breaks the artificial deferral of mobile, passive income otherwise accumulated via “transfer mispricing”), the discussion draft alleges that CFC regimes are rules aimed at reaching income earned in compliance with transfer pricing yet sourced in low-tax jurisdictions. This is contrary to BEPS Project Mandate and to numerous statements made earlier by the OECD and the G20 in the context of the BEPS Project.

The discussion draft goes on and further states:

“23. Firstly, the type of CFC rule that would most effectively replace transfer pricing rules for transactions within the same control group would be a full-inclusion system. Given a sufficiently high tax rate, such a system, where there is no exemption for income arising from economic activity undertaken by the CFC (and all income is therefore included as attributable CFC income), provides the most complete example of the backstop effect because it removes the benefit to related parties of engaging in transfer pricing manipulation. In fact, full inclusion removes the benefit associated with any type of intragroup arbitrage because all income from such transactions will be taxed at the parent company level under a full-inclusion system. Partial-inclusion systems, particularly those that focus on formal classification of income, often only capture transfer pricing schemes haphazardly, since the determination of which income is attributed for CFC purposes does not align with the determination of what prices should be charged.”

The aforementioned argument is allegedly offered to defend that CFC rules complement transfer pricing rules and vice-versa; nonetheless it seems to imply or to suggest that a “full-inclusion system” would be not only a type of CFC rule acceptable to the OECD, but also somewhat superior to a “partial-inclusion system”. Brazilian Industry must interpret this section of the
discussion draft as covered by the “caveat” offered in the first page, i.e., the OECD CFA cannot be in agreement with such suggestion.

The discussion draft further states, in emphasizing rate differences and alleged “arbitrage” practices:

“25. Thirdly, if the tax rate of the parent state is lower than the tax rate applicable to some of the subsidiaries, it will still be advantageous to the MNE to shift profits away from those higher-tax subsidiaries.

26. Fourthly, businesses can avoid the effect of CFC rules by restructuring under companies resident in jurisdictions without CFC rules or with low tax rates while still accessing the same capital markets. Transfer pricing rules, in contrast, can be applied by all countries where economic activity takes place to protect their own tax bases.

28. In addition, transfer pricing rules alone will not capture all the income that would be targeted by CFC rules. Whilst both transfer pricing rules and CFC rules can be regarded as preventing the erosion of domestic tax bases, transfer pricing rules do so by focusing on individual transactions between related parties, while CFC rules do so by focusing on profit earned by a controlled party from transactions with a variety of counterparties. The overlap between these two rules is thus not exact, and not all profit earned by foreign subsidiaries that would be captured by CFC rules would be captured by transfer pricing rules. Also, while transfer pricing rules intend to align primary taxing rights with value creation, they are not designed to address the challenges raised by profit shifting to low-tax jurisdictions or stateless income. Effective CFC rules would, however, deter taxpayers from shifting profits into foreign subsidiaries in low-tax jurisdictions or jurisdictions that do not recognise the subsidiary for tax purposes, and they would therefore ultimately complement transfer pricing rules as a backstop. A further reason to have both CFC rules and transfer pricing rules is that this combination provides tax administrations with two different enforcement tools to combat BEPS. Finally, CFC rules are designed to be deterrent measures, which means that they may have the effect of eliminating structures and transactions entirely. The reasons above highlight why both transfer pricing rules and CFC rules may be necessary.”
If the statements above are interpreted exclusively in the context of passive income accumulation, captive portfolio investment entities and the like, there would be some sense to the policy implications to which they allude. However, no such context is provided, and quite to the contrary, “full-inclusion systems” are noted in the same thread, hence suggesting an over-interpretation of the statements that might condone the use of over-reaching anti-deferral rules such as Brazil’s. This disservice through omission (or collusion) is extremely negative from the viewpoint of Brazilian Industry, particularly from the viewpoint of Brazil’s MNEs which expect the OECD to serve as a source of proper guidance, and as a beacon that might shed light on international tax standards which are often misunderstood or misinterpreted by policymakers and tax authorities.

CFC Definitions

The discussion draft moves on to define that anti-deferral rules and corresponding thresholds should apply to controlled foreign companies (and other forms of controlled enterprises). One full section is devoted to the definition of “control”. And in a refinement of concepts, apparently needed to increase the consistency of existing CFC rules from around the world, different situations or fact patterns are examined regarding forms of enterprises (i.e., application of the rule to transparent entities, permanent establishments, etc.): a “narrow option” and an alternative “broad option” are recommended.

Here again in the area of definitions of “control” and of “CFC” any outcome would be more reasonable than the current anti-deferral rules adopted in Brazil. Particularly as in Brazil all income (active or passive) is subject to immediate inclusion, whether or not earned through a controlled enterprise or through an uncontrolled venture of any form\(^2\).

Nonetheless, in response to the main question raised in the discussion draft, it would seem that the “broad option” would appear more feasible to

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\(^2\) New Zealand is cited as another jurisdiction which includes earnings from uncontrolled ventures, with a 40% threshold (still more favorable than Brazil’s); whilst the bulk of the rules attempt to ascertain or construe whether control is evident or should be presumed.
inclusion in a CFC regime (rather than the “narrow option” which attempts to link the CFC regime to other BEPS Actions).

The discussion draft then illustrates that different countries use “threshold requirements” to facilitate administration of this SAAR, and makes recommendations as follows:

"I. Recommendations

43. The recommendation is to include a low-tax threshold where the tax rate calculation is based on the effective tax rate. The low-tax threshold should also use a tax rate that is meaningfully lower than the tax rate in the country applying the CFC rules.

II. Explanation

44. Three different types of threshold requirements were considered by the countries involved in this work:

(i) a set de minimis amount below which the CFC rules would not apply,

(ii) an anti-avoidance requirement which would focus CFC rules on situations where there was a tax avoidance motive or purpose, and

(iii) a low-tax threshold where CFC rules would only apply to CFCs resident in countries with a lower tax rate than the parent company."

Setting a “de minimis” amount below which the CFC rules would not apply is a sensible approach to the administration of this SAAR both from the viewpoint of tax administrations as well as from the perspective of taxpayers. Whereas having a “low-tax threshold” so as to avoid the application of the CFC rules in situations that are not perceived as abusive is a common and sensible practice worldwide which is consistent with the object and purpose of this anti-deferral SAAR.

It should be noted that while the rules from around the world that are cited in the discussion draft cover a range of “low-tax thresholds” that are often “relative” to the home-country rate, and which seems quite favorable from a Brazilian perspective (e.g., 50% of the parent tax rate in China, 55% in France), the average rate of corporate income tax of OECD Member Countries (as well as the Chinese rate) is well below the Brazilian rate of 34%. And again, in these countries the “exemption” applies to “mobile income”, “passive income”, or “tainted income” – whereas in Brazil no such
thresholds apply to avoid the precipitation of Brazil’s incremental tax on undistributed (and often reinvested) active income. In this sense, a new standard which perfects the current low-tax thresholds to prevent BEPS or to prevent disproportionate exemptions would be very much welcomed by Brazilian Industry, if such new standard could be considered for adoption also in Brazil (irrespective of an overall approximation of Brazil’s rules regarding “control” and “active income”).

In addressing “control” the discussion draft compiles rules from multiple countries and recites all possible standards or “control” and “influence” (, and makes the following recommendation:

"68. The above approaches are often combined to prevent circumvention and to ensure that rules operate effectively. Based on the above analysis it was agreed that a control test should focus on a combined approach that includes at least legal and economic control. Both of these tests are reasonably mechanical and so should limit the administrative and compliance burden involved. However, countries could also consider supplementing these tests with either a de facto test or a test based on consolidation for accounting purposes. Both of these, but particularly a broad de facto test, could increase complexity and compliance costs. Therefore countries that are attracted to using one of the latter two tests to address specific problems (such as those raised by inversions) may find that these problems could be better addressed with separate targeted provisions rather than through an extension of the concept of control for CFC purposes.”

Legal and economic “control” (considering control at over 50%) are indeed reasonable standards, whereas a broad de facto test is nothing more than a “substance-over-form” or “anti-abuse” measure to ascertain such control (and thus also acceptable). However, developing CFC rules based on standards stemming from accounting consolidation is a rather distortive proposition. Enterprises that are not under common control may be consolidated for accounting purposes if one exerts significant influence over another and in certain situations of operational interdependence; the object and purpose of such consolidation is to adequately portray the assets and liabilities (and the returns) of such consolidated “ventures” so that stakeholders can understand such ventures before conceding credit or otherwise taking risks from dealings with such ventures. This is not at all to
say that each deconsolidated entity which is not under common control (and which is often subject to conflicting or adversarial interests) is free to manipulate earnings allocations, shift profits, or to reinvest or distribute income, etc.

Hence, no SAAR standard in the form of a CFC rule should apply to impose a parent-level tax on such uncontrolled ventures and their foreign retained earnings. This is precisely what triggers part of the Brazilian conundrum, as the business profits of uncontrolled foreign enterprises may be partly consolidated for Brazilian accounting purposes (via “equity accounting”), which misled Brazilian policymakers to ascertain a Brazilian corporate tax on such earnings as if they were artificially retained abroad and were thus equivalent to mobile income. One would hope the OECD to concur that such outcome is inconsistent with the letter and the spirit of the OECD Model Convention.

It is worrying for Brazilian Industry that the discussion draft mentions, somewhat loosely, the possibility for jurisdictions to consider lower levels of control (beyond *de facto* control which is, in effect, a “substance” test), as this could be interpreted as an authorization by the OECD for jurisdictions to apply anti-deferral rules to any and all uncontrolled foreign subsidiaries of a resident entity, regardless of whether the parent company controls the employment of profits generated by the foreign enterprise. This would certainly be contrary to the purpose of CFC rules and would be detrimental to international trade and investment. In fact, the discussion draft even mentions that a “much lower control threshold” could represent a hindrance to EU freedoms, without discussing whether adopting such a much lower threshold would or would not be contrary to the purposes of CFC legislation and consistent with the OECD Model Convention, be it in Europe or worldwide.

**Definition of CFC Income**

Here again the discussion draft not only misses the opportunity to enlighten tax authorities from around the world as to the meaning of a CFC SAAR, but makes an effort to appease countries (such as Brazil) which adopt “broader rules” that are inconsistent with OECD standards.

Firstly, the discussion draft puts forth the following “note” to introduce Chapter 5:

"Note for consultation"
This chapter does not yet include recommendations for the building block on the definition of CFC income. Instead, this chapter discusses several possible options for provisions that jurisdictions could implement in order to accurately attribute income that raises BEPS concerns. The 2015 report on Action Item 3 will include recommendations on the definition of CFC income, and the OECD welcomes comments and suggestions during the public consultation about the design of such recommendations.

In line with the general comments setting out the non-consensus status of the discussion draft as a whole, it should be emphasised that the approaches to defining CFC income do not reflect a consensus view. In particular, there are different views on the excess profits approach set out at Part III B. The differences arise because some countries believe that an excess profits approach will include income irrespective of whether it arises from genuine economic activity of the CFC and where there is appropriate substance. Other countries believe that excluding a normal return on eligible equity is an effective method for identifying CFC income.

The approach taken by this chapter is first to outline general features that would likely be included in effective CFC rules, including a form-based analysis and several different versions of a substance analysis. This chapter then discusses how CFC rules should attribute the categories of income that raise the most challenges for existing rules. These categories of income include dividends, interest and other financing income, insurance income, sales and services income, and royalties and other IP income. This chapter then discusses two possible approaches that could accurately attribute these categories of income, whether implemented separately or in combination with each other. Finally, this chapter concludes by discussing whether CFC rules should take a transactional or entity approach to attributing income. Based on the discussions in this chapter, the public is invited to provide comments about the form of recommendations for the building block on the definition of CFC income.

So far, so good: the note emphasizes the lack of consensus regarding the definition of CFC income, and highlights that the main debate revolves around whether and how a new and alternative “excess profits approach” could be adopted, over the more traditional “categorical approach” (with a
renewed and more sophisticated “substance analysis” as opposed to a form-based analysis). Further descriptions of such alternative approaches and analyses follow under items 84 (page 35) through 125 (page 52). The debate over such alternative approaches and tests is at the core of the discussion draft and of the discussion concerning the effectiveness of CFC rules in the context of BEPS.

Nonetheless in an apparent attempt to reflect the view of countries that adopt anti-deferral rules that are inconsistent with OECD standards (and with the OECD Model Convention), the discussion draft makes yet again unfortunate references to the so-called “full-inclusion method”:

"82. This chapter discusses the fourth CFC building block on the definition of CFC income. Once a foreign company has been determined to be a CFC, the next question is whether the income earned by the CFC is of the type that raises BEPS concerns and should be attributed to shareholders or controlling parties. CFC rules therefore need to define attributable income, which is also referred to here as “CFC income”. Existing CFC regimes apply one of two approaches. They apply either a full-inclusion system, which treats all income earned by a CFC as CFC income regardless of its character, or a partial-inclusion system, which only attributes certain types of income earned by a CFC. As all income is included under full-inclusion systems, there is no need to separately define CFC income, but such an approach will catch categories of income that do not raise specific profit shifting concerns. Partial-inclusion systems, however, need to accurately define CFC income.

83. Many countries have chosen to implement CFC rules because they are more mechanical than transfer pricing rules. More mechanical rules, however, are generally broader by nature and cannot be as easily targeted to BEPS concerns. Therefore, existing CFC rules that are more mechanical may attribute more income than is required in order to combat BEPS. This is the case for all CFC rules that apply full-inclusion systems and for many partial-inclusion systems that define CFC income broadly. Although jurisdictions can implement a full-inclusion approach or a broad partial-inclusion approach if they are focused on broader policy aims than combating profit shifting, this chapter focuses on more narrowly targeted partial-inclusion systems that only attribute income that raises profit shifting concerns. Member
States of the European Union in particular may need to combine more mechanical CFC rules with a substance test to ensure that CFC rules do not attribute income earned from genuine economic activities.”

And the discussion draft “footnotes” that “the ability of jurisdictions to implement a full-inclusion system is, of course, subject to jurisdictions’ other international obligations” and that “jurisdictions that are applying CFC rules narrowly to focus on profit shifting may also combine more mechanical CFC rules with a substance test.”

Brazilian Industry regrets the repeated use of such language in the discussion draft, in spite of the potential disagreement of the Committee on Fiscal Affairs (CFA) of the OECD. References to a “full-inclusion system” imply that it might be potentially acceptable by the OECD and not as exotic as it is (whilst not acceptable within the European Union, and not practiced by non-EU OECD Members such as the United States, for example) is detrimental to countries such as Brazil who are struggling to develop rules that do not trump competitiveness and are not barriers to international investment.

The draft moves on to describe the allegedly “narrow” body of rules which constitute the bulk of all CFC regimes from around the world, and to make significant recommendations to enhance such rules, albeit remaining “narrowly” focused on the (very broad and very deep) issues that trigger BEPS concerns. The discussion draft very appropriately identifies its scope and lists the categories of potential CFC income as follows:

“84. This chapter does not set out general recommendations for how to define CFC income, but it instead discusses several possible approaches that jurisdictions could adopt. Whichver approach is adopted, CFC rules should accurately attribute income that raises base erosion and profit shifting concerns. In particular, CFC rules should be able to accurately define attributable income in the context of income earned by CFCs that are holding companies, income earned by CFCs that provide financial and banking services, income earned by CFCs that engage in sales invoicing, income from IP assets, income from digital goods and services, and income from captive insurance and re-insurance. In practical terms, this means that CFC rules must be capable of dealing with at least the following types of income:
• Dividends
• Interest and other financing income
• Insurance income
• Sales and services income
• Royalties and other IP income

85. Accurately attributing this income does not mean that CFC rules should include all of this income in CFC income. It instead means that, at a minimum, CFC rules should attribute income that raises BEPS issues within each category and should not attribute income that arises from value-creating activity in the CFC jurisdiction. If CFC rules are designed to apply only to stripping of the base of the parent jurisdiction, then income should not be attributed if it arises from value-creating activity in any jurisdiction other than the parent jurisdiction.

I. General approaches to defining CFC income

86. The general principle underlying most existing partial-inclusion rules is that highly mobile and/or “passive” income should be attributed to shareholders because it is likely to have been diverted away from the parent jurisdiction or a third jurisdiction and into the CFC jurisdiction. CFC rules generally achieve this principle by defining CFC income to include, at a minimum, interest, royalties, and dividends, and by excluding “active” income that was earned in the course of an active trade or business from the definition of CFC income.

87. The fundamental challenge that CFC rules face is how to define CFC income so that highly mobile income that does in fact represent profit shifting is attributed but income that arises from actual activities undertaken by the CFC is not.”

The discussion draft then identifies that countries use either a “form-based analysis” or a “substance analysis” to determine whether the aforementioned categories of income should fall under the reach of CFC anti-deferral rules. It discusses that the form-based analysis would typically “include dividends, interest, and royalties in CFC income and exclude sales, services, and other income that is by its nature more associated with the carrying on of a trade
or business”. The discussion draft then acknowledges the limitations and imperfection of such “form-based analysis” and explains why most countries with sophisticated rules adopted some form of “substance analysis”, as follows:

“88. A pure form-based analysis does not, however, accurately attribute income earned in the modern business environment. Although this mechanical approach has the benefits of reduced administrative and compliance costs, it can be easily manipulated and does not attribute all income that arises from base erosion and profit shifting. Attributing only interest, dividends, and royalties means that income that was, for example, earned from the use of an IP asset but was legally treated as sales income would escape CFC taxation, an issue that is exacerbated in the digital economy. Attributing all interest, dividends, and royalties also means that income that falls into these categories but in fact arose out of an active business (for example, income earned from a business engaged in active financing) will be attributed even if it does not raise any concerns about base erosion or profit shifting.

89. Because of these weaknesses with a pure form-based analysis, existing CFC rules typically apply some sort of substance analysis that looks to whether the income arose from substantial activities undertaken by the CFC itself. This rule may apply in place of or alongside a form-based analysis, but most existing substance analyses apply alongside other more mechanical rules and are not stand-alone rules. Although such rules add to the complexity of CFC rules, they appear to be necessary to accurately identify and quantify shifted income. They may also be particularly necessary in CFC rules that apply between Member States of the European Union, since a substance analysis could prevent CFC rules from attributing income that arises from genuine economic activities.”

The discussion draft then summarizes and illustrates alternative forms of “substance analysis” used by different countries (e.g., the U.S., the U.K., Germany, etc.):

(a) “Substantial contribution” analysis: a threshold test that applies a facts and circumstances analysis to determine whether the employees of the CFC have made a substantial contribution to the income earned by the CFC. Once
the CFC has shown a given level of activities, all income earned by that CFC would then not be treated as attributable.

(b) “Viable independent entity” analysis: Rather than trying to determine what constitutes a substantial contribution, this option would look at all the significant functions performed by entities within the group to determine whether the CFC is the entity which would be most likely to own particular assets, or undertake particular risks, if the entities were unrelated.

(c) “Employees and establishment” analysis. This would use employees and establishment as a more mechanical way of determining whether the activities required to earn the CFC income are located in the CFC jurisdiction.

The discussion draft emphasizes that

"the second and third options could be applied as either threshold tests or proportionate tests. If they were threshold (or "all-or-nothing") tests, a set amount of functions or employees and establishment would allow all income of the CFC to be excluded. Therefore, if the viable independent entity test were applied as a threshold test, a CFC that had engaged in sufficient management or control to qualify as a viable independent entity would have all of its income excluded from CFC taxation. A CFC that had not engaged in these activities would have all of its income included in CFC income. If the employees and establishment test were applied as a threshold test, a CFC that had the required employees and establishment would have all of its income excluded, but a CFC that did not have all of these required employees and establishment would have all of its income included. If they were applied as proportionate tests, this would allow some income to be excluded from CFC taxation if the CFC carried out some of the required substantial activities. In order to apply a proportionate test, the CFC rules would have to determine the substance and activities which would have to in fact be performed to earn the CFC’s income and compare this to the substance and activity of the CFC. This would increase the administrative complexity and compliance costs of the rules, but it could also ensure that only income that arose from BEPS would be attributed. Although many CFC rules with substance analyses apply these analyses as operates at arm’s length. FBEs are places of business with a physical structure that are used (or will continue to be used) for at least one year. These places of business must be where the business of the CFC is undertaken and they must be suitably
equipped and staffed with managerial and operational employees who render services for the purpose of conducting the CFC’s primary operations.”

The discussion draft acknowledges that all such forms of substance analyses add significant complexity to the administration of and compliance with CFC regimes. Nonetheless, it demonstrates that such substance analyses were necessary to prevent CFC SAARs from representing an obstacle to legitimate cross-border investment, to avoid unduly damaging the competitiveness of MNEs and their ability to generate economic growth and employment across nations.

From the viewpoint of Brazilian Industry, a “substantial contribution” analysis is the most suitable approach to CFC rules, as it focuses on economic substance and limits artificial arrangements whilst not imposing an unmanageable administrative compliance burden on taxpayers and tax authorities. Out of the three alternatives, the “viable independent entity” analysis is inadequate, as it is quite unrealistic, given that virtually all MNEs operate interdependent global value chains (as discussed under Actions 1, 8, 9 and especially 10). In order for the substantial contribution analysis to be enhanced, however, it may well be more closely linked to transfer pricing and perhaps a proportionality method could be devised in tandem with the refinement of transfer pricing currently encompassed in the BEPS debate.

The discussion draft compiles and illustrates multiple standards for CFC income inclusion or exclusion for each of the categories cited (i.e., dividends, interests, insurance, sales and services, and royalties/IP income). Needless to say, either one or all of these forms of “substance analyses” and standards, however, would be welcomed by Brazilian MNEs if ever adopted in Brazil, in lieu of Brazil’s current anti-deferral rules. In sum, the “categorical approach” would be as follows:

“(...)

- Dividend income – Dividend income earned by a CFC will generally be treated as passive (and therefore included) unless the dividend was received from a company that was engaged in an active trade or business that produced active income (or, if the company received partly active income and partly passive income, then only the proportion of the dividend that represents the proportion of active income to the company’s overall income will be excluded) or the CFC
itself was engaged in the active trade or business of dealing in securities. If dividend income is generally exempt from taxation, this exemption will continue to apply to any dividends that would have been exempt if they had been earned by the parent company.

- Interest and other financing income - Interest and other 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.

- Insurance income – Income from insurance will generally be treated as active (and therefore excluded) unless (1) the income was derived from contracts or policies with a related party or (2) the parties to the insurance contract or the risks insured were located outside the CFC jurisdiction. However, income from insurance that falls under these two exceptions will only be treated as passive (and therefore included) if the CFC was overcapitalised or did not have sufficient substance to assume and manage the risks on its own accord.

- Sales, services, royalties, and IP income – Income from sales, services, royalties, and IP will generally be treated as passive (and therefore included) unless the CFC had the required substance to earn the income itself.”

The discussion draft examines, nonetheless, an alternative approach aimed at capturing “embedded IP” (in fact, “economic rents”) that may escape traditional CFC regimes and transfer pricing rules, yet which also aims to simplify the application of CFC standards (by circumventing the very complex “substance analyses” used as current standards). The alternative “excessive profits” approach (which has some variants) is at the center of the current debate and lack of consensus between country delegates and the OECD, as it seems the such approach is preferred by the CFA but not by the delegates of key countries involved in the debate.

The alternative “excessive profits” approach is summarized as follows:

“122. An excess profits approach must calculate the “normal return” and then subtract this normal return from the income earned by the CFC. The difference is the excess return, all of which is treated as CFC income. An excess profits approach could follow the steps below. Note
that 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.”

The discussion draft then experiments with a potential calculation of such “normal return” and with variant calculations aiming to ascertain such “excess profits”. The complexity of determining such “normal return” and “excess profits” given the fragmentation, specialization, and diversification of value chains and country operations within each MNE cannot be underestimated.

Accordingly, some key caveats are made in the discussion draft (page 50):

“(…) some countries believe a mechanical excess profits approach can be easier to administer and effectively targets the income that gives rise to BEPS concerns. These countries believe that it is not necessary to combine the excess profits approach with any other exclusion, although jurisdictions could choose to adopt some form of exclusion, if desired. However, other countries consider that some design features of the excess profits approach could attribute profits that were not shifted. These countries believe that it is necessary to address the over-inclusion associated with the mechanical application of this approach. One way to achieve this would be to combine the excess profits approach with a substance-based exclusion. Moreover, most Member States of the European Union would consider that a form of substance-based exclusion would be needed to ensure that the excess profits approach complies with EU law.”

And finally:

"Without a substance-based exclusion, some countries believe that the excess profits approach will not focus only on shifted income and will not meet the BEPS aim of ensuring that profits are taxed where the economic activities giving rise to them took place. As with other approaches, the excess profits approach uses a proxy to identify shifted income, and it may therefore be both over-inclusive and under-inclusive. This is because the normal return, as defined, may not approximate the return that the CFC’s assets and activities would necessarily generate in the absence of BEPS."
Some countries believe that absence of a substance-based exemption would lead to a shift away from the traditional approach of excluding active income or income from value-creating activities.

As normal returns are not subject to taxation under an excess profits approach if it is applied as a stand-alone rule, this approach could potentially create incentives to shift normal returns to a CFC in order to escape taxation. However, given that normal returns are defined by reference to equity invested in active assets, this disadvantage may not be unique to an excess profits approach.

It is difficult to value the various assets in order to calculate eligible equity. If book value is used, the outcome could be manipulated by transferring assets, and the normal return may overall be inaccurately low. If only certain types of assets give rise to eligible equity, intragroup arrangements could be used to generate those types of assets, and it may be difficult to determine which assets fit the definition of eligible assets.

If the excess profits approach is combined with a substance-based exclusion, it will be less simple and mechanical as the exclusion will add the related complexities of a substance-based analysis.

An entry criterion that narrows the scope of the excess profits approach may raise classification issues and could mean that it does not attribute all the income that raises BEPS concerns.”

Again the hurdles to develop a proper set of rules that does not over- or under-estimate the “normal returns” that should accrue to each country, and the “excess profits” that would be taxable at the parent level without deferral, are simply immense. While the idea of developing such an alternative standard is commendable (in the sense that it aims to capture mobile income through econometrics), this solution may not be feasible in practice given the wide diversity of value chains operated within multiple legal entities of MNEs. The attempt to simplify the rules may create an overly complex fiction which unduly ascertains mobile income. In fact it may represent an alternative formulaic apportionment (if “normal returns” are formulaic and fall outside the arm’s length principle) and hence trigger distortionary allocations of taxing rights.
Still, it may represent a better rule as compared to Brazil’s current anti-deferral regime. Therefore, Brazilian Industry is open to collaborate in the investigation and potential development of this alternative approach.

Double-Taxation Relief

CFC Income and Transfer Pricing Adjustments

One aspect that the draft discussion fails to address is the need for local CFC rules to avoid double taxation that may be generated by the joint application of both CFC and transfer pricing rules. For example, under Brazil’s anti-deferral rule, where any income of any controlled or uncontrolled foreign entity is included in the tax base of the parent company as if it were “tainted” or “mobile” CFC income (irrespective of control), if the Brazil parent company exports goods to foreign affiliates but is required to make an adjustment to its tax base as per local transfer pricing rules, the amount thus included in its tax base will possibly suffer double taxation: once on the transfer pricing adjustment and again on the “CFC”-like inclusion of the foreign (unadjusted) income.

While it is true that, under article 9.2 of the OECD Model Convention, a corresponding transfer pricing adjustment would be required in the jurisdiction of residence of the foreign controlled entity, it is important to remember that (i) not all countries do perform a corresponding adjustment properly (this is not peculiar to cases involving Brazil and its inconsistent rules); (ii) corresponding adjustments may not be reflected in the accounting books of the controlled foreign entity and, therefore, may not be captured when income of such entity is included in the parent company’s taxable basis under CFC; and (iii) many situations may occur of transfer pricing adjustments in relation to transactions with controlled entities not resident in a jurisdiction with which the parent company’s jurisdiction has signed a treaty following the OECD Model Convention and, as such, a corresponding adjustment may not be available. It is therefore important that the Committee clearly states in the draft that CFC rules, while avoiding base erosion via profit shifting, should employ mechanisms to avoid double taxation as a result of the joint application of CFC and transfer pricing rules.

Inter-Temporal Differences
It would be important for the OECD to address in further depth the issue of inter-temporal differences arising from anti-deferral rules and CFC regimes, which often trigger double-taxation if CFC rules are not well designed. In short, if foreign earnings are deemed distributed or otherwise taxed at the parent level during a fiscal period prior to the later moment when corresponding foreign taxes would be imposed on that same income, the “early” inclusion may trigger one instance of tax at the parent without a corresponding foreign tax credit. Whereas, at a later point in time when foreign taxes are imposed on that same income (bis in idem), no corresponding foreign income would be recorded, thus creating an issue of “excess foreign tax credits” that, if not creditable (and effectively used) against other foreign income recognized in that same future year, represents a true “double-taxation” cost.

It is common for CFC regimes to address this problem of inter-temporal mismatches by permitting the “blending” or “cross-crediting” of foreign income and foreign taxes from different jurisdictions, one way or the other – yet this solution is often ineffective. A well designed anti-deferral system would avoid this problem by either:

(a) Allowing a current foreign tax credit at the parent level of future foreign taxes accrued at the time of CFC inclusion; or

(b) Allowing a deferral of the parent-level taxes related to such CFC income, so as to permit the credit of future taxes levied against such tax liability; or

(c) Granting a interest-bearing refund of parent-level taxes “pre-paid” on such foreign earnings, so as to avoid economic double-taxation and effectively recognize the foreign taxes paid on such income.

II. Enforcement and Interpretation Issues Affecting Industry within Brazil

(a) Inbound FDI – Brazilian-Source Income of Foreign Investors

The Brazilian rate of corporate income tax tends to be higher than that of most investors, and given its unfavorable legal and tax environment Brazil is not commonly used as an intermediary jurisdiction in “triangular” business
models and structures which might generate low-tax CFC income sourced within Brazil. As such, it is not expected that the contemplated changes to CFC rules would directly affect inbound FDI into Brazil.

To the extent the U.S. entity classification (check-the-box) rules are repealed, or to the extent “substantial contribution” standards are altered, however, manufacturing assets located in Brazil and manufacturing activities carried out within Brazil which may be under the management or ownership of “super-holding” structures or “principal hubs” located primarily within Europe, might no longer serve a global value chain model, and, hence, the competitiveness of such Brazilian operations may decrease even further. As such, as an indirect consequence of such potential changes, it is conceivable that the level of economic activity could decrease in Brazil (particularly in the area of manufacturing).

Finally, to the extent such changes increase the global effective tax rate of non-Brazilian MNEs, it is possible that overall FDI might decrease, causing a secondary indirect impact to FDI in Brazil.

(b) Outbound FDI – Brazilian MNEs Foreign Source Income

Nonetheless, given the history of insular and inconsistent interpretation and application of tax treaties by Brazil’s Tax Enforcement Authorities, and in particular given Brazil’s openly assumed position of not changing many of its current rules in spite of the BEPS Project, it is quite likely that the changes discussed under the BEPS Action Plan, will adversely affect Brazilian MNEs, the Brazilian Treasury, and the Brazilian Economy as a whole.

Brazilian Tax Enforcement authorities often remain entrenched in an outdated view of Brazil as merely a capital-importing nation, and often overlook that practices and policies which may seem protective of the national tax base can actually result substantial shifting of Brazilian tax revenues to other countries within which Brazilian headquartered companies operate.

Brazil is uniquely positioned at a disadvantage as a country with the combination of its rejection of OECD Transfer Pricing Methods and Guidelines, the ineffectiveness of Action 14, and its current anti-deferral “full-inclusion” rules that impose a current tax on all active and passive
foreign source income of controlled and uncontrolled enterprises. The discussion draft under Action 3 clearly demonstrates that the Brazilian rules are the most hazardous in the world and do not address BEPS, but function as a true deadweight cost not only to Brazilian MNEs but to the world economy.

### III. Enforcement and Interpretation Issues Affecting Brazilian Industry in China, India, and in Developing Countries

This is a serious matter of competitiveness. The Action 3 discussion draft illustrates that although Chinese-headquartered MNEs operate under a worldwide tax system with CFC rules, a low-tax threshold to avoid the application of CFC rules is set at 50% of the statutory rate in China. The statutory Chinese rate is generally 25%, however it is reduced to 15% in industries that benefit from incentives from the Chinese government. Therefore, China would permit the accumulation and reinvestment abroad of earnings by foreign ventures controlled by Chinese MNEs without a current tax at the Chinese headquarter level as long as such foreign earnings are subject to an effective rate of tax of 7.5%-12.5%. Brazilian MNEs are generally required to pay any rate differential on foreign earnings up to the Brazilian statutory rate of 34%.

Brazilian MNEs compete with Chinese MNEs in markets throughout the world and most fiercely within Brazil and China. To the extent a Chinese MNE and a Brazilian MNE compete within Brazil and benefit from comparable tax incentives (e.g., the Manaus Free Trade Zone, SUDAM or SUDENE programs), and/or use interest-on-equity, goodwill deductions, export financing and/or other tax benefits granted within Brazil, such Chinese MNE would not have a current incremental Chinese tax burden to pay and would compete within Brazil on equal footing with the Brazilian MNE. Conversely, if the same Chinese and Brazilian MNEs operate within China under tax holidays (such as those available in the multiple free trade zones that exist throughout China), the Brazilian MNE would have an incremental tax burden to pay, which would reduce its competitiveness not only within China but also within Brazil, and provide a competitive advantage to the Brazilian competitor in the Brazilian market.

The situation would be the same throughout the developing world, in emerging countries and/or countries that are rich in natural resources (e.g.,
in Africa and the Middle-East) wherein corporate income taxes are often the object of tax holidays and/or are not a key source of state revenues. And it would be the same in all developed markets wherein Brazilian and Chinese companies invest and compete (i.e., the U.S., and Europe), given that the average rate of corporate income tax in OECD countries is nearly 9% below that imposed in Brazil, and such rate differentials would trigger a current tax burden in Brazil even for income that arises from active trade or business and that is earned by uncontrolled ventures.

Base erosion would result in Brazil from a relative reduction of economic growth and local production, related to the reduced activities of Brazilian headquartered MNEs within Brazil and abroad, and the correspondingly reduced “positive spillovers” from such Brazilian MNEs. And consequently income would shift out from Brazilian enterprises (and out from Brazilian employees) and into the countries of competitor MNEs.

IV. Enforcement and Interpretation Issues Affecting Brazilian Industry in Europe and North America

The same situation occurs with respect to competitor MNEs headquartered in the U.S., the E.U., Japan, and virtually all other countries. The contemplated changes to CFC rules may, perhaps, increase the parent-level tax burden of non-Brazilian MNEs; and it might also increase the non-Brazilian taxes imposed on global value chains under super-holding structures controlled by Brazilian MNEs; nonetheless, to the extent such non-Brazilian rules become more consistent and stable, it is quite likely that the European Union will remain extremely competitive vis-à-vis the U.S. and that both will retain an enormous tax advantage over Brazil. Be it to operate global value chains under principal hubs and super-holding structures, be it to serve as the primary capital markets and attract the headquarters of any MNE.

As acknowledged by the OECD and the G20 in the Action 3 discussion draft (page 8), over-inclusion of foreign source income, and inadequate CFC rules can serve as a trigger for corporate inversions:

"This competitive disadvantage may in turn lead to distortions, for instance it may impact on where groups choose to locate their head office or increase
the risk of inversions, and it may also impact on ownership or capital structures where groups attempt to avoid the impact of CFC rules. CFC rules can therefore run the risk of restricting or distorting real economic activity.

There is a perception that robust CFC rules can lead to inversions, that is, that groups will change the residence of the parent company to escape the effect of CFC rules. However, whilst it is likely that CFC rules will increase the risk of inversions, they will not be the only factor and other issues such as tax rate and the general system of taxation (e.g., worldwide or territorial) will also play a role. For this reason inversions, and the rules that some countries have adopted to combat them, are not covered in this discussion draft, but countries may want to consider them as a separate matter.”

Although such inversion events cannot be justified solely by CFC rules, the robustness of capital markets in the U.S. and the E.U., and the general advantages of these locations over Brazil in terms of capital markets, investment climate, economic development (consumer and supply markets, productivity), robustness of institutions, legal culture, and democratic rule of law, do make this risk quite realistic for Brazil. Similarly, if not the risk of planned inversions, CFC tax differentials create an incentive for U.S., E.U. (as well as Chinese and other) MNEs to consider their Brazilian MNE competitors as “targets” for acquisitions. One is left to wonder whether such potential damage to Brazil (which may be advantageous to other OECD and G20 countries) is viewed as a potential collateral by the parties involved in the BEPS discussion.

Temporary remedies recently enacted in Brazil (i.e., a deemed credit that reduces the rate differential and incremental Brazilian tax on foreign source income from certain sectors, burdensome deferral and consolidation or “blending” possibilities) are insufficient to mend the design flaws of Brazil’s rules. In this Action 3, more than in any other, Brazil could benefit from an approximation to the global anti-BEPS standards, as strict as they may be, and Brazil would greatly benefit from an overall alignment with OECD standards and guidelines on CFC rules.
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29 April 2015

Submitted by email: CTPCFC@oecd.org


Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE’s members are 41 leading industrial and employers’ federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

In the BEPS Action Plan the G20/OECD has set out the aim to develop recommendations regarding the design of controlled foreign company rules and states that this work will be co-ordinated with other work as necessary. Action 3 of this plan stresses the need to address base erosion and profit shifting using controlled foreign company (CFC) rules. Many countries already have CFC rules, but these rules do not always counter BEPS in a comprehensive manner. While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spill over effects in source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled “BEPS Action 3: Strengthening CFC Rules” issued on April 3rd 2015 (hereinafter referred to as the Draft).

General Comments

The mandate for Working Party 11 for Action 3 was to “develop recommendations regarding the design of controlled foreign company rules... that are effective in dealing with base erosion and profit shifting”. What is not clear, however, is whether this mandate is interpreted as requiring the development of “best practice” recommendations that individual countries are at liberty to implement into their own domestic law wholly or in part, or in the development of a co-ordinated and consistent...
CFC policy that most countries would agree to implement in a consistent and timely manner. It appears from some of the observations and recommendations in the Draft that the output may be a menu of policy options, with commentary on best practice, which countries will adopt where the particular menu option is consistent with domestic policy drivers. BUSINESSEUROPE would support a clear statement of the purpose of implementing a CFC regime and clear recommendations for the implementation of coordinated and efficient CFC regimes that meet the policy objectives. The Draft is not clear whether the purpose of a CFC regime is to capture passive income that has been diverted from a parent entity in a territorial system, or to provide a mechanism to ensure capital import/export neutrality in a worldwide system. A CFC design that attempts to implement conflicting policy objectives is likely to result in failure to achieve either policy, while creating additional administration, confusion and cost. There is also 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.

BUSINESSEUROPE does not believe that the “minimum standard” approach will provide countries with the necessary information to understand which CFC rules would be most appropriate for their policy objectives, nor will it encourage consistency in the design and implementation of CFC rules. As there appears to be a lack of consensus on the purpose of CFC rules within the working party, a more useful approach would be to critically review the effectiveness of current CFC rules in those jurisdictions that have experience of their operation, and to recommend a small number of clear best practices and more coordinated rules that can be effective and efficient for both tax administrations and tax payers to operate and comply with. This could assist countries in deciding which best practice rules they could implement to tackle BEPS activity that is not addressed by the other BEPS actions, and understand the effect that CFC rules would have on international competitiveness and investment flows.

BUSINESSEUROPE considers that the most effective method for reducing compliance cost within a CFC regime is the use of a combination of subjective, objective and mechanical filters to exclude entities that carry a low risk of CFC or BEPS activity. This allows more effort to be focused by both tax administrations and tax payers on the higher risk entities. As there is no common business model or process used by MNEs, it is not possible to mandate the same tests or order of tests for all businesses: therefore the filter methodology should allow some flexibility in the ordering of tests with the test that has the clearest result for that business being applied first, and using more subjective tests where they operate appropriately for some taxpayers, and allowing more mechanical tests for those businesses where they work better.

BUSINESSEUROPE acknowledges the commitment in the Action Plan on BEPS to coordinate the work on development of recommendations on CFC rules with the work on the other Actions of the BEPS plan; however while the Draft refers in paragraph 5 to those other Action Items, the body of the Draft does not make any clear connection with any of the other BEPS actions and it is not clear how or whether any interaction between the CFC recommendations and those on other actions have been considered
or addressed. It is critical for the effectiveness of the whole project that a detailed review process is implemented prior to finalisation of all of the 15 Actions to develop a clear agreement over the specific BEPS behaviours and abuses that are being targeted, and which recommendation should be implemented to address the specific issues. Making different recommendations to address the same issue creates unnecessary compliance costs and uncertainty, unless a clear hierarchy of measures is defined. BUSINESSEUROPE would welcome a more detailed explanation of how the various Action Items are being co-ordinated and the existing areas of overlap between Actions are being reconciled to eliminate redundancy and duplication. The BEPS timetable will result in many new international tax rules being implemented in a very short timescale and it is imperative that full attention is given to the co-ordination of those rules to reduce as far as possible unnecessary and duplicative initiatives.

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, with efforts to obtain a broad consensus within the participants in the BEPS process on the hierarchy to reduce the opportunity for dispute between countries and MNEs over the order of utilising different measures. Within CFC rules, there should also 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 to ensure that any practical failures to give effective relief across different country regimes can be rectified promptly.

BUSINESSEUROPE is also concerned by the comment in the preamble to the Draft 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, which leads on to the principal reference in the draft to other BEPS Action. While the 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 a great concern as this would add significant complexity and administrative cost as well as significant uncertainty for international business and appears to be another departure from the Arm’s Length Principle that the OECD has reiterated should be the basis for the allocation of income between companies and countries.

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, an objective that BUSINESSEUROPE would support. 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 a 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.

Many of the questions raised in the Draft address complex issues relating to unusual investment or management structures. BUSINESSEUROPE has not had sufficient time to obtain information from its member federations or international businesses to be able to answer all of these questions, and so does not offer an opinion where no response based on practical experience has been provided by members. However, it is the experience of most BUSINESSEUROPE members and representatives of international business that a very significant majority of international business investments and structures are within a 100% owned group of companies where there is no uncertainty over control or profit attribution so that it is not possible to make helpful or informed comments concerning more complex structures. As most business structures are not highly complex, a balance needs to be established between the compliance burden of the many businesses with relatively simple structures and the effectiveness of targeted measures to address the few more aggressive arrangements.

The principal responses of BUSINESSEUROPE to the questions raised in the draft are included in the more specific comments below

Specific Comments

Chapter 2: Definition of a CFC

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.

The broad version of the hybrid mismatch rule may be easier to apply in practice as there is no requirement to determine whether there is a base-eroding mismatch, but
both versions of the rule would require additional analysis and cost of reporting and preparation of returns. The Draft refers in paragraph 5 to co-ordination with the work on Action 2 (hybrid mismatch arrangements), but it is not clear how there would be a need for a hybrid mismatch rule for CFCs if the recommendations for Action 2 were implemented in either or both of the parent and CFC jurisdictions.

Chapter 3: Threshold Requirements

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 and would be helpful.

Calculation of effective tax rates is frequently affected by special tax regimes aiming to attract certain investments; differences in the capitalisation, amortisation 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. The use of a rolling average effective rate could limit the volatility of the effective rate calculation, although this would create some additional administrative burden, but careful consideration needs to be given to the appropriate period for which the rolling average would apply.

Anti-fragmentation rules can create particular additional challenges where international businesses operate through separate business units with no common management, accounting or reporting systems: similarly, CFC rules that evaluate risk on a country by country basis rather than on a separate entity basis can create reporting difficulties for MNEs whose financial reporting systems do not make information readily available to prepare any country by country consolidation or aggregation.

Experience of MNEs with some current CFC regimes is that detailed calculations of effective tax rates are required for all controlled subsidiaries and other entities treated as controlled, even though for many of them, it is clear that no CFC adjustment would be required, or any adjustment would be immaterial and below de minimis thresholds. The development of a gateway test or tests to eliminate preparation of detailed calculations for entities where there is no risk of CFC adjustment would be strongly supported to reduce administrative costs for both MNEs and tax administrations.

The discussion in Chapter 3 focuses exclusively on monetary thresholds and other threshold options are not addressed. BUSINESSEUROPE would encourage the OECD to consider other options, including time and the use of exempt periods,
particularly where different CFC regimes apply to the same group of companies. Changes in ownership can cause companies that were previously outside of CFC regimes to be treated as CFCs immediately on acquisition, whether or not there is any BEPS risk. An exempt period to allow for reorganisation and integration of the new group companies after an acquisition would be of benefit to both MNEs and tax administrations.

While there is currently limited experience of dealing with tiers of CFC regimes, as some of the jurisdictions commonly used for holding companies do not have CFC regimes, BUSINESSEUROPE is concerned that, if the result of Action 3 is that more jurisdictions implement CFC regimes, there will be more practical examples of tiers of CFC regimes, and this will lead to multiple layers of effective tax rate calculations unless there is a common standard that could be applied.

Chapter 4: Definition of control

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 behaviours 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.

The experience of BUSINESSEUROPE in dealing with structures where completely unrelated parties have any influence over activity in an overseas entity is very limited, so no useful comment on the practical problems of applying a control test is possible.

Chapter 5: Definition of CFC Income
Questions 9-10

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, whereas 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.

**Chapter 5: Definition of CFC Income**
**Questions 11-14**

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.

BUSINESS EUROPE is not aware of any existing CFC rules that reduce administrative and compliance burdens relating to these categories of income.

**Chapter 5: Definition of CFC Income**
**Questions 15-20**

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.

BUSINESSEUROPE is also concerned that this approach would place MNEs headquartered in higher tax rate jurisdictions at a competitive disadvantage. For example, the (excess) profits of a subsidiary of such an MNE, owning and exploiting IP and operating in a lower tax jurisdiction, may be subject to tax in the headquarter jurisdiction, whereas a domestic entity, owning and exploiting comparable IP in the lower tax jurisdiction would pay a lower rate of tax on all of its profits, potentially putting it at a competitive advantage.

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" and therefore, if the purpose of the Draft is to target particular BEPS concerns accurately, the categorical approach would be the more appropriate of the two.

**Chapter 5: Definition of CFC Income**

**Questions 21-23**

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, BUSINESSEUROPE 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**

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, then there would be an additional level of complexity as 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**

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**

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 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.

Deemed dividend and flow through treatment of CFC income attribution are not treated the same by many double taxation conventions, and the nature of the flow through income and utilisation of foreign tax credits is not clearly addressed. The credit mechanism is clearer for dividends, and therefore treatment as a deemed dividend is generally a better option.

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, in practice, 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 BUSINESSEUROPE 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.

BUSINESSEUROPE would strongly recommend that only one set of CFC rules should apply at any one time to any entity. This highlights the fundamental importance of establishing a clear order of how and when different jurisdictions’ CFC rules should apply. Clarifying which rules should apply to avoid double taxation and dispute over who has taxing rights over CFC income.

BUSINESSEUROPE would be willing to engage in a constructive dialogue with the OECD on strengthening the CFC rules.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

James Watson
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May 1, 2015

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Dear Mr. Pross,

Re: OECD Base Erosion and Profit Shifting (“BEPS”) – Action Item 3

The Canadian Life and Health Insurance Association (“CLHIA”) is pleased to provide comments on behalf of its member companies on the Discussion Draft released on April 3, 2015 by the OECD on BEPS Action Item 3: Strengthening CFC Rules (the “CFC Draft”). Our comments relate only to certain of the specific questions that are posed in the CFC Draft, as indicated below in greater detail. Further, our comments are intended to be limited to the specific industry perspective that our association represents.

The CLHIA is the national trade association for life and health insurers in Canada. Our member companies account for 99 per cent of Canada’s life and health insurance business and provide a wide range of financial security products such as life insurance, annuities and supplementary health insurance to 28 million Canadians. Canadian life insurers operate in over 20 countries around the world and three of our members rank among the top 15 global life insurers by market capitalization. A quarter of the CLHIA’s members operate as subsidiaries or branches of foreign insurers or reinsurers from the United States and Europe. The CLHIA is also a member of the Global Federation of Insurance Associations (GFIA) based in Brussels.

The CLHIA supports the G20 and the OECD’s initiative to combat aggressive tax planning, including “cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it”.

However, as we have previously

noted, we urge that the measures recommended by the OECD be proportionate and balanced, taking into account the unique commercial realities of the global insurance and reinsurance business models. Further, the recommendations should avoid any unintended consequences which would impede the efficient functioning of primary insurance and reinsurance markets, and thereby seriously hinder operations of insurers to the point where there is a reduction in the types and amount of life and health insurance products offered, resulting in increased costs to and reduced choices for consumers.

Unique Characteristics of Global Life Insurance Business Model

What makes the insurance and reinsurance business models unique and distinct from other businesses are that they operate on an inverse business cycle. That is, insurers and reinsurers receive consideration (insurance premiums) well ahead of delivering the service - a promise to pay (the insured) a sum of money (insurance claims) upon the occurrence of a predetermined event. However, there is always much uncertainty as to the occurrence of the event and extent and timing of claims. The claims can occur many years later, as much as 50 or 60 years later, or even longer, in the case of life insurance and reinsurance.

Given the inverse business cycle and the importance of the "promise to pay", it is vital that insurers be in a position to fulfill their obligations. Hence, capital adequacy is key for the operational viability of insurers. Capital allows insurers to underwrite risks, and signals to policyholders an insurer's ability to fulfill potential claims. Capital is also the main tool at the disposal of regulators around the world to protect the rights and interest of policyholders. Insurers and reinsurers create value by pooling various types of uncorrelated risks, which in turn reduces the cost of coverage to policyholders. While insurance and reinsurance is sold locally, the management of these risks through global risk pooling and diversification has been a mainstay of the insurance and reinsurance industries for many decades. The main vehicle for global risk pooling is reinsurance, both third party and intra-group reinsurance. Reinsurance is both a risk and capital management tool of insurers, allowing the industry to respond to the need for a broader range of protection for traditional (life insurance, property and casualty) and new risks (longevity, environmental).

The experience in recent years of longevity improvements (growing payouts on annuity and pension products) and damage to lives and property caused by disasters illustrates the importance of insurance protection to individuals and businesses alike. Such large scale impacts also validate the need for global risk pooling and diversification. It is important to have a strong, efficient and innovative global insurance and reinsurance sector to provide the growing protection consumers and businesses require and also relieve the burdens on governments to intervene to meet the growing needs of aging population or when disasters strike.

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2 We refer to our Submission dated 9 January 2015 on the OECD’s Discussion Draft on Action Item 7 - Preventing the Artificial Avoidance of PE Status, released on 31 October 2014 (the “PE Submission”).

3 Our PE Submission contains a more detailed discussion of the global business model.
Summary of Comments

The CFC Draft sets out a discussion of various “building blocks” for CFC rules, including recommendations on most of these building blocks – all except for the item on the “definition of CFC income”, Chapter 5. Our comments in this submission are focused mainly on questions that relate to the definition of CFC income. While each of the building blocks is important, we believe that this is the most important one, which raises the most fundamental policy issues, and the one in respect of which the considerations relating to the unique commercial realities of the global insurance business model are most pronounced.

Chapter 5 of the CFC Draft poses a number of specific questions (Questions 9-23). Many of these questions can affect the treatment of value-creating activities that are carried on in the insurance and reinsurance sectors, although Question 11 relates most directly to our industry – and is the focus of our comments:

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 (ii) and (iii)? If so, what are they and how can they be dealt with?

In brief, and as discussed below in greater detail, it is our view that a business that is licensed under an appropriate regulatory body and is market-facing, including a reinsurance business carried on by a CFC of a multinational insurance or reinsurance group, does not raise significant BEPS concerns because it does not reflect practices that artificially segregate taxable income from the activities that generate it. In particular, our comments reflect the following perspectives:

- Income should not be considered to have been artificially “shifted” to the CFC if that income has genuinely been earned from activities carried out by the CFC, and is properly determined in accordance with the arm’s length principle, in light of appropriate regulatory and commercial considerations and given the CFC’s functions, assets and risks.

- Income should not be treated as attributable CFC income just because it arises from revenues generated in a jurisdiction other than the CFC jurisdiction. This would be inappropriate and “over-inclusive” in a global economy where a very significant proportion of international trade in goods and services occurs in a cross-border context, between both related and unrelated parties. This would effectively subject large portions of the global economy to CFC income attribution, and would be inconsistent with the territoriality principle and would interfere with countries’ abilities to set their own tax rates. CFC rules should be designed by countries to “backstop” their corporate income tax regimes, and countries which operate territorial corporate income tax regimes should not be required to fundamentally
transform and repurpose their CFC rules in ways that conflict with their choices as between operating territorial rather than extraterritorial corporate income tax regimes.

- It is important to be sensitive to the global nature of the insurance / reinsurance business model which is based on risk and capital management, through the geographical and other diversification and pooling of risk. It is thus important to distinguish the location where the CFC’s value-creating activities occur (i.e., the assumption of risks and thus the putting of capital at risk, as well as any other value-creating activities) from the location where the assumed risks may originate and from which the premiums may be paid. Provided that premiums are properly priced, the cross-border coverage of risk does not result in the artificial “shifting” of income. The cross-border coverage of risk effectively removes the risk from the jurisdiction in which it originates and thus provides financial stability and security to that jurisdiction, both in terms of its economic position and its tax base, sheltering it from bearing the economic and tax cost of any loss which may be incurred. It is worth noting, capital relief is only granted in the originating jurisdiction if it can be established to the satisfaction of the local regulator that the underlying economic risk has been transferred to the reinsurer.

Before proceeding to a more detailed discussion of Chapter 5 of the CFC Draft, we begin with a discussion of the fundamental policy considerations that we believe should inform the design of CFC rules in general, as well as an overview of the Canadian CFC rules that are relevant in the context of insurance and reinsurance activities.

**Fundamental Policy Considerations**

*Territorial versus Worldwide Taxation*

In the context of formulating recommendations on the design of CFC rules, we would urge the OECD to be particularly sensitive to the core prerogatives of countries with respect to the tax policy choice of operating a corporate income tax ("CIT") system that is territorial rather than worldwide or extraterritorial in scope, and with respect to the rates that they may choose to impose based on their economic and fiscal policies. As noted in the CFC Draft, many countries have adopted CFC rules “to prevent shifting of income either from the parent jurisdiction or from the parent and other tax jurisdictions.” This is a fundamental distinction and reflects the difference between operating a territorial rather than extraterritorial CIT system. The essential purpose of CFC rules is to “backstop” a country’s CIT — that is, to prevent the artificial avoidance or deferral of the income tax that is

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4 Paragraph 7.

5 It is noted in the CFC Draft (paragraph 21) that “CFC rules are thus often referred to as ‘backstops’ to transfer pricing rules.” The CFC Draft also notes that this terminology “is misleading” because it is generally “not that the principle of CFC rules is to capture income from transfer pricing manipulation but that certain CFC provisions may sometimes have this effect.” In contrast, it would be fair to say that the principle of CFC rules is to “backstop” the CIT more generally.
intended to be levied under its CIT. Thus, we believe that countries should not be required to fundamentally transform and repurpose their CFC rules in ways that conflict with their choices as between operating a territorial rather than extraterritorial CIT.

Under a territorial approach, income is subjected to the CIT of a particular jurisdiction only to the extent that it arises within that jurisdiction. This approach is the most likely to put resident corporations on a level playing field with non-resident corporations carrying on business within that jurisdiction. In addition, this approach is the most consistent with operating a CIT in part as an effective means of taxing non-residents only on income arising within that jurisdiction. CFC rules should be consistent with that principle, and should not indirectly result in the taxation by a jurisdiction of non-resident shareholders in respect of the foreign source income of the corporate group.

Artificial BEPS versus Location of Legitimate Business Activity

In the context of the insurance and reinsurance sectors in particular, it is important to be sensitive to the equally fundamental distinction between artificial “base erosion and profit shifting” and the genuine location of legitimate economic activities that generate the income in question in a particular jurisdiction. Locations for economic activities are selected because of business considerations such as regulatory constraints, capital considerations and the availability of qualified personnel, or even because of a more efficient tax environment. The CFC Draft notes that a broad approach in the definition of CFC income could “treat any income generated in a jurisdiction other than the CFC jurisdiction as CFC income”. As noted in the CFC Draft, such an approach “would be harder to manipulate but may attribute income that has genuinely been earned from activities carried out by the CFC” and could thus be “over-inclusive”. We would agree with this statement and, in particular, with the concerns about being ’over-inclusive" and attributing “income that has genuinely been earned from activities carried out by the CFC”. In our view, provided that the income of the CFC has genuinely been earned from activities carried out by the CFC, then it should not be characterized as being “artificial”, regardless of the location in which the CFC may be established or in which its activities may be carried out. A very significant percentage of global trade in goods and services occurs in a cross-border context between related and unrelated entities. It does not seem appropriate to us in principle to treat all income that has genuinely been earned from activities carried out by the CFC as CFC income just because it arises from revenues generated in a jurisdiction other than the CFC jurisdiction. This

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6 As noted in the CFC Draft, CFC rules may also be used to “backstop” a country’s personal income tax.
7 This can result in double taxation as noted in Chapter 8 of the CFC Draft, but also in the inappropriate single taxation by an intermediate jurisdiction of income that arises outside that jurisdiction and ultimately belongs to shareholders that are resident outside that jurisdiction. We do not see any tax policy justification for such a result.
8 As noted in footnote 1 of the CFC Draft.
9 Paragraph 94.
10 Paragraph 94.
11 As noted in the CFC Draft (paragraphs 11-14), in the context of the European Union, CFC rules must be justified on the basis of an even stricter standard, requiring a showing that they affect only “wholly artificial” arrangements.
would effectively subject large portions of the global economy to CFC income attribution, and would interfere with countries’ abilities to set their own tax rates.

The *2010 Report on the Attribution of Profits to Permanent Establishments*, Part IV Insurance, (the “PE Report”)\(^\text{12}\) includes an extensive discussion of the attribution of profits in the insurance and reinsurance sectors. As noted in the PE Report, “the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise”, although other elements will also be relevant, and may be located in different jurisdictions or entities, depending on the specific facts and circumstances.\(^\text{13}\) Moreover, as further noted in the PE Report:

> Once a location performing the insurance risk assumption function has been determined and the respective insurance risk has been attributed to it, it will be necessary to attribute an appropriate amount of assets to that location to back that risk (*i.e.* assets backing both reserves and surplus). Further, it will also be important to reward other functions in accordance with the arm’s length principle. It should also be noted that there is no presumption that these other functions are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of rewards from performing these other functions can be expected ranging from, at one end, low value rewards to at the other end rewards based on a share of the residual profit of the part of the enterprise acting as the key entrepreneurial risk-taker. In short, the functional and factual analysis determines the attribution of profits to the PE in accordance with its functions performed, assets used and risks assumed, and informs also the attribution of assets and investment income to the PE.\(^\text{14}\)

Where the activities carried out by the CFC include the assumption of insurance risk – being the key entrepreneurial risk-taking function for an insurance enterprise – then the income of the CFC, determined:

i) in accordance with the arm’s length principle, and

ii) including the income from the investment of an appropriate amount of assets to back that risk (representing both reserves and surplus reflecting both business considerations and relevant regulatory and capital requirements)

should be considered to have been genuinely earned from activities carried out by the CFC. In other words, the location of this key entrepreneurial risk-taking function validates the geographical attribution to that location of an appropriate amount of capital and the income therefrom.

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\(^{12}\) Unless otherwise indicated, references to paragraphs of the PE Report are references to paragraphs of Part IV of that report.

\(^{13}\) See, in particular, paragraphs 68, 69, 93 and 94 of the PE Report.

\(^{14}\) Paragraph 71 of the PE Report.
On this basis, among other considerations, we would emphasize:

- the importance of distinguishing the location of these key functions and supporting assets from the location of the risks to which they relate, and
- the inappropriateness of any general presumption that the insurance of risks outside the CFC jurisdiction represents some sort of arrangement to “artificially segregate taxable income from the activities that generate it”.

In the context of insurance and reinsurance, the geographical diversification and pooling of assumed risks are essential risk and capital management strategies driven by bona fide business considerations, enhancing the financial security of, reducing costs to and increasing choices for consumers, including both individuals and businesses.

Perhaps another way to look at the question of “base erosion and profit shifting” in the context of cross-border insurance and reinsurance is to focus on the question of whether the arrangements result in the artificial “pushing” of expenses into the jurisdiction where the risks are located. Provided that the coverage and any other elements are properly priced, then the economic costs borne by the jurisdiction obtaining the coverage should approximate the economic costs that it would have borne in any event as a result of the occurrence of the risks in question. Thus, rather than eroding the base of the jurisdiction in which the risks are located, the effect of cross-border insurance or reinsurance coverage is not to increase economic costs (or to reduce tax revenues) in that jurisdiction but rather to provide financial stability and security to that jurisdiction, both in terms of its economic position and its tax base.

Indeed, in the context of insurance and reinsurance, the relevant business activities can often give rise to the realization of significant losses to the insurer or reinsurer. The bearing of these losses in fact results in capital moving into (rather than out of) the jurisdiction in which the assumed risks originated and from where the premiums may be paid. This shelters that jurisdiction from bearing the economic and tax cost of any loss which may be incurred. Moreover, if these losses arise in a low-tax jurisdiction, their cost to the global tax base is diminished accordingly. 15

It is for these reasons that we urge that the measures recommended by the OECD must take into account the unique commercial realities of the global insurance and reinsurance business models. We are concerned that the CFC Draft does not sufficiently distinguish insurance and reinsurance income from other types of income that CFC rules must be capable of dealing with. 16 Nevertheless, we acknowledge the following statements (emphasis added):

15 We note the recommendation in Chapter 6 of the CFC Draft “that jurisdictions should have a specific rule limiting the offset of CFC losses so that they can only be used against the profits of the same CFC or against the profits of other CFCs in the same jurisdiction”; we believe it is unfair and asymmetrical for countries to tax the income of a CFC in the hands of its shareholders but not to permit those shareholders to deduct losses on that same basis. This type of asymmetry can also have a distortionary impact on business decision-making.

16 See paragraph 84 of the CFC Draft.
Accurately attributing this income does not mean that CFC rules should include all of this income in CFC income. It instead means that, at a minimum, CFC rules should attribute income that raises BEPS issues within each category and should not attribute income that arises from value-creating activity in the CFC jurisdiction. If CFC rules are designed to apply only to stripping of the base of the parent jurisdiction, then income should not be attributed if it arises from value-creating activity in any jurisdiction other than the parent jurisdiction.\textsuperscript{17}

A CFC’s income from the insurance or reinsurance of risks, properly measured, is necessarily and by definition commensurate with its functions, assets and risks assumed, and this is the foundation of our comments, consistent with the PE Report.

\textit{Canadian CFC Rules}

Canada has had relatively robust CFC rules for decades, designed to strike a balance between curtailing base erosion and maintaining international competitiveness. These rules have been refined on numerous occasions, and continue to be refined, both in general and with respect to their application in the context of insurance and reinsurance activities. In very broad terms, Canada’s CFC rules seek to attribute income which is either “passive” rather than “active” in nature, or which is derived from certain types of gross revenues arising in Canada. More specifically, a CFC’s business income must generally be characterized as being from an “investment business” or a “business other than an active business” or a “non-qualifying business”\textsuperscript{18} (which can result in attributable income), rather than from an “active business” (which does not result in attributable income and to which a “participation exemption” may be applicable, reflecting the territoriality principle.)\textsuperscript{19}

With respect to the insurance or reinsurance of risks, a CFC’s business may be characterized as an “investment business” if it is conducted principally with non-arm’s length persons or if it does not employ more than 5 employees full time (including services provided outside Canada of certain employee equivalents) in the active conduct of the business. Income from an “investment business” (including premiums and related investment income) is characterized as “income from property” and would be attributable unless it is recharacterized as “income from an active business”\textsuperscript{20}. Income can be recharacterized as

\textsuperscript{17} See paragraph 85 of the CFC Draft.
\textsuperscript{18} A “non-qualifying business” is defined (in subsection 95(1) of the Canadian Income Tax Act (the “CITA”) as a business carried on through a permanent establishment in a jurisdiction that is a “non-qualifying country”, other than an “investment business” or a “business other than an active business”. A “non-qualifying country” is defined, essentially, as a country with which Canada has not concluded an income tax convention, and for which the \textit{Convention on Mutual Administrative Assistance in Tax Matters} is not applicable, if Canada has, more than 60 months before the relevant time, either
(i) begun negotiations for a comprehensive tax information exchange agreement (a “TIEA”), or
(ii) sought, by written invitation, to enter into negotiations for a TIEA, and still no such TIEA has been concluded and come into force and effect.
\textsuperscript{19} See the definitions and rules in subsections 95(1) and (2) of the CITA.
\textsuperscript{20} See the definitions in subsection 95(1) of the CITA.
“income from an active business” if it arises from activities that are “directly related” to qualifying foreign “active business” activities, or if it arises from gross revenues that are derived directly or indirectly from payments that are deductible in computing the foreign “income from an active business”, of a qualifying foreign affiliate or of the relevant Canadian taxpayer if the taxpayer is a qualifying multinational life insurance corporation.\footnote{See paragraph 95(2)(a) of the CITA.} Subject to certain exceptions and \textit{de minimis} thresholds, income from the insurance or reinsurance of “Canadian risks” (as determined under various prescriptive rules and supported with anti-avoidance rules),\footnote{See paragraphs 95(2)(a.2), (a.21), (a.22) and (b), as well as subsection 95(3), of the CITA.} together with related investment income, is characterized as income from a “business other than an active business”, and is thus attributable.

In general, these determinations are made without regard to any “same country” requirement, nor to any prescriptive requirement with respect to the CFC’s capitalization or the effective tax rates it may be subjected to outside Canada. Nevertheless, Canada’s CFC rules both in general and with respect to insurance and reinsurance activities are meaningfully stricter than they would need to be to focus only on income that has not been genuinely earned from activities carried out by the CFC. In particular, the “more than 5 employees” requirement for exclusion from “investment business” treatment is stricter because it sets a minimum and arbitrary threshold for people functions. In addition, the requirement that the business not be conducted principally with non-arm’s length persons, also for exclusion from “investment business” treatment, is stricter because, in principle and in general, income can genuinely be earned from activities carried out by a CFC in the ordinary course of a business conducted principally with non-arm’s length persons. These two requirements only apply to businesses that have a financial character. Similarly, Canada’s CFC rules are stricter in segregating income from the insurance or reinsurance of Canadian risks even if it is genuinely earned from activities carried out by the CFC. However, in recognition of the territoriality principle, as well as efficiency and competitiveness considerations that are important in light of increasing globalization,\footnote{As noted in the CFC Draft (paragraph 88), “A pure form-based analysis does not, however, accurately attribute income earned in the modern business environment.”} income genuinely earned from the insurance or reinsurance of foreign risks arising in the course of the “active business” operations of qualifying affiliated entities, including the reinsurance of active primary insurance operations, is characterized as “income from an active business”.

\textit{The CFC Draft}

As noted above, Canadian CFC rules distinguish between attributable and non-attributable income on the basis of a variety of tests, which reflect elements of the approaches described in the CFC Draft as “form-based analysis” and “substance analysis”.\footnote{See paragraphs 88 and 89 of the CFC Draft.} With respect to income from the insurance or reinsurance of risks, Canadian CFC rules also look at “\textit{from whom} [the income] was earned (i.e., from related parties or from others) and \textit{where} it was earned”, as contemplated by the CFC Draft.\footnote{See paragraph 93.} However, because of the territoriality
principle and other valid considerations, these elements are mainly relevant to identifying and attributing income derived from gross revenues arising in Canada, in a manner designed to not be “over-inclusive”.26

Categorical Approach

With respect to income from the insurance and reinsurance of risks, the CFC Draft makes a number of more specific statements on which we offer our comments. We begin with the statement that “The general concern underlying the treatment of income from the insurance of risks is that profits can be shifted away from jurisdictions in which those risks are located and into a low-tax jurisdiction”.27 Further, the CFC Draft posits the following:

For example, an insurance company that is licensed to carry on an insurance business in a particular jurisdiction may underwrite insurance policies in respect of persons or businesses located in that jurisdiction and then reinsure some or all of these risks to a CFC that is resident in a low-tax jurisdiction (and that is generally not licensed to carry on an insurance business in the particular jurisdiction), thereby shifting profits associated with the insurance of those risks. In addition groups that are not generally involved in insurance activities may establish “captive” insurance companies (often in a low-tax jurisdiction), and by various means insure risks associated with the groups normal business activities with the captive insurance company, thereby shifting profits to the captive insurance company. Generally speaking, little activity is required in the management of these reinsurance operations or these “captive” insurance operations.28

In this regard, we would emphasize that:

1. As noted above, it is important to distinguish between the location of the CFC’s activities (i.e., functions, assets and risks) and the location of the underlying risks to which they relate. Profits that are properly attributable to the jurisdiction(s) in which activities of a CFC involving key entrepreneurial risk-taking functions are in fact carried on, and through which capital is committed and put at risk, should not be considered to be “shifted away” from any other location. This proposition would be inconsistent with the PE Report.

2. The fact that some of these profits may be properly attributable to “a low-tax jurisdiction” should not raise BEPS concerns, because they do not reflect “cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it”29 (emphasis added). In other words, whether these activities are in fact carried on in the parent jurisdiction or in the CFC jurisdiction, and whether or not the parent jurisdiction or the CFC jurisdiction is “a

26 See paragraph 94 of the CFC Draft.
27 Paragraph 102.
28 Paragraph 102.
low-tax jurisdiction”, these profits are not properly attributable to, and should not be considered to be “shifted away” from, the jurisdiction in which the underlying risks may be located.

Of course, in both of the examples above, it will be important that the insurance or reinsurance coverage is properly priced, but if it is, then the coverage should merely provide financial stability and security to the jurisdiction in which the risks may be located – including risk and capital management benefits to a primary insurer in that jurisdiction and thus indirect benefits to consumers in that jurisdiction.

The CFC Draft also notes that “due to the complexity of the insurance of risks generally, taxing authorities may not have the capacity or ability to successfully challenge the extent to which companies have actually transferred the risks to related CFCs. As such, CFC attribution rules may play a key role in preventing BEPS in this context.”

We acknowledge that insurance and reinsurance activities necessarily involve complexity. However, it is in our view incumbent on tax authorities and tax policymakers to develop and apply the skills, expertise and systems (including information sharing) necessary to properly examine and evaluate these questions in accordance with the principles reflected in the PE Report, and in light of applicable industry and regulatory standards and practices. Policymakers should not simply and reflexively default to CFC attribution or any predisposition to challenge such arrangements.

The CFC Draft also posits the possibility of distinguishing between attributable and non-attributable income from the insurance or reinsurance of risks on the basis of the following factors:

(i) whether the income was derived (directly or indirectly) from a related party (and, for a narrower rule, whether the related party was able to deduct insurance premiums paid to the CFC),

(ii) whether the parties to the insurance contract or the risks insured were located outside the CFC jurisdiction,

(iii) whether the CFC had sufficient substance to assume and manage the risks on its own accord, and

(iv) whether the CFC was overcapitalised.

As noted above, the last two of these factors are inherent in the income attribution analysis to be conducted in accordance with the PE Report. Thus, it is not necessary or useful to reconsider these factors in distinguishing between attributable and non-attributable income, particularly in the context of CFC rules designed to respect the principle of territoriality.

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30 Paragraph 102.
31 Paragraph 104. See also paragraph 112.
32 With respect to the capitalization of the CFC, we acknowledge and agree with the conclusions reflected in the PE Report that the focus should be on the amount of assets required to back the risks undertaken by the CFC, in light of financial, regulatory and capital market considerations, and not necessarily on the distribution of this capital as between reserves and surplus, or only on regulatory requirements. See, in particular, the discussion in paragraphs 123 to 166 of the PE Report.
With respect to the question of “overcapitalization”, we further note that regulated insurance and reinsurance groups are normally not likely to commit more capital to a CFC (i.e., assets reflected as a combination of surplus and reserves) than the amount that is reasonably required because of bona fide regulatory and commercial considerations, although this often exceeds the regulatory minimum.

Similarly, the first and second factors are neither necessary nor appropriate in the context of CFC rules designed to respect the principle of territoriality, except perhaps in identifying income arising from gross revenues derived from the parent jurisdiction. Even in that context, however, as noted above, it must be noted that the geographical diversification of assumed insurance risks is an essential risk and capital management strategy. Thus, for example, while Canadian CFC rules do focus on the coverage of “Canadian risks”, the coverage of such risks does not give rise to attributable income if “more than 90% of the gross premium revenue of the affiliate for the year from the insurance of risks (net of reinsurance ceded) was in respect of the insurance of [arm’s length non-Canadian] risks”. While the “more than 90%” standard may be very strict and arbitrary, it does seek to balance base erosion considerations with efficiency and competitiveness considerations.

**Excess Profits Approach**

The CFC Draft posits that “risk-shifting transactions among related parties could be susceptible to systematic mispricing, leading to a profit in excess of the normal returns that would not occur if the same transactions were undertaken with unrelated parties.” While we acknowledge this proposition, it does not follow in our view that attributable CFC income should be identified on the basis of some arbitrary and formulaic approach to the determination of the income of a CFC in excess of a hypothetical “normal return”. Rather, as noted above, it is our view that a CFC’s income from the insurance or reinsurance of risks, properly measured in accordance with the arm’s length principle and in light of legitimate financial and regulatory considerations, is necessarily and by definition commensurate with its functions, assets and risks assumed. Any portion of a particular CFC’s income that is not commensurate with its relative functions, assets and risks should be attributed to the units of the multinational group to which it is properly attributable in accordance with a functional analysis, and should not simply and by default be treated as attributable CFC income. Here, too, we would emphasize our view that it is incumbent on tax authorities and tax policymakers to develop and apply the skills, expertise and systems (including information sharing) necessary to properly examine and evaluate the appropriate pricing and capitalization questions in accordance with the principles reflected in the PE Report, and in light of applicable industry and regulatory standards and practices.

33 This configuration mainly reflects a “transactional approach”, coupled with an “entity approach” as a safe harbour.
34 Paragraph 118.
Conclusions

In conclusion, we urge the OECD to approach this area with caution. As noted in the CFC Draft, this is an area which cuts across and interacts with a broad spectrum of tax policy considerations, and requires coordination with a large number of other Action Item areas.\(^{35}\) We urge that the measures recommended by the OECD be proportionate and balanced, taking into account the unique commercial realities of the global insurance and reinsurance business models, which contribute to global financial stability and security through the geographical and other diversification and pooling of risk.

Yours Sincerely

\[\text{\[N.Simon\]}\]

Noeline Simon  
Vice President, Taxation and Industry Analytics

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\(^{35}\) The CFC Draft notes that: “The work on CFCs is being co-ordinated with the work on other Action Items. The Action Items that are most closely associated with CFC rules include Action Item 1 (addressing the tax challenges of the digital economy – this co-ordination involves working closely with the Task Force on the Digital Economy Liaison Group.), Action Item 2 (hybrid mismatch arrangements), Action Item 4 (interest deductions), Action Item 5 (countering harmful tax practices), Action Items 8-10 (transfer pricing), Action Item 11 (methodologies to collect and analyse data), Action Item 14 (dispute resolution mechanisms), and Action Item 15 (developing a multilateral instrument).” That leaves out only Action Items 6, 7, 12 and 13.
1 May 2015

**CBI RESPONSE TO THE OECD PUBLIC DISCUSSION DRAFT ON BEPS ACTION 3: STRENGTHENING CFC RULES**

1. The CBI is pleased to comment on the OECD’s Public Discussion Draft on Action 3: Strengthening CFC Rules.

2. As the UK’s leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

3. The CBI continues to support the BEPS programme to update international tax rules to reflect modern business practice, tackle abusive tax structures and target the incidence of double non-taxation. However, we are concerned that if complexity and uncertainty are not avoided, the outcome will be an increase of double taxation and resulting legal disputes, which could have a substantial and negative impact on cross border trade and investment, but also on tax administrations with limited resources.

**Overview**

4. The discussion draft lacks a clear direction and policy as to what BEPS behaviour is in relation to CFC income. This needs to be clearly defined to ensure the proposals in the final recommendation can be measured and targeted against such behaviours.

5. The UK CFC rules introduced in 2013 provide a balanced approach between protecting the UK tax base, EU law, compliance burden for business and maintaining UK competitiveness. We recommend that the UK model could be used as an example of an effective modern CFC regime. CFC rules should not have a two-tier system differentiating the treatment of EU from non-EU territories.
6. A regime which focuses on the protection of the parent company country tax base is the most proportionate response to the CFC risk. A regime which also covers third country profit diversion is often a blunt tool which is difficult to target local risks and issues, and ends up with an arbitrary apportionment back to the parent company jurisdiction rather than the jurisdiction from where the profits were diverted from.

7. We are concerned about the unnecessary complexity and compliance burden being created by including transparent entities and PE’s within the regime. Transparent entities should only create a risk to the effect they are hybrid entities, and separate proposals are being made to deal with this risk. Any restriction to exempt PE’s should be incorporated within branch exemption rules themselves and not subject to the complexity of a regime which is designed to deal with separate legal entities.

8. We are concerned at the lack of threshold requirements other than the most compliance heavy version of a low tax test. CFC regimes are inherently complex and therefore the compliance burden should be proportionate and focused just on entities which create a high risk of a CFC apportionment. Threshold requirements are an important feature to ensuring that only high risk entities need to undertake parent company tax regime calculations. The current proposals in the working draft would generally create an unworkable regime for many large MNE’s.

9. In preparing the final recommendations on Action 3, the OECD should consider the inclusion of further threshold and other filter type tests such as those in the UK regime. Each of these should have equal status so tax payers can review the ones which are most likely to apply to their low risk entities to ensure an appropriate low compliance burden for these entities can be achieved.

10. The definition of control needs to be carefully designed to ensure that the rules only apply where a shareholder is able to exert significant influence over behaviour, the information to comply with the regime is available and that commercial lending and other banking transactions do not impact the analysis.

11. CFC income needs to be clearly defined and CFC regimes should ensure that only that income is subject to a CFC charge. Whereas a transaction-based approach enables such rules to be targeted, it does create a significant extra compliance burden attached in identifying the profits attributable to such transactions. It is critical to ensure CFC regimes only require such calculations from high risk entities.

12. We disagree strongly with the proposals outlined in respect of “excess profits”. The proposals seem to be the least well targeted and create significant extra compliance work. The policy principle is difficult to comprehend as to why such profits should be reallocated to the parent jurisdiction. The calculation of a normal return on capital would be complex and subjective in nature. If such a regime is to be considered further, it should be restricted to just the specific types of income to which it is being designed to capture (e.g. passive IP income) and not be applied across a wider spectrum. However, such a regime must recognise that IP is inherent in very many of business transactions and therefore any such approach needs to be capable of separating passive IP income (pure income streams with no ongoing activity) from IP which is actively managed and integral to the product or service being provided.

13. Further work needs to be undertaken in relation to the attribution of income, especially for regimes where there is no de-minimis on shareholdings to determine control. In addition, where there are different definitions of determining control (e.g. economic, or voting, or accounts), then recommendations should be made to ensure only 100% of profits of the CFC can be attributed to shareholders (e.g. so if one shareholder has 100% votes, but another shareholder has 100% economic rights, the total profits of the CFC company should only be attributed once) – we would recommend an approach should be based on the economic return for the shareholders of the profits of the CFC in the accounting period in question.

Detailed Comments
14. We have outlined below our answers to the questions raised in the consultation paper in addition to any other comments and observations we had in reading the paper.

Chapter 1 – Policy Considerations

15. The UK has recently undertaken a substantial review of its CFC rules. As part of that review the UK government considered a number of factors including competitiveness, EU law, compliance burden for business, and the required protection for the UK tax base.

16. As a result of the review which concluded with the introduction of new CFC rules in 2013, UK business accepts that the current rules provide a proportionate regime to protect UK tax revenues whilst having a manageable compliance burden. Our comments in the paper below reflect the experience and outcome of the recent UK review.

17. As outlined in the discussion draft, one of the critical features that had to be taken into account was the position under EU law. The UK review resulted in one regime applying to all CFCs with no distinction between CFCs resident in EU member states and CFCs in other jurisdictions. This reflects all anti-discrimination principles and treaties and also the U.K.’s position as a major trading partner in a global economy which aims to treat trading partners fairly.

18. We do not necessarily agree with the comment on p 10 of the discussion draft that CFC rules are EU compliant simply because they extend to domestic situations. For example, even in the Cadburys case, they used a second comparison of an Irish sub (CFC) with a Dutch Sub (no CFC because of the tax rate) to confirm an unlawful restriction.

19. In the case of states which operate a territorial system of taxation, it would make little sense for the CFC regime to primarily target anything other than the diversion of profits from the parent state, in order to remain consistent with the overall policy on taxation. Third country to third country diversions of profit would not be taxable in the UK, for example, regardless of where they were earned and whether subsequently repatriated to the UK. In a territorial system of taxation, a CFC regime which targets third country diversions of profits would at best, only be able to deter foreign-foreign BEPS activity in an indirect way (i.e. due to the anticipated spill-over impact as noted in the discussion draft). The remedy of an attribution to the parent company would not achieve a key BEPS objective of ensuring that tax is paid in the jurisdiction where value is created. Such a system would encourage inversions and corporate migrations and distort the M&A market to make companies more attractive to investors in regimes where there are no CFC rules. The OECD has already identified the tools to deal with such cases, in particular the transfer pricing approach to risk set out in the Discussion Draft on Actions 8 to 10.

20. Therefore, in light of the need to protect the parent jurisdiction’s tax base, comply with EU law, avoid competitiveness concerns and manage the compliance burden, our view is that the UK system is a suitable CFC regime for a modern territorial tax system. Whilst we do understand the arguments for a CFC regime to act as a deterrent to foreign-to-foreign stripping especially with regard to developing countries, we do feel that the recommendations proposed under other BEPS actions should deal with the majority of these concerns in a more targeted manner. Thus, for example, although there may be concerns over base erosion of a third country through offshore financing, this should be dealt with through the actions on interest deductibility and hybrid mismatch arrangements. With regard to base erosion through the licensing of IP from abroad, there are probably two main areas of concern. First, IP may be licensed in from an overseas company with insufficient substance. In that case, provided, if that company did not exist, the IP would have been licensed in from another overseas company which is the “economic owner”, any concerns should be adequately dealt with through normal transfer pricing. Second, if IP is stripped out of a country and then licensed back, the country itself should consider developing its own anti-avoidance rules to counter such arrangements – it is not a parent company/CFC issue. Therefore, to design a CFC regime, including the introduction of any secondary rules, to counter foreign-to-foreign stripping is in our view not the most effective or targeted approach.
21. We also recognise that worldwide systems of taxation may have different objectives when compared to a territorial system of taxation in so far that it will be important for that jurisdiction that profits are not diverted away from the parent’s jurisdiction purely for the avoidance of paying tax on remittance.

22. It is clear that the discussion draft issued by the OECD is a non-consensus document, and we believe part of this is due to the wide ranging views of countries towards CFC regimes. These views range from some countries which are very unlikely to ever implement a CFC regime right through to other territories which believe a very broad CFC regime is required to protect both their own domestic tax basis as well as acting as a deterrent and a remedy for many of the BEPS actions.

23. This wide range of views has led to a discussion draft that lacks a clearly articulated policy objective essential for the development of proportionate tax standards. Given the difficulties on reaching a consensus on the proposed rules we believe the most appropriate approach would be to review the effectiveness of different existing rules and determine building blocks for countries which wish to implement a CFC regime should consider when reconciling to the overall tax policy of the Government.

Chapter 2 – Definition of a CFC

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

24. The main practical issues arising from treating transparent and PE’s as separate entities is the potential risk for double taxation. For example if you had an offshore partnership held by a US company which is held by a UK parent company. The partnership income is already subject to tax in the US at a much higher rate (35%) than the UK (20%). However if the partnership was treated as a separate enterprise for UK CFC purposes, there is no tax paid by the partnership and therefore a UK CFC charge could also arise on the same income.

25. This is just one example that shows there should be no need to treat transparent entities as separate entities in situations where the tax treatment is exactly the same in both the parent jurisdiction and the jurisdiction which holds the transparent entity (which will be the case in the majority of times). If the proposed rules on hybrids outlined in paragraph 36 of the discussion draft are implemented, then there should be no need for further rules to be introduced to bring transparent entities within the CFC regime.

26. Likewise, with regard to permanent establishments which are exempt in the territory of incorporation of the company, we believe that it is an unnecessary complication to bring these within the scope of the CFC regime. A much better approach is to incorporate rules addressing base erosion through low tax branches into the branch exemption regime itself to ensure that the entity itself is subject to full taxation in the territory in which it is resident when appropriate. This is more effective than trying to transpose a regime which has the complexities inherent in dealing with separate legal entities.

Question 2 - should the recommendations consider any other issues related to determine which entities could be considered to be CFCs?

27. As outlined above we believe that the CFC rules should be restricted to just apply to just companies. More targeted rules can be applied to tackle other types of transparent entities.

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

28. The UK rules operate by treating the CFC that receives income as a UK company and determines the income on the UK tax principles. Therefore there should be no mismatch in the treatment between the parent jurisdiction and the intermediate holding company.

29. We would note that hybrid entities or instruments tend to be used to take advantage of mismatches. It would seem strange to prohibit their use in a situation (e.g. the example given for the broad version of
the modified hybrid rule) where there is no base-eroding mismatch. There is no explanation of why the broad option is required.

Chapter 3 – Threshold Requirements

30. One of the critical features of the UK CFC regime is the menu of different thresholds which gives the possibility of low compliance routes for low risk CFCs. As outlined below, and in discussion draft itself, applying just a low tax threshold based on an effective tax rate calculation is an extremely compliance heavy process if it has to be applied to all CFCs. Large multinational groups can have thousands of CFCs in the group and to perform home country tax computations in respect of everyone is impractical. A more pragmatic approach must be adopted for a proportionate regime and therefore other thresholds such as a de-minimis test and low margin tests should also be included. Different entities will find different threshold tests easier than others, so there should be no specific ordering requirements to such thresholds. If a company passes one threshold, it should be excluded.

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

31. In the UK the threshold condition applies by comparing the tax paid locally by the CFC with the tax that would have been paid in the UK if it were a UK resident company, both after allowing relief for any third country taxes suffered on the CFC’s income under the two jurisdiction’s double taxation relief rules. Having this as a sole threshold would mean applying the longest tax code in the world to every single CFC in the group which as noted above may be in the thousands for large MNE’s. This is both impractical, time consuming to the extent that filing deadlines would probably not be met, extremely costly if outsourced, and would be disproportionate to the risk that the CFCs actually pose.

32. Tax rate thresholds also struggle to distinguish between harmful low tax regimes and simple and acceptable differences of sovereign tax policy. For example, timing differences can lead to significantly different amounts of tax being paid on a year by year comparison with the parent company which can lead to intermittent CFC charges despite the overall level of tax over the life of a project being approximately the same. As is noted in the BEPS Action Plan, low-tax is not a problem per se, so long as it isn’t associated with BEPS Activities – therefore, any proposals should be clearly targeted at BEPS issues.

33. It is also necessary to ensure that tax paid in respect of a CFC’s profits is included in the calculation when that tax is paid by another entity, for example because of a consolidated tax filing or because the entity is regarded as transparent and tax is paid by the parent under the laws of the jurisdiction of residence of the CFC.

Question 5 - How could these problems be addressed or mitigated?

34. The main solution to these problems can be seen from the UK CFC regime. The low tax threshold is a useful test, but it is just one of a number of thresholds that can be applied. Each of these thresholds can be applied in priority to one another and therefore taxpayers have the option as to which one is tested first. This enables them to test one threshold which is most likely to apply. This significantly reduces the compliance burden for companies especially where there is a de-minimis threshold, white list of higher tax countries with similar tax systems and other tests such as low margins. Also applying a transaction-based approach rather than an entity approach enables some companies to be immediately eliminated from further compliance if they have no types of income which are subject to a CFC charge.

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

35. The discussion draft outlines one way in which the differential in tax rates may be addressed for permanent establishments. However, as outlined above, we would recommend such aspects are dealt
with in the branch exemption rules themselves rather than complicating both the treatment of branches and the CFC regime further.

**Chapter 4 – Definition of control**

36. The UK regime defines control not only on a 50% test but also in cases of joint-ventures where both parties own more than 40% (but one does not own more than 55%). This test is measured and can be met based on either a voting, economic or a consolidated accounts basis.

37. We can accept that some complexity is required to prevent avoidance in this area. However, we believe that best practice would be to have a primary definition of control, which is supplemented only where there is a motive of avoiding the control test. For example, if the primary test of control is legal control, we consider that other tests of control, such as economic control or accounting consolidation should only need to be considered if there is intention to avoid legal control. Such an approach would prevent cases where inadvertent control can arise due to commercial factors (such as the banking example below) and addresses the concern that more than one parent might be found to control the same entity, which in the worst case could lead to multiple apportionment of the same profits. Further tightening the control requirements would likely create substantial additional burden for minimal benefit.

**Question 7 – What practical problems, if any, arise when applying the control test?**

38. A practical problem arises in obtaining information in situations where the control test applies despite owning less than 50%. It is not always possible to have access to information in respect of minority holdings.

39. Careful consideration must be taken around the definitions of control and the ability for the terms of ordinary banking relationships (e.g. lending arrangements and other financial transactions) to create control. For example, a lender may be found to have economic control of an independent third party borrower from time to time, depending upon the financial condition of the borrower. However, this is clearly a situation which should not create a CFC.

40. Such cases would be minimised by the approach outlined in paragraph 37 above. Alternatively there should be sensible carve-outs. In the case of lenders such carve-outs must ensure their independent third party customers are not CFC’s and that minimal work is required to arrive at that conclusion.

**Question 8 – Are there any particular 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?**

41. Please see paragraphs 37-40 above.

**Chapter 5 – Definition of CFC Income**

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

42. The biggest practical issue with regard to substance tests is any requirement that the substance must be in the CFC itself. There are many commercial reasons why employees may be employed by a different company to the one for which they performs services. For example, insurance groups are sometimes required for regulatory purposes to have separate employment companies from the regulated insurance entities. Also, employees may have responsibilities in more than one company. For example, a CEO may have responsibility for 3 companies, but is legally employed by one of them and his time is charged by that company for time spent on the affairs of other companies. This should not mean the other two companies do not have substance. However, restricting the substance on a jurisdictional basis will need to consider EU law.
43. The second point regarding having substance tests in CFC rules that require the necessary substance to be in the CFC itself, is that this does not necessarily result in any diverted profits being taxed where the related economic activity is located. If such a test is failed, the parent company is automatically subject to a CFC charge regardless of whether the actual substance is in the parent jurisdiction or elsewhere.

44. The final point is that if a “number of employees” test is adopted, then whilst simplistic and easy to administer, it could lead to a swamping of high value operations in the parent country territory by employing a large number of manual low value added employees in the CFC territory. The main objective of a substance analysis should be to ensure there are sufficient employees and substance required for the functions of the relevant economic activity. Having a large cleaning staff is irrelevant for determining economic activity relating to the exploitation of IP.

45. In order to adopt a consistent approach, countries wishing to adopt a policy of preserving the home country tax base, and/or needs to comply with EU law, should follow the UK approach in relation to substance and focus only on situations where the significant people functions (“SPF’s”) in relation to the CFC’s activities are located in the parent jurisdiction. These rules allow group employment companies, should be EU compliant, only attributes profits diverted from the UK and focuses on the value the employee creates for the CFC rather than being an absolute numbers game.

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

46. Substance tests will generally involve a level of subjectivity. There is unlikely to be a pure mechanical answer that is accurate. The UK approach goes beyond the normal transfer pricing considerations (by applying Article 7 allocation principles in an Article 9 context) and thus would be onerous if it were the only available test without the other filters referred to in this paper. However, by adopting a combination of OECD transfer pricing and profit attribution principles which build on the transfer pricing documentation that is already required under BEPS Action 13, it uses established principles and documentation in a way which helps ensure coherence and minimises duplication.

Question 11 – How can CFC rules accurately attribute income that raises concerns about BEPS (i) in a business that is licensed under appropriate regulatory body and is market facing in a particular jurisdiction, (ii) in a reinsurance business carried on by a CFC of a multi-national 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 (ii) and (iii)? If so, what are they and how can they be dealt with?

47. We have read the response to the discussion draft prepared by the Association of British Insurers (“ABI”) which provides substantial detail on the insurance industry which we support. We agree with the key conclusions of the ABI:

The features of insurance operations that create economic and value creating activity and do not give rise to BEPS activity are:

a. The reinsurance contract is priced on arms-length terms.

b. There would be diversification and pooling of risk in the reinsurer.

c. There would be a demonstrable and quantifiable capital benefit – the economic capital position of the group has improved as a result of diversification and therefore there is a real economic impact for the group as a whole.

d. Both the insurer and reinsurer would be regulated entities with broadly similar regulatory regimes applying with regulators that required evidence of risk transfer and appropriate capital levels. Additionally, rating agencies’ capital requirements may be relevant.

e. The original insurance involves third party risks outside the group.

f. In addition to having the risk and appropriate capital levels the entity would have the requisite skills and experience at its disposal. This would involve having employees (or those of a related
service company) with senior underwriting expertise sufficient to accept the risk as well and/or 
an actuary. Although some non-key entrepreneurial risk-taking functions could be outsourced, 
the decision makers would likely to be officers of the company with suitable experience and 
authority.
g. The entity would have a real possibility of suffering losses as well as making profits.

We therefore believe insurance income that has all or most of the features in the paragraph above 
should not suffer a CFC charge.

Our view is that the UK CFC rules effectively achieve this by having the right balance between ensuring 
that any insurance income that relates to BEPS activity is within their CFC rules, whilst insurance 
operations that create economic and have value creating activity are outside the rules. We therefore 
suggest that the UK’s CFC rules should be regarded as good practice when considering CFC rules for 
insurance income.

48. The answer to question 11 only deals with the insurance sector. Please see answers to question 13 
below for issues which arise in other regulated businesses.

**Question 12** – *Are there practical problems with applying the same rules to sales and services income and IP income?*

49. The definition of passive income is far too broad especially with regard the interaction of IP with sales 
and services income. Almost every transaction, be it internal or external for the supply of goods or 
services will include, to varying degrees a return which relates to some IP (whether it be registered IP 
such as trademarks, patents or copyrights, or unregistered IP such as goodwill or know-how which will 
normally form a very direct component of an active trade). To have to attempt to review every global 
transaction to identify any return relating to IP compared to a supply of personal services and physical 
goods will make CFC rules unworkable.

50. The approach adopted in the subsequent paragraph 114 suggests that sales and services income should 
be treated automatically as passive unless certain substance tests are met. This would clearly create a 
significant administrative burden for which little additional benefit can be obtained. The reverse 
 presumption (i.e. passive sales and service income is very much the exception rather than the norm) 
would seem a more reasonable reflection of commercial generalities.

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

51. Again, we refer to the UK CFC system. This does not distinguish IP income from between sales and 
services and rather than attempting to classify them as active or passive, it applies the substance based 
tests to determine whether there has been any diversion of profit from the parent company. The rules 
accurately attribute income from these categories of income which have been diverted from the UK by 
requiring the identification of SPF’s related to the product being sold (which can include underlying IP) 
and then attributing a return based on the SPF analysis.

52. In relation to other regulated businesses, such as banking, it is important to recognise that income such 
as interest and dividends is likely to be active income (we do not refer to dividends from subsidiaries in 
this context), which is genuinely being earned in the CFC jurisdiction, and which should not be subject 
to tax under a CFC regime. CFC regimes should therefore include straight forward approaches to allow 
such taxpayers to confirm the CFC rules are not applicable in low risk cases.

53. The UK rules also include a practical approach to identifying active finance income in the financial 
services sector and to assessing, with regard to non-tax commercial factors, whether an entity is 
appropriately capitalised.
Question 14 – Does the discussion above consider all categories of income that should be attributed under CFC rules?

54. As noted above, the categories of income highlighted in the paper is significantly wider than is required under a CFC regime. However, this probably arises due to the fact that the paper has not clearly defined the type of behaviour and structures that BEPS Action 3: Strengthening CFC Rules are attempting to prevent. Without clear direction, the definition of income has become arbitrary.

55. We specifically refer back to paragraph 85 of the discussion draft which states that CFC rules should not attribute income that arises from value-creating activity in the CFC jurisdiction and for those which are designed to only apply to stripping the base of the parent jurisdiction, then income should not be attributed if it arises from value creating activity in any jurisdiction other than the parent company.

56. These key issues outlined in paragraph 85 are then not addressed in Chapter 5 Section II and further work should be undertaken to ensure these policy criteria are met. Examples can be seen by a detailed review of the UK system.

57. We welcome the recognition in paragraph 101 that active finance income derived from an entity that is not overcapitalised should not be attributable. We would ask that any rules around these aspects should be practical and easy to administer, flexible (e.g. to take account of changing requirements as to the level of capital that should be held by banks) and focussed on cases where a tax avoidance motive exists (e.g. there may be non-tax commercial reasons for higher levels of capitalisation which should not require an attribution of income).

Question 15 - Is it clear how the two approaches above would work? If not, what further details is required to clarify the approach? – Does the discussion above consider all categories of income that should be attributed under CFC rules?

58. It is not clear how the excess profits approach would work, nor that it is appropriate. As drafted, it is proposed to act as a primary test which will need to be applied in a broad range of cases. As implied in question 19 below, if the target is low taxed IP income then a better approach would be to have the excess profit approach adopted as the method of calculating CFC income under the IP category only after first having used other tests to narrow down the entities to which the test should be applied’. As a general remark, the excess profit approach moves away from the agreed principle established under Actions 8-10 that the arm’s length principle should remain the primary method for allocating income and expenses and is also inconsistent with EU law principles.

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

59. CFC rules can be an extremely blunt instrument for dealing with BEPS risks if they are not properly targeted. Having a one size fits all approach to all categories of income will extend the scope beyond the diversion of profits using BEPS methods. If commercial income already subject to tax is caught under BEPS, then companies will question whether to carry out that business at all.

60. There are a number of big practical considerations to be addressed on the excess profits approach:

- How should the eligible capital be determined?
- What income measure is used as the comparator?
- How should the commercial return for the capital provided be determined?

These tests will be very subjective and likely provide an inaccurate measure of BEPS. It does not take into account the substance and activities being carried out in the CFC and therefore is unlikely to be consistent with EU law which requires a wholly artificial arrangement (which is determined by whether sufficient substance is present in the CFC to carry out its activities).

Question 17 – How could the practical problems be addressed or mitigated?
61. We do recommend that the UK approach is followed which clearly outlines the income which is intended to be caught in a Gateway approach. For each class of income caught, a specific and proportionate rule to determine BEPS activity which diverts profits away from the parent company jurisdiction is then applied. For example, all income which is not financial or property income is subject to a substance test and if failed, a transfer pricing approach is applied to UK functions. Generally, however, with regard to Interest payable to a CFC from the UK, or that is diverted from the UK, the income will be subject to full inclusion. However a reduced inclusion amount is applied if the interest payment is foreign to foreign to reflect the policy of maintaining a territorial regime.

Question 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?

62. There is insufficient detail on the two methods to evaluate how accurate they would be at addressing BEPS concerns, however it is difficult to see how the excess profit approach can be fundamentally made to work to align substance with economic profit, especially in the area of IP. It completely disregards the substance and activities being carried out in a jurisdiction and focuses solely on the capital of the company.

63. We would encourage the OECD to review the UK approach of a SPF analysis to determine the base erosion and profit shifting from the parent company jurisdiction and to accept that third country base erosion is best dealt with under the transfer pricing work being carried out under Actions 8-10 which would reallocate the profits back to where the substance and economic activity is being carried out.

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

64. We would not recommend the excess profits approach be applied to any income under a basic CFC regime for the reasons outlined above in paragraph 62.

65. Under the UK CFC regime, it could be said that a variation of the excess profits approach is adopted in relation to financial trading income. However, as noted above, it has been important that any rules around these aspects should be practical and easy to administer, flexible (e.g. to take account of changing requirements as to the level of capital that should be held by banks) and focussed on cases where a tax avoidance motive exists (e.g. there may be non-tax commercial reasons for higher levels of capitalisation which should not require an attribution of income).

We would note that the UK rules for financial trading income focus on excess capitalisation and therefore focus on providing a normal return on any excess capital provided by the UK parent rather than attributing “excess profits” back to the UK (though these can be attributed back to the UK under a different class of CFC income if the SPF’s in relation to the profits are in the UK). Again, this is a proportionate response to protecting the tax base of the parent jurisdiction.

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

66. Under a CFC regime which targets the protection of the tax base of the parent jurisdiction, the main approach for determining profits and returns which should be attributed back to the parent company is to determine the profits attributable to the activity and substance carried out in the parent company jurisdiction in relation to the profits earned in the CFC. This would achieve the realignment of economic substance with taxable profit.

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

67. In 2013, the UK changed from a pure entity approach to an approach which still focuses on the entity to determine whether a CFC charge should apply, but then applies a more transaction based threshold tests to determine the actual income chargeable. The key issues, both positive and negative, are highlighted in the discussion draft. The combined approach enables the benefits from the positive...
aspects of each approach to be adopted (e.g. an entity based approach to determine which companies could be subject to a CFC charge with multiple filters to ease compliance, whilst having further transaction based filters on attributing income to enable the rules to be focused on areas where profits are diverted from the parent company tax base). It also provides protection from the significant downsides (the significant compliance burdens of a transaction based approach, and swamping of income under an entity basis).

68. The main practical concern which can arise in relation to genuine trading activities under both tests is the location of the substance. As outlined above in this letter, central employment companies are common both from a jurisdictional basis, but also in some cases to achieve regional efficiencies which are not tax related. Requiring substance in the CFC itself will bring a majority normal active trading companies with no passive income within the rules. A jurisdictional approach is better but it difficult to reconcile with EU law, and therefore targeting activity in the parent jurisdiction is an approach which can be applied consistently and measured from the parent company jurisdiction itself.

69. The UK system has recognised many of the concerns regarding the compliance burden and has built in many features to help mitigate this without diluting the impact of the rules in their ability to address base erosion.

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

70. Compliance burdens for taxpayers of broad ranging and inflexible CFC rules are both disproportionate and will in many cases be impractical to comply with for taxpayers and to administer for tax authorities. This is relevant to both approaches.

71. Taxpayers will generally accept a level of compliance and work to be undertaken if the entity itself is carrying out activity or earning income which has a genuine risk of being within both the scope and the intention of the rules. What business generally objects to is having to undertake a significant amount of work to comply/analyse a company to confirm that no CFC charge arises, when it is clear that the activities of the company were never going to be, or were not within the intended scope of the rules.

Question 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 arise from BEPS concerns?

72. The critical feature of managing concerns and/or practical problems is to ensure that any detailed and burdensome compliance work is restricted purely to high risk entities/income streams and that the low risk entities (which the significant majority of CFCs in large multi-national groups generally are) can be easily and quickly identified and not subjected to an unnecessarily detailed assessment under the CFC regime.

73. The proposals outlined in the paper do not go far enough to identify the low risk entities or income streams. The current proposals in the discussion draft for a single low tax threshold (especially if it has to be worked out on parent company tax principles) are simply insufficient.

74. We suggest that a fundamental feature of a practical CFC regime is to adopt a menu of features and threshold tests which if any are met (so taxpayers can identify which ones are most likely to apply and test those first) would automatically take an entity or income stream out of the CFC regime. We would recommend all of the below be included in the building blocks of a CFC regime:

Both entity based or transactional:

- Low tax (as proposed by the discussion draft)
- De-minimis (this is critical, and as with the UK regime, can be applied at different levels for different types of income to distinguish between low risk trading and higher risk passive income). Also, allowing such a test to be based on accounting profits, with suitable adjustments (e.g. under transfer pricing rules), rather than just profits computed under the parent jurisdiction’s tax rules
would help to reduce the compliance burden).

- A white list of countries which should be as inclusive as possible of territories with similar rules and rates of at least an appropriate percentage of the parent company jurisdiction. If a country generally passes these criteria but has a special tax regime that fails, then lists of the special regimes can be made as specific exclusions to allow the normal companies in that territory to still qualify.
- Low margin tests
- Initial period test to allow groups undertaking a commercial acquisition to deal with any CFC risks in acquired groups.
- Small cash balances for active trading groups (e.g. a fixed ratio of 5% seems both reasonable and easy to apply)

**Entity based approach**

In addition to the ones listed above, our experience of the entity based approach would also require the following tests to be included:

- Motive test (to allow genuine commercial activity which gets caught up to still be exempt if it can be proved the motive to setting up the entity was not to divert profit)
- A wholly artificial arrangement test would be required in addition to ensure the regime was EU compliant.

**Transaction-based approach**

- The additional advantage of a transaction based approach is that the definitions of attributable income can also act as a further threshold if clearly defined. The UK approach of clearly defining different categories of income which it wants to include as a Gateway approach before any calculation of the CFC attribution was a welcome addition to the UK rules and one which could be adopted as best practice.

75. Having each of the rules above should provide different alternatives and degrees of objectivity/subjectivity which can be applied by businesses depending which suits their business model the best, but should not dilute the impact of tackling BEPS.

**Chapter 6 – Rules for computing income**

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

76. We would agree that the first option, based on the home country tax regime, is probably the right answer from a BEPS perspective.

77. However, we would note that it is unworkable for large multi-national groups to have to undertake this calculation (i.e. it is effectively a complete second set of tax calculations) for every group company. Therefore, as noted above, it is essential that the scheme is designed so that all the low risk entities are carved out on simple and easy tests and therefore the complex work on re-computing income under parent company tax principles is strictly limited to only high risk entities and only income streams which are subject to a CFC charge.

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

78. Following on from the logic of our answer to question 24 above, if the home country tax rules should apply, the full scope of the rules on losses should also apply to allow the availability of loss carry
forwards/back within the CFC, but also apply anti-avoidance rules such as loss restrictions where there are changes in activity.

79. If the parent company has losses and receives an attribution of income under a CFC regime, then as a general rule the parent company losses should be available to offset against the CFC income (provided it is consistent with the offset of losses if the income had arisen in the parent company jurisdiction itself).

Chapter 7 – Rules for attributing income

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

80. The UK regime requires a 25% holding for an apportionment to be made. This reflects the UK approach of determining that a company is a CFC for a party with a minority interest, if the CFC is controlled from the UK. We do believe this is a sensible limit to reflect when a company which does not have control nonetheless has a substantive interest.

81. We would not necessarily recommend a common fixed limit to apply to all CFC regimes, but if the OECD were to consider this, it should be higher than the implied 10% of the discussion document. If a CFC charge is to be made, investors must be able to get the documentation and financial information to do this. Many investors around the 10% level will not be able to do this.

82. A difficulty not identified in the discussion draft arises when an investor has different levels of voting to say economic rights of a company. So a company may own 100% of the voting power, but only say 50% of the economic rights due to different types of shares. UK law in this area requires a “just and reasonable” approach. The language in the legislation does leave a high degree of uncertainty. The normal approach taken by both taxpayers and tax authorities is to work on an economic basis. This works well in most cases, and we would recommend a specific preferred approach to this issue is identified and confirmed in the final recommendations on this BEPS Action. This difficulty can also be addressed by adopting our suggestion above of determining control by means of a primary rule, supported by means of a secondary rule (or rules) only where there is an intention to avoid the primary rule.

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

83. We do not have any UK experience of a top-up approach and therefore cannot speak from practical experience. If you have a regime which is properly targeted at just the diversion of profit from the parent company jurisdiction, then it would seem counter-intuitive from a BEPS perspective to charge the CFC profits to tax at any rate other than the home country rate.

84. The top up tax highlights one of the key downsides of a wider scope regime which is targeting third country diversion of profits. If provisions can be adequately targeted to highlight where profits should be allocated, then the appropriate remedy would be to allocate the profits back to the jurisdiction from where they were diverted and not a CFC charge. If such rules cannot be properly targeted and third country profits become attributable to the parent company jurisdiction under CFC rules, this income being allocated to the parent company does not belong in that jurisdiction, and provides a direct competitive disadvantage for companies operating in that parent company regime. We cannot understand the rationale for a top-up approach to be added to properly targeted rules.

Chapter 8 – Rules to prevent or eliminate double taxation

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

85. Double tax relief rules are generally complex and in many cases difficult to apply and this does appear to be underestimated. The prevention of double taxation is a critical area for business and therefore
again is a further reason why the scope of CFC rules should be limited to BEPS, in particular parent company diversion of profits.

86. If a consistent set of CFC principles are not achieved (and based on the discussion draft, there could be a wide range of possible CFC regimes in future), it is essential to ensure that credit is achieved for tax arising in intermediate holding company CFC regimes, even if the CFC regime is entirely different to that applying to the ultimate parent.

87. It is also necessary to ensure that credit is given for tax paid in respect of a CFC’s profits when that tax is paid by another entity, for example because of a consolidated tax filing or because the entity is regarded as transparent and tax is paid by the parent under the laws of the jurisdiction of residence of the CFC.

88. We welcome the proposals about a tiering system to make it clear who has primary taxing rights and where credit should be given for what taxes. We would like to see further analysis and clear guidance in the final recommendations to ensure this works as intended.

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

89. We have no specific comment to note other than the points outlined above and already noted in the discussion draft.

**Conclusion**

90. The UK has recently undertaken a long and detailed consultation to update and modernise its CFC regime. The outcome has achieved a fair mix of protection of the UK tax base for the UK Government whilst addressing EU law concerns, avoiding taxing many commercial structures supported by substance, and addressing business concerns regarding maintaining a proportionate compliance burden. We do recommend that the UK regime is considered a good example of best practice for countries wishing to adopt a CFC regime. Further, for countries with a territorial approach to taxation, will believe that an appropriate CFC regime is one which is aimed at preventing diversion of profit from the parent company jurisdiction.

91. We trust that you will find the above comments helpful in understanding the potential impact of the proposals outlined in your paper. We remain committed to ensuring that each BEPS Action achieves its stated goals, whilst ensuring that genuine business arrangements are not unduly impacted to which this Action forms a key part.

92. We remain at your disposal should you wish to discuss the issues we have raised in this paper in more detail. Please contact neil.anthony@cbi.org.uk for more information.
Joint Opinion Statement FC 8/2015
on strengthening controlled foreign company rules
(BEPS Action 3)

Prepared by AOTCA and CFE
Submitted to the OECD
in May 2015

The AOTCA (The Asia-Oceania Tax Consultants’ Association) was founded in 1992 by 10 tax professionals’ bodies located in the Asian and Oceanic regions. It has expanded to embrace 20 leading organizations from 16 countries/regions.

The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Its functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe. The CFE is registered in the EU Transparency Register (no. 3543183647-05).

AOTCA and CFE unite almost 500,000 individual tax professionals in 37 countries (19 OECD member states).
Introduction

This is a joint Opinion Statement of the Asia-Oceania Tax Consultants’ Association (AOTCA) and the Confédération Fiscale Européenne (CFE), the European federation of tax advisers, responding to the OECD discussion draft on BEPS Action 3 (Strengthening CFC Rules) of 3 April 2015\(^1\) (hereinafter: the Discussion Draft). If you should have any questions on the comments below or on AOTCA or CFE, please contact Rudolf Reibel, CFE Fiscal and Professional Affairs Officer: brusselsoffice@cfe-eutax.org.

This is a preliminary version. The final version will be made available in the course of May 2015 on the CFE website.

General comments

1. All income derived by a controlled foreign company (CFC) such as operational income which does not raise profit shifting concerns and is thus meaningless from a BEPS point of view should be excluded as an available option in the final recommendations on Option 3.

2. There is no consideration of the CFC issues as they concern countries which tax on a receipts basis rather than a residency/citizenship basis. They appear to be irrelevant to the receipts based countries but the inter-reaction with jurisdictions that have CFC legislation needs analysis.

3. It is observed in the Discussion Draft that CFC rules provide a backstop to transfer pricing actions. However, the Discussion Draft does not provide any consideration about how transfer pricing disputes (which tend to be very lengthy) should interplay with the CFC rules and how they are to be resolved by competent authority negotiations.

4. We are concerned about the possible interaction of BEPS Action 4 (interest deductions and other financial payments) with Action 3 and the double taxation issues that can arise if on the one hand interest is considered not deductible with the paying company while on the other hand it is included in the CFC income of the shareholders in the CFC.

5. For jurisdictions such as Hong Kong, Malaysia and Singapore, CFC rules are not that relevant for the following reasons:

   a) They do not tax on worldwide income but impose tax based on the principal of territoriality;

   b) Hong Kong and Singapore are relatively low tax jurisdictions so profits being shifted away from these jurisdictions and kept in foreign controlled corporations are less likely an issue; and

c) even if profit shifting is an issue, there are other existing tax rules in those jurisdictions which may be used to deal with shifting profits offshore e.g. the general anti-avoidance rules.

Comments relating to specific chapters of the Discussion Draft:

6. CFC rules as preventative measures (paras 16 and 17):
   The claim is made at paragraph 16 and thereabouts that the existence of CFC rules has an impact on the erosion of profits from the source country (as compared with the ultimate recipient country). This appears to be based solely on the existence of CFC rules being a deterrent to engaging in deferral behaviour in respect of recipient countries. There is no evidence offered to support this proposition. The real focus of BEPS should be on the country which has a base erosion problem rather than a country which has a deferral issue. It is not at all clear that CFC legislation offers any substantive advantage to source countries suffering base erosion.

7. How CFC rules can accurately attribute income that raises BEPS concerns; interest and other financing income (paras 100 and 101):
   While the Discussion Draft mentions that CFC rules must be capable of dealing with, among other types of income, interest and other financing income, it does not deal in any great detail with attributing financing income of a CFC to its shareholders of controlling parties. While non-trading intra-group finance profits will almost always be fully attributable under a best practice CFC regime, an issue for consideration is whether a CFC that is not overcapitalised and has the substance to generate the finance income itself should be excluded from the CFC regime.

8. Question 16: What practical problems arise with applying the categorical approach and the excess profits approach?
   The excess profits calculation which the Discussion Draft notes may be able to better address some of the issues arising from transactions involving intellectual property. The risk of this approach is that it not only focused on shifted income and would need to be combined with a substance based exclusion.
BEPS Action 3: Strengthening CFC rules
Response by the Chartered Institute of Taxation

1 Introduction

1.1 The Chartered Institute of Taxation (CIOT) is pleased to respond to the Public discussion draft published on 3 April 2015 on BEPS Action 3: Strengthening CFC rules (Discussion Draft).

2 Chapter 1: Policy Considerations

2.1 This chapter is a useful summary of the main policy considerations which lead to CFC rules being implemented.

2.2 The document notes that CFC rules can either be specifically targeted at profit shifting, or they can be a tool of a worldwide tax system aimed at ensuring inclusion of worldwide income in a company’s tax return. It is the view of the CIOT that the OECD BEPS project should focus on how CFC rules can prevent profit shifting, whatever the system in which they are used. Acknowledging this explicitly will help focus the debate.

2.3 The Chapter notes (Section IV) that CFC rules are a preventative measure. In a territorial system this is usually the case, as CFC measures bring back into charge income that could otherwise be shifted ‘out of charge’. However, in a worldwide system, the basic principle of a CFC measure is the inclusion of all foreign income in the parent jurisdiction, and then the exclusion of foreign income under certain conditions. All income is initially taxed at the parent jurisdiction rate; and rather than act as a deterrent, the challenge for rule makers is to ensure the exclusions provided by the CFC provisions do not present opportunities for profit shifting.

2.4 The CIOT believes it is important for the OECD to consider issues arising from situations where CFC rules introduced (in territorial regimes) to combat profit shifting
are too weak and issues arising from ‘inclusion’ CFC regimes ‘excluding’ too much income.

2.5 Recommendations in regard to CFC rules should take account of actions arising from other BEPS reports, and should resist trying to solve too much of the BEPS agenda under this action. Not every BEPS problem can or should be solved by each action point. It would be helpful if there could be more focus on precisely what aspects of BEPS the OECD expects CFC rules could or should deal with. The origin of CFC rules related to ‘money box’ companies. Whilst CFC rules and international taxation have clearly moved on, - it may be that a 'CFC light' (that is a much less complex rule) might be welcomed by some countries.

2.6 In particular BEPS actions around transfer pricing impact on some of the areas discussed in the Discussion Draft. The CIOT anticipates that transfer pricing rules – in particular the rules relating to intangibles - will be strengthened such that the returns available to any company will be made commensurate to the economic substance of that company. Any substance requirements in the CFC rules should follow the same principles as in revised transfer pricing rules. We would also anticipate that more robust transfer pricing rules will limit ‘foreign to foreign’ stripping. Much of the debate in paragraphs 21-28 of the document may need to be reconsidered in the light of the final outcomes of the BEPS project on transfer pricing.

2.7 We would further note that the BEPS Action Plan in 2013 set out the aim of Action 3 to be producing ‘recommendations regarding the design of the CFC rules’. Thus the aim of this Action should not be to achieve the introduction of an international CFC rule, but instead should focus on ensuring that the principles of any country’s CFC rules protect against BEPS. A large number of countries do not currently have any CFC rules. We suggest that too ambitious recommendations regarding such rules will reduce the likelihood of widespread adoption of them. It would be counter-productive for the result to be very strict CFC rules in some countries and none in others; this could lead to distorted tax competition.

2.8 We welcome the discussion in paragraphs 11 to 14 regarding EU law and its impact on CFC rules at least for Member States of the EU. This is also acknowledged in paragraph 122 regarding the necessity that an excess profits approach complies with EU law.

2.9 In relation to this, in our view, it would not be helpful to attempt to ensure CFC rules comply with EU law by applying them equally to both domestic subsidiaries and cross-border subsidiaries. Simply extending CFC rules to domestic subsidiaries does not necessarily make the rules lawful. This can be seen from the second comparison test made in Cadbury (finding that the Netherlands subsidiary was not a CFC, but that the Irish subsidiary was). This is our understanding of the quote from Cadbury in the second bullet point of paragraph 14. This is also supported by Deutsche Shell GmbH (C-293/06) and subsequent restriction cases.

2.10 Our preferred route is to ensure that, as the UK has done, CFC rules do not apply to genuine economic activities and are therefore consistent with the ECJ’s ‘wholly artificial arrangements’ limitation.
3 **Chapter 2: Definition of a CFC**

3.1 We would agree with the principle that the definition of a CFC can extend beyond a corporate entity. However, given differing legal codes, and classification of entity rules for tax purposes, it may be difficult to prescribe best practices in this area.

3.2 The classification of an entity for tax purposes is, generally, driven by the legal classification of the entity, and this can vary according to the terms of establishment of the entity. An entity can be classified differently by multiple jurisdictions. As such it would be necessary to determine how the entity is tax in each of the relevant jurisdictions to determine whether any BEPS is occurring. For example, intermediary jurisdictions may tax the income of the CFC or its owners. This complexity should be considered.

3.3 We cannot see any rationale from a BEPS policy perspective for the broad option of a ‘modified hybrid mismatch rule’ as suggested in paragraphs 37-39. As is acknowledged in paragraph 38, this could subject more income to CFC taxation than is necessary to combat BEPS. If, as explained in paragraph 39, the transactions between B Co and C Co in Figure 1 are not caught by BEPS Action 2 (Hybrid mismatch arrangements) and, as such, do not exhibit BEPS characteristics, then tackling them should not form part of the recommendations under this BEPS action. In addition to this suggestion being beyond the scope of BEPS policy, our concern is a practical one: how far would this recommendation go? What if there were more layers in the chain above A Co? The practical implications for compliance and reporting could be significant and onerous.

3.4 Thus, in our view, the narrow option set out in paragraph 40 would be preferred, although even this rule is not consistent with a territorial system of taxation which exists in many territories. We wonder whether a hybrid mismatch rule is required within recommendations regarding CFC rules in light of the output of Action 2.

4 **Chapter 3: Threshold Requirements**

4.1 As noted above, CFC recommendations should take account of other BEPS measures. In many cases, CFC legislation will be a ‘backstop’ to pick-up instances of base erosion that are not covered elsewhere. This would indicate that the thresholds could well be crafted relatively simply and at levels to exempt most SME’s. The document leans towards complexity in this area, which should be avoided if possible.

4.2 We would support the suggestion in paragraph 51 that a threshold could be supported by an anti-fragmentation rule.

4.3 An anti-avoidance threshold requirement has only been considered briefly in the Discussion Draft and it is suggested that such a requirement could increase the administration and compliance burden of CFC rules. While we would prefer the application of CFC rules to be as mechanical as possible, for the ease of taxpayers and tax administrations, an anti-avoidance rule would be helpful as a final gateway or filter. We suggest that further consideration should be given to a ‘motive test’, as it can be a useful filter for transactions and structures which are not the result of tax avoidance.

4.4 Whilst we agree that a low-tax threshold should be included in a properly focussed CFC regime, its practical limitations should be recognised.
4.5 Our understanding is that taxpayers do not rely on lower level of tax exemptions as a first choice, even for entities located in higher tax jurisdictions. The key reason for this is the complexity that derives from the need to recompute 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. As a result, 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.

4.6 Footnote 30 to paragraph 61 demonstrates some of the complexities that determining an effective tax rate can bring. In particular, it discusses how to treat loss carry forwards when determining the tax base to be used to calculate the effect tax rate. In our view it should be permissible for losses to be carried forward and given relief. CFC rules should not permit an asymmetric situation where tax arises in years of profit, with no relief for losses in other years. We would suggest that CFC rules follow the UK rules (as amended by Finance Act 2012) in this regard.

5 Chapter 4: Definition of Control

5.1 We would agree with the main conclusion in regard to type of control, in that control should largely be determined according to legal and economic factors. A ‘de facto’ control test is too complex. In addition, this and a consolidation test would bring into consideration entities and interests of unrelated parties that do not have sufficient levels of legal control to make them susceptible of use in BEPS structures, such as some commercial joint venture entities. BEPS is really aimed at contrived arrangements within groups and, thus control determined by legal and economic factors should be sufficient.

6 Chapter 5: Definition of CFC Income

6.1 Again, we would agree with the principle that CFC rules should primarily target passive income, rather than active trading income. This is also an area where we believe it is important that other BEPS measures are taken into consideration when designing CFC rules. In our view, the outcomes from the BEPS work on transfer pricing, permanent establishment and treaty abuse are likely to go a long way to eradicate BEPS practices arising from sales and servicing income and royalties and IP income, rendering CFC rules significantly less important as a tool for these areas. Dividend income is frequently tax exempt in any event, and with anti-hybrid and treaty abuse measures, we see little role for CFC measures in taxing dividend flows. By contrast, we would take the view that CFC rules are well suited for combatting BEPS around financial income, and provide a much better route than some of the interest restriction measures proposed under Action 4 of the BEPS programme.

6.2 We suggest that the discussion points around substantial contribution, viable independent entity and employees and establishment analysis (paragraph 91) will be addressed by outputs of BEPS Actions 7, 8 and 10 and do not need to also be considered in relation to CFC rules.

6.3 We would also like to comment on the discussion about insurance income in paragraphs 102 to 104. Many of the statements in paragraph 102 are very broad and for the most part do not reflect the reasons behind reinsurance as a risk management tool, and an essential part of the model of an insurance group. There
have been similar discussions around this point under BEPS Action 9, Risk and Capital and progress has been made in ensuring there is proper understanding. We would like to see similar understanding under this Action 3 that where there is a genuine risk transfer, and provided the pricing of the premiums is at arms-length, there is no mischief from a BEPS perspective. We would like to see recommendations in relation to CFC rules recognise and respect this principle. Similarly, for a captive insurer, it is not unusual for the management of the assets in the captive to be outsourced, usually to a third party: and therefore payment for those services would be made at arms-length.

6.4 Paragraph 103 discusses measurement of whether or not a company is overcapitalised: the insurance industry has engaged extensively under Action 9 to explain that capitalisation is driven by a combination of solvency and regulatory requirements set in the local jurisdiction, and also rating agency requirements. It is very difficult to determine a ‘correct’ level of capitalisation, and we suggest that it would not be appropriate for CFC rules to attempt to do this. We are not clear why the location of risk mentioned in paragraph (ii) gives rise to any BEPS concern. Insurance premium taxes are levied in the country where the risk is located so tax is already being applied on the premium paid. There may be any number of reasons why the insurer is in a different location from the risk insured, including freedom of services rules under EU law, surplus lines of business (for example where local insurers do not want to have the business, so open the market up to foreign insurers), or where a risk is insured under an umbrella policy (for example, for a multinational group spanning several jurisdictions). There are very strong commercial reasons why this is a reasonable approach and should not be seen as a BEPS concern. We strongly suggest that any concerns should in this areas should be dealt with under Action 9.

6.5 Paragraph 103 also provides a good example of the interaction between CFC rules and transfer pricing: if any reinsurance is with a third party, and arms-length premium payments can be demonstrated, then this should be sufficient to satisfy and BEPS concerns without the need for a separate, additional layer of testing under the CFC rules.

6.6 We would also note 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. However, to have one set of functional analysis rules for transfer pricing and another for CFCs would be a huge burden for businesses and tax administrations alike. Accordingly, we would strongly recommend that substance-based rules for CFC purposes follow existing transfer pricing functional analysis methodologies.

6.7 We have significant concerns around the practical application of the excess profit approach (Section B of Chapter 5). We think it would be very difficult to build into this approach a way to take account of the vast differences between industries and businesses as to what is a ‘normal return’; thus an excess profit test will often be nearly impossible to apply in practice. Indeed, even across companies in the same sector, the facts and circumstances of structures, people, jurisdictions, M&A activity, organic growth, investment strategy, working capital requirements will all impact on what is a ‘normal return’ from time to time. Thus we would be opposed to any such test.

6.8 An entity approach would be simpler to administer and provide more certainty for multinational groups which clearly do not pose a BEPS risk. However, alone it could
also lead to swamping or tainting. A transactional approach would place a larger compliance burden on taxpayers. We would suggest a dual approach: 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. This would provide simplicity where an entity does not have significant high risk income, and proportionality where the safe harbour limits are breached.

7 Chapter 6: Rules for computing income

7.1 We would take the view that the parent jurisdiction rule is the correct approach. We would caution against overly-restrictive loss restriction rules; losses arising from commercial activities should be able to offset in general against income of all types, whether active or passive.

8 Chapter 8: Rules to prevent or eliminate double taxation

8.1 We agree that a fundamental policy consideration raised by CFC rules is how to avoid double taxation. One view is that CFC rules enable a parent jurisdiction to tax profits they have no right to tax under ordinary principles. Thus, although the rules are generally constructed so as to tax an amount computed by reference to the profits or the non-resident company, rather than the actual profits (Bricom), arguably CFC rules are one of the biggest examples of double taxation. In this regard consideration could be given to the OECD providing a new article for the Model Tax Treaty that deals with CFC rules and their potential impact. If it becomes the norm for countries to have CFC rules, two countries could agree when negotiating a Treaty that their CFC rules do not apply to the profits of a company resident and taxed in the other territory.

9 The Chartered Institute of Taxation

9.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT’s work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members’ experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT’s comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT’s 17,000 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.
Strengthening CFC Rules - Action Item 3

A Representation
Strengthening CFC Rules

Background

On 31 October 2014, the Organization for Economic Co-operation and Development (‘OECD’), as part of its work on the Action Plan to address Base Erosion and Profit Shifting (‘BEPS’), released a Discussion Draft (Action Item 3) in relation to strengthening Controlled Foreign Corporation (CFC) Rules. This Action is focused on the need to address issues related to tax base erosion and shifting of profits to lower or no tax jurisdictions using CFCs.

The OECD, in the past, has not examined CFC rules in detail. It has however, as part of BEPS Action Plan, identified that controlled foreign affiliates create tax avoidance opportunities by routing income of a resident enterprise through such non-resident affiliate. It has observed that while CFC rules in principle lead to inclusion of income in the residence country of the ultimate parent, they also have positive spillover effects in source countries because payers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.

The OECD has identified that the absence or weak application of anti-deferral/anti-exemption rules in view of controlled corporations permit the use of triangular structures involving finance affiliates in no/low-tax jurisdictions resulting in relatively low and possibly negative effective tax rates. CFC rules, generally, aim to prevent shifting income to lower tax jurisdictions. While these rules usually focus on protecting the investor country’s tax base, the competitiveness of a third country should not be compromised on. Therefore, it was imperative to introduce standard recommended rules to ensure that the dichotomy of a foreign investment - i.e., ensuring that tax base is retained while maintaining competitiveness - is preserved.

The Discussion Draft identifies seven “building blocks” to form the design principles of establishing effective CFC rules. The building blocks represent draft recommendations with the exception of one, the definition of CFC income, which instead considers different approaches to defining CFC income as no consensus recommendation could be reached.

We recognize the efforts of OECD towards addressing the conflicting issues arising out of CFC rules as implemented by most countries. India, however, does not have CFC rules in place within its domestic laws, although the draft Direct Taxes Code, 2010 does make provision for it. We wish to highlight certain aspects of the CFC regime that need to be analyzed to provide

1 Tax Effects on Foreign Direct Investment – No. 17 Recent Evidence and Policy Analysis, OECD 2007
holistic guidelines that combat base erosion in residence States of the parent as well as the foreign affiliate without hampering market competitiveness.

1. Treatment of Permanent Establishment as a CFC

Concern

The proposal regarding applying CFC rules to Permanent Establishment may lead to double taxation. For instance, consider the illustration below:

A Co. is a tax resident of Country A which has CFC rules wherein a PE owned by a CFC is treated to be a tax opaque entity. A Co. holds 100% interest in B Co., a resident of Country B, which is classified as a CFC. B Co. has a PE in Country C.

It is generally accepted that the income earned by a PE is treated as business income by its parent. Therefore, the income earned by PE in Country C is deemed to be the income of B Co. Even if Country B (following territorial based taxation) exempts such income from taxation per its domestic laws, when the income of B Co. is attributed to A Co., the income earned by PE will also be attributed to A Co. and be subject to taxation in Country A. In such a case to separately attribute the income of PE to A Co. would lead to double taxation of such income.

Recommendation

Treatment of PEs as tax opaque entities should be avoided in view of the accepted position that the income of a PE is deemed to be business income of its headquarter— B Co in this case. The income of a PE is already treated as business income of B Co. Therefore, while including the
income of B Co. as CFC income, such income is already accounted for. A second allocation of income of the PE to A Co. should be avoided since it would lead to double taxation.

2. Non-Discrimination between Domestic and Foreign Subsidiaries

Concern

It has been proposed that a domestic subsidiary be treated at par with cross border subsidiaries for application of CFC Rules to ensure non-discrimination. However, CFC rules cannot be applied to a domestic corporation since it does not amount to any base erosion for the resident country.

Recommendation

Since the facts and circumstances guiding tax implications on a domestic company vis-à-vis a foreign company are different, identical rules cannot be applied. Given the threshold of tax rate applied to a CFC, a domestic company would not be able to satisfy this since the country applying CFC rules are usually high tax jurisdictions.

3. Avoid entity classification based on residence of CFC

Concern

Creating black list/grey list countries for blanket application of CFC rules may lead to double taxation of genuine transactions having business expediency. A country that may be treated as black listed in another jurisdiction may have a beneficial environment for hosting a specific type of business. Creating a black list tampers with such business expediency that a conglomerate may have for investing in such countries, therefore impacting global competitiveness in a negative manner.

Further, it also removes from examination such other subsidiaries that may not be in a “black list” country but be a CFC in all other aspects.

Recommendation

Countries should not create “black lists” to eliminate jurisdictions that may potentially host CFCs. This defeats the basic premise of BEPS. CFC rules must be enforced in such a way irrespective of the jurisdictions so that tax base is not eroded and global competitiveness is maintained. It is recommended that an entity approach and transaction approach should be
adopted for determining whether a company/ income is classified as CFC as opposed to a jurisdictional approach.

4. Time limit for set off of actual dividend payments against CFC payments

Concern

An issue may arise with respect to income- that is deemed to be included in the income of a parent of a CFC in a previous year- is actually distributed. This may be illustrated as below:

A Co., a resident of Country A having CFC rules and tax rate of 30%, holds 100% interest in B Co, resident of Country B and classified as CFC for purposes of Country A rules. Further, under the tax laws of Country A, tax credits on actual repatriation of CFC income are allowed only for 10 years. In Year 1, B Co. earns Rs. 100 of CFC income which is deemed be attributed to A Co. A Co.’s tax liability on this Rs. 100 is Rs. 30 in Country A. In Year 5, B Co. repatriates Rs. 80 to A Co., the tax on which (Rs. 24) is set-off against Rs. 30. However, B Co. does not repatriate any further dividends for another 6 years. The tax on deemed income of A Co. of Rs. 6 is therefore lost.

Recommendation

It is recommended that the outstanding tax (Rs. 6 in the above example) should be carried forward for perpetuity. Such taxes should be credited against all tax liabilities on the passive payments made by a CFC to its parents. However, if the CFC does not make any payment and it is disposed of, such outstanding taxes should be set off against capital gains arising out of such sales.

5. Allocation of CFC Income

1. Classification as CFC Income

Concern

While examining the allocation of CFC income to the parent entity, the classification of income as active and passive must be thoroughly considered. Given that the primary reason for introduction of CFC rules is to ensure that income that is not deployed into the business of the conglomerate earned by a foreign subsidiary remains untaxed, income classification as
“employed in business” or not becomes relevant. A CFC may earn passive income that forms part of its active business such as royalty arising out of intellectual property developed by it on which it has incurred expenses. Therefore, applying a straight-jacket approach may not capture all income that may be classified as CFC income or on the contrary may include such income that should ideally not be taxed in the parent entity as it arises out of active business/ is reemployed into the business.

Recommendation

It is recommended that the substance of the entity classified as a CFC must be considered in view of its business. Further, while allocation of income of an entity classified as a CFC to its parent, only such portion should be attributed that does not pertain to its active business and is not taxed under the laws of the country in which the CFC is a tax resident.

2. Interest in CFC

Concern

While determining allocation of income, in case a CFC has more than one shareholder where the country of residence of each shareholder has CFC rules, the income attributable to such shareholders, whether related or not, may be doubly taxed. Reference may be drawn to the illustration below.
Countries A, B and C have CFC rules in force. Country A and Country B treat the income of CFC attributable to A Co. And B Co. respectively. Therefore, 55\% of income of CFC is attributable to A Co while 30\% is attributable to B Co. Country C applies “Acting in concert” rule and attributes 45\% of the income of the CFC to it. Thus, the total income exceeds 100\% leading to double taxation.

Recommendation

For classification purposes, direct and indirect holding may be considered. However, for attribution of CFC income, only direct holding must be looked at. In the present case, though A Co. holds 55\% of interest (directly and indirectly combined) only 25\% of CFC income should be attributable to it.

6. **A foreign company classified as a CFC under the laws of more than parent company’s jurisdiction**

Concern

Our concern regarding this focuses on a structure where a subsidiary is treated as a CFC for more than entity holding interest in it directly or indirectly. The Draft Discussion paper examines this in Chapter 8 where it discusses Rules to Prevent or Eliminate Double Taxation-Issues With respect To Relief for CFC Taxation in Multiple Jurisdictions. It has been highlighted in the Draft that if “a subsidiary is treated as a CFC under the rules operating in multiple jurisdictions, then the subsidiary’s income could potentially be taxed by the CFC jurisdiction and by any other jurisdiction that considers the subsidiary to be a CFC. An indirect foreign tax credit could be applied in this situation but 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. There should also be a hierarchy of rules to determine which countries should have priority, and this hierarchy could prioritise the CFC rules of the jurisdiction whose resident shareholder is closer to the CFC in the chain of ownership.”

Given that the purpose of the rules is to avoid profit shifting, the only country whose base is being eroded is the immediate parent of the CFC. Applying CFC rules by both direct and indirect parent entities would mean replication of income at different levels.

Recommendation

Once the income is taxed at the immediate parent level, the profits are captured there. Therefore, attribution to the indirect parent is a redundant exercise since the tax base of the
indirect parent has not been impacted in view of the fact that it is the profits of the direct parent entity that has been moved into the CFC. However, in case the jurisdiction in which the direct parent is resident does not have CFC rules, in such a case, the rules of an indirect parent governed by CFC rules could be applicable.

7. **Conflict between CFC rules and Double Tax Avoidance Agreements**

**Concern**

The major concern on this issue is whether the provisions of a double tax avoidance agreement can be used to avail tax exemption for payments deemed to be made by a CFC to its parent. To illustrate, Country A and Country B are signatories to a Double Tax Avoidance Agreement (DTAA) where they allow for withholding taxes paid in source country. A Co., resident in Country A having CFC rules in its domestic tax laws, has a subsidiary B Co. in Country B, which is treated as a CFC under Country A’s laws. In case of deemed repatriation from B Co. to A Co., three broad issues arise:

- Whether the payment (a legal fiction under the laws of Country A) be entitled to benefits under the tax treaty?
- How would CFC income be characterized under the DTAA vis-à-vis the domestic taxation?
- In the event, there has not been actual withholding in Country B, would Country A allow a tax credit for the deemed dividends.
- Further, how would the tax treatment be in case of actual payment by B Co.? On actual repatriation, when B Co. would withhold taxes per the DTAA, how would Country A treat such withholding especially in cases where the amount repatriated is different from that which has already been included as dividend income for A Co.?

**Recommendation**

A parity between the CFC rules in the domestic laws and the DTAA need to be aligned to address income characterization issues, i.e, if CFC income is treated as deemed dividends under the domestic laws, the protection should be provided for in the DTAA for taxes already levied on such income under the domestic laws.

The Confederation of Swedish Enterprise is Sweden’s largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled "BEPS Action 3: Strengthening CFC Rules" 03 April 2015 – 01 May 2015 (hereinafter referred to as the Draft).

General Comments

The Confederation of Swedish Enterprise appreciates the opportunity to give comments on the OECD discussion draft regarding the strengthening of CFC-rules.

We agree with BIAC that the Draft seems to lack a clearly articulated policy objective. Different alternatives to CFC rules are presented without a proper analysis as to their effectiveness. Such an analysis would greatly facilitate countries possibilities to select the rules best suited for that country’s tax system. As the Draft is outlined now, it is difficult for countries to reach any conclusions on what is the most appropriate CFC rules for their particular situation. There is a clear risk that if the recommendation only sets out different policy options, the Draft will not result in a clear and consistent implementation and interpretation of CFC rules, resulting in increased compliance costs and uncertainty for taxpayers.

In the BEPS Action Plan under Action 3 it is stated that the work will be coordinated with other work as necessary. In para 5 of the Draft it is stated that such
coordination has indeed been conducted. The Confederation of Swedish Enterprise would appreciate a more detailed account in the Draft on how the co-ordination between Action 3 and other Action Items have been dealt with. There is little doubt that the BEPS action plan will lead to increased compliance burden for taxpayers. Consequently, coordination between different action points is essential in order to reduce unnecessary and duplicative initiatives.

A Secondary Rule is mentioned in the Draft that would be applied to income earned by CFC’s that did not give rise to sufficient CFC taxation in the parent jurisdiction. The Confederation of Swedish Enterprise is strongly opposed to such a rule since it would increase the complexity and administrative costs for businesses and lead to additional uncertainty.

**Chapter 1: Policy Considerations**

The Confederation of Swedish Enterprise welcomes the discussion in chapter 1 regarding capital export and import neutrality. However, there is need for further consideration to conclude whether CFC rules can actually achieve both objectives at the same time.

We also welcome the comments on the need to take into consideration EU law when developing CFC rules. However, the OECD seems to open up for two sets of standards. Para 13 states that “EU member states may need to modify these recommendations to comply with EU law”. Instead of having parallel standards, one for EU members and one for non EU members, the OECD should develop minimum standards that are compliant with EU law and thus is capable of consistent adoption.

It is important that a clear order of how and when CFC rules should apply is established. Without it there is a risk that several CFC rules are applied simultaneously. In order to avoid disputes over what jurisdiction has taxing rights, with the risk of potential double taxation, we recommend that the OECD clarifies who has taxing rights over CFC income.

In a number of areas the OECD has not made a clear recommendation in the Draft, but are rather giving countries the possibility to adopt rules of their choosing. This will lead to that countries have substantially different approaches in their CFC rules, increasing the compliance burden for taxpayers. The Confederation of Swedish Enterprise therefore urges the OECD to make clear recommendations in all areas of the Draft, assuring a uniform adoption.

In the Draft the interaction with transfer pricing rules are mentioned and it is found that such rules can exist side-by-side with CFC rules. We share the view that transfer pricing rules and CFC rules can coexist, but we request a deeper discussion on how the transfer pricing rules dealt with in Action Points 8-10 will be effected by
the proposed CFC rules. We are concerned that transactions in accordance with the transfer pricing rules may still be targeted by the CFC rules.

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?

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?

In Chapter 2 a hybrid mismatch rule is proposed. Two options are compared; a broader adoption of the rule or a more narrow approach. The broad version may be easier to apply in practice since there is no need to analyze whether there is a base-eroding mismatch. However, the broad version will bring more income into scope, not necessarily BEPS related, creating additional compliance burden and risk of double taxation. On that basis we would prefer the narrow version.

We do however question if there really is a need for a hybrid mismatch rule for CFCs if the recommendation for Action 2 (hybrid mismatch arrangements) were to be implemented in both the parent and CFC jurisdictions. We recommend the OECD to explain the coordination with action 2 and why there is a need for a special hybrid mismatch rule to be applied on CFCs.

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?

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

A low-tax threshold based on an effective tax rate (ETR) gives rise to a number of concerns. To be able to calculate the ETR it is crucial to have access to relevant data. This can be hard if the data is required at an early date before local accounting and tax reporting has been completed. It would thus be helpful if the CFC calculations were conducted at a later stage after the accounting year.
An ETR may fluctuate widely depending on when it is calculated due to e.g. differences in the capitalization, amortization, tax depreciation and timing of revenue recognition. One way of dealing with the volatility of the effective tax rate is to use a rolling average effective rate. The length of such a period must be carefully considered before determined. In addition, it may not be possible to use the same rolling period for all industries. It must also be evaluated how such an approach can be implemented without causing substantial difficulties for taxpayers.

Para 58 of the Draft suggests that the ETR is calculated according to the rules of the parent jurisdiction or an international standard such as IFRS. For MNEs operating a number of subsidiaries owned by parents in different jurisdictions, the compliance burden for complying with CFC rules would increase when different rules and accounting standards need to be applied.

Para 63 mentions the possibility to calculate ETR per income stream. Due to the enormous compliance burden this would cause MNEs we strongly believe that calculating ETR per income stream should be avoided.

In para 51 it is stated that no general recommendation is made regarding the de minimis threshold, but if such a threshold is applied it should be combined with an anti-fragmentation rule. We encourage the OECD to evaluate the different thresholds presented in Annex 1 and present one as a clear best practice recommendation. A best practice would mean a more consistent rule and a lowering of the compliance burden for taxpayers.

Regarding an anti-fragmentation rule it should be acknowledge that such rule can cause difficulties when separate businesses operates with separate accounting or reporting systems. In such a case it can be hard to present consolidated or aggregated information, since the financial reporting system do not make the information readily available.

In addition to the thresholds mentioned in the Draft we encourage the OECD to evaluate other types of thresholds, such as a time threshold. Such threshold can be useful when a subsidiary is sold from a parent in one jurisdiction to a new parent in another jurisdiction. To give the entity time to adapt to the new CFC rules applied in the country of the new parent, a time threshold that creates an exempt period from the time of the acquisition could be applied.

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?
The Confederation of Swedish Enterprise shares the view expressed in para 65 that legal and economic tests can be effective in determining control. De facto control is difficult to establish and would mean significantly higher costs and complexity compared to a legal or economic test. A de facto control test would in most scenarios include a subjective element which means less certainty for taxpayers. We encourage the OECD to strengthening its wording in the recommendation and recommend a combination of an economic and legal test as best practice.

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?

Chapter 5 of the Draft does not include recommendations for the building block on CFC income. Instead several different options are discussed. The chapter do raise some concerns as the options presented represent different perspectives. Given the fundamental differences between the options we are worried that there might not be possible to reach consensus in this area, especially given the very tight time schedule for the BEPS project. We are also concerned about paras 83 and 89 of the Draft, stating that EU member states may need to incorporate a substance based test in order to be in compliance with EU law. As much as we agree that CFC legislations should be EU compliant, we believe that the OECD should make that recommendation for all countries, not only for EU member states. If not, there will be two parallel systems with increased complexity as a result.

Regarding the substance analysis we agree with the OECD that such tests are a necessary addition. However, all three options have some practical problems and the compliance burden must be carefully considered before making any conclusions. Although there may be some common ground between substantial contribution analysis and functional analysis required for transfer pricing documentation, there are however differences and it should thus not be assumed that a substantial contribution analysis can be developed from the existing transfer pricing documentation.

Of the three options, the viable independent entity analysis has the most subjective approach. This option will therefore be the one with the highest risk of causing disputes and uncertainty. The employees and establishment analysis is in theory more mechanical and easier to apply. However, since there is a need to determine whether the CFC has establishment and employee functions, the analysis is rather similar to the viable independent entity analysis.
The Confederation of Swedish Enterprise recommends that MNEs are given the opportunity to use its own preferred method to initially determine and document which CFCs have sufficient substance. MNEs should be able to use one or a combination of the three options of analysis.

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?

As stated in para 114 of the Draft, sales and service income is assumed to be passive income. Only if the substance analysis requirements is met can the income be treated as active. We would welcome a deeper analysis as to the benefits and disadvantages of active and passive assumptions. This could lead to more pragmatic threshold approaches that would identify risk entities in a more accurate way. Since a passive assumption for sales and services will increase the compliance burden for taxpayers in situation that do not represent a BEPS risk, we support an active presumption for sales and services.
to an Excess Profits Approach. We are concerned that the Excess Profits Approach would not only target BEPS situations, but also profits that has not been shifted. The risk of bringing active income into scope will cause legal uncertainty for taxpayers. In addition the determination of normal return, as suggested in the Draft, would be highly complex and exposed to arbitrariness. It is also questionable if the Excess Profits Approach is consistent with the Arm’s length principle and in compliance with EU law.

In para 117 it is proposed that the Excess Profits Approach could be used to complement more traditional CFC rules. To use it as an add-on would heavily increase compliance burden for taxpayers. To motivate such a solution it would be necessary to explain why this approach is needed, especially under the circumstances that all other recommendations of the BEPS Action Plan were to be implemented.

Confederation of Swedish Enterprise believes that the Categorical Approach could address BEPS concerns in a more accurate way than the Excess Profits Approach, and that approach is therefore recommended.

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 most significant problem related to a transactional approach is the difficulty in obtaining accurate data. Obtaining the relevant information on an entity level is not associated with the same difficulties and we therefore propose a best practice based on the latter.

Chapter 6: Rules for Computing Income

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?

The Draft recommends the use of the parent jurisdictions’ rules to calculate a CFC’s income. This means that many businesses have to prepare duplicate accounting and tax reporting for the CFC to compute income under the same principles as the parent. Often the data needs to be maintained for several years due to balance carry forwards and tax adjustments. If action 3 leads to that more countries implement CFC rules, there would be an increased complexity for taxpayers. Many CFCs are owned by parents in several jurisdiction, making the calculation more complicated.

Chapter 7: Rules for Attributing Income

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?

We believe that additional analysis is needed for the top-up tax to be readily applied and how it might work in practice. The advantages and disadvantages for this approach should also be elaborated more closely. The top-up tax would probably only be relevant for those jurisdictions that operate a worldwide taxation approach.

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?
29. What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?
The Confederation of Swedish Enterprise is very concerned over the lack of clear recommendations regarding the elimination of double taxation. The Draft only proposes a “minimum standard”, giving countries vast flexibility in the implementation of their rules to eliminate double taxation. There is an obvious risk that different conflicting CFC rules are created, which would increase the risk of double taxation.

We are also concerned that the lack of cohesion will lead to that some countries may not recognize credits for foreign taxes collected by virtue of competing rules.

The Confederation of Swedish Enterprise urges the OECD to create a clearer recommendation regarding the elimination of double taxation. Without such clarification, countries may adopt CFC rules that could have a very negative impact on trade and investment.

On behalf of the Confederation of Swedish Enterprise

April 30, 2015

Krister Andersson
Head of the Tax Policy Department
Dear Mr Pross

COMMENTS ON PUBLIC DISCUSSION DRAFT ACTION 3 (STRENGTHENING CFC RULES) OF THE BEPS ACTION PLAN

We refer to the above titled document, and its identification of building blocks towards coherent CFC regimes. At the outset, we wish to highlight the concern, indeed identified in the Discussion Draft, that inappropriate CFC rules will lead to double taxation. As we understand them, CFC rules are not intended per se to raise revenues, but rather to act as a deterrent to egregious relocation for profit shifting purposes.

While all of the questions in the consultation document are pertinent and important, Ireland does not at present operate a classical CFC regime. Therefore for now we confine our observations to the following two questions.
9. **WHAT ARE THE PRACTICAL PROBLEMS WITH ANY OF THE THREE SUBSTANCE ANALYSES SET OUT ABOVE? HOW COULD THESE PRACTICAL PROBLEMS BE DEALT WITH?**

As an EU Member State, Ireland is subject to the provisions of the EU Treaties, not least those governing the “four freedoms” of movement of people, goods, services and capital. Because it is in the nature of CFC rules to deem where profits arise, thereby subordinating the tax sovereignty of one of the nations concerned, CFC rules present an opportunity for conflict with binding EU Treaties. We acknowledge that this risk is recognised in the Discussion Draft.

We endorse the suggestion of a substance analysis, at Para 89, in determining whether CFC rules should apply in any given scenario. In this regard, the jurisprudence established by the Cadbury Schweppes case C196-04 is helpful. While its outcomes are of immediate relevance within the EU and the EEA, it provides what may be a helpful reference point to measure the proportionality of CFC arrangements.

A substance test should provide a reliable gauge as to where bona fide commercial activity with tax consequences stops, and where a tax consequence which drives the relocation of a particular commercial activity starts. The employees and establishment analysis may be the closest of the three types of substance test to the principles contained within EU jurisprudence. Just as importantly it may be the easiest analysis to operate in practice, thereby containing to some degree at least the compliance burden.

29. **WHAT ADMINISTRATIVE OR PRACTICAL DIFFICULTIES ARISE CURRENTLY IN RESPECT OF DOUBLE TAX RELIEF RULES AND HOW COULD THESE BE MITIGATED OR DEALT WITH?**

One further refinement to the approach of the EU Courts may be necessary in the design of best practice in relation to CFC legislation. In protecting the commercial freedoms of the EU treaties, it has been established in EU case law that the tax rules of an individual country must support the cohesion of the tax system (see Case C-204/90 Bachmann v Belgium, Case C-279/93 Schumacker).

For example Irish legislation does not exempt dividend income from foreign subsidiaries in the hands of the receiving company, but rather taxes it granting a credit for underlying tax. A CFC regime which would in turn tax that dividend income a second time might also be in breach of this principle of cohesion.
It would follow that a participation exemption for foreign source dividends might have to be extended to those companies which themselves are within the “control” (for CFC purposes) of a foreign parent, or that some other mechanism should be identified to ensure that profits already subject to tax under CFC provisions are not subject to double taxation when distributed to the parent. While the possibility of extending the participation exemption to “controlled” companies is adverted to at Para. 164 of the Discussion Draft, the particular difficulties it would create for EU Member States may require further consideration.

You may wish to note that this response is from a representative body. The Consultative Committee of Accountancy Bodies – Ireland is the representative committee for the main accountancy bodies in Ireland. It comprises Chartered Accountants Ireland, the Association of Chartered Certified Accountants, the Institute of Certified Public Accountants in Ireland, and the Chartered Institute of Management Accountants, which represent a combined membership of some 40,000 accountants. Brian Keegan, Director of Taxation at Chartered Accountants Ireland (brian.keegan@charteredaccountants.ie, +353 1 6377 347) may be contacted if any further details in relation to this letter are required.

Yours faithfully

Paul Dillon, Chairman, CCAB-I Tax Committee
April 27, 2015

Costa Rica

Public Discussion Draft Beps Action 3

Strengthening CFC Rules

As general comments, it should be noted that Costa Rican tax system is territorial which means that it excludes revenues generated from extraterritorial sources from income taxes, although such extraterritorial income is attributed to taxpayers domiciled in Costa Rica. Therefore Costa Rican Tax Administration is able to tax such income produced by capital used, services provided and assets located in Costa Rica.

The control of companies in Costa Rica within the international taxation context seeks to identify transactions with related companies and determine whether the assessment of them corresponds to the principle of independent operator through the application of the transfer pricing methods.

Currently the Ministry of Finance is working on a proposal to amend the Income Tax Law which includes a thin capitalization rule to control financial expenses.

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?

In the fiscal context a company would be defined as transparent if it is not considered as an income taxpayer in the country of incorporation, or where having its main administration or place of effective management in the country, their income is attributed to its members, partners, shareholders or beneficiaries. In the case of Costa Rica, the possibility of taxing the income of a foreign corporation occurs when it has a permanent establishment, which means an entity that performs its activity in a place within Costa Rica’s territory, in whole or in part, . The existence of a permanent establishment allows to attribute the Costa Rican source’s income and to tax them.

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

It is important to pay attention to companies that report significant amounts of non-taxable income.

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

We have no response since the Tax Administration has no experience in the application of CFC rules.
4. What practical problems, if any, arise when applying a low-tax threshold based on an effective tax rate calculation?
Some transactions may be considered suspected of fraud even though they are actually not, and hence high administrative costs would arise from exercising control over those transactions.

5. How could these problems be addressed or mitigated?
They could be addressed by using an informative statement that requires any entity (transparent or not) to declare their transactions with related parties.

6. Does the discussion above correctly address the situation of permanent establishments that are subject to a different tax rate than CFCs?
It is considered that there must be equality in tax treatment granted to companies regardless of their legal status.

7. What practical problems, if any, arise when applying a control test?
A practical problem would be the difficulty in obtaining information about the relationships of dependence or related parties, especially when they are located in non-cooperative jurisdictions.

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?
There is no practical experience regarding the resolution of specific cases involving the application of control tests to non-resident companies in Costa Rica.

9. What are the practical problems with any of the three substance analyses set out above? How could these practical problems be dealt with?
We have no response since the Tax Administration has no experience in the application of CFC rules.

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?
We have no response since the Tax Administration has no experience in the application of CFC rules.

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 have no response since the Tax Administration has no experience in the application of CFC rules.
12. Are there practical problems with applying the same rule to sales and services income and IP income?
Revenues from abroad are considered non-taxable income in Costa Rica under the principle of territoriality. Revenues attributable to a local company or permanent establishment are treated with the transfer pricing guidelines.

13. Are there existing CFC rules that accurately attribute any or all of these categories of income while also reducing administrative and compliance burdens?
Specifically there are no rules on CFCs.

14. Does the discussion above consider all categories of income that should be attributed under CFC rules?
There is no additional category of revenue that has not been incorporated in the document.

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

16. What practical problems arise with applying the categorical approach and the excess profits approach?
We have no response since the Tax Administration has no experience in the application of CFC rules.

17. How could the practical problems be addressed or mitigated?
We have no response since the Tax Administration has no experience in the application of CFC rules.

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 cannot express an opinion because there is no experience in the application of CFC rules.

19. Could the excess profits approach be applied to income other than IP income and what would be the practical implications of this?
We cannot express an opinion because there is no experience in the application of CFC rules.

20. What other approaches could be considered for determining excess profits or excess returns?
We cannot express an opinion because there is no experience in the application of CFC rules.

21. What difficulties or practical problems arise in applying an entity approach or a transactional approach?
We cannot express an opinion because there is no experience in the application of CFC rules.

22. What concerns arise from the two approaches in terms of administrative burdens and compliance costs?
We cannot express an opinion because there is no experience in the application of CFC rules.

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?
We cannot express an opinion because there is no experience in the application of CFC rules.

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?
We cannot express an opinion because there is no experience in the application of CFC rules.

25. Does this chapter accurately reflect the issues that could arise with losses or are there any other situations that need to be considered?
There is no additional category of losses that have not been incorporated in the document.

26. What difficulties, if any, arise under existing CFC provisions for attributing income?
We cannot express an opinion because there is no experience in the application of CFC rules.

27. Does the description of a top-up tax set out all the advantages and disadvantages of such an approach?
We cannot express an opinion because there is no experience in the application of CFC rules.

28. Are there any other double taxation issues that arise in the context of CFC rules that are not dealt with here?
We cannot express an opinion because there is no experience in the application of CFC rules.

29. What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?
We cannot express an opinion because there is no experience in the application of CFC rules.
Comments on the OECD Discussion Draft on BEPS Action 3  
“Strengthening CFC Rules”

April 30th, 2015

E-mail: CTPCFC@oecd.org

To: Achim Pross

Head, International Co-operation and Tax Administration Division, OECD/CTPA.

Dear Sir,

As suggested by Dr. Raffaele Russo, I welcome the opportunity to comment on the OECD’s Public Discussion Draft regarding the prevention of base erosion and profit shifting about Strengthening CFC Rules and I have preferred to be as concise as possible. In case I could have the opportunity to explain further details, do not hesitate to contact me.

Some considerations:

A true motivating factor of the BEPS project of OECD is the possibility to face issues in a cooperative and coordinated way, rather than in an entirely one-sided way. To undertake the coordination of international taxation issues is considerably difficult. Therefore, the BEPS project covers several thorny issues of the international policy of taxation, e.g. transfer pricing of intangible assets and the application of central concepts to digital activities\(^1\).

However, considering that the challenge with the CFC regulation is definitely more demanding, it is thus to be considered that the pathway to undertake should be organized in a more thorough way than for other areas within the BEPS action range. Action 3\(^2\) within the action plan on base erosion and profit shifting of OECD (BEPS), regarding the regulation of controlled foreign companies (CFC), is one of the most debatable items referring to the actions implemented with the BEPS Project on behalf of OECD.

\(^1\) “L’Ocse contro l’evasione digitale” in Il Sole 24 ore, 26 April 2015.
\(^2\) Action 3 within the Action Plan on base erosion and profit shifting of OCSE (BEPS), regarding regulation of the Controlled Foreign Companies (CFC), is considerable especially for its simplicity in defining the need to develop some suggestions regarding the regulations of the controlled foreign countries, integrating such work with all the other actions needed to reach the purpose.
Many of the BEPS actions, especially those officially presented so far, include some references which illustrate the significant specific issues to be faced. These make it supposed that the open nature of this assignment is clearly reflected into being taken into account, relying on the evidence that regulations on CFC are without any doubt particularly interesting legal tools for the BEPS initiative and therefore it is absolutely necessary to consider some significant points at that regard.

- CFC regulations are directly related to the reversal of BEPS.
- Secondly, CFC regulations are a mechanism compliant with the agreements which allow something otherwise extraordinary.
- CFC regulations are definitely a great resource for the BEPS Project.

Some answers:

*Is Action 3 of the BEPS Project set as a point of reference in the CFC regulation?*

Yes indeed, as it is certainly clear - by reading *Action 3 of the BEPS Project* - that the purpose is the need for the Countries of a constant reference in order to establish the CFC Rules. For those Countries already provided with such regulation, the need is for it to be implemented in order to balance the existing CFC regulations with the BEPS Project. The consideration of all the constitutive elements of a CFC and reference to the cd “Seven building blocks” clearly state this will. These blocks start from the definition of CFC and end with indicating the rules to prevent or eliminate double taxation, passing through the definition of control.

*Can suggestions on the base erosion and profit shifting dispute, through the indication of these seven points, effectively be considered adequate as long as they have a value that is beyond the simple consideration of “Soft law”??*

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4Mitchell A. Kane, The Role of Controlled Foreign Company Legislation in the OECD Base Erosion and Profit Shifting Project in Bulletin for international Taxation, June/Jule 2014, “Where applied, CFC regulations generate a considerable income integration or growth of the tax base. At least, other aspects of the BEPS Project – e.g. the presentation of a report on behalf of each Country – can generate some useful information for the Governments to reply to BEPS, but they do not produce an integration to income themselves”.  
5 Specifically, such regulations potentially allow a Country di tax the registered profit of a Company resident in a member Country of the agreement in absence of a permanent factory (PE) and without having to face the adjustment of the transfer pricing.  
6 the CFC regulations really a great resource for the BEPS Project and it can be easily presumed by how the action collocates in the decisive coordination with other points of the BEPS project. That clearly defines the significance of Action 3.
Yes indeed, as it is clear that there is the will to reach a homogeneity of CFC regulations of the Countries and to establish a clear pathway to follow in the implementation of a CFC regulation in those Countries where it still is not present.

The notion of control, which is the third building block and is obviously considered a decisive element for the definition of a CFC, requires two different determinations: the required type of control and the level of such control. By types of control, it refers to legal and economical control, while for the level it refers to the % of control, in order to actualize the CFC rules. In this view, is there space for a clear determination of control through a cd Control test?

Yes indeed, the cd control test, as clearly highlighted in the BEPS Project, becomes effective from a legal and economical point of view. That surely involves some practical difficulties because the existing regimes of CFC refer to the notion of control in a Company in different ways. Therefore, it is considered to be right to have a combination of at least both the legal and economical control, as in any case the Countries have the possibility to complete such controls with more focused ones for the solution of more specific problems.

Regards,

Diego Del Vecchio
Dear Achim

Discussion Draft on Action 3: Strengthening CFC rules

Thank you for the opportunity to comment on the Discussion Draft – BEPS Action 3: Strengthening CFC rules published on 3 April 2015 (the “Discussion Draft”). Our comments are made from the perspective of the UK.

We support the G20/OECD’s efforts to limit BEPS through the use of effective controlled foreign company (‘CFC’) rules.

We have set out our responses to the questions raised in the Discussion Draft in the appendix to this letter; however we would also make some general comments.

Many of the design principles set out in the Discussion Draft are familiar and reflect the current UK CFC rules. The recommendations and principles set out in the Discussion Draft should, once more fully developed, allow countries to design new CFC rules or assess their existing rules. We support flexibility in design to allow the CFC rules of a country to reflect its domestic tax legislation. One of these areas could be whether CFC rules should only address BEPS activity which affects the parent jurisdiction or all BEPS activity. In our view, CFC rules are effective in protecting diversion of profit from the parent country but are not the appropriate way to counter other forms of base erosion – such as from subsidiaries.

As noted in the Discussion Draft it is unlikely that either CFC rules or transfer pricing rules in practice eliminate the need for the other set of rules. However, it is also recognised that CFC rules may target the same income as transfer pricing rules. We believe that it is important that this overlap is recognised in the associated legislation and compliance burden. Generally we would suggest that transfer pricing rules take precedence which should allow the scope of any CFC rules to be more closely targeted. A consequence of this could be that, as in the UK, the CFC rules include straightforward exemptions which exclude low risk entities and transactions in a simple manner. It is only when these exemptions do not apply that the legislation requiring more detailed analysis needs to be considered. This allows the UK to tackle BEPS...
activity through the application of its CFC rules, amongst other means, whilst ensuring that the compliance burden of those which are not the intended target is kept at a reasonable level.

Addressing abusive arrangements with respect to intellectual property income (IP) is a recurrent theme throughout and the Discussion Draft considers the excess profit approach as one alternative in dealing with such income. In general we consider this approach be too mechanical in nature with a number of subjective assumptions that do not focus on profit shifting. Consequently, this approach is likely to result in an over inclusion of CFC income and, in practice, would not represent a viable solution. In addition, and as noted in the Discussion Draft, it would need to be combined with a substance based test in the EU. This could significantly increase the compliance burden for little benefit. Therefore we consider rules that focus on combining both form and substance based measures remain more appropriate in defining CFC income.

We consider that this Action should not lead to a minimum standard requiring that all countries adopt CFC regimes. CFC regimes should be tailored to a country’s economic position and tax system – which means that not all countries need them. Some counties can protect against possible BEPS through an anti-abuse rule; this choice is best left to each country.

If you would like to discuss any of these points further please do not hesitate to contact Simon Cooper (sjcooper@deloitte.co.uk) or me.

Yours sincerely

WJI Dodwell
Deloitte LLP
Enc
Appendix 1 – Responses to questions raised in the Discussion Draft

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?

It is not clear what the first case of treating transparent entities as separate entities is trying to achieve or in which circumstances this is expected to apply. As noted in the Discussion Draft we are in agreement that to the extent any partnership income is already taxed in the parent jurisdiction it would not be necessary to treat the transparent entity as a CFC and therefore we struggle to see how the first case as outlined in the Discussion Draft differs from this premise.

With regard to the second case to treat transparent entities as separate entities for the purposes of CFC rules we presume this in relation to instances such as the following:

- The transparent entity is located in a high tax jurisdiction and is subject to tax in that jurisdiction in respect of its profits;
- The shareholder(s)/relevant interest holder(s) of the transparent entity is a CFC of the parent jurisdiction, where the CFC is located in a low tax territory.
- CFC territory does not tax the transparent entity in its territory.
- The tax paid in the CFC’s partnership jurisdiction is taken into account in the parent’s CFC rules.

If this is the case, we agree with the principle that it may be necessary to treat transparent entities as separate CFCs to prevent the blending of low and high tax rates to avoid the CFC rules. An alternative could be for the parent’s CFC rules to only take into account tax paid in the CFC’s jurisdiction. As transparent entities could be very different to corporates, it would be appropriate to carefully consider the attribution of income of the CFC, control and double tax relief definitions with regard to the transparent entity.

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

We have no additional comments.

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

The narrow version would require a greater level of information to be provided to the parent jurisdiction and would be an additional compliance burden in assessing whether a payment is a base eroding one or not. In wholly owned group situations this should be relatively easy to obtain. Although likely to create an additional compliance exercise, we would suggest that the narrow version be adopted since this better targets BEPS activity. The broad version of the rule may inadvertently capture income which does not pose a BEPS risk and therefore lead to an over-inclusion of CFC income.

It should also be noted that many countries adopt the tax rules of the parent to calculate the relevant income to be attributed to the CFC and therefore whether there is a need for special CFC hybrid rules could depend on whether the CFC’s parent has hybrid rules.

Chapter 3: Threshold Requirements

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

This is considered below together with question 5 of the Discussion Draft.

5. How could these problems be addressed or mitigated?

As noted in the Discussion Draft, the UK’s CFC rules operate a low tax threshold by providing an exclusion where the “local tax amount” (i.e. broadly the tax paid locally by the CFC subject to certain...
adjustments) is at least 75% of the “corresponding UK tax” (i.e. broadly the effective tax payable in the UK had the CFC profits been calculated in accordance with UK principles). The UK’s existing legislation and tax authority guidance provide solutions to address a number of the practical problems that could arise when applying a low-tax threshold based on an effective tax rate calculation, and these are considered below.

**Fiscal consolidation**

As the effective tax calculation typically involves assessing the actual tax paid by the CFC, practical problems can arise in cases where the CFC’s jurisdiction operates a form of fiscal consolidation. In such cases the CFC’s effective tax rate can often be distorted in either direction (on an entity basis tax paid could be higher, lower or nil compared to its individual profits/losses) where the CFC’s local taxable profits are aggregated with other group company amounts in order to compute taxes paid in its jurisdiction either by the CFC or some other person (i.e. another member of the consolidation group). Therefore tax paid on an entity basis may not be identifiable or may not represent the true effective tax rate to assess whether the threshold applies or not.

In these situations, the UK’s CFC rules provide that the tax payable on this aggregated amount is to be apportioned on a just and reasonable basis to establish the local tax paid on an entity basis. The following example is taken from the UK’s CFC guidance which illustrates the above.

**CFCs A, B and C are all resident in the Netherlands and decide to form a fiscal unity. Under the arrangements B’s and C’s local chargeable profits are accounted for on a consolidated basis by A with tax payable by A on the local chargeable consolidated profits of A, B and C. This will have the effect that, if during an accounting period A made a profit of 100, B made a loss of 200 and C made a profit of 400 for Dutch tax purposes, A would be charged to tax on a consolidated sum of 300. If Dutch tax were charged at a rate of 25% the total tax paid by A is 75. Accordingly, in order to determine the local tax amount for CFCs A, B and C, the Dutch tax of 75 will need to be apportioned amongst the three CFCs on a just and reasonable basis. It will normally be appropriate to pro rata the tax amongst the profit making companies in calculating the local tax amount for A, B and C as each CFC is considered on an entity basis. This means that in this instance CFC A will have a local tax amount of 15 (1/5 of the tax paid on its proportion of local chargeable profits of 500 before netting off B’s losses), B will have a local tax amount of nil (as on an entity basis it had no local chargeable profits) and CFC C will have a local tax amount of 60 (4/5 of the tax paid on its proportion of local chargeable profits of 500 before netting off B’s losses).

It should be noted that an appropriate method would not be to choose which profits the losses are allocated against to prevent managing the effective tax rate of entities within the consolidation to fall within the threshold.

**Designer rates**

A ‘designer rate regime’ is one that allows CFCs to effectively choose the amount of tax they pay such they the local tax amount can be set at level to meet the relevant threshold. Therefore it may be appropriate to exclude a CFC benefiting from any threshold requirement where it operates under a designer rate regime.

Other areas that may cause practical problems in applying a low-tax threshold based on an effective tax rate calculation include:

**Differences in the tax bases**

Differences, both permanent and temporary, between the tax base of the CFC and the parent could distort the effective tax rate calculation. In most cases it would be expected that these differences would not be adjusted for, but there could be exceptions, for example:

- Income inclusions/ expense disallowances at the CFC level which may have been motivated to meet the effective tax rate test.
- Timing differences, where there are no other CFC exemptions, and an overseas subsidiary could find itself a CFC in one year but not the next due to, for example, differences in the rates of tax depreciation in the CFC and parent jurisdictions.
• Differences in loss utilisation rules between the CFC and parent jurisdiction, which may result in an overseas subsidiary being a CFC despite using genuine economic losses locally such that no local tax is paid.

From our experience of UK CFC rules, calculating the low tax threshold based on a percentage of the tax that would have been paid under parent jurisdiction principles is a significant administrative burden. The approach only provides an effective solution to exclude low risk entities for simple CFCs. However, the UK rules are supplemented with a number of other exemptions. Taxpayers are then free to choose which exemptions apply and detailed analysis is only required in a limited number of cases, thus managing the compliance burden. It is important to include some form of white list, perhaps with qualifications for some types of income.

Late paid tax or adjustments

As noted, the effective tax calculation typically involves assessing the actual tax payable by the CFC. This can be distorted in cases where there are late paid taxes, tax repayments or other adjustments. These possibilities may need to be reflected in CFC rules, for example, by including a ‘reasonable to assume’ provision for late paid tax or adjustments or allow for the position to be revisited after tax filing deadlines.

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

We agree with the general principle as set out in the Discussion Draft that it may be necessary to prevent the tax rates of the permanent establishment and the CFC from being blended to avoid the low-tax threshold. However, we consider that it should be up to each individual jurisdiction to introduce measures that are in-line with existing domestic rules with respect to the treatment of permanent establishments.

Chapter 4: Definition of control

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

We consider the most significant practical problems are likely to arise in respect of applying a de facto control test. Given its nature, as noted in the Discussion Draft, it would require significant analysis of facts and circumstances and a possible subjective assessment. It is therefore inherently less certain compared to more mechanical tests of control such as legal control or control based on consolidation.

The added compliance burden and complexity for tax payers and tax administrations to verify such a control test seem unavoidable and therefore we consider the remainder of the control tests outlined in the Discussion Draft as more appropriate for the purposes of a control test.

If de facto control were to be included, it may not be apparent what income should be attributed to the party exercising this control. There may be control but, unlike legal or a consolidation test, it may not be possible to attribute a percentage to it. We do not believe that there should be an automatic 100% allocation to any party exercising de facto control in the same way that there should not be a 100% allocation to a 51% shareholder that has legal 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?

Identifying interests held by unrelated resident parties from a practical perspective is likely to be a challenge, which would be more pronounced if there is no local requirement to prepare financial statements for shareholders or such statements do not include shareholder information.

In addition, aggregating holdings with significant institutional investors is unlikely to be an appropriate approach. Institutional investors could include pension funds, which are often tax exempt and do not need to consider local CFC rules. Therefore a control test that requires the aggregation of unrelated resident parties would introduce a significant compliance burden on an on-going basis and a scenario where ultimately the information necessary to be compliant may not be available. It could also result in there being CFC income attribution which is not appropriate.
Furthermore, CFC income pick-ups which are not appropriate may also arise in cases of aggregating non-resident related party interests as a result of the relationship between the related parties. For example, suppose A Co (resident in country A) owns 90% of the CFC and 100% of B Co (resident in country B). B Co holds the remaining 10% of the CFC, and country B’s CFC rules aggregates all related party interests regardless of how those related parties are related, and 10% of the CFC’s income would be attributed to B Co. From B Co.’s perspective it does not control or exert any significant influence over the CFC and therefore it may not be appropriate for any CFC income to be attributed to B Co.

In general, we consider the aggregation of any related parties and taxpayers acting in concert should be sufficient in addressing concerns of groups circumventing control tests.

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?

Although it is clear that the employees and establishment analysis approach requires less fact intensive analysis compared to a viable independent entity analysis or substantial contribution analysis, we consider this approach to be too narrow. It does not take account of commercial outsourcing arrangements which in certain industries are typical even in the case of core functions. For example in the pharmaceutical industry it is not uncommon for research and development activities to be outsourced for commercial reasons, despite being a crucial element of the life cycle of that industry. In addition, the exclusion of activities that are outsourced by the CFC to another group company within the same jurisdiction would not seem to further the policy objectives of a CFC regime. For example in the insurance industry in the UK it is common for regulatory purposes to have staff employed by a group service company working for more than one regulated insurer. Such group service companies are also common in the banking industry. If the substance test was applied on an entity basis, rather than on a group basis, this may lead to a substance threshold not being met.

Furthermore where this approach is applied on a proportionate basis difficulty is likely to arise in calculating the relevant CFC income to which its employees and establishment does not relate to the CFC.

Under former and existing CFC rules in the UK, our experiences of concepts analogous to substantial contribution and viable independent entity analysis are that they can require substantial fact gathering and be difficult to apply in practice. In particular any rules that require a counter-factual based analysis on assessing what would be the normal commercial outcomes and functions if the parties were unrelated, can be highly subjective. Complex and integrated operating models often mean that there may not be one clear outcome - making it difficult for taxpayers to support what the counter-factual analysis may be, thus creating a level of uncertainty. As set out in our covering letter, we would therefore suggest that groups which are clearly not the intended target of a country’s CFC rules should be excluded by straightforward legislative provisions. Only those groups that cannot benefit from these exclusions should need to consider these more detailed rules which are likely to be time-consuming to apply.

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?

The UK’s existing CFC regime operate rules most closely align to viable independent entity analysis that requires an analysis of the group’s activities which includes the significant people functions (SPFs) of the business and then making a hypothetical allocation of assets and risks between the UK and elsewhere based on the split between UK and non-UK SPFs. This split of assets and risks is then used in determining the profits attributable to the UK and thus taxable under the CFC rules.

As noted above, in our experience this approach is fact-intensive and can be difficult to apply in practice, however the compliance burden is minimised through the use of separate targeted entity level exemptions that provide an exclusion from the CFC rules for those entities that pose little BEPS risk and therefore do not require this level of analysis to be undertaken. Even, in cases where the entity level exemptions do not apply and UK SPFs are identified, where such activities and functions represent a minority of overall SPFs (i.e. less than 50% threshold) there is no CFC income pick-up. In addition
although independent viable entity analysis can be subjective to apply in practice, the UK CFC rules are supported by a non-statutory clearance procedure.

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 a business that is licensed under an appropriate regulatory body and is market-facing in a particular jurisdiction is unlikely to cause significant BEPS concerns as this would typically involve local persons undertaking insurance or other regulated activity. In such cases we would not expect profits to be picked up as CFC income where there is substance and activity undertaken locally. Any rules that are based on local licences should, however, cater for the single market rules that allow a company that is licensed in one EU or EEA member state to provide services throughout the EEA.

There are number of commercial and non-tax reasons for groups to reinsure risk within a multi-national insurance or reinsurance group, and therefore there should not be any automatic presumption that a CFC undertaking group reinsurance activity should give rise to taxable income in the hands of a parent company. We note, however, that where group reinsurance is carried out by a CFC for tax reasons it may be necessary to attribute profits from this activity as CFC income. To the extent that CFC rules are intended only to protect the tax base of the parent’s jurisdiction (as opposed to the worldwide tax base), we would expect income to be attributed to the CFC only where the relevant profits arise from insurance of risks that directly or indirectly erodes the parent’s jurisdiction’s tax base.

Similarly, there are a number of non-tax reasons why companies within non-insurance groups choose to reinsure with a group captive insurance company; and the scope and design of the CFC regime where appropriate should reflect the parent jurisdiction tax regime. We note that the current UK tax rules do provide for certain captive business within non-insurance groups to come within the CFC charge, and the distinction between the specific captive insurance rule and the rules which also apply to insurance groups does not appear to be problematic in practice.

We would also note that the scope of CFC rules that deal specifically with insurance and reinsurance transactions must depend to some extent on the definition of “insurance” in the legal system of the parent jurisdiction (for example, on the weight that the system gives to the spreading of risk within the insurer); and also to some extent on the parent jurisdiction’s appetite to impose and apply complex or judgemental rules. As an example of the second point, the UK’s rules to determine whether an insurer or reinsurer is carrying excess assets (the income on which would be taxable) rely on a judgement based on specific facts and commercial circumstances.

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

We believe that there is no reason why the same rule could not be applied to sales and services income and IP. Obviously, it will need to be ensured that this is considered by each jurisdiction when designing their CFC regime.

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

There will always be a trade-off between accuracy and ensuring that the associated compliance is manageable and appropriate. We are not aware of any CFC regimes which accurately attribute any or all of these categories of income whilst also completely reducing administrative and compliance burdens.

In the UK, this is managed by a number of statutory CFC exemptions which groups are free to consider first before undertaking the detailed analysis required by certain parts of the legislation.
14. Does the discussion above consider all categories of income that should be attributed under CFC rules?

As noted in the Discussion Draft there may be other types of income such as property or rental income which individual jurisdictions may want to include in the scope of their CFC rules. Depending on an individual jurisdiction’s domestic rules this may be necessary to counter BEPS activity. In the UK property businesses are treated as active businesses and their rental profits are specifically exempt from the UK CFC rules. This reflects the nature of these businesses and the fact that our domestic rules deal with instances in which overseas territories generate rental income on UK property assets under our non-resident landlord scheme. In these instances a form of UK withholding tax is due on the rental income which is payable.

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

The principles of both the categorical and excess profits approach are clear; however the details of the excess profits approach will always lead to uncertainty.

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

**Categorical approach**

This approach broadly reflects many existing CFC rules and is therefore familiar. The Discussion Draft notes the main possible problems, in particular, substance over form and the fact that some forms of passive income will be active for certain groups (for example, interest income in a financial services group could be active income).

It is also possible that active income could be used to generate passive income. A common example of this could be where trading profits, which are not distributed, are placed on short-term deposit. It is appropriate to exclude some or all of these profits from a CFC’s income, since they are an inevitable consequence of the active trade.

As noted in the Action 6, Treaty Abuse, papers, intermediate holding companies can play an important commercial role and we would suggest that there should not be an automatic presumption that should be a CFC. Particular issues can arise for holding companies- for example, activity could be spread across companies in the same jurisdiction and measuring ‘active’ business may not always be straightforward. If the parent jurisdiction does not tax distribution income or capital gains, and these rules are applied at the CFC-level, there should be no CFC pick-up. However, a holding company could also have incidental income (for example, interest income from invested distribution receipts), and it may be appropriate to exclude this income, assuming it is incidental, from a CFC pick-up.

**Excess profits approach**

We are not aware of any jurisdictions adopting this approach in practice and therefore there is no precedent. We envisage practical problems to arise from the mechanical nature of the calculation of determining a normal return, in both the rate of return and the eligible equity.

The proposed options of applying a blanket rate in Options 1 and 2 of the Discussion Draft for the rate of return, although simple and easy to administer are blunt measures and particularly may favour some groups and negatively impact others regardless of whether they have entered into BEPS activity. Such options ignore a number of variables taken into account in determining a risk inclusive rate of return. Even Options 3 and 4, which take into account individual group’s cost of capital, would be difficult to apply consistently and for tax authorities to administer.

We also have concerns with regard to the calculation of eligible equity. Given that this approach is primarily to focus on IP income, the inherent nature of IP will mean that identifying the IP and valuation of such IP to appropriately and accurately determine eligible equity will be difficult in practice. The example
provided in the Discussion Draft provides an over-simple scenario in which IP was acquired and therefore is clearly identifiable. However in real-life business models IP will often be a combination of different types of IP of which some will be internally generated with little or no base cost and therefore any calculation may be significantly underestimated.

Therefore we consider the risk of this approach, which could be too mechanical in nature, is that it would not focus solely on shifted income and will lead to an over inclusion of CFC income. Further, as noted in the Discussion Draft, from an EU context such an approach is unlikely to be feasible without being combined with some form of substance based exclusion.

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

We believe that the issue with excess profit approach is its lack of focus. Perhaps it might work for a cash-box but it would not work for more commonly-encountered business situations. It is for this primary reason that we would not recommend its adoption.

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?

Although the principles of excess profits approach could in theory be more effective in terms of dealing with some IP income, as noted above, we find it difficult to see how excess profits approach could operate consistently for all taxpayers without making crude assumptions. In our view, transfer pricing methods should limit the attribution of income to a cash-box, thereby rendering this solution unnecessary.

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

Please note our responses above.

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

As noted above as we consider the excess profit approach to be limited and therefore we have not commented further in this area.

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

See 23 below

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

See 23 below

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?

Although the transactional approach better targets BEPS activity, it does require greater analysis on an income by income stream basis. The UK’s existing CFC regime aims to balance the compliance burden yet still focus on transactions that are likely to pose the greatest risk by combining both an entity, and transactional approach. In the UK, an entity approach can be applied to those entities that pose little risk from a CFC perspective through a number of entity level exemptions which provide exclusion for all of the CFC’s income and then a transactional approach is applied in all other cases.
Chapter 6: Rules for computing income

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?

We have no additional comments.

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

Any CFC rules that adopt a categorical approach or a form based analysis such that there are separate rules for different types of income, need to consider whether losses are utilised on an income by income basis as opposed to the overall profit or loss position of the CFC.

Chapter 7: Rules for attributing income

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

We have no additional comments.

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

We consider the Discussion Draft does achieve the above, and ultimately it will be for individual jurisdictions to determine whether a top-up tax or applying the tax rate of the parent’s jurisdiction is more appropriate in assessing how much tax they want to charge under their CFC rules.

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?

Consideration should be given to the interaction of CFC rules and any proposals under the transfer pricing special measures work of the BEPS project. The current early-stage examples of special measures in the Discussion Draft on Risk, Recharacterisation and Special Measures (Actions 8-10) published on 19 December 2014 include situations in relation to ‘excess profits’ and minimally functional entities. After application of the arm’s length principle (taking into account BEPS outcomes in relation to transfer pricing) limited profit will remain in a minimal functional entity – likely to be a return equivalent to financing IP or other assets. We would expect CFC rules (rather than special measures) to address concerns about whether such a return is low-taxed and potentially base eroding. However, if countries were to introduce special measures in addition to CFC rules, it is essential that there is (i) a clear ordering to establish which rules take priority and (ii) a mechanism that allows for relief for any double (or multiple) taxation of the same income.

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

As credit for ‘taxes’, both foreign and domestic against a CFC charge could operate on a paid basis, consideration should be given to jurisdictions which apply a time limit to claiming double tax relief. In instances where as a result of, for example, a transfer pricing adjustment or dispute by a tax authority foreign tax may be been paid significantly after the initial CFC charge is assessed, we recommend that anytime limits with respect to claiming double tax reliefs should be extended. This extension could be part of the parent’s double tax relief or CFC rules depending on which legislation provides relief.
I am writing in response to the request of the OECD for comments on the BEPS Action 3: Strengthening CFC Rules Public Discussion Draft. Please note that the comments presented in this letter are solely my personal opinions and not those of Ministry of Finance of Turkey.

In M&A transactions the bidder could conclude a domination agreement with the target company. Such agreement would enable the bidder to give legally binding instructions to the management board of the target company. Would domination agreements, as a part of the M&A arrangements, put the CFC related tax burden on the bidder before the share transfer completed? M&A history shows us that some of the M&A transactions have not been completed as the wish of bidder but the domination agreement had been valid until the final decision made. So during the time period of domination agreement be valid, should the bidder be responsible of the CFC related tax?

In my opinion OECD should address the domination agreements at the definition of control in the Strengthening CFC Rules Report.
Comments on the Public Discussion Draft

BEPS Action 3:
Strengthening CFC Rules

May 1st, 2015

Committee on Fiscal Affairs (CFA), OECD
By email: CTPCFC@oecd.org

You will find below some general comments on the public discussion draft BEPS Action 3: Strengthening CFC Rules (the CFC draft) with respect to the consultation taking place from April 3, 2015 to May 1, 2015.

This document may be posted on the OECD website. Full credit goes to Robert Robillard, DRTP Consulting Inc.¹

1. Context

We have had the opportunity to review this OECD Public discussion draft in an upcoming paper.² For the purpose of this OECD consultation, we shall provide a few additional comments on some of the key public policy issues arising from this draft.

Without strong (and accurate) international taxation public policy foundations, we fail to see how the technical discussion included in the draft would have any relevance for “enhanced” CFC rules.

2. Are Tax Rules Deterrent by Design?

In general, we do not believe that tax rules should act as a deterrent factor by design. That is, unless they are meant to be specific anti-avoidance provisions. CFC rules are typically used to “prevent shifting income either from the parent jurisdiction or from the parent and other tax jurisdictions”, according to paragraph 7 of the draft. They are an anti-avoidance tool, according to paragraph 16 of the CFC draft.

¹ Robert Robillard, Ph.D., CPA, CGA, MBA, M.Sc. Economics, is Senior Partner at DRTP Consulting Inc. He also teaches tax at Université du Québec à Montréal; 514-742-8086; robertrobillard@drtp.ca. Robert is the former Transfer Pricing Chief Economist at RBRT Transfer Pricing (RBRT Inc.) and a former Competent Authority Economist and Audit Case Manager at the Canada Revenue Agency. The opinions expressed in this document are those of the author.

² This paper will be made available on drtp website in the coming weeks.
However, the argument on the relationship between CFC rules and transfer pricing rules (the arm’s length principle) in paragraphs 21-28 of the draft goes too far on that matter.

Paragraph 21 of the CFC draft suggests that the arm’s length principle acts as a deterrent which prevents “business from entering into certain arrangements”. We certainly appreciate that the purpose of this view is to illustrate the alleged “imperfect symbiosis” between the CFC rules and the transfer pricing rules in international taxation. But this characterization of the arm’s length principle is inaccurate.

From a historical perspective, the development of the arm’s length principle since the 1920s has been driven toward ensuring the balance between the needs of economic growth and those of international taxation in an ever increasingly international world, not to generate “deterrence”.

This unusual interpretation of the arm’s length principle as a deterrence mechanism signals that “recharacterization” may become the “new normal” in transfer pricing. This view directly conflicts with paragraphs 1.64-1.69 of the OECD Transfer Pricing guidelines (July 2010 Edition).

Even new Section D.4 on “non-recognition”, as it is worded in public discussion draft BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures) (December 1, 2014), does not posit the “recharacterization” process as a standard bearer for transfer pricing purposes.3


Paragraph 8 of the CFC draft indicates that countries with CFC rules are put at a “competitive disadvantage relative to jurisdictions without CFC rules”. This seems to imply that countries where the tax mix is different from the one found in industrialized countries should be targeted for their reluctance to increase the tax burden on their taxpayers.

This idea is rendered in the CFC draft as “striking a balance between taxing foreign income and maintaining competitiveness”. It is in line with the tax allegory of “less than

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3 It is noteworthy that the slowly growing “diverted tax profit” creed exclusively led by industrial countries (so far at least) also challenges this guidance.
single taxation” that can be found in the OECD Action Plan on Base Erosion and Profit Shifting.⁴

The notion that there may not be “sufficient CFC taxation” with the actual set of rules, hence the alleged BEPS phenomenon, permeates the whole draft. Remarkably, Chapter 3 of the draft raises the issue of “low effective tax rate” which could act as a threshold to apply “bonified” CFC rules.

This blatant bottom-line driven approach is reprehensible in international taxation. The “low effective tax threshold” proposed in Chapter 3 of the draft should be condemned for its industrialized countries partiality.

More than likely aware of this huge inadequacy, paragraph 42 of the CFC draft suggests that “the scope of the CFC rules” could be limited in order to disregard companies that are “likely to pose little risk of base erosion and profit shifting”.

But in itself, this “methodological approach” is a huge concern.

Public discussion draft BEPS Action 11: Improving the Analysis of BEPS, released on April 16, 2015, clearly demonstrates that it is impossible to differentiate between commercial activities and alleged tax based activities with any sort of accuracy or objectivity.

To posit that some subjective factors would lay the foundations of an “international set of CFC rules” is at best ludicrous. It would create an incredible amount of tax litigations and tax disputes and a considerable level of uncertainty.

4. Conclusion

International tax principles should not rest on the partisan considerations and self-centered interests of the industrialized countries.

It is becoming more and more obvious from the recent “public discussion drafts” that the sole purpose of the BEPS initiative is protect those particular interests, nothing else.

After reading this incendiary draft, our only comfort is in the fact that the “document does not necessarily reflect consensus views of either the Committee of Fiscal Affairs (CFA) or

of WP11 regarding the issues it addresses."^5 Hopefully, the whole content of the draft will now be laid to rest without further dithering…

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May 1st, 2015.

^5 Op. cit., p. 3; italics in the text.
European Business Initiative on Taxation (EBIT)

Comments on the OECD Public Discussion Draft on BEPS Action 3: Strengthening CFC Rules

EBIT’s Members at the time of writing this submission: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, DIAGEO, GSK, INFORMA, JTI, LDC, MTU, NUTRECO, REED ELSEVIER, ROBECO, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCA, SCHRODERS and TUPPERWARE.
EBIT comments on the OECD’s Public Discussion Draft on BEPS Action 3: Strengthening CFC rules

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Submitted by email to: CTPCFC@oecd.org

Brussels, 1 May 2015

Dear Achim,

EBIT is grateful for this opportunity to comment on the OECD’s Public Discussion Draft on Action 3: Strengthening CFC rules (the “Discussion Draft”).

• We generally welcome the OECD’s efforts to try to provide further detailed guidance with regard to the strengthening of CFC rules, however, the OECD’s latest proposals are in our view as business practitioners extremely complex and will be very difficult to apply. We are concerned that the guidance provided in the Discussion Draft will lead to very complicated legislation and to a severe increase of the compliance costs for both taxpayers and tax administrations.

• We note that the OECD acknowledges that there is no consensus among the BEPS-44. The Discussion Draft mentions that some countries with a territorial system, often supplemented by anti-abuse rules, do not apply CFC rules and that for those countries CFC rules will have to be limited to targeting profit shifting, and that countries with a worldwide tax system may have broader policy perspectives, such as preventing long term base erosion. We note that countries with a territorial system which do not apply CFC rules do not do so for a good reason: they have other instruments to prevent profit shifting (e.g. in the Netherlands by not granting the participation exemption or using the exemption method for passive income and by a Transfer Pricing approach that gives more weight to economic substance than the contractual form).

• EBIT Members are therefore unclear about the exact purpose and remit of the Discussion Draft. Is the idea to describe existing best practices regarding CFC rules, which countries can consider adopting or adhering to at will, and “cherry-pick” from for domestic law purposes, or is the purpose to try to strengthen CFC rules through more coordination? It seems to EBIT that the different goals and perspectives of the BEPS-44 should clearly lead to tailor-made CFC rules. No distinction is made in the Discussion Draft. Also, the proposed approach by the OECD in the Discussion Draft could result in a further move away from a BEPS-44 level playing field and increased competition between many OECD/BEPS-44 countries which have strict CFC rules whilst others outside the OECD/BEPS-44 don’t. In our view, the OECD should rather formulate realistic, targeted rules to counter the artificial diversion of profits from parent company jurisdictions which may actually be adopted by the majority of countries.

• The Discussion Draft recalls in the introduction that the OECD’s work on CFCs is being co-ordinated with the work on other BEPS Action Items. The Action Items that are most
EBIT comments on the OECD’s Public Discussion Draft on BEPS Action 3: Strengthening CFC rules

closely associated with CFC rules include Action Item 1 (addressing the tax challenges of the digital economy), Action Item 2 (hybrid mismatch arrangements), Action Item 4 (interest deductions), Action Item 5 (countering harmful tax practices), Action Items 8-10 (transfer pricing), Action Item 11 (methodologies to collect and analyse data), Action Item 14 (dispute resolution mechanisms), and Action Item 15 (developing a multilateral instrument). However, and this is worrying according to EBIT’s Members, nowhere in the Discussion Draft is any link made with any of these other BEPS Actions. EBIT is concerned that the OECD is apparently conducting the work on the interlinking BEPS Action Items in silos without coordination, and that the OECD does not appear to follow a holistic approach, as it announced at the start of its BEPS initiative. We believe however that cross-coordination and taking all the BEPS policy interlinkages and the complementarity amongst them into account and reconciling them from the start is key, especially given the potential for overlap and duplication between Actions. It is also pertinent that the BEPS-44 establish a clear hierarchy of application of the above-mentioned Action Items, which EBIT suggests should logically be: first transfer pricing, then interest deduction, and then CFC rules. This would pre-empt and reduce a surge in disputes between countries and MNCs over the right order of application and unrelieved double taxation. Also, there is no clear analysis in the Discussion Draft why CFC rules are still necessary as a backstop after having implemented all the other BEPS Action Items, nor why such broad and complicated CFC rules as proposed are still necessary.

EBIT is also concerned by the reference to a possible introduction of a secondary rule which could be imposed by BEPS-44 countries on income allegedly sourced in a particular BEPS-44 country which accrues to a CFC which has not been subject to “sufficient” CFC taxation in the parent company jurisdiction. EBIT is not in favour of such secondary rule. This will only be relevant in very, very few situations, and appears to be a potential extension to source country taxation rights. We consider that a parallel can be drawn here with the proposed special measures in the OECD’s Public Discussion Draft on BEPS Actions 8-10 where it concerns Special Measures. A secondary rule would add significant complexity and administrative cost and significant uncertainty for MNCs and is another departure from the Arm’s Length Principle that the OECD has reiterated should be the basis for the allocation of income between companies and countries. We wish to note that if all BEPS-44 states brought in CFC rules then there would be no need for such secondary rules.

EBIT Members support the ‘building blocks’ which the OECD has identified, but we are concerned about the plans regarding identification of the allocation of the appropriate income to the parent territory as set out in Chapter 5. We welcome the OECD’s position that full inclusion and excessively broad partial inclusion systems are not suitable and proportionate to prevent base erosion and profit shifting and may have an adverse effect on growth, international trade and investments. The bottom line for us as practitioners is that the aim of applying CFC rules must be to target artificial shifting of profits and not to tax activities where genuine economic activity is taking place in other countries.

The Discussion Draft seems to implicitly recommend in our view that CFC rules be designed to pre-empt both base stripping in the parent company jurisdiction and “foreign-to-foreign” stripping to prevent erosion of all tax bases. To do so would actually widen the scope of many existing CFC rules considerably and create uncertainty over taxing rights, double taxation and the applicable double tax treaties, and goes beyond the original ambit of Action 3. EBIT is concerned that the OECD’s real aim is seemingly to impose a principle of minimum taxation on MNCs where transfer pricing, interest loan restrictions, hybrids and other rules, taken together with action on harmful tax competition do not result in an effective tax rate that is within an acceptable range. However, the range of the acceptable range remains unclear, and we are concerned that this proposal heralds another proposed departure from current international tax practice and policies.
EBIT comments on the OECD’s Public Discussion Draft on BEPS Action 3: Strengthening CFC rules

- Compatibility with EU law. The draft suggests that this could be solved by applying CFC rules also domestically. Even if this were legally correct, this does not seem to be a viable solution. It imposes a heavy compliance burden on parent companies of domestic CFCs while one would expect little additional revenue. Moreover, the second comparison in Cadbury Schweppes (C-196/04) i.e. Dutch v Irish treasury subsidiaries, and the Deutsche Shell restriction case C-293/06, suggest that even extension of a CFC regime by an EU or EEA country may not necessarily render that regime wholly EU law compliant.

Specific comments

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?

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?

- According to EBIT Members, introducing any broad definition of CFC rules to include transparent entities runs the risk of being over-inclusive, and it should be ensured that the other elements of the CFC rules work effectively to curb double taxation and limit taxation to the types of income that are seen as raising BEPS concerns.

- From our daily experience, we note that the classification of entities for tax purposes is subject to the domestic legal classification of an entity, and we are concerned that different countries may apply different classifications of entities. OECD proposed rules for the treatment of transparent entities as separate entities should be applied and interpreted in a consistent manner across all BEPS-44. The OECD should also give due consideration to the treatment of the entity in intervening jurisdictions as well as the parent company’s jurisdiction. In general, the Discussion Draft as it stands will open the door to a lot of unwelcome extra complexity, a huge compliance burden given the detailed technical and legal analysis required and a lot of uncertainty for MNCs.

- We consider that both the narrow and the broad version of the proposed modified hybrid mismatch rule will require substantial additional analysis and an increased admin burden for companies in practice. We urge the OECD to clarify why a specific and apparently different hybrid mismatch rule is contemplated for CFC rules, outside the scope of the BEPS Action 2 recommendation to apply hybrid mismatch rules in parent company and CFC jurisdictions already.
EBIT comments on the OECD’s Public Discussion Draft on BEPS Action 3: Strengthening CFC rules

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?

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

- Generally, EBIT Members welcome entity-based threshold requirements for CFC regimes as long as they are targeted.

- EBIT Members’ experience with existing CFC regimes is that they require a significant admin burden with very detailed calculations of effective tax rates for all controlled subsidiaries and other entities that are treated as controlled, despite the fact that it is clear from the outset that no CFC adjustment would be required for many of them, or that any adjustment would be immaterial and below any de minimis threshold. EBIT urges the OECD therefore to develop clear gateway tests aimed at excluding having to provide detailed calculations for the significant number of entities which do not carry a risk of CFC adjustment. This will help mitigate the admin burden of both taxpayers and tax administrations.

- In our experience a “white list” – such as the UK’s Excluded Territory Exemption further reduces compliance burdens compared with a low tax threshold exemption which requires detailed tax computations that often don’t deal adequately with issues such as foreign tax credit relief.

- EBIT considers that as long as there is a consistent application of parent company jurisdiction rules, a tax exempt permanent establishment in the CFC jurisdiction ought to be treated as a separate entity for CFC purposes, and that a low-tax threshold test should be applied separately to the tax exempt PE and the principal entity in the CFC jurisdiction.

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?

- EBIT Members agree generally with the suggestion in the Discussion Draft that both a legal control test and an economic control test can be helpful to mitigate undesirable possible circumvention of CFC rules.

- EBIT does have grave concerns, however where the Discussion Draft apparently agrees to lower the control threshold below 50% across the board, i.e. including aggregation of the ownership of unrelated parties, who individually have no control over the actions of a CFC, are not acting in concert, but who are also resident in the same jurisdiction. The proposed measure would in our view put such taxpayers at a competitive disadvantage compared with CFCs held by shareholders in different jurisdictions.
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?

- We note in general that the Discussion Draft introduces additional methods i.e. substantial contribution analysis, viable independent entity approach and the employees and establishment analysis. These methods deviate from the OECD’s Transfer Pricing approach. However, no thorough or convincing analysis is provided why a Transfer Pricing approach would not lead to acceptable results. Given the diversity of MNCs, who may use different accounting systems and observe different levels of internal risk management and control, there is not a one size fits all analysis. At best, EBIT advocates that MNCs should be able to choose their own preferred method for determining and documenting which CFCs have sufficient substance, using one or a combination of the three types of substance analysis proposed.

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?

- EBIT is concerned that the Discussion Draft in paragraph 114 is over-inclusive where it considers that by default, all sales and service income should be treated as passive income unless one of the substance analysis requirements can be met. In many cross-border business transactions this is simply not the case. In most of these transactions there is no direct link to be found between sales or service income and IP income, as can be seen in the active trade or business test found in some existing CFC regimes, such as those of the UK and Germany. EBIT is concerned that the active income part will become very small as a result of the proposals as is the case for instance in Germany. The proposed approach would shift the burden of proof on the taxpayer to rebut a presumption that all sales and services income is not passive CFC income, which again would include entities that should not give rise to any BEPS concerns, which must be the focus. In our view, reversing the burden of proof on the basis of the inadequate analysis in paragraphs 105-106 would be highly inappropriate and ill-advised. Appropriate OECD BEPS Transfer Pricing rules will in our view take away most of the BEPS concerns relating to CFC substance-based rules.
EBIT comments on the OECD’s Public Discussion Draft on BEPS Action 3: Strengthening CFC rules

- When looking at financing income, in order to ensure that CFC rules are appropriately targeted at the artificial diversion of profits, rules should be put in place to ensure that income earned from the investment of trading profits earned by the CFC (and not subject to apportionment) should not be subject to a CFC inclusion.

- EBIT Members consider that the CFC income categories covered in the Discussion Draft are appropriate in the light of BEPS concerns.

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?

- The Discussion Draft’s categorical approach is generally clear but EBIT Members urge the OECD to expand its guidance as to how the specific definitions of income should be included in each category and which categories should be treated as CFC income exactly. EBIT Members are more unclear about the proposed “excess profits approach” which introduces significant complexity and uncertainty about what is to be regarded a “normal” return, and which would need to be considered per company and industry sector. Whilst we appreciate the OECD’s objective is to promote a simpler and more mechanical approach, the approach appears to be inconsistent with other BEPS Actions, the Arm’s Length Principle and EU law. It also seems to EBIT Members that the excessive profit approach is intended to serve primarily U.S. domestic policy considerations, and not necessarily the common BEPS-44 agenda. We wish to note that if all BEPS-44 states brought in CFC rules then there would be no need for secondary rules.

- Of the two approaches, EBIT Members believe that the categorical approach with adequate substance tests will be more effective in mitigating BEPS concerns.

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?
EBIT comments on the OECD’s Public Discussion Draft on BEPS Action 3: Strengthening CFC rules

- As stated above, an entity approach alone could easily result in over-inclusion and would result in a lower administrative effort and cost required from companies. It is also more targeted at higher risk entities which warrant a material adjustment. EBIT considers that using a combination of elements of both approaches may be most appropriate for businesses as they would ensure simplification for low-risk entities and transaction approach proportionality for situations where the safe harbour limits are not observed.

Chapter 6: Rules for computing income

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?

- EBIT’s Members face practical difficulties with computing the income of CFCs, in particular where local requirements and rules regarding CFC reporting, accounting and tax information differ from that in the parent company jurisdiction, which often obliges them to duplicate accounting and tax reporting, and which also involves keeping data concerning relevant carry forwards and tax adjustment with regard to the CFC on file for a longer period.

- EBIT generally agrees with the Discussion Draft’s recommendations on computing the income of CFCs. With regard to the possibility for CFC loss relief, we consider that following parent company jurisdiction loss offset rules can be appropriate in as far as the losses within a CFC can also be used to offset profits in other entities in the CFC jurisdiction, and that they do not prevent the use of fiscal unity related losses.

Chapter 7: Rules for attributing income

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?

- See our comments above in relation to unrelated parties Chapter 4.

- The use of a top up tax is bound to be limited to some jurisdictions with a worldwide tax system.

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?

29. What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?
EBIT comments on the OECD’s Public Discussion Draft on BEPS Action 3: Strengthening CFC rules

- EBIT Members consider that the Discussion Draft underestimates the practical difficulties and complexity in calculating double taxation relief and assumes that effective relief will be generally available, which in our experience does not reflect reality. In particular, the Discussion Draft does not seem to take into account CFC jurisdictions which do not or will not adhere to the recommendations outlined in paragraphs 154-155.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are committed to a constructive dialogue with the OECD and are always happy to discuss.

Yours sincerely,

European Business Initiative on Taxation – May 2015

For further information on EBIT, please contact its Secretariat via Bob van der Made, Telephone: +31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com

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1 May 2015

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

Dear Mr. Pross:

EY appreciates the opportunity to submit these comments to the OECD on the Discussion Draft on BEPS Action 3: Strengthening CFC Rules dated 3 April 2015.

Action 3 represents a new area of focus for the OECD. The OECD has not previously done any substantial work on questions related to the design or operation of CFC regimes. As has been the case with other BEPS discussion drafts, the Action 3 discussion draft includes a caveat that the recommendations it contains do not reflect a consensus view. Moreover, with respect to the core question of what income should be covered by a CFC regime, the lack of consensus is such that the discussion draft includes possible options rather than recommendations. However, it is stated that the final report on Action 3, which is to be issued later this year, will include recommendations with respect to the income to be covered by a CFC regime in addition to recommendations with respect to the other core design elements of a CFC regime. We are concerned that this plan for comprehensive recommendations with respect to CFC rules is unrealistic and that allowing this work to be driven by artificial deadlines would be imprudent. Our concern about the timetable for completion of this work is heightened by the fact that there is so much work yet to done with respect to the other BEPS Actions. We believe that the more prudent course of action would be to take a more deliberative approach to the work on Action 3, even if that means delaying delivery of the final report.

The aim of CFC rules is commonly considered to be protection of the taxing rights of the country where the parent company is located. CFC rules are designed to achieve this objective and the effectiveness of CFC regimes is measured against this objective. However, in its July 2013 Action Plan on BEPS, the OECD identified another potential objective behind CFC rules, which is to help protect the tax bases of third countries. This seems to be quite a novel perspective on CFC rules. The discussion draft alludes to this protection of third countries concept, but does not develop it in any detail. It is not clear to what extent the
recommendations and options contained in the discussion draft are aimed at this new and novel objective rather than at the traditional objective of protecting the tax base of the headquarters country. As the work on Action 3 continues to move forward, we urge the OECD to be clear about the objectives it is seeking to further with its recommendations and options relating to the core elements of a CFC regime.

In our view, CFC rules should function mainly as anti-abuse rules. In this regard, as the discussion draft details, the anti-abuse nature of CFC regimes is the basis on which such rules have been found to be acceptable under the treaty governing relationships in the European Union. Taxation of the foreign earnings of a CFC to its parent company under a CFC regime is a departure from general international tax concepts and the generally accepted notion of country sovereignty. In keeping with the anti-abuse rule role, we believe that CFC rules should be narrowly targeted. The discussion draft, however, takes a much broader approach – too broad an approach in our view. We believe that the OECD should revisit these issues and should develop a CFC design approach that better aligns with the anti-abuse rule function of CFC regimes.

It is important to recognize that countries have made very different choices with respect to CFC rules. Some countries do not use CFC rules at all. Countries that do use CFC rules have chosen a broad range of approaches with respect to the scope and reach of such rules. Underlying these choices are decisions countries have made regarding competitiveness and encouraging investment. For these reasons, we do not believe that a single set of CFC design recommendations is a realistic or appropriate goal. Indeed, even developing best practices recommendations will be challenging in light of the different objectives that are served by CFC rules. We believe that the OECD should consider an approach that would associate best practices recommendations for design of CFC rules with the different objectives that could be served by such rules.

In connection with any best practices recommendations, we encourage the OECD to address those situations where multiple anti-abuse rules could be applicable, such as where multiple CFC regimes could apply to the income of a CFC held by a chain of entities. Moreover, the OECD should address the double taxation risk that arises where the source country denies the deduction for payments that are not sufficiently taxed in the receiving jurisdiction but the amount is subject to a CFC inclusion in a parent company of the receiving entity. The work on Action 3 should include development of ordering rules in the full range of situations where there is risk of multiple taxation of the same income.

The Action 3 discussion draft includes a reference to a proposal for a secondary rule that would apply where an entity is not subject to sufficient tax under CFC rules and that would allow other countries to tax the entity’s income on some undefined basis. The discussion draft indicates that consideration has not been given to whether this proposal should be taken forward. Such a rule would be a radical departure from international tax norms and would seem to be unworkable. We urge the OECD not to advance this idea any further.
Finally, we would note that there is significant interaction between this BEPS Action 3 and several other BEPS Actions. The discussion draft acknowledges the need to coordinate the Action 3 work with the work on multiple Actions, including Action 1 on the digital economy, Action 2 on hybrid mismatch arrangements, Action 4 on limitations on interest deductibility, Action 5 on harmful tax practices, and Actions 8-10 on transfer pricing. We agree that close coordination is essential and therefore we are concerned about the practicalities of accomplishing such coordination under the BEPS timeline while the work on these other Actions is still in progress.

We urge the OECD to take the time to evaluate the outcomes of the other BEPS Actions and also to reassess the objectives of the Action 3 work. Given all the issues with respect to this focus area, we would recommend that work with respect to Action 3 should be deferred until the work on the other Actions is completed so that it can be approached with clearer focus and with due consideration of the implications of the measures that result from the other interconnected Actions.

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If you have questions or would like further information regarding any of the points discussed above, please contact Barbara Angus (barbara.angus@ey.com), Jim Tobin (james.tobin@ey.com) or me, Alex Postma (alex.postma@ey.com).

Yours sincerely
On behalf of EY

Alex Postma
FFSA’s Comments on OCDE Discussion Draft on « BEPS ACTION 3: Strengthening CFC rules »

The French Federation of Insurance Companies (FFSA) is a trade association which groups together insurance and reinsurance companies representing 90% of the French market. In particular, its purpose is the promotion of insurance, the defense of the interests of the profession and the establishment of common ethical standard.

We welcome the opportunity to participate in the consultation process on action 3: “Strengthening CFC rules” and our comments will focus on the measures that could affect particularly the insurance sector.

• In this BEPS action 3 public discussion draft on CFC rules, the working group classifies insurance income among the revenues raising BEPS issues, and that could be subject to a targeted approach.

This position is detailed in paragraph 102 of this draft. Indeed, the working group reckons that insurance income “is a profit that can be shifted away from jurisdictions in which those risks are located and into low-tax jurisdictions.” To illustrate this view, the following example is provided: an insurance company regulated in a particular country to cover risks located in that country reinsures some or all of these risks to a subsidiary resident in a low tax jurisdiction, hence allowing, according to the document to shift “profits associated with the insurance of those risks.”

This illustration raises some issues as it challenges the principle of reinsurance, which is an essential and vital tool for market equilibrium and for the development of all forms of insurance. The fact that reinsurance is carried out with a related or/and an operator based in another country cannot be considered as raising profit shifting issues as a matter of principle.

• Hence, it seems important to highlight the following elements:

a) In view of current OECD principles, insurance or reinsurance activities are taxed where the risks are accepted, and not where the risks are located. This approach makes sense as insurance and reinsurance activities are taxed where the risk taking activity, namely the underwriting, is performed and where the related income, expenses and assets covering these commitments are booked and taxed.
Concerning insurance activity, these two locations often coincide. For reasons related to solvency monitoring, national prudential authorities require insurers to be established in their jurisdiction in order to accept risks within their territory. But this rule does not apply to reinsurance - which is by nature a global and international activity - and insurance activities which know an important exception in the European Union, with the EU principle of freedom of services.

However, it cannot be assumed that there would be a profit shifting issue when the taxation of the activity related to the risk taking function is being undertaken outside the country where the risk is located. In insurance business, this country often levies a tax, in the form of an insurance premium tax, impacting the insurance activity.

b) This document seems to consider the insurance income as a profit or a conventional income.

Actually the insurance business basically consists in the transfer of a risk to which is exposed the insured - and who transfers that risk upon payment of a premium - to an insurer who accepts this transfer of risk and its related consequences should the hazard occurs, in accordance with the terms of the contract. Reinsurance reproduces this pattern between the insurer - who wants to cover part of the risks he accepted - and the reinsurer who will then accept these risks and manage it through pooling and diversification at its own level. Every participant undertakes its share of risk exposure which can trigger a loss or a profit.

Since both insurers and reinsurers undertake their share of risk under related contractual terms so that the risk is distributed among various stakeholders, it makes sense that the operational profit or loss - is also distributed among them.

c) Insurance and reinsurance businesses are highly regulated activities subject to multiple controls by prudential authorities in their host countries.

Since harmful consequences could arise from the default of a participant, these economic actors are subject to very specific rules given the special nature of their activity. These rules relate mainly to solvency and governance and include the minimum capital required to carry out their activity, the provisioning rules of risks underwritten or assumed and the nature of the underlying assets to cover them.

Each participant is then subject in its home country to careful monitoring by the authorities controlling the sum of risks taken and the compliance with technical rules and solvency ratio. And one of the major concerns of insurers and reinsurers is their ability to fund these risks within acceptable economic conditions.

d) Finally, reinsurance is a vital tool to organize in the most suitable way the exposure to risk and to be able to take risks, which would otherwise not be covered or too much concentrated.

-From the point of view of the reinsured, reinsurance enables him to increase his commercial presence while maintaining exposure to various risks adapted to its own characteristics;

-From the point of view of the reinsurer, reinsurance acceptance enables him to geographically diversify his exposure in order to have the ability to organize an optimum pooling and diversification;
• The basic characteristics of insurance / reinsurance activities are independent from whether any of the actors are or are not CFC of the other. The technical and financial constraints and the regulatory burden on operators would be the same, whether it would be inside or outside the group.

From an economic standpoint, internal group reinsurance setups are justified. In an insurance group, for instance, an internal reinsurance will allow to group into a dedicated entity - local or foreign – risks of different kind from several entities of a group. Such a combination provides better pooling - financial and geographical - of commitments taken by the various entities, and can hence release equity at the level of reinsured entities while the capital requirements in the country of establishment of the CFC may be lower. Hence this organization puts the group into a position to find out better reinsurance conditions than those that could have been obtained directly by each entity in an isolated manner, given the volumes and risk dispersion to give up, that facilitate external reinsurance.

In these circumstances, the vital element is to justify insurance price. So it is primarily a transfer pricing issue.

• Setting forth a presumption that under the CFC rules, insurance or reinsurance transactions with related parties and / or covering risks located outside the host country are “attributable income” is excessive and would be particularly detrimental for all concerned operators.

Even though the working group admits that this presumption is rebuttable, the fact remains that such an approach would put all operators subject to this rule in a weak position and in a major uncertainty. This would compel them to demonstrate systematically for legitimate economic operations that their group counterparty has the necessary substance needed to manage and take these risks, and this without any details about the criteria that would be used by Tax authorities to assess the situation.

• Among other approaches for the determination of attributable income to a CFC, the working group explores the idea of an «excess profit approach ».

Schematically, this method aims to determine a theoretical income from the activity of a subsidiary subject to the CFC rules, and considers that the excess income is an "attributable" income.

It should however be noted that such an approach is inappropriate and not applicable for insurance and reinsurance activities. Indeed, this method assumes that there can be a standardized income for the activity carried out by the subsidiary, which would be calculated by the application of a rate of return to the amount eligible equity, the eligible equity being defined as the equity - invested in assets held by the CFC and used in the active conduct of its trade business. In insurance business, firstly there is the issue of the determination of eligible assets, which are held and required for their activity, but which are essentially the counterpart of commitments undertaken by the company. In addition, due to the inversion of the production cycle, the net income of an insurance or reinsurance business is highly cyclical and variable from year to year. Hence the determination of an annual standardized income makes no sense from an economic standpoint. Should this method be chosen for the insurance industry, it should fit the inverted production cycle and the income should be considered on a long term basis per insurance risk category.
• The insurance sector would also be directly affected by any specific provision that could be introduced on financial products generated by a subsidiary company or by the different forms of funds used by the insurer to realize its investments.

In this discussion draft, the working group suggests that dividends and interest revenues perceived by a controlled subsidiary are passive and attributable incomes, unless this subsidiary satisfies certain conditions or by the different forms

Even though it can be rebutted, such a presumption would be unnecessarily harsh in a sector where financial investments and related products – interests and dividends - are inherent to their activity in the sense that they are essential to cover commitments made in respect of policy holders.

Yours faithfully,

François Tallon

Head of Tax Affairs – FFSA
Comments on the Public Discussion Draft of BEPS Action 3: Strengthening CFC Rules

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

Introduction

The OECD released its latest draft on the public discussion of the strengthening the CFC rules on 3 April 2015 with comments invited by 1 May 2015. The comments provided below are prepared by the author as representative of Gazprom Marketing & Trading Ltd.

A. General Overview and High Level Thoughts

The first point to make is that the very existence of CFC rules is a tacit admission by governments and tax authorities that the transfer pricing rules do not work properly or as intended. In theory a fully functioning set of transfer pricing rules would avoid the need for CFC rules as all income would be properly taxed in the hands of the rightful owner under the arm’s length principle. We would therefore encourage the OECD to redouble its efforts to fix the parts of the transfer pricing rules that are deemed to be the source of the need for CFC rules, and to spend less time developing a further complicated set of rules that very crudely give tax authorities “two bites of the same cherry”!

To the extent that CFC rules are still required the first and most important step is to determine the purpose of the regime. In this respect the OECD paper sets out interesting summary of the policy considerations with respect to CFCs in chapter 1 of the discussion draft, including recognition of the fact that the purpose of CFC rules is to act as a deterrent. They are a “fence” aimed at preventing the shifting of income rather than a “net” to catch income. We agree with this approach. CFC rules should be limited to the artificial diversion of profits that would otherwise have accrued in the parent company. This leads to some interesting observations.

1. CFC rules work on the concept of control as this is necessary to artificially divert profits. Therefore they should operate at the level of the holding company (controlling shareholder) and seek to protect the tax base of that company and that company alone. Foreign to foreign transactions that do not impact the territory of the holding company should therefore be exempted. This is especially the case for parent companies located in jurisdictions that operate the ever more common territorial basis of taxation.

2. Only artificial transactions and structures should be within the rules. Anything with a bona fide commercial basis should be exempted. This is often assessed by reference to whether there is “substance” in the subsidiary. Substance is in turn being increasingly determined by the location of the people that manage the assets or business. In this respect it is critical to respect the fact that different businesses clearly have different commercial business models and that these are nearly always not tax driven. For instance banks and trading companies try for a number of very good reasons to manage their capital, risks and other business
matters centrally from one location (often the parent company location). Also to remain competitive and to manage a global business these very same companies do operate through a global network of subsidiaries and branches. The fact that a lot of the more important functions (such as risk management) are centralised should not cause the subsidiary concerned to fail the substance test, notwithstanding that the subsidiary concerned might hold valuable assets and be possibly located in a territory with a lower tax rate than the parent company.

3. The rules should apply to profits only. Capital gains should be exempt. This is important as otherwise future profits would be caught (most valuations are NPV of future cash flows into perpetuity) which we consider wholly unreasonable.

4. The distinction between active and passive profits should be carefully considered. Anything deemed to be a passive activity (such as leasing) should not necessarily be automatically swept up into the CFC rules. The same principle of “artificial diversion” should apply to both categories of activities and profits.

5. All payment of dividends out of active profits should be exempt and should keep this character as they are paid up the ownership chain to the ultimate parent company so that intermediate holding companies are not tainted.

6. The issue of “diversion” should also be considered carefully and this needs to be assessed by reference to whether the CFC rules are being applied at the level of the ultimate parent company or at a lower intermediate level. At the level of the ultimate parent company there is a rebuttable presumption that income would arise in the parent company jurisdiction unless there is a commercial rationale and explanation as to why the income arises in a foreign (sometimes lower taxed) jurisdiction. To the extent there is a reasonable explanation the subsidiary should be exempt. However for an intermediate holding company it is arguable that there is no such rebuttable presumption on the basis that all income arising in that jurisdiction has been diverted into it by the mere fact that the MNC decided to locate there in the first place. It made a conscious choice to establish in that location and so the issue of “profits diverted away from the parent company” should be viewed through a different lens for intermediate holding companies established in a different location than the ultimate parent company. Put simply we consider that the notion of diverted profits should only apply to the ultimate parent company.

There is of course a clue to what should be caught in the title of CFC. It should only apply to Controlled Foreign Companies. We would make the following observations:

1. Only controlled companies should be caught. This should be set at the normal commercial level of control (>50%) and should not therefore extend to joint ventures and other structures over which the taxpayer has no control. This is especially important when the JV concerned might have shareholders from various countries subject to different tax regimes. The post-tax return can be directly impacted by misguided CFC rules that will in turn impact investment decisions.

2. Only foreign companies should be caught by the rules. It makes no sense to apply the rules to domestic subsidiaries as they can be dealt with by the domestic tax system.

3. Finally, the rules should only apply to companies. They should not apply to branches and permanent establishments which are a part of the same juridical entity. Tax authorities can
protect against any mischief by simply taxing branch profits and allowing a credit for the local tax paid.

The OECD is also mindful of the administrative and compliance burden that CFC regulations impose on business with attendant costs and impact on competitiveness and also the need to avoid double taxation. With these principles in mind it should be the case that any CFC regime should be designed to be as light touch as possible, to compliment and fit within the existing and ever growing raft of compliance and reporting obligations imposed on business. Extra cost and administrative burdens have an effect on economic growth and so reduce the positive economic benefits for society through employment and tax revenues.

B. Design of a CFC regime – OECD paper.

General observations

As noted above we recognise that CFC rules are regarded by many fiscal authorities as a necessary component of a comprehensive tax regime. Their aim is to influence behaviour at the margin; they are not intended to be a primary tax raising measure. Consequently CFC provisions should be sufficient to support policy objectives but go no further.

In order to avoid adverse impacts on commercial activity they should be designed and implemented taking into account the true cost and burden of compliance to law abiding tax payers who do not seek to artificially divert profits. Tax authorities should therefore be highly sensitive to the impact of such provisions on genuine businesses.

In order to minimise the inevitable adverse impact on business CFC provisions should have the following elements:

- They should be clear and simple to understand, the rules should be stable, leading to certainty over their application.
- They should recognise the economic and hidden costs of compliance.
- They should not aim to regulate or influence tax cost or policy beyond the jurisdiction in which they are imposed – no jurisdiction should seek to police the world.
- Secondary charges in addition to those generated by a single set of clear primary rules should not be implemented. These add cost and complexity; generate uncertainty and impact on the competitiveness of genuine commercial activity.
- Taxation based on so called “excess profits” or above a “normal” rate of return should also be rejected as these are impractical and highly subjective measures.

Filters and thresholds

In order to facilitate the efficient operation of a CFC regime (which provides clarity and certainty to taxpayers and tax authorities alike), the use of clearly defined filters and thresholds is strongly supported. These should be incorporated at all stages of the CFC assessment framework. They allow for genuine business activity to be quickly identified and excluded from assessment saving time and resource for taxpayers and tax authorities.
CFC regimes should recognise that where clear business drivers underpinning the arrangements are in place and supported by appropriate substance then such activity should not be subject to CFC assessment, even if the activity is undertaken in a lower tax regime.

Hence the design and implementation of an initial screening test to exclude genuine activity is strongly recommended. For example such a test could include;

- no principal motivation for tax avoidance, or
- appropriate “local” management of overseas assets, functions or risks, on the basis of the group’s commercial business model (c.f. our earlier comments on why centralised management functions are sometimes commercially necessary), or
- overseas business has sufficient “substance”, or
- overseas profits are of specified (exempted) types.

Satisfaction of any one test should allow the potential CFC to be excluded from assessment.

**Definition of a CFC**

**Entities**

It is essential that corporate and business structures which fall within CFC provisions are unambiguously defined. The OECD proposals recommend that non corporate entities such as partnerships, trusts and PEs should be included. As noted in section A. above we disagree with extending the definition beyond companies.

It should be recognised that partnerships, and other unincorporated joint ventures, are often used to facilitate collective commercial activity with no tax avoidance motive. Any risk of exposing innocent adoption of such structures to an additional CFC charge would be inappropriate. Any type of collective activity implies that one or more of the participants will not control the activity, hence increasing the chance of making the application of CFC rules to inappropriate participants more likely.

Hence, if non corporate vehicles of this nature are included extreme care should be exercised to ensure that there is no element of double taxation of any income.

Only foreign companies should be included. It is inappropriate to apply CFC rules to domestic entities.

**Rate**

On balance we agree with the OECD proposals that the effective tax rate is a sensible basis to use, subject to careful consideration and definition of how that rate is calculated. There needs to be equity in the assessment and calculation of the rates in the parent and CFC jurisdiction. Effective rates and statutory rates should not be mixed when assessing CFC status.

However we suggest that a material difference in rates is needed as the measure, rather than a “meaningful” difference as suggested in the OECD paper. This would place greater emphasis on the need for tax avoidance as the basis for any CFC charge and thereby reduce the potential impact on the bulk of compliant taxpayers.
Clearly “material” is a subjective term. In order to minimise the burden on legitimate business activity, whilst still identifying high risk structures a rate in the range 75% to 50% of the parent jurisdiction would seem appropriate.

Calculation of the effective tax rate should take into account the fact that certain income is sometimes exempt or subject to lower tax rates in a parent jurisdiction. For example Russia ignores the fact that dividends may be subject to a zero rate - thus the calculation of the effective tax rate in foreign holding companies receiving dividends always arrives at a lower effective tax rate, which unfairly catches innocent foreign companies.

**Exclusions**

A de-minimis activity threshold (irrespective of the tax rate in the jurisdiction) should also be implemented. It is essential to set this at a level that eliminates sensible amounts of activity from exposure to CFC assessment. It needs to be simple and quick to assess.

As cross border tax differentials are only likely to be exploited where the tax savings are material to the organisation concerned and the costs involved, only larger organisation are likely to consider such structures. For example, assuming a 10% tax differential and a $1m p.a. saving to make a structure worthwhile implies a taxable profit level of c. $10m as an indicative level for a de-minims threshold.

Failure to adopt a material level will not realise the intended savings in time and resource for tax authorities or tax payers.

**Definition of Control**

We agree with the proposals that the control threshold should.

- Typically be set at >50%.
- Cover both direct and indirect control.
- Include both legal and economic control tests traced through the ownership chain with control considered at each level.

However, taxpayers should be able to rebut the presumption of control and hence avoid a CFC assessment in cases where the parent passes the control tests, but is not, as a matter of fact, able to control the CFC.

Examples of this type of circumstance might include; business arrangements where there are “joint deadlock” provisions in the commercial agreements, practical operational circumstances or where other superior legal or regulatory constraints mean control is not in practice exercised by the parent jurisdiction.

We are opposed to the implementation of other “de facto” tests of control being included in CFC legislation. They will tend to be subjective and as a result complex, lack clarity and certainty. Hence they are likely to be “compliance heavy” to operate and administer for little or no benefit.
Definition of CFC income

We note that a further consultation paper will be issued in due course. In the interim we have the following observations to make.

General features

In our view the following are important aspects in the design of a CFC regime.

“Active” income should be excluded from CFC assessment. This is a common theme across existing regimes. An active business operation or “trade” in areas that might otherwise be typically categorised as “passive” (e.g. financing and leasing) should be treated as active income.

Similarly dividends arising from active companies should retain this active character and not be treated as passive income at some later stage.

We find it difficult to assess accurately the differences between the various tests noted. Close alignment with existing requirements for analysis and documentation under transfer pricing rules suggest that the “viable entity” test may be preferred over a “substantial contribution” approach. However, the essential feature of any test is that it should be based on the practical and commercial requirements of the business under consideration. As such it needs to be flexible and capable of being tailored to fit a wide variety of businesses, industries and structures adopted by them for many different reasons. Consequently any test based on rigid measures such as numbers of employees or physical size of office accommodation is unlikely to be appropriate. We repeat our earlier comment that many businesses have many different business models and the vast majority of them are non-tax motivated.

Given that a further consultation paper will be issued in due course we suggest that this area could be addressed again at that time.

We would however recommend that on passing the adopted “entity test” that the entire activities of the enterprise should be exempted from CFC assessment. A proportional approach only leads to incremental activity and costs and is inconsistent with the view that functioning local entity exists.

Difficult income – financing, dividends, IP

In addition to the comments above in relation to potentially passive income (financing, dividends), we recognise that IP and royalty income is a difficult and contentious area. However we would recommend that the general rules apply such that only “artificially diverted profits” are caught by any new rules and that genuine commercial structures backed by appropriate substance are exempted. The fact that IP companies and businesses are people “light” should not be viewed as suspicious with a presumption of tax avoidance.

Excess profits / Normal returns

We are strongly opposed to the adoption of any kind of “excess profits” or “normal return” approach. These will inevitably be highly subjective measures and hence lack certainty of interpretation for all parties.
Any adoption of an assessment basis implementing such subjective measures and a deemed “excess” return leaves an inequitable imbalance of power in the hands of tax authorities. It raises the prospect of uncertainty, cost and competitiveness for genuine business and may undermine trust in the tax authorities by fostering the suspicion that aggressive tax authorities simply use such a measure to get the result they want, rather than one based on clear rules consistently applied.

Existing obligations on tax payers, (e.g. self assessment rules, disclosure requirements, transfer pricing regulations, targeted and general anti-avoidance provisions), plus clearly drafted CFC rules should be more than sufficient to regulate activity effectively.

**Transactional v entity assessment**

We have a preference for an entity based approach. It is likely to be more closely aligned with other reporting requirements, so reduce the need for reconciliations to numbers reported for other purposes.

**Implementation**

**Computation of Income**

The OECD paper (chapter 6) suggests that application of the law of the parent company is the best, and actually only one solution\recommendation. It discusses using IFRS but then rejects it. We believe that it would be fair to leave the taxpayer a choice: either to calculate in accordance with the domestic rules, or calculate based on IFRS. The latter is actually more convenient and saves costs to an MNC that anyway has to prepare consolidated financial statements and collect IFRS statements from its subsidiary companies.

**Attribution of income to shareholders**

We agree with the OECD recommendation to the extent that an entity remains subject to a CFC assessment the attribution threshold should be linked to the minimum control threshold and it should be proportionate to level and period of ownership /influence.

Attribution of income should be no earlier than the normal charging period for tax in the parent jurisdiction and at a rate no higher than applying in the parent jurisdiction, there should be no punitive effect.

**Prevention of double taxation**

We agree with the recommendations on double tax relief, but CFC assessments should never give rise to any double taxation. Full relief is essential for all taxes actually paid including CFC assessments in intermediate countries. All dividends and capital gains attributable to income previously assessed to CFC taxation should be fully exempted from any subsequent charge.

**Conclusion**

We understand many countries consider it necessary to implement a CFC regime as part of a fully integrated tax system. We do not share this view and would suggest that efforts would be better spent improving the transfer pricing rules.
However, notwithstanding this view, we are of the opinion that in designing and enforcing CFC rules, the impact on genuinely commercial activity by the majority of law abiding tax payers should be a primary consideration in the minds of policy makers and legislators.

Any rules should be strictly limited to the artificial diversion of profits and only apply to controlled foreign companies. Tests around appropriate substance should give due consideration to the many different and legitimate business models used by tax payers. A “one size fits all” approach should be avoided. Every effort should be made to exempt genuine commercial activity even if it is taxed at a lower rate of tax. Ultimately each government has the right to set its own rates of taxation. CFC rules are in fact only necessary to the extent that countries have different tax rates. A country that sets a high tax rate should not be able to penalise resident companies that genuinely establish commercial activity overseas.

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

Introduction

The Global Federation of Insurance Associations (GFIA) through its 38 member associations represents insurers that account for around 87% or more than $4 trillion in total insurance premiums worldwide. GFIA is pleased to provide comments on the OECD discussion draft on BEPS Action 3: Strengthening CFC Rules (the "discussion draft"). In general, the GFIA supports the objectives of the OECD BEPS Action Plan to address weaknesses in the international tax environment. Accordingly, the GFIA supports the broad policy objective of the discussion draft to "develop recommendations for CFC rules that are effective in dealing with base erosion and profit shifting". However, it is critical that any measures adopted by the OECD are workable, well targeted to only apply to cases of base erosion and profit shifting, and do not result in unintended consequences that negatively impact the efficiency of commercial insurance operations and the availability and cost of insurance coverage for consumers. In particular, given the highly regulated nature of the insurance industry, particularly with respect to capital requirements, we are concerned that the discussion draft's broad reach, which is not limited solely to base erosion and profit shifting, will negatively impact the availability of capital, which in turn will negatively impact the availability and cost of insurance, given the importance to insurers of being able to diversify portfolios through reinsurance.

General comments

The proposals in the discussion draft are complicated and conflicting, partly because they need to address both worldwide and territorial tax systems, which has resulted in inconsistencies due to the fundamental differences between the two approaches. It is not clear how the recommendations in the discussion draft interrelate with the other BEPS Actions, making it difficult to consider these recommendations in isolation.

The insurance industry is highly regulated for the protection of customers. GFIA therefore believes that any recommendations should not result in CFC income being attributed with respect to insurance where there is economic and value creating activity. The GFIA believes that the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) ("Part IV") is highly relevant to the discussions about the attribution of income in the highly regulated insurance context. Referencing Part IV would be the best approach to dealing with the insurance industry, given the time and effort which has already been invested in the development of Part IV and the very tight time constraints in finalizing the BEPS initiatives.

The draft needs to recognize the critical role of capital in the insurance sector. Any discussion about capitalization in the insurance industry needs to take into account the fact that regulators in all jurisdictions require insurers to hold an appropriate amount of capital in order to ensure that policyholder claims can be paid in all circumstances. The precise amounts depend on the regulatory regime in question. But in all situations this
is the minimum amount of capital that must be held by the insurer. In addition to regulatory capital, ratings agencies impose additional conditions to satisfy credit rating requirements. Insurers’ credit rating and financial strength is critical since:

- most customers will only place their business with a financial institution with a strong credit rating
- some investors are only able to invest in entities with a prescribed credit rating or higher
- it allows them to attract capital at a reasonable cost.

Insurers typically hold additional capital in excess of the minimum regulatory capital as a buffer to ensure they have sufficient capital to write new business and pay out claims. Insurers need to ensure they hold capital of sufficiently high quality such that it qualifies as regulatory capital, which is constantly managed. The ability to manage capital efficiently is a key source of competitive advantage in the sector. The maintenance of an appropriate level of capital within a jurisdiction is critical to an insurer’s ability to carry on business – it is not primarily a tax-motivated decision.

Specific comments

*Economic Benefits of Insurance and Reinsurance*

Insurers create value for the economy as a whole by assuming risks, which may be catastrophic, from businesses and individuals, in return for an insurance premium. The benefits of spreading risks over a large number of policyholders significantly reduce the cost of insurance. Insurers actively manage the risks they take on, using reinsurance to diversify and manage their risks and to generate capital efficiency. For insurers, the pooling and diversification of risk is crucial to their business, which is recognised both by rating agencies and regulators. Multinational insurers manage risk on a global basis using reinsurance. Pooling of insurance risk in one entity in the corporate group facilitates the purchase of external reinsurance. This allows the insurance group to efficiently transfer global risk to third party reinsurers. The group’s efficiency is maximized through centralized pooling of risks from different lines of business across geographies, leading to global diversification of risks with optimal use of capital (a scarce resource) and improved risk management. This optimization reduces the requirements for costly external reinsurance.

The insurance industry is highly regulated and insurers are required to maintain sufficient capital to protect policyholders. Capital is needed for growth and writing new business. Reinsurance is also an effective method of providing capital to subsidiary insurance companies, since regulators can give significant credit for intra-group reinsurance, in recognition of the real transfer of risk. The insurer’s regulator will only agree to the risks being transferred and to the attendant capital reduction if it is satisfied that the reinsurer has the capital and capability to assume and manage the risks. Similarly, the reinsurer’s regulator will only allow the reinsurer to accept the risk if it is satisfied that the reinsurer has the capital and capability to assume and manage the risks. As a result, there are two independent regulators who need to be satisfied that the risks have indeed been transferred to the reinsurer.
Inconsistencies Between Discussion Draft and Part IV

Part IV includes an extensive discussion of the attribution of profits in the insurance and reinsurance sectors. As noted in Part IV, “the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise”, although other elements will also be relevant, and may be located in different jurisdictions or entities, depending on the specific facts and circumstances.\(^1\) Part IV goes on to say:

Once a location performing the insurance risk assumption function has been determined and the respective insurance risk has been attributed to it, it will be necessary to attribute an appropriate amount of assets to that location to back that risk (i.e. assets representing both reserves and surplus). Further, it will also be important to reward other functions in accordance with the arm's length principle. It should also be noted that there is no presumption that these other functions are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of rewards from performing these other functions can be expected ranging from, at one end, low value rewards to at the other end rewards based on a share of the residual profit of the part of the enterprise acting as the key entrepreneurial risk-taker. In short, the functional and factual analysis determines the attribution of profits to the PE in accordance with its functions performed, assets used and risks assumed, and informs also the attribution of assets and investment income to the PE.\(^2\)

Accordingly, we urge that the OECD’s recommendations take into account the unique commercial realities of the global insurance business model. We are concerned that the discussion draft does not better distinguish insurance and reinsurance income from other types of income that CFC rules must be capable of dealing with, such as dividends, interest and other financing income, sales and services income, royalties and other IP income.\(^3\) We strongly agree with the following statement in paragraph 85 of the discussion draft (emphasis added):

Accurately attributing this income does not mean that CFC rules should include all of this income in CFC income. It instead means that, at a minimum, CFC rules should attribute income that raises BEPS issues within each category and should not attribute income that arises from value-creating activity in the CFC jurisdiction. If CFC rules are designed to apply only to stripping of the base of the parent jurisdiction, then income should not be attributed if it arises from value-creating activity in any jurisdiction other than the parent jurisdiction.

\(^1\) See, in particular, paragraphs 68, 69, 93 and 94 of Part IV.

\(^2\) Paragraph 71 of Part IV.

\(^3\) See paragraph 84 of the discussion draft.
Paragraph 102

Paragraph 102 of the discussion draft states:

“The general concern underlying the treatment of income from the insurance of risks is that profits can be shifted away from jurisdictions in which those risks are located and into a low-tax jurisdiction. For example, an insurance company that is licensed to carry on an insurance business in a particular jurisdiction may underwrite insurance policies in respect of persons or businesses located in that jurisdiction and then reinsure some or all of these risks to a CFC that is resident in a low-tax jurisdiction (and that is generally not licensed to carry on an insurance business in the particular jurisdiction), thereby shifting profits associated with the insurance of those risks. In addition groups that are not generally involved in insurance activities may establish “captive” insurance companies (often in a low-tax jurisdiction), and by various means insure risks associated with the groups normal business activities with the captive insurance company, thereby shifting profits to the captive insurance company. Generally speaking, little activity is required in the management of these reinsurance operations or these “captive” insurance operations.”

In regard to paragraph 102, we would like to emphasize that:

1) As noted previously, it is important to distinguish between the location of the CFC’s functions (including risk assumption and risk management) and assets and the location of the related risks. Profits that are properly attributable to the jurisdiction(s) in which key entrepreneurial risk-taking functions are carried on, and through which capital is committed and put at risk, should not be considered to be “shifted away” from any other location, as that would be inconsistent with Part IV.

2) The fact that some profits may be properly attributable to “a low-tax jurisdiction” should not raise BEPS concerns because they do not reflect “cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it”\(^4\) (emphasis added). Of course, the insurance or reinsurance coverage must be properly priced. The jurisdiction in which the risk is located receives valuable benefits resulting from the efficient operations of the insurance market through the spreading and diversification of risk.

Question 11 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 (ii) and (iii)? If so, what are they and how can they be dealt with?

In our view, insurance that creates real economic value does not give rise to BEPS and should therefore not be subject to the CFC rules. Key features to identify reinsurance that creates real economic value include the following:

- the underlying risk involves third party risks outside the corporate group
- the reinsurance contract is priced on an arms' length basis
- insurance is written on a global basis. This enables diversification and pooling of risks in the reinsurer
- the entity has a real possibility of incurring losses
- the entity has the expertise to assume and manage risk in the form of underwriting and actuarial professionals (or such services are available in a related service company). In evaluating whether an entity has sufficient expertise it should be noted that:
  - Reinsurers require significantly less employees than an insurer since there are significantly less contracts to manage (this should be considered in any evaluation of substance under an "employees and establishment analysis" as described in paragraph 89 of the discussion draft).
  - Although insurance groups employ staff in the territories in which they operate, these employees may be employed by a service company of the insurance group. This is a common business model in the insurance sector and is often due to regulatory requirements (for example, EU Life Insurance and Non-Life Insurance Directives).

**Paragraph 112**

Paragraph 112 suggests that, under a categorical approach, "Income from insurance will generally be treated as active (and therefore excluded) unless (1) the income was derived from contracts or policies with a related party or (2) the parties to the insurance contract or the risks insured were located outside the CFC jurisdiction. However, income from insurance that falls under these two exceptions will only be treated as passive (and therefore included) if the CFC was overcapitalised or did not have sufficient substance to assume and manage the risks on its own accord."

Given the importance to insurers of capital and the needs for geographic diversification to spread risks, we do not believe that the requirements above are appropriate since:

1. **any concerns about related party reinsurance should more appropriately be dealt with through transfer pricing rules,** and
2. the requirement that the parties to the insurance contract or the risks insured be located outside the CFC jurisdiction is inconsistent with the need to manage and reduce risks on a global basis through geographic diversification.

In addition, from a practical perspective, there are uncertainties as to how any such rule would apply in practice. For example, it is not clear how "sufficient substance" would be determined in the insurance context. As noted above, any determination of substance should take into account that:
- reinsurance operations require less appropriately qualified staff (such as actuaries and underwriters etc.) to assume and manage insurance risk than direct writers since there are significantly less contracts
- due to regulatory requirements, or other business reasons, staff in the territory may be employed by a service company of the insurance group.

In addition, it is not clear how overcapitalization should be measured for insurers – consideration needs to be given to the fact that, as mentioned previously, insurers need to hold capital in excess of the regulatory capital. It is important to note that insurance operating subsidiaries are in general not overcapitalised since it does not make commercial sense for a subsidiary of an insurance group to hold excess capital, even where the subsidiary is in a low tax territory. Any capital above what is needed for the insurance operations will be passed up to the parent company, to ensure capital can be deployed quickly if needed in another territory to support sales and generate income in other territories.

**Excess profit approach**

Insurance results (profits/losses) are volatile since they depend on uncertain future events. At the time a reinsurance contract is signed, it is not known whether a profit or loss will ensue and the timing of profit/loss recognition is uncertain. Accordingly, an excess profit approach is completely inappropriate for insurance income.

**Recognition of Insurance Losses**

Insurance income is fundamentally different from the other forms of CFC income (dividends, interest and other financing income, sales and services income, royalties and other IP income) since an insurance business can generate profit or losses, whereas the other forms of CFC income generally do not have losses. Given that losses can arise in the insurance business, relief should be available for any losses to either be set off against other CFC profits in the same territory in the same year or to be carried forward in the CFC against profits in later years.

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**About the GFIA**

Through its 38 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 58 countries. These companies account for around 87% of total insurance premiums worldwide. The GFIA is incorporated in Switzerland and its secretariat is based in Brussels.
BY EMAIL

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1 May 2015

Dear Mr Pross

OECD Public Discussion Draft - BEPS Action 3: Strengthening CFC Rules

Grant Thornton International Ltd welcomes the opportunity to comment on the OECD Public Discussion Draft entitled BEPS Action 3: Strengthening CFC Rules, issued on 3 April 2015.

Our observations and detailed comments are set out below.

General comments

As a general rule, we agree with the comment in paragraph 85 of the discussion draft that CFC rules should be designed to apply only to stripping of the base of the parent jurisdiction.

CFC rules must also be compatible with EU law and the principles established in the Cadbury Schweppes case (C196-04) and related jurisprudence which focus on "wholly artificial arrangements" while there should not be a two-tier system differentiating the treatment of EU from non-EU territories.

Additionally, we consider that a CFC regime must have a broad range of exemptions to ensure that CFC rules only apply to real cases of artificial diversion of profits from the parent jurisdiction. No single approach to establishing whether an entity should be exempt from CFC rules is likely to be appropriate.

To minimise the compliance burden on taxpayers and ensure CFC rules are targeted at only real cases of serious tax avoidance, there must be provision for exemptions which can apply to an entity as a whole particularly where this is based in a high tax country, has only a minimal amount of profits or a low profit margin. Newly acquired companies not set up to avoid tax in the parent jurisdiction because they were not previously controlled from that jurisdiction should also be able to benefit from a "period of grace" from the application of CFC rules.

If companies do not meet one of these broad exemptions, then the rules should focus on whether the activities that generate the CFC’s profits are in fact located in the parent jurisdiction so that there can be said to be diversion of profits from the parent entity. This should not be an all or nothing approach and instead should focus on a company’s individual profit streams, some of which may be good and others potentially bad from a CFC perspective.
Additionally, there should remain scope for the use of offshore finance companies and group insurance vehicles particularly where such entities transact only with companies that are themselves exempt CFCs and not with the parent entity. In such situations, there should not usually be much possibility of artificial diversion of profits from the parent jurisdiction subject to certain limitations which we consider further in our detailed comments below.

Our general comments above and more detailed views expressed in the remainder of this document are mainly based on our practical experience of the recently introduced UK CFC regime which applies to accounting periods beginning on or after 1 January 2013. During the consultation process for this regime which began in 2007, many issues similar to those mentioned in the discussion draft were considered at length. For that reason we believe that the UK CFC rules represent a suitable example of best practice in this area of international taxation.

The length of the consultation process for the UK CFC regime was approximately six years which highlights the difficulty of this area of international tax law and would suggest that the OECD’s timescale for making recommendations is unrealistic. If such recommendations are not fully considered they are likely to be unworkable in practice and could in fact lead to loopholes and opportunities for tax avoidance.

We therefore suggest that the OECD does not make any detailed recommendations but focuses instead on publishing a detailed survey of best practices. This information could be obtained by the OECD directly from the tax authorities of the relevant territories which might include the UK, US and Germany, for example. Member countries without comprehensive CFC legislation can then understand the options which might be available to them to combat tax avoidance through the artificial diversion of profits from their jurisdiction.

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?**

   The discussion draft notes that CFC rules should apply to transparent entities in two cases: where entities that are not taxable in one jurisdiction are subject to tax in the parent jurisdiction and where entities that would otherwise not be taxable are owned by another CFC.

   Given that the income of transparent entities is often treated as taxable in the hands of the interest holders as opposed to the entity itself, we do not consider that such a transparent entity should be treated as a CFC. In particular, if such vehicles were characterised as CFCs, this could lead to potential double taxation if their income were included as CFC income of another entity higher in the ownership chain.

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

   Not all territories apply the same approach to establishing whether an entity is transparent or opaque for tax purposes which could lead to inconsistency of treatment for CFC purposes. In this situation, it may be consistent to apply the entity classification approach used by the immediate parent jurisdiction of the relevant entity.

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

   It should not be necessary to incorporate specific anti-hybrid measures into CFC legislation where such measures already exist in calculating the actual profits of the relevant entities under their domestic laws, including the parent company of the CFC entity. This conclusion assumes that the parent company computes the profits of a non-exempt CFC using the normal tax principles applying to an entity which is resident for tax purposes in the parent company's jurisdiction.
Chapter 3: Threshold Requirements

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

Compliance burden

A low-tax threshold based on an effective tax rate calculation could impose a significant compliance burden in terms of having to apply the parent company's tax rules to the profits of the CFC, particularly if this was to be the only test available of whether an entity is a "bad" CFC. This would be a huge amount of work for many groups in all but the most straightforward cases.

Where a low-tax threshold is to be used it should apply on a company by company basis as this would be a simpler approach than a calculation using a country by country approach as not all companies in a single jurisdiction may exist with the purpose of artificially diverting profits.

Therefore, while a low-tax threshold test is one possible test that should be used, to mitigate the potential compliance burden, it is important for a country's CFC regime to impose alternative tests such as a "black" or "white" list (with additional safeguards which restrict the amount of "bad" or low tax income of the CFC to a negligible amount such as 10%).

There may also be grounds for completely excluding foreign entities from CFC legislation (subject to an overriding main purpose test) which are based in much higher tax jurisdictions such as the US, Australia, Canada, France, Germany and Japan as with the UK's CFC exemption for excluded territories. Such alternative tests may often be simpler to apply in practice yet still remain appropriately targeted against artificial diversion of profits.

Consistency with other BEPS measures

There is no mention of BEPS Action 6 concerning harmful tax practices in the discussion draft other than in the introductory section at paragraph 5. There may be merit in linking CFC measures with known harmful tax practices either by specifically including them on a "black" list subject to minimum income thresholds. However, this may be too narrow an approach as it may mean that certain other potentially harmful tax practices not already identified do not fall within the ambit of CFC rules.

Again, the approach in the UK CFC legislation regarding the CFC exemptions known as the tax exemption and excluded territories exemption may provide a practical solution in additional to a simple low-tax threshold test. The tax exemption is specifically prevented from applying in situations where the CFC's territory operates designer rate rules which would allow the CFC to choose its own effective tax rate so that can meet the thresholds of a local tax based CFC exemption in its parent company's jurisdiction.

The excluded territories exemption does not apply where the greater of 10% or £50,000 of a CFC's income is "bad". Bad income for this purpose includes:

- income the tax on which is reduced under investment incentives or tax rulings or falls to be repaid to any person
- non-local source non trading income (i.e. "mobile" income) that is offset by notional deductions on equity
- profits have not been subject to one-sided transfer pricing adjustments
- trust or partnership income which is not included in accounting profits; and
- income of the above from permanent establishments in third territories that are excluded countries and which would fall within any of the other "bad" categories above if the PE were a CFC resident in its country of establishment.

There are also two further tests applying to the company as a whole which focus on whether the company has been involved in an arrangement with a main purpose of obtaining a UK tax advantage for any person and whether intellectual property has been transferred to the company from the UK in the last six years.

In terms of a minimum level of tax to which a CFC should be subject in its territory of residence we note that the foreign tax threshold in the third-country PE anti-abuse measures in BEPS Action 6 is 60%.
Accounting mismatches

There may be mismatches between local accounting rules and the accounting rules of the parent jurisdiction in terms of establishing the profit before tax of the company as the starting point for the taxable profits calculation.

5 How could these problems be addressed or mitigated?

Please see our comments in 4 above.

In addition, to address the potential problem of accounting mismatches, CFC rules could prescribe what acceptable accounting practice should be used which, as with the UK CFC rules, could be local GAAP, GAAP in the parent jurisdiction or IFRS.

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

The discussion draft states at Paragraph 41 that if CFC jurisdictions exempt PEs from taxation, the effective tax rate of PEs of a CFC should be calculated separately from that of the CFC to ensure that the tax rates of the PE and CFC cannot be blended to avoid the low-tax threshold.

While we note this as a potential option, the alternative referred to above under question 4 in relation to the UK excluded territories exemption from the UK CFC rules may also be a viable solution as it should result in a reduced compliance burden.

We would in any case expect this issue to become more prevalent following the implementation by OECD countries of BEPS Action 7 concerning the artificial avoidance of PE status and so a practical solution that does not increase the compliance burden for taxpayers will be essential.

It should also be noted that the UK applies its CFC rules with certain minor modifications to foreign PEs of UK tax resident companies which have elected for their foreign PEs to be exempted from UK corporation tax. Therefore, there should generally be no UK tax advantage for a UK parent company from doing business through a foreign PE compared with a foreign company.

Chapter 4: Definition of control

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

Control threshold

We consider practical problems are most likely to arise where the control threshold in a CFC regime is too low, e.g., where this encompasses an unconnected minority shareholder owning in excess of 10% of a CFC but less than 40%. By way of analogy, 40% is the threshold for a UK company’s interest in a joint venture to be treated as a CFC but only where the other (non-UK resident) joint venture partner also holds at least 40% but no more than 55%, given that a joint venture partner owning more than 55% is likely to be able to control the joint venture outright.

It is rare in practice for holders of interests of less than 40% effectively to exercise control over a company. Where they “act together” this will typically be for wholly commercial reasons to ensure efficient corporate governance and not to avoid taxes.

Protected cell companies and incorporated cells

Special rules may be needed to deal with protected cell companies and incorporated cells which are forms of entity which exist in certain jurisdictions.

A protected cell company is essentially a single legal entity comprised of a core and several cells that have separate assets and liabilities, so that the assets and liabilities of a cell are legally ring-fenced from those of other cells. The core capital of the cell is typically held by a third party who exercises control over the protected cell company as a whole, with the core often providing financial management services to the individual cells which are usually owned by non-connected companies.

In substance, an individual cell is like a separate company but it is not always caught by CFC rules of a parent jurisdiction because the wider protected cell vehicle is held by a third party.
Interests in protected cells are typically used to hold investment income or assets of insurance companies which are required for the purposes of meeting future liabilities of the insurance business. In practice, it may be more commercial to structure part of an insurance business in this way to have access to financial management and other services and to ring-fence certain business from a regulatory perspective.

In substance, each cell could be viewed as separate company but from a legal perspective there is only one corporate vehicle. Additionally, where a protected cell company is comprised of a number of cells each owned by third parties, it would also not be possible that any owner of a particular cell can exercise economic control.

More recently, the legal concept of an incorporated cell company has been developed by some jurisdictions. Such vehicles are typically established under the articles of a foreign company and have separate legal personality from the latter company but which are not themselves companies. As the incorporated cell is not a company per se, it may not be treated as a CFC under the parent jurisdiction's CFC legislation.

The UK CFC rules contain specific provisions dealing with individual cells including incorporated cells whereby they are treated as separate companies for CFC purposes. Therefore, the UK CFC rules, including exemptions if relevant, apply to each cell in isolation.

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?

Please refer to the response to question 7 above.

Chapter 5: Definition of CFC Income

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

In practice, the key issue is likely to be complexity and the compliance burdens which could be generated along with potential uncertainty of treatment. To mitigate these problems, it will be important to choose an approach which is consistent with existing OECD principles.

In this respect we note from page 8 of the discussion draft dated 31 October 2014 concerning BEPs Action 7 that the OECD does not propose significant changes as part of its BEPS initiative to its existing policies on the attribution of profits to PEs (as set out in the July 2010 OECD Report on the Attribution of Profits to Permanent Establishments). Therefore, a substance analysis approach which mirrors these existing profit attribution policies, as with the current UK CFC regime, would appear to assist with managing the practical position.

Such an approach is particularly apt given the OECD proposes that CFC legislation should also be applied to foreign permanent establishments (Paragraph 30 of BEPS Action 3 discussion document).

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?

We would draw your attention to the UK CFC rules which follow the approach mentioned in 9 above. In addition, the UK CFC rules contain a number of different safe harbours which focus on such factors as the main purposes of the CFC's trading activities and whether these are intended to avoid UK tax, whether a substantial amount of the profits of the CFC are generated by significant people functions in the UK, e.g. in circumstances which would not be found in arm's length situations and whether, amongst other conditions more than 20% of the CFC's income is derived from the UK.

Safe harbours approaches such as the above mean that CFC rules should generally only target real cases of serious tax avoidance. They can also be used in the context of mobile income such as passive interest income earned by trading or holding companies. Broadly, the UK CFC rules do not tax such profits unless they comprise more than 5% of trading profits or exempt dividend income of the relevant entity. In addition, safe harbours exist for example where a CFC holds interest-generating funds on a short-term basis pending the payment of dividends or planned investment in trading assets.
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?

(i) Please refer to the response to question 9 above. In addition, CFC rules could consider whether the regulated entity is excessively capitalised or has excess free assets compared with the position that the local regulator would require in an arm's length situation (plus a prudent commercial buffer). An alternative test could be based on the regulatory requirements of the parent company's jurisdiction although this is likely to impose a significant additional compliance burden in requiring consideration of a hypothetical regulatory scenario. Any such CFC rules would need to make concession to special business circumstances of the CFC e.g. where additional capital is needed for ratings agency purposes or because the CFC is entering into a new market.

(ii) Please refer to (i) above. It is of specific note here that the July 2010 OECD Report on the Attribution of Profits to Permanent Establishments focuses on the underwriting function as being the key function of an insurance enterprise. Therefore, if the underwriting function is properly established in the CFC's territory of residence the scope for CFC taxation should be limited. Also, the relevant CFC rules could focus on whether the tax avoided in the parent’s jurisdiction from the reinsurance arrangement exceeds the non-tax financial benefits of the reinsurance which might include freeing up regulatory capital in the parent and other jurisdictions to write additional business that would generate profits taxed at normal rates. In this respect, we do not believe it would be appropriate for the parent jurisdiction of the CFC to be able to tax income which is diverted from subsidiaries in other jurisdiction. In this situation, it is up to the fiscal authorities in such other jurisdiction to impose their own restrictions such as deeming the reinsurer to have a local PE.

(iii) We consider that the same approaches as identified in (i) and (ii) above should apply to (iii) as these should also help to establish whether the captive insurance company is effectively dealing with affiliated companies on arm’s length terms and reducing their external insurance costs or simply diverting profits in an artificial way.

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

Please refer to 9 and 10 above. In addition, a number of entity-level exemptions in the UK CFC rules are based on IP not being transferred to the CFC from the UK in the preceding six years.

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

Please see 9 – 12 above.

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

We note that the discussion draft does not consider property income. However, such income is typically not mobile as it can generally only arise in the territory where the property is actually located. Therefore such income is not usually at risk of leading to artificial diversion of profits from the parent company's jurisdiction.

A potential exception to this rule may exist where property located in the parent jurisdiction is held through a company resident in a different territory. This is not generally a problem under the UK CFC rules however, since non-UK resident landlords are subject to UK income tax at 20% on UK source rental income. This rate of income tax is the same as the UK corporation tax rate which would apply if the foreign company holding the UK company was UK resident.

A number of groups have offshore finance companies which receive interest income from entities in other jurisdictions. Again, there should not be any scope for artificial diversion of profits from the parent jurisdiction if such vehicles are not used to finance the parent or other group companies in the parent’s jurisdiction. In addition, safeguards need to be in place so that finance companies are not
used to make loans to group companies that are not exempt CFCs and so would be able to use interest
deductions to reduce their own CFC income.

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

For the reasons mentioned in 9 above, it is not practical or helpful to employ an excess profits
approach as this is not consistent with other related OECD principles concerning the attribution of
profits.

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

Please see 9 - 15 above.

17 How could the practical problems be addressed or mitigated?

Please see 9 - 15 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?

Please refer to 9 -15 above. It is possible that an excess profits approach might be suitable in cases
where IP is held only as a passive investment. However, the same result is likely to be achieved
through following the approach set out in 9 above where there CFC owning the IP does not exercise
any significant people functions in relation to the IP. Hence, there does not appear to be any merit in
employing a different set of rules for 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?

Please refer to 9 – 15 and 18 above.

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

Please refer to 9 – 15 and 18 above.

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

With its current CFC regime, the UK has moved from a pure entity approach to an approach which
still focuses on the entity to determine whether a CFC charge should apply, but then, if certain entity
level tests are not met, applies a more transaction based threshold tests to determine the actual income
chargeable. This combined approach allows the practical aspects of each approach to be adopted e.g.
an entity based approach to determine first which companies could be subject to a CFC charge
combined with a multiple range of further filters to mitigate the compliance burden.

This type of system provides protection from the significant disadvantages of following a single
approach i.e. the compliance burdens of a transaction based approach and the risk of swamping bad
income with good income under an entity basis.

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

Please see 21 above.

In addition, it is likely that taxpayers will be prepared to deal with some level of compliance work to
confirm if subsidiaries are carrying out activity or earning income which has a genuine risk of being
within both the scope and the intention of CFC rules. However, businesses should not have to carry
out a major amount of work to confirm that no CFC charge arises, when it is clear that the activities of
the company were never going to be, or were not within the intended scope of CFC rules.

Taxpayers with non-controlling interests in CFCs may find it very difficult to obtain the information
necessary to carry out a full CFC analysis. This emphasises the need for the control and attribution
thresholds for CFCs to be reasonable and not too low.
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?

Please refer to our comments on questions 9 - 15 and 18 above.

Chapter 6: Rules for computing income

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?

We consider that the first option for computing CFC income which is to apply the tax laws of the parent jurisdiction is likely to be the most robust and effective method as it should ensure the CFC is treated in the same way as if it was resident in the same territory as its parent. This should produce a sensible and equitable result as it would mean that only profits that would be taxable under the parent territory’s tax laws would be picked up for CFC purposes.

OECD member countries should have freedom as to whether capital gains should be included or not within domestic CFC rules. However, there are strong policy arguments not to include capital gains given that the aim of CFC rules is to capture mobile income and not long-term capital growth.

The second, third and fourth options set out in this chapter for computing income do not appear to meet the real objective of CFC rules which is to prevent artificial diversion of profits to low tax jurisdictions where these profits would be taxable under the rules of the parent jurisdiction if they were not diverted, while the final option is too complex to be viable.

We agree that the second option may allow for less income to be attributed under CFC rules and hence create tax planning opportunities while it would be administratively burdensome to apply different tax rules to individual CFCs if they are located in separate jurisdictions.

Allowing the taxpayer to choose between the rules that could apply to compute a CFC’s profits could also create complexity and uncertainty while potentially creating planning opportunities if the choice of the rules of one jurisdiction offered distinct advantages from a tax perspective.

The fourth option would potentially require the development of an entirely new tax regime to be applied solely to CFCs and would presumably require detailed consensus of all OECD member countries. This would be a very ambitious approach that is unlikely to be practical or achievable in the remaining timescale for the BEPS project. It would also risk the creation of new loopholes and planning opportunities.

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

We consider that greater coherency and simplicity would be achieved by restricting the use of CFC losses to other income of the same CFC. This should also reduce the scope for further tax avoidance. Also, such an approach should follow the usual principles of the tax law of the parent jurisdiction which may allow such losses to be offset against other income of the loss-making CFC of the same period or carried back or carried forward to offset prior or future profits.

However, the parent company should not be prevented from using its own tax losses (or losses claimed from other group companies in the parent jurisdiction under local group relief or tax consolidation rules) to offset CFC profits. There should be only a minimal risk of tax avoidance in this situation as such losses would then not be available for offset against other profits in the parent jurisdiction so there should not be instances of double non-taxation.

Chapter 7: Rules for attributing income

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

An ownership threshold of only 10% for attribution to be required is likely to be too low in practice as holders of such small interests in CFCs are unlikely to be able to exploit them for tax avoidance purposes.

A more practical approach, as is the case with the UK CFC legislation, would be not to tie the attribution threshold to the control threshold. For example, the attribution test could require the interest-holder to have a stake of at least 25% and only in situations where the foreign entity is already regarded as controlled from the parent jurisdiction because entities (even if not connected with one another) resident in the latter jurisdiction already control more than 50%.
A 25% test may need to aggregate holdings of connected persons to help reduce the scope for avoidance.

As a general rule, if the interests in the CFC comprise only ordinary shares, then attribution of profits on a pro-rata basis by reference to the extent of the ordinary shareholding should be appropriate. However, there may be instances where there are different types of interests in a CFC e.g. different classes of shares with varying income rights including preference shares for example. In this situation, the attribution of CFC income should be carried out on a "just and reasonable" basis.

This may mean that in some situations a parent entity that controls an CFC and holds the greater part of its share capital would not be subject to an attribution of its profits if the other interest holders in practice are entitled to all of the CFC’s income. Clearly, the position could then vary from year to year depending on the level of profitability of the CFC and the nature of the various interests.

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

We consider that parent jurisdictions should be able to exercise their discretion as to the rate of tax that should apply to CFCs and whether they wish to adopt a top-up tax approach. However, we note that there is the potential with a top-up tax approach based on a minimum tax rate for artificial structuring of a group's operations to move the holding of overseas operations to benefit from more generous CFC rules.

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?

Where an entity is subject to the CFC rules of more than one parent jurisdiction, it needs to be considered which parent jurisdiction should have the primary taxing right. Alternatively, the UK CFC rules adopt a more "territorial" approach and give credit for CFC tax paid in any territory i.e. not just that of a subsidiary jurisdiction but also that of an ultimate parent based outside the UK.

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

Please see 28 above.

Yours sincerely

Global head - tax services
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STRENGTHENING CFC RULES: OECD PUBLIC DISCUSSION DRAFT

ICAEW welcomes the opportunity to comment on the public discussion draft *Strengthening CFC rules* published by OECD on 3 April 2015.

This response of 1 May 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty’s Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

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Ten Tenets for a Better Tax System

Appendix 1
ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW’s regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 144,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
INTRODUCTION

1. We welcome the opportunity to comment on the public discussion draft Strengthening CFC rules published by OECD on 3 April 2015.

GENERAL COMMENTS

Overall comment

2. The CFC rules of a parent company/entity jurisdiction should not seek to tax the activities of overseas controlled companies/entities where (1) there are genuine economic activities in the overseas territories and (2) within an EU context those activities are not wholly artificial; the latter concept is important and should not be confused with a balanced application of taxing rights, which is a separate concept. We comment separately on these EU issues in paragraphs 6 to 13 below.

Definition of CFC income

3. We think that the success, or otherwise, of the ultimate OECD recommendations on CFCs will depend on the definition of CFC income. It is accepted in paragraph 83 that full inclusion and excessively broad partial inclusion systems go beyond what is necessary to prevent BEPS and may ultimately impact negatively on international trade and growth. We believe that the objective of CFC rules should be to seek to tax activities in the territories where there are genuine economic activities.

Countries taking unilateral action

4. We are concerned that if a number of the 62 countries now engaged in the BEPS Action Plan decided to take unilateral action, as the UK has done with its Diverted Profits Tax, which Australia may also now introduce when it announces its Budget on 11 May this could lead to disastrous confusion and a serious undermining of the BEPS project which is supposed to create international coordination and a collective approach to international tax recalibration.

CFC rules should not be asymmetric

5. If a CFC makes a profit, then a loss and then a profit in three succeeding accounting periods then any CFC rules should take into account the intervening loss in determining what element of the second profit, in the third accounting period, should be attributed to the "parent" company.

CFC rules applied to EU Member States (MSs) must comply with the judgments of the Court of Justice of the European Union (CJEU)

6. In the rest of this submission we present an analysis of CJEU judgments as it will be important to ensure that the final recommendations of OECD are compliant with EU law and can, potentially, be adopted by the 28 EU Member States.

7. The need to comply with the judgments of the CJEU is recognised at paragraph 11 of the discussion draft:

“…it is generally acknowledged that the European Court of Justice’s case law imposes limitations on CFC rules that apply within the EU (European Union).”

8. We have some concerns with the analysis of the CJEU judgments in the subsequent paragraphs of the discussion draft.

9. The Thin Cap Group Litigation and SGI cases mentioned at bullet points 3 and 4 in paragraph 14 were in relation to transfer pricing and not CFCs. There is a distinction as to the application of the wholly artificial concept for CFCs (under Cadbury Schweppes) and a balanced allocation of taxing rights in relation to transfer pricing.

10. We also do not believe that the final statement in the second bullet point of paragraph 14 is correct “if a CFC rules treats domestic subsidiaries the same as cross-border subsidiaries, it
arguably should not be treated as discriminatory under the case law of the ECJ (sic)” and footnote 10 cites the legislation in Denmark. Our reason for this is because in the CJEU’s Cadbury decision, the Court compared the position of subsidiaries established in different MSs, and not just Irish versus domestic subsidiaries.

11. Moreover, Deutsche Shell shows that the restriction of forex losses with regard to a Permanent Establishment in another Member State was an unlawful restriction on Freedom of Establishment even where there could be no domestic comparator, as German law prohibited accounting for German operations in anything other than the D-mark. So extending CFC to domestic subsidiaries may still be an impermissible restriction even though no longer discriminatory.

12. To summarise, in Cadbury Schweppes the CJEU used a second comparison of Irish subs (held to be a CFC) compared with Dutch subsidiaries, which were not CFCs (because they did not benefit from a low tax rate), so the discussion draft does not take into account either the Deutsche Shell restriction case or the second comparison in the Cadbury Schweppes case even though quoted in paragraph 14.

13. We do have more sympathy with the Thin Cap GLO comment, but we believe it is incomplete. Paragraph 81 which is quoted in the text does indeed state that the Court should determine “whether the transaction represents, in whole or in part, a purely artificial arrangement”. But paragraphs 92 and 133 use the phrase “the existence of a purely artificial arrangement”. Paragraph 81 is of course a reference to the excess over arm’s length being a distribution or otherwise disallowed, so it is understandable that the CJEU in this context refers to the transaction being “in whole or part, a purely artificial arrangement”.
ICAEW TAX FACULTY’S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person’s tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

Mexico City, May 1, 2015

Via email

CTPCFC@oecd.org

Mr. Achim Pross
Head of the International Co-operation
and Tax Administration Division OECD/CTPA

Dear Mr. Pross,

On behalf of IFA Grupo Mexicano, A.C. (Mexican branch of the International Fiscal Association), please find below our comments on the Public Discussion Draft “BEPS ACTION 3: STRENGTHENING CFC RULES” (the “Discussion Draft”). Comments are divided by Chapter and, within each Chapter, reference is made to both the Recommendations and certain Questions for consultation.

CHAPTER 2: DEFINITION OF A CFC

I. Recommendations

We agree with the Recommendations in paragraphs 30-31 of the Discussion Draft.

- Questions for consultation

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

We support the narrow option over the broad option since the latter could potentially subject more income to CFC taxation than is necessary to combat BEPS. However, we note that further work needs to be undertaken in order to clearly define when a payment is “base eroding”.

CHAPTER 3: THRESHOLD REQUIREMENTS

I. Recommendations

We agree with the Recommendations in paragraph 43 of the Discussion Draft.

In such regard, we consider that the low-tax threshold should compare the tax rate in the CFC jurisdiction to a percentage of the tax rate of the parent country’s own rate (i.e., at the most 75% of the statutory corporate tax rate).

We also believe that, for purposes of calculating the effective tax rate, the denominator should be the tax base in the parent jurisdiction had the CFC income been earned there (as opposed to the tax base computed according to an international accounting standard).
Regarding the “unit” used for the calculation, we favor the broad approach on a company-by-company basis, as using other units would increase both the administrative complexity and compliance burden associated with the low-tax threshold.

Finally, we consider that the abovementioned features would, at the same time, address BEPS concerns and grant certainty to taxpayers.

- Questions for consultation

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

Our experience shows that practical problems often arise in calculating the tax base in the parent jurisdiction (i.e., Mexico) had the CFC income been earned there, particularly in relation to timing issues, foreign exchange (FX) gains/losses and taxable/deductible inflationary adjustments, since other jurisdictions recognize certain items of income at a different moment or do not recognize FX or inflationary effects at all.

5. How could these problems be addressed or mitigated?

We consider that both FX gains/losses and inflationary adjustments should not be included for purposes of calculating the effective tax rate, since such gains/losses or adjustments are dependent on the particular situation of the parent jurisdiction and not on that of the CFC jurisdiction.

CHAPTER 4: DEFINITION OF CONTROL

I. Recommendations

We agree with the Recommendations in paragraph 65 of the Discussion Draft.

Regarding the level of control, we consider that (a) control should be found when the parents own more than 50% control; (b) in order to determine whether or not minority shareholders are acting together, a focus on related parties must capture most structures that raise BEPS concerns; (c) non-residents should not be taken into account in determining the level of control; (d) control should be defined to include both direct and indirect control; (e) control should be found if the control threshold is met at each level of the chain of ownership; (f) control should be established at the end of the year, including an anti-abuse provision; and (g) CFC rules should consider interests held by all resident taxpayers.

- Questions for consultation

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?
Yes. Applying a control test that considers interests held by unrelated or non-resident parties, particularly in the “acting-in-concert” version, will probably create significant administrative and compliance burdens (e.g., lack of information available, uncertainty, disputes). These burdens could be dealt with by designing a control test with the features mentioned above.

CHAPTER 5: DEFINITION OF CFC INCOME

- 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?

We consider that the main problem with all of the substance analyses is that they would probably lead to uncertainty, if they are stand-alone rules and are not applied alongside other more mechanical rules.

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

We suggest clarifying how should other categories of income (e.g., rents, other income) be treated.

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

It is not clear how would other categories of income be treated (e.g., rents, other income).

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, in principle, the categorical approach attributes income more accurately than the excess profit approach. However, the latter when combined with a substance-based exclusion might become a simpler and more mechanical approach than that required by a substance analysis. If that were the case, we would favor option 4 for the risk-inclusive rate of return and using the tax basis of tax acquisition cost for the valuation, as determined under the law of the parent jurisdiction.

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

We favor the entity approach over the transactional approach since the former reduces administrative burdens.

22. What concerns arise from the two approaches in terms of administrative burdens and compliance costs?
We believe that the entity approach is more appropriate than the transactional approach in the context of developing countries, since it is easier to administer for both taxpayers and tax administrations.

I. Others

For purposes of determining if the different types of income received by the CFC (interests, dividends, etc.) shall be considered as CFC income or not, depending if they derive from an active trade or business, the possibility of requesting a ruling before the local tax authorities of the parent jurisdiction confirming such situation could be established, specifically in those cases in which there is uncertainty.

This alternative would grant legal certainty to taxpayers, although they shall bear the administrative burden of providing the tax authorities all the necessary documents demonstrating that the referred income derives from an active trade or business.

CHAPTER 6: RULES FOR COMPUTING INCOME

I. Recommendations

We agree with the Recommendations in paragraph 131 of the Discussion Draft.

- 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?

On the question of whether the use of losses should be limited to offset against profits of the similar character (e.g., passive losses against passive profits), once again we consider such a limit would cause administrative complexity and increased compliance burdens. A related issue would be how to properly identify expenses that resulted in both active and passive losses with only one of them; an allocation rule would be needed in such regard.

CHAPTER 7: RULES FOR ATTRIBUTING INCOME

I. Recommendations

We agree with the Recommendations in paragraphs 142-143 of the Discussion Draft. We believe, however, that the attribution threshold should be tied, or at least very much aligned, to the minimum control threshold, as to reduce the administrative complexity and compliance costs of the rules.

We further consider that the attributed income should be treated as having been earned by the taxpayer directly, in order to reduce the need for any separate characterization rules.
- Questions for consultation

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

One of the most important difficulties in such regard arises when the attribution threshold and the minimum control threshold are not aligned and, thus, the determination of how much income should be attributed does not capture the taxpayer’s influence on the CFC.

CHAPTER 8: RULES TO PREVENT OR ELIMINATE DOUBLE TAXATION

I. Recommendations

We agree with the Recommendations in paragraph 155 of the Discussion Draft.

II. Others

Regarding the sale of shares of a CFC in which the taxpayer holding the shares has already been taxed on undistributed income of the CFC, another alternative (besides not taxing the sale) in order to avoid double taxation, could be to increase the tax cost basis of the shares with said undistributed income recognized by the taxpayer (after tax).

* * *

The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA branch and in no case in the name or on behalf of Central IFA or IFA as a whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano, A.C.
May 1, 2015

BEPS Action 3: Strengthening CFC Rules
Comments by the Insurance Company Working Group on BEPS

Introduction and summary of recommendations

These comments are being submitted to the OECD by the Insurance Company Working Group on Base Erosion and Profit Shifting (BEPS), who were members of a group of global insurance and reinsurance companies, in response to the public Discussion Draft released on 3 April 2015 by the OECD entitled “BEPS Action 3: Strengthening CFC Rules.” Our companies include numerous controlled subsidiaries and branches based outside the parent company’s jurisdiction that are actively engaged in the business of insurance or reinsurance. We have several concerns with the discussion of insurance and reinsurance income on page 43 of the Draft. We hope this submission will further the OECD’s understanding of the insurance business and its regulation, an understanding that is critical in developing practical CFC rules that are consistent with our business models and the regulatory regimes that overlay and are integrated into all our business functions.

We also have concerns that several of the general “triggers” relating to when CFC rules should be applicable are inconsistent with industry practices and thus would have unintended consequences. Most importantly, we believe the arms-length standard as interpreted by the OECD applies in such a manner that CFC rules generally would not be necessary to ensure that regulated insurance and reinsurance companies do not create a BEPS problem. CFC rules should therefore only act as a back stop and anti-abuse regime, particularly in circumstances where tax policy makers are concerned that arms-length transfer pricing standards may not produce the right results from a tax policy perspective.

As a key standard, paragraphs 85 and 86 of the Draft recognize that CFC rules “should not attribute income that arises from value-creating activity in the CFC

1 The members of the Working Group are AIA Group Limited; American International Group, Inc.; MetLife, Inc.; Prudential Financial Inc.; Prudential plc; Swiss Reinsurance Company Limited, and XL Group plc
jurisdiction” and that CFC income should not include income that was earned in the course of an active trade or business. It follows that, in response to question #11 on page 45 of the Draft, we believe that the active insurance or reinsurance income of a multinational insurance group should not be subject to CFC rules when:

- The insurance or reinsurance income relates directly or indirectly to insured or reinsured risks of third parties;
- The relevant entities within the insurance group are subject to regulation and, in the case of reinsurance, the transactions are subject to the approval or oversight of the regulators in the country in which the third-party risk was originally insured and in the country in which the insurance is being ceded;
- The relevant entities are sufficiently capitalized according to applicable regulatory requirements at both the group-wide and local levels; and
- Profits and losses are allocated to CFCs in accordance with the guidance under the OECD Part IV report,\(^2\) which applies the separate legal entity approach in order to allocate profit or loss to the respective parts of a multinational insurance group. OECD Part IV, and its subsequent adoption into domestic laws and tax treaties, is widely regarded by both tax authorities and insurers as a reasonable and fair approach to taxing multinational insurers.

**Insurance income and reinsurance within a regulated insurance group**

Turning to the discussion of insurance income in paragraphs 102-104 of the Draft, we would like to illustrate that reinsurance within a multinational insurance group is done for valid business reasons. We think it would be helpful to explain the nature, economics, and regulation of the insurance business.

The separation of profits from the business operations that produced them, which is the concern underlying the BEPS Action Plan, is not generally found in a regulated insurance group dealing with third party risks because financial regulations require the group’s operating entities to hold sufficient capital and to have managers and other staff with necessary training and experience to

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\(^2\) OECD Report on the Attribution of Profits to Permanent Establishments, Part IV—Insurance (22 July 2010) ("OECD Part IV")
prudently manage the business. The OECD has previously recognized this in guidance\(^3\) stating that:

*The significant people functions relevant to the assumption of risk and the significant people functions relevant to the economic ownership of assets will vary from business sector to business sector.... For example, in the case of financial assets of financial enterprises, the same significant people functions will generally be relevant both to the assumption of risk and to the economic ownership of those assets.... Because of the special relationship between risks and financial assets in those specific sectors, the authorized OECD approach uses the “key entrepreneurial risk-taking function” (“KERT function”) terminology in describing the functions relevant to the attribution of both risks and assets....*

The OECD has recognized that the KERT function of an insurance or reinsurance operation is the assumption of insurance risk, as it is this function that puts capital at risk and drives profitability.\(^4\)

Insurance and reinsurance companies use a variety of strategies to manage the risk that they take on in their business. A key strategy is the use of reinsurance contracts to transfer risks between entities, and to pool risk in as capital-efficient a manner as possible.

It is important that tax administrators respect intra-group reinsurance within a multinational insurance group as a business-driven transaction and recognize that entities should be compensated for bearing risk based on the arm's length principle.

Without the global management and diversification of risk that is made possible by reinsurance, the demand for marketable and affordable insurance coverage in particular locations around the world – locations that, for example, are prone to hurricanes and other natural disasters – would far exceed the capacity of insurance companies in the particular jurisdiction. Many of the largest insurance and reinsurance markets, while located in centers such as London, Bermuda or Munich, are markets for the placement of *global* wholesale risks by airlines, shipping firms, engineering groups, professional services firms seeking indemnity coverage, etc. This is because, without diversifying geographical risks, no property and casualty

\(^{3}\) OECD Report on the Attribution of Profits to Permanent Establishments, Part I – General Considerations, paragraph 16 (22 July 2010).

\(^{4}\) OECD Part IV, paragraphs 68 and 69.
insurance group would be able to operate on a commercial basis in one country or region given the additional capital requirements that would be generated due to the risk concentration.

Reinsurance is used in both the life and non-life insurance sectors as a tool for managing risk and capital. In the life insurance sector, reinsurance is typically of long duration and is widely used to manage longevity risk and mortality risk. Regarding property and casualty insurance, according to AM Best's 2013 Global Reinsurance Segment Review (September 2013), over the last few years worldwide catastrophes have resulted in $190 billion of insured losses, with an inflation-adjusted 10-year average per year of about $61 billion. These losses are ultimately funded through the global reinsurance market.

In summary, reinsurance (both external and intra-group) is a means to:

- Provide insurance capacity to the markets, particularly smaller markets -- for example those vulnerable to natural catastrophes where local insurers may not otherwise be able to meet liabilities or lack diversification within their portfolio.
- Smooth volatility, reduce capital requirements, and improve returns to investors.
- Access expertise and knowledge of specific markets, products, and risk management solutions.

Intra-group reinsurance, within a multinational insurance group, is a means to:

- Manage capital at the level of the insurer, also reducing the risk of "stranded capital" which could happen if other forms of capital were used instead.
- Protect the local insurer against significant insurance losses arising on the business it has underwritten.
- Pool risk and accordingly achieve diversification, which inherently frees up capital to be used most efficiently. This freed-up capital can then be used in a number of ways, including being redeployed to write more business either in new or existing markets, retained at the parent company level to provide a capital buffer for efficient deployment in times of stress, or returned to shareholders.
- Satisfy regulatory requirements, which under Solvency II reward the pooling and diversification of risks.
- Allow for the movement of capital in order to manage liquidity risk.
• Obtain greater purchasing power by combining risks before seeking external reinsurance.

In most reinsurance contracts, there are no significant transfer pricing issues associated with the pricing of the risks. For example, in quota-share reinsurance, the primary insurer transfers a pre-determined percentage of its gross premiums, claims and acquisition costs to the reinsurer, whether on a whole account or line of business basis. The reinsurer would typically pay the primary insurer a ceding commission to compensate for passing on the business and to cover the expense ratio associated with the partially ceded book of insurance business. The pricing of the risk is determined on an arm's-length basis based on the original premiums and risks accepted by the primary insurer, with the premiums paid to the reinsurer being directly commensurate with the underlying risk.

In considering whether related-party reinsurance gives rise to BEPS concerns, the importance of financial regulation cannot be over-emphasized. Because regulators simply do not allow risk to be borne in an insurance company unless it has the required amount of capital and pre-approved staff performing the KERT function of deciding to take on and manage underwriting risk, the arm’s length principle will cause income to be allocated for tax purposes to the appropriate entity within an insurance group.

The regulation and economics of insurance, including reinsurance and its role in the insurance industry, was a key consideration in the development of OECD Part IV. The guidance in OECD Part IV states that “reinsurance is a mechanism through which insurers can manage insurance risk by shifting or ceding one or more insured risks to reinsurers….. By allowing insurers to tailor their insurance risk, reinsurance plays an important role in the efficient functioning of insurance markets.”

**MNE insurance groups versus non-regulated groups**

It is also important in the context of the Draft and any discussion of the insurance industry to distinguish related-party reinsurance within a regulated multinational insurance group from certain captive insurance arrangements within a non-regulated, non-insurance group.

Reinsurance within an insurance or reinsurance group is subject to oversight or is approved by group-wide and local regulators. No equivalent regulatory oversight applies to captive insurance entities in non-regulated, non-insurance groups.
(although the captive itself will likely still be regulated). Captive insurance within a non-insurance group therefore does not involve all of the same capital management and risk diversification benefits discussed above in relation to reinsurance of third party risks within an insurance group.

The UK CFC rules make a distinction between captive insurance within a non-insurance group and reinsurance with an affiliate within an insurance group. Under the current UK CFC rules, there is a section specifically on captive insurance which has the effect of excluding reinsurance within a multinational insurance group, because the section only applies where the underlying insured risk is that of a related party. Therefore intra-group reinsurance is excluded because the underlying insured risks are those of third parties. When the UK rules were drafted, the UK government consulted extensively with the industry and drafted the rules in this way in order to target the rules appropriately. Annex III of the Draft fails to reflect the fact that there is an implicit recognition in the UK CFC rules that reinsurance of third party risks within a multinational insurance group is part of the active trade or business of the group.

CFC rules and insurance income

CFC rules should act as a back stop and anti-abuse regime, particularly in circumstances where tax policy makers are concerned that arms-length transfer pricing standards may not produce the right results from a tax policy perspective. As noted in paragraph 21 of the Draft, “CFC rules are seen as a way for a parent jurisdiction to capture income earned by a foreign subsidiary that may not have been earned had the original pricing of the income-creating asset been set correctly.”

While the Draft continues on to make the case that “transfer pricing rules alone will not capture all the income that would be targeted by CFC rules,” as is discussed above, the OECD previously has crafted transfer pricing guidance that we believe does indeed address the allocation of profits and losses within a multinational insurance group in a manner that precludes BEPS results. For example, as noted earlier, a reinsurer will pay an arm’s-length commission to an affiliated insurer that is ceding business to the reinsurer. Such a commission is payable even if the ceded business results in a loss for the reinsurer. In such a case, affiliated reinsurance shifts income from the reinsurance CFC to the related insurance company, rather than the other way around.
It is important to note that in a regulated insurance context there is a real transfer of risk. Regulatory oversight ensures that the licensed reinsurer is adequately capitalized so as to be able to pay any claims made under the reinsurance contracts it has entered into. If the regulator did not approve the reinsurance contract (i.e., through providing no capital credit for the reinsurance), the insured would be required to hold additional capital or require the reinsurer (through a mechanism like a trust fund or funds withheld arrangement) to maintain sufficient capital in the insured’s jurisdiction to cover the risk.

Insurance income, unlike dividends, interest, and royalties, is not a stream of payments representing the yield from certain property. Rather, insurance income is from the conduct of an insurance business, which in any given year may produce a net loss or net income. At the point in time when the risk is reinsured, both parties do not know if that transfer of risk will result in a loss or in a profit. Therefore, in a regulated insurance context, it is important to note that an insurer that reinsures risks it has underwritten “thereby shift[s] profits [or losses] associated with the insurance of those risks.” (Quoting from paragraph 102 of the Draft, with modification added.) Experience shows that CFCs engaged in reinsurance of affiliated insurers’ contracts have often incurred substantial losses as a result.

Turning next to the level of activity required to manage a regulated reinsurance operation, as noted above, the OECD has recognized that the necessary KERT functions exist in a reinsurance business. Therefore, we are unsure what is meant by the statement in paragraph 102 of the Draft that “generally speaking, little activity is required in the management of these reinsurance operations.” The reinsurance operations of CFCs in multinational insurance groups need day-to-day management by qualified and highly experienced staff. These operations are reviewed frequently by the local insurance regulator to ensure that the business is being properly managed.

In the case of reinsurance, it is also important to note that the references in paragraphs 103-104 to the location of the insured risks do not take into account the fact that the reinsurance market is a global market and that it has to be so. Reinsurers typically aggregate risks from all over the world, regardless of whether the reinsurer is in London, Zurich, Munich, or Bermuda. Similarly, it would be inconsistent with EU insurance regulation for CFC rules regarding insurance income to focus on whether the insured risks were located outside the CFC’s jurisdiction, because EU rules permit the underwriting of risks throughout the EU under a single license granted by an EU member state. U.S. CFC rules also recognize that income related to insuring risks outside of the CFC’s jurisdiction
should not be subject to the CFC rules when the income relates to the activities of the CFC.

**Substance analysis of a CFC’s business**

Regarding the three possible approaches to analyzing the substance of a CFC’s business (discussed in paragraphs 89-92 of the Draft), we believe that a substance analysis must recognize the nature, economics, and regulation of insurance and reinsurance businesses. Foremost, it is critical that the OECD not develop recommendations relating to CFC rules that will conflict with regulatory requirements, or with the work the OECD has already done relating to the KERT analysis. As noted above, the KERT analysis works for the insurance industry because it represents the reality and the regulation of the insurance and reinsurance business.

Reinsurance companies operate with low headcounts compared to other industries because the KERT function of underwriting can be performed by a small number of qualified employees. In the Lloyd’s insurance market, for example, the risk bearing entity has no employees and all of the functions are performed by a managing general agent. Therefore, we are concerned that the substance approaches outlined in the Draft might be misapplied in the insurance context.

Also, insurance companies are often subject to regulations that effectively require group services, including risk management, treasury, governance, and setting of underwriting standards, to be housed in an unregulated affiliate that deals only with affiliated entities. Still, the KERT functions would be done in the jurisdiction of the insurer/reinsurer. Due to cost efficiencies, certain routine functions may be outsourced to affiliates in developing countries. Such affiliates would normally earn a profit margin under the arm’s length principle, so it is difficult to see any BEPS problem that would justify subjecting affiliates to CFC rules under these circumstances. The OECD should be concerned that tax rules that could conflict with this practice would deter insurance groups from using service centers in developing countries in this way, contrary to OECD policy.

In addition, we do not believe that a burdensome overcapitalization test is advisable for determining whether CFC rules should apply to insurance income of a CFC engaged in an active insurance business. To the extent that insurance groups have surplus capital, regulators increasingly require that it be held at the parent company level as they are concerned that, in times of economic stress, the capital needs of the parent company not be jeopardized due to excess capital that would be
“trapped” in local jurisdictions. The amount of capital held in lower-tier operating companies is determined by the amount of risk underwritten by the company and the local insurance regulations, which may vary substantially from country to country. Therefore it is unlikely that a regulated insurance company will be overcapitalized. That said, we can see why some governments may wish to introduce such a test to catch “money box” type income. However, it is important to note that, given the varying types of insurers and the varying regulatory requirements around the world, a formulaic overcapitalization test for CFC purposes would not be practical, given this regulatory context. While we understand that there may be a limit to the capital that an insurance company may have, any tax-based requirement must take into account local regulatory reserve and capital requirements, as well as local market practice and business determinations as to the capital required to properly operate an insurance company.

**Excess profits approach vs categorical approach**

We do not favor the excess profits approach to determining the attributable income of a CFC. This approach requires the determination of a “normal return” as discussed on pages 49-50 of the Draft, which is a novel and extremely uncertain concept. For example, a normal return for an equity investor in listed stocks is likely to be higher than the 8-10% risk-inclusive rate of return mentioned in the Draft.

For certain insurance companies, particularly certain property and casualty insurance companies, an excess return concept is entirely inappropriate. Catastrophe risk insurers, for example, may go for extended periods in which they do not pay out losses and may in those periods earn more than what is considered a “normal return” on their assets. However, those returns are a necessary function of a business that will eventually have to make enormous pay outs to insure catastrophe business and personal losses. The excess profits approach could thus inappropriately attribute income from a CFC’s active business to controlling shareholders in cases where there is no excess return.

Consequently, we believe that the answer to question #18 on page 53 of the Draft is that the categorical approach is more likely to accurately attribute income that gives rise to BEPS concerns.
Definition of a CFC

The Draft recommends an extremely broad definition of entities to which CFC rules should apply, including certain Permanent Establishments (PEs). The draft acknowledges that CFC rules should not apply to entities that are taxed currently by the home jurisdiction. However, the Draft suggests that branches potentially should be treated as CFCs under an exemption system. The Working Group recommends that the OECD reconsider whether a true branch of a parent company operating in a foreign jurisdiction should be treated as a CFC for purposes of CFC rules.

The distinguishing characteristic of a true branch is that it is an integrated and interdependent part of a larger corporation. This integration has real and meaningful business, financial and regulatory consequences that create fundamental differences (wholly apart from the differences in tax treatment) between true branches and subsidiaries.

The integrated and interdependent nature of a true branch makes it very difficult to apply CFC rules to such an entity. That is precisely why there is no globally consistent standard among exemption systems for applying CFC rules (or income tax rules generally) to foreign branches. Among other key issues, determining the taxable income of the branch can be extremely difficult when local country insurance regulators do not require insurance branches to have their own capital (which is the case in many jurisdictions). Moreover, there are no consistent tax rules for allocating group-wide regulatory capital to a branch in those many cases in which the local regulator does not require a branch to have its own capital.

Threshold requirements

The Draft recommends in paragraph 43 a low-tax threshold to limit the application of CFC rules in those situations in which there is little risk of BEPS. Specifically, the Draft indicates in paragraph 56 that CFC rules should only apply when the effective tax rate (ETR) of the CFC is less than 75% of the home country tax rate. This low-tax threshold raises several concerns that suggest such a threshold warrants further consideration.

For groups based in high tax jurisdictions (e.g., the U.S. or Japan), the use of a low-tax threshold of 75% of the home country rate would effectively mean that CFC rules would apply to subsidiaries in nearly every jurisdiction in which such a group operates. The threshold thus would not act as a meaningful limitation on the
application of CFC rules for such groups. Therefore, the OECD should consider recommending a “white list” of countries that could act as an override to a low-tax threshold.

The Working Group appreciates the acknowledgment in the Draft that calculating a CFC’s effective tax rate using the CFC’s home country tax regime as a base could cause anomalies in the ETR calculation. This is a significant issue for insurance companies and other regulated financial institutions, due to differences in tax base and tax calculation methods, and difficulty in obtaining necessary information from relevant jurisdictions. While a local jurisdiction may have a generally high rate of tax, if income is recognized in different time periods for the parent jurisdiction and the CFC jurisdiction there may be substantial over-taxation in the parent jurisdiction. This often arises in the insurance industry because of both differing rules on reserving and the large investment portfolios that insurance companies maintain to support those reserves.

For example, if the parent jurisdiction determines the income of a bond portfolio on a realization basis but the CFC jurisdiction measures taxable income on a mark-to-market basis, the CFC jurisdiction could see a large drop in income if interest rates change, but that drop would not occur in taxable income calculated under the parent country rules. This means that the CFC jurisdiction may temporarily be a low tax jurisdiction, subjecting the CFC to tax in the parent company jurisdiction, even though the accounting for the relevant item will reverse in future years.

The Draft does not contain any rules that would enable the parent of the CFC to offset that income or balance it out over time, e.g., by averaging the effective tax rate over a number of years or allowing some kind of carry-forward or tax credit for these timing differences.

**Secondary rule**

On page 3 of the Draft, the OECD notes that some countries have proposed a “secondary rule” that would apply to income of a CFC when CFC rules in the home country of the CFC’s parent company do not impose sufficient home-country tax on the income. It is noted that Working Party 6 is considering options for special measures under Action Items 8-10 that could operate as such a secondary rule.

The Working Group is very concerned about this proposal to have a secondary rule allowing source countries to impose tax on a CFC’s income in the event that the
income is not taxed in the parent country’s jurisdiction under CFC rules of that jurisdiction. In the absence of more details regarding the proposal, it is difficult to provide a specific critique, but as a concept it strikes us as a radical departure from international income tax norms. It would also create substantial uncertainty and significant compliance burdens.

The Working Group has already submitted comments on the OECD’s discussion draft regarding the transfer pricing aspects of risk and capital under Action Items 8-10. In those comments, we expressed our concerns about the special measures options described in that discussion draft. We urge the OECD to adhere to international norms of taxation such as the arm’s length principle, rather than introducing novel concepts that may have unintended consequences (such as increased double taxation) and produce unnecessary compliance burdens for taxpayers.
Insurance Europe supports the objective of the Organisation for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) action plan to tackle weaknesses in the international tax environment and welcomes the opportunity to comment on this discussion draft. Insurance Europe also supports the aim of developing controlled foreign company (CFC) rules which are effective in dealing with BEPS issues.

However, Insurance Europe believes that this discussion draft lacks a clearly articulated policy objective; in fact, it attempts to satisfy multiple competing objectives, resulting in what is in Insurance Europe’s opinion a set of complicated and conflicting proposals. Insurance Europe is concerned that the CFC proposals could undermine the detailed work already done under other BEPS actions. In this context, Insurance Europe would also point out that CFC rules should be devised to deal with BEPS issues but that they should not go further than that.

**Specific comments**

**Chapter 2: Definition of a CFC**

Insurance Europe believes that no CFC charge should apply to fund vehicles because the use of funds doesn’t relate to BEPS activities. Investment funds are primarily a means of making investments on behalf of third parties. As long as this fact can be proven and verified (ie as long as the fund is genuine) and income associated to the fund is taxed at an appropriate level, no CFC charge should apply.

**Chapter 3: Threshold requirements**

In Insurance Europe’s view, this chapter should include minimum standards allowing countries some degree of flexibility in adopting CFC rules, thus avoiding an undue increase in compliance cost. For this purpose,
Insurance Europe believes that CFC rules should be strictly applied on a yearly basis, without the need to obtain a disapplication ruling in the tax periods where CFC conditions are not fulfilled. Furthermore, CFC regimes should also include an appropriate de minimis profit threshold so as to avoid a disproportionate administrative burden.

Any low-tax effective tax rate threshold should be arrived at using an average rate over several years as suggested in footnote 26 of the discussion draft. Finally, the effective tax rate should not fall under the required threshold due to the fact that tax losses have been used. Tax losses should be computed according to the tax law of the respective CFC entity.

Chapter 5: Definition of CFC income

Insurance Europe believes that only insurance income that raises BEPS concerns should be attributed under CFC rules and therefore welcomes the OECD’s recognition of this in paragraph 85.

Paragraph 89 of the discussion draft addresses the substance analysis. In this context, Insurance Europe would point out that if few staff members are employed in a certain jurisdiction, it shouldn't be assumed the substance test cannot be met. Such an assumption wouldn’t hold in insurance and in particular in reinsurance, where it can be that only a small number of well-qualified staff (like underwriters and actuaries) is required to effectively take on and manage insurance risk. In addition, the paragraph doesn’t consider the fact that it is not unusual in the insurance sector (which can be down to regulatory requirements) for staff to be employed by a service company of the insurance group and not by the insurance company operating in the jurisdiction itself. This arrangement should be taken into account in the context of employees and establishment analysis.

Given that the 2010 OECD report on the attribution of profits to permanent establishments provides a comprehensive analysis of the insurance value chain in its part IV, Insurance Europe would suggest that this should serve as a basis when deciding whether an insurance company has the necessary substance in a territory, irrespective of whether the insurer is in a low or high tax jurisdiction. Insurance Europe also believes that the viable entity analysis has considerable advantages (as explained in the second bullet point of paragraph 92).

Paragraphs 98 and 99 set out a possible rule for dividends and for interest income which states that they will generally be treated as passive unless certain requirements are fulfilled. This rule goes beyond current rules applicable in certain jurisdictions (such as Germany), where dividends in particular are generally treated as active income.

Paragraph 102 expresses concerns that profits of insurance companies may easily be shifted away from jurisdictions in which those risks are located into a low-tax jurisdiction and that CFC attribution might play a role in preventing BEPS in this context. Insurance Europe believes that this logic does not reflect the real structure of insurance operations which is heavily influenced by regulation and capital management. In general, insurance is the contractual assumption of risks by one party in exchange for a premium payable by another party. This is how insurers create value for the wider economy. Insurance is often written globally and insurers have to use both internal and external reinsurance and retrocession in the process of managing the risks they take on. This generates important benefits via diversification, flexibility in global risk management and capital efficiency. Therefore, it should not be suggested that income resulting from underwriting must remain in the same territory as the risk covered by the insurance policy. Insurance Europe is strongly of the view that it does not mean that if insurance income is in a different territory to the risk, there is BEPS activity. This is merely a consequence of insurers managing risks on a global basis, including through reinsurance.

For insurance groups, the pooling and diversification of different categories of risk is crucial to their business. This fact is recognised both by rating agencies and regulators. The pooling of insurance risk in one entity also facilitates the purchase of external reinsurance whereby the insurance group transfers risk to third-party reinsurers. When a reinsurance contract is concluded, a genuine transfer of risk takes place between the
parties. In fact, both the regulator of the insurer and that of the reinsurer need to be satisfied that the reinsurer has the needed capital and capability to take on and effectively manage the risk transferred.

If there is a perceived threat posed by the risk and capital of insurers then this should be addressed through the transfer pricing BEPS actions, particularly actions 8-10. Intra-group reinsurance should therefore remain subject to the OECD transfer pricing rules and the arm’s-length principle. Additional tax rules like CFC rules should not restrict the commercial operations of insurers and arrangements which are demonstrably required to optimise capital efficiency and to reinsure third-party risks.

In addition to the above considerations, it must be noted that insurers which are regulated in the European Union are allowed to write cross-border business under the EU freedom of services, including when income-generating policies cover risks in another EU member state.

**Paragraph 112** sets out a possible rule for insurance income under the CFC regime: “Income from insurance will generally be treated as active (and therefore excluded) unless (1) the income was derived from contracts or policies with a related party or (2) the parties to the insurance contract or the risks insured were located outside the CFC jurisdiction. However, income from insurance that falls under these two exceptions will only be treated as passive (and therefore included) if the CFC was overcapitalised or did not have sufficient substance to assume and manage the risks on its own accord.”

The paragraph should be clarified with respect to what “overcapitalisation” means in this context and to which capital is relevant in this consideration (e.g. Solvency I regulatory capital of the country of residence, Solvency II risk capital, a comparable average capital of competitors in the market, etc). Insurance operating subsidiaries are generally not overcapitalised, given that this would make no commercial rationale even if a subsidiary is located in a low-tax jurisdiction. Excess capital in a subsidiary is routinely passed up to the parent company so that it can be deployed easily in another territory if needed. A definition of the substance requirement would also be desirable.

In addition, Insurance Europe would point out that an excess profit approach is not appropriate for insurance income because it is never known at the outset of the (re)insurance contract whether a profit or a loss will result from the policy.

**Chapter 6: Rules for computing income**

In general, Insurance Europe believes that the rules for computing income should be simpler and easier to understand for the taxpayer. Insurance Europe recommends that there should be minimum standards that allow countries to have flexibility in adopting rules that do not unduly jeopardise competitiveness, such as rules that avoid mismatches and thus a wrong application of CFC rules.

Insurance Europe believes that the recommendations should allow relief for losses to be set off either against other CFC profits in the same territory in the same year or to carry forward in the CFC against profit in later years. This is because substantial real losses can occasionally arise in insurance.

**Paragraph 131** recommends using the rules of the parent jurisdiction to calculate a CFC’s income. It should be clarified that that this applies only for passive income.

**Chapter 7: Rules for attributing income**

**Paragraph 143(v)** recommends that in the context of income attribution, the tax rate of the parent jurisdiction should be applied. Here it should be clarified which tax rate is meant exactly and whether trade tax should be included or not.

**Chapter 8: Rules to prevent or eliminate double taxation**
Paragraph 155 recommends that in order to prevent double taxation, a credit for foreign taxes should be allowed. It should be clarified that foreign tax credits include CIT and trade tax.

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income.
Insurance makes a major contribution to Europe’s economic growth and development. European insurers generate premium income of more than €1 110bn, employ almost one million people and invest over €8 500bn in the economy.
To: Mr Achim Pross  
Head, International Co-operation and Tax Administration Division, CTPA  
Organisation for Economic Cooperation and Development  
2 rue André-Pascal  
75775, Paris, Cedex 16  
France

(sent via email to CTPCFC@oecd.org)

29 April 2015

Dear Mr Pross,

**BEPS Action 3: Strengthening CFC Rules**

IHG welcomes the opportunity to submit comments on the OECD Discussion Draft ‘BEPS Action 3: Strengthening CFC Rules’ (‘The Discussion Draft’). We support the OECD’s work on BEPS and we recognize the role CFC rules can play in helping to address BEPS.

**About IHG**

IHG (InterContinental Hotels Group) [LON:IHG, NYSE:IHG (ADRs)] is a global organisation with a broad portfolio of hotel brands, including InterContinental® Hotels & Resorts, HUALUXE® Hotels and Resorts, Crowne Plaza® Hotels & Resorts, Hotel Indigo®, EVEN™ Hotels, Holiday Inn® Hotels & Resorts, Holiday Inn Express®, Staybridge Suites® and Candlewood Suites®. In January 2015, IHG acquired Kimpton Hotels & Restaurants, the world’s leading boutique hotel business.

IHG manages IHG® Rewards Club, the world’s first and largest hotel loyalty programme with over 84 million members worldwide. The programme was relaunched in July 2013, offering enhanced benefits for members including free internet across all hotels, globally.

IHG franchises, leases, manages or owns over 4,800 hotels and more than 710,000 guest rooms in nearly 100 countries, with over 1,200 hotels in its development pipeline. Over 350,000 people work across IHG’s hotels and corporate offices worldwide.

InterContinental Hotels Group PLC is the Group’s holding company and is incorporated in Great Britain and registered in England and Wales.

**A. Summary of our Comments**

1. We support the use of appropriately targeted CFC rules to protect parent jurisdictions against
the diversion of taxable profits to non-resident subsidiaries.

2. We can also see that appropriately targeted CFC rules may have a role to play where unintended and unacceptable double non-taxation would otherwise arise (after first applying more targeted rules arising under other Actions- in particular Transfer Pricing rules as per comment 14 below) and where there is a principled underlying reason for attributing additional taxing rights to the parent jurisdiction rather than elsewhere.

3. CFC rules can however be exceptionally blunt instruments which have significantly more drawbacks than benefits if drafted as broadly or inflexibly as is proposed in The Discussion Draft.

4. Firstly, given the wide (and ever increasing) variety of different profiles of normal commercial activities, broad and inflexible rules are likely to be incapable of adequately distinguishing between tax avoidance and normal commercial activity. We illustrate this point by reference to our own business model below.

5. Secondly, they will struggle to adequately distinguish between harmful low tax regimes and simple and acceptable differences of sovereign policy choice between what to tax and when to tax it. For example, a subsidiary jurisdiction tax law which gives relief for certain categories of capital expenditure in year 1 rather than via amortisation (or in the year of disposal rather than via amortisation) in circumstances where the parent jurisdiction amortises, can lead to intermittent CFC charges in the parent solely as a result of policy differences concerning when to give relief for expenditure. And

6. Thirdly, the compliance burdens for taxpayers of broad ranging and inflexible CFC rules are not just disproportionate but can be close to impractical. Rules must be capable of being applied by both taxpayers and tax authorities in a reasonably straightforward manner otherwise they will create harmful effects and will fall into disrepute. For example, our perspective of the UK CFC rules prior to their update was that both taxpayers and the tax authority got to the position where CFC compliance could not be dealt with as a matter of routine compliance but became a question of ‘as a practical matter how can we make these rules work?’.

7. Our understanding is that it was these types of reasons that led the European Court of Justice to view CFC rules as a restriction on the right to establish overseas which could only be justified in narrow, well targeted, circumstances. Otherwise the rules act as a barrier which inhibits normal commercial decisions to conduct trade overseas. In our view the rules as currently set out in the Discussion Draft would represent an unjustifiable barrier which would inhibit normal international trade. We therefore believe that modification is required to mitigate these features. That is not just to try and ensure that recommended rules are EU compliant but because, irrespective of EU law constraints, rules should not be recommended which create disproportionate barriers.

8. We suggest that a fundamental feature of a good CFC system is that it has a menu of different filter types which give a possibility of low compliance routes for a first stage exclusion of low CFC risk entities so that more detailed and burdensome compliance work can be focussed on high risk entities. An associated feature which helps enable that is building in flexibility in the sequence in which tests can be applied so that, if the application of a test would exclude an entity from a CFC charge, then that test can be applied at any point in the testing sequence rather than that sequence being fixed (e.g. as with a testing structure which says first test for control, then test whether there is a low tax rate, then …).

It should be noted that whether a filter test is easy or difficult to apply will often depend on the profile of a particular business model and entity rather than one type of test always being
simpler. For example, (for IHG’s business model), we do not agree that mechanical tests are necessarily simpler. A white-list or equivalent (which is essentially a subjective assessment by the parent jurisdiction of comparative tax-systems, combined with, where necessary, some conditions) does in our experience work well as a low cost filter.

9. An alternative, or supplementary, approach is to build in low compliance cost markers to act as preliminary filters to help identify what are high CFC risk entities—where more detailed and compliance heavy analysis is required.

10. We currently have significant concerns with respect to the ‘Excess Profits’ proposals as they seem to us to be the least well targeted and most onerous proposals in compliance terms. We also currently find these proposals difficult to comprehend, both in terms of the underlying principle of why the profits as calculated should be considered to be properly attributable to the parent and, at a more basic level, as to how particular components of the calculation are to be measured (Eligible Equity? Income?). For example, if we as a UK parented group acquire the parent of a multinational group, what is the Eligible Equity in each of its subsidiaries and why, if those subsidiaries have built up goodwill or other IP value over many years, is it considered reasonable that associated foreign earnings should be attributed and taxed on a current basis in the parent entity (however high or low they are in comparison to a rate of return on eligible equity)?

11. In our view a fundamental drawback of the current Excess Profits proposal is that it appears to be proposed that it should act as a primary test which will need to be applied in a broad range of cases. For the reasons given above we do not believe it is well suited to that. We would suggest that, if an Excess Profits approach is to be considered at all, it should be developed as a proposal which might be applied once the types of preliminary filtering described in 8. and 9. above have already been used. In particular, if a primary target is passive IP which generates something which broadly equates to a pure income profit stream and requires very limited supporting local functionality or substance, then we believe it would be better to have preliminary non computational filters which help identify the presence of those features—and only require the application of Excess Profits tests and principles to a suitably narrowed down sub-set of entities. As a supplementary risk assessment matter the Country by Country Reporting proposed under Action 13 might assist tax authority audit and targeting processes—and we assume this was part of its intended purpose.

12. If CFC rules are to be appropriately targeted then we believe that it is essential to recognise that not all IP has the passive profile which we describe above. Indeed that profile may well now be much rarer than that of IP which has a relatively short life and requires significant on-going cost to continuously update and replace it. We illustrate this below in the context of IHG’s business model and the role and types of IP used in that. To use a metaphor which compares IP to tangible fixed assets, we suggest that much (perhaps most) modern IP has a commercial role and profile which is much closer to that of plant and machinery in a traditional business than to that of a freehold property.

13. In accordance with the above points we have significant concerns that attempts to use CFC rules to deter third country BEPS may well give rise to disadvantages which are disproportionate in the context of the uncertain nature of any spill-over benefits. That is firstly because CFC rules can only deter avoidance if they can be narrowly targeted on avoidance and not normal commercial activity—otherwise they deter normal commercial activity. It is secondly because the additional compliance cost and complexity for the parent jurisdiction of identifying third country diversion is likely to be disproportionate. The third and fundamental point is of course that BEPS which does shift profits from third countries needs to be counteracted by measures which reallocates profits back to those third countries— and not by CFC measures which add in a misallocation of profits to the parent jurisdiction. We therefore
remain of the view that narrow CFC rules which focus primarily on diversions from parent companies are preferable to broad rules which attempt to also address third country profit diversions. And

14. We note that the Discussion Draft is acknowledged to be an initial non-consensus document which will need further development including consideration of how CFC proposals should best dovetail with other BEPS Actions. We believe that it is particularly important to consider how CFC rules can best be drafted so that they complement Transfer Pricing rules rather than potentially conflicting with or overlapping with those provisions (as updated by work under other Actions). As part of that consideration of links with other Actions we think that it would also be helpful to develop a clear statement of objectives for the CFC rule recommendations under Action 3 (i.e. what categories of BEPS they are designed to address).

B. IHG’s Business Model and Related Comments

As summarised above IHG’s primary business models involve the provision to third party hotel owners of franchise and management services with respect to IHG hotel brands. IHG owns or leases extremely few hotels itself (only 9 as at 31 December 2014 out of over 4,800 hotels operating under IHG brands).

There are three primary forms of receipt arising under these business models (see IHG’s 2014 Annual Report):

(a) Revenue based franchise fees (and equivalent fees under management contracts) for the provision of rights and services to enable hotels to consistently deliver high quality hotel services in accordance with the individual brand concepts and brand standards. This principally comprises the maintenance, continuous update, and delivery of know-how concerning every aspect of hotel operations –and the rights to use the associated brand trademarks;

(b) Profit based management fees where we also have responsibility for supervising the operation of the hotel in accordance with brand standards; and

(c) ‘System Fund Assessments’ – these are payments made by branded hotels to IHG which contractually create corresponding obligations for IHG to spend money to provide various types of marketing, loyalty programme and reservation services, directed at hotel guests or potential hotel guests, so as to drive additional revenues and profits for owners of IHG branded hotels. These are ‘not for profit’ arrangements [i.e. IHG does not directly profit from them—although on a significantly scaled down basis higher owner revenues and profits will translate to higher IHG franchise and management fees— and equally IHG is not obliged to spend more than the funds received].

We note the following points which are relevant to consideration of particular issues and questions raised in the Discussion Draft:

1. Our core commercial activity is the provision of IP rights and the provision of services. We are concerned that the Discussion Draft seems to use the provision of rights and services as a per se marker of avoidance rather than drawing finer distinctions which help segregate BEPS activity from normal commercial activity;

2. Our 2014 Annual Report disclosed our consolidated group fee margin [i.e. consolidated global revenues less costs for items (a) and (b) above] as 44.7%. We note that this calculation excludes receipts and expenses under category (c) in view of their not for profit status. We believe that this illustrates that this business, although it involves the continuous development,
maintenance and exploitation of IP is an active business with substantial associated annual costs. We are concerned at the assumption in The Discussion Draft that all IP is passive;

3. The conduct of our external business involves contributions from large numbers of regional and global functions situated in a relatively small number of primary locations, together with smaller scale supporting functions in various satellite jurisdictions. It does not involve discrete external services being provided on a self-standing one to one basis from a single IHG entity to a given hotel owner in one of the approximately 100 jurisdictions in which there are IHG branded hotels. In common with most other multinational groups (but perhaps to an even larger degree) we therefore have substantial levels of intra-group service provision, which supports external contracts entered into by given entities. We are concerned that intra-group service provision appears to be treated as a marker of avoidance in Chapter 5 rather than drawing finer distinctions which help segregate BEPS activity from normal commercial activity;

4. Where we conduct management business we provide franchise services but are in addition responsible for supervising the operations of the third party hotel in accordance with relevant IHG brand standards. This will generally result in the need for an IHG local entity or branch in order to capture and meet local tax and other compliance requirements. We may however not have any establishment of our own there and may have just a single locally based representative in the form of a General Manager seconded to work at the third party hotel. I.e. in many cases all other hotel employees would be employees of the third party hotel owning company. Local accounting, tax return and company secretarial and similar compliance requirements may be outsourced, in both these smaller scale jurisdictions and many larger ones. We see these aspects as being relevant in the context of the following aspects of The Discussion Draft:

i. When considering substance analysis of various forms (Chapter 5 para 89) it is important to consider substance by reference to what is necessary and appropriate in the context of the particular business model concerned - indeed that is our understanding of what European Law requires;

ii. There does appear to be a potential tension between Action 7, which seeks to create a taxable presence (and by implication a worthwhile profit allocation to the source jurisdiction) even where there is limited local substance, and Action 3 if that seeks to attribute profits to the parent whenever there is limited substance. Clarity is needed as to the intended outcome; and

iii. Where local accounting or tax compliance is outsourced, the need for duplicated CFC calculations using local legal entity numbers restated to parent company accounting principles and tax computation principles can be disproportionately onerous [particularly for group entities which are more complex than these simple local management entities] as it can only be done at the parent level whereas information in the necessary detail is primarily held locally. For example, if permanent establishments are included as 'entities' IHG has approximately 350 entities worldwide. Having to perform 350 parent company jurisdiction based computations for CFC compliance purposes in circumstances where we do not expect CFC charges to arise would in our view be disproportionate;

5. In common with most longstanding multinationals we will frequently have multiple entities in some jurisdictions (e.g. as a result of acquisition or development history, or legal desires to ring fence risk). People and premises will however tend to be in as few entities as possible and serve as a general local resource. It is important that substance tests consider what people and premises are available in a given jurisdiction rather than just in a given legal entity; and

6. Third country withholding taxes are frequently deducted from our franchise fees (or sometimes
from other fees and assessments) in accordance with prevailing domestic law and tax treaties. Given that our franchise fees are not pure income profit, withholding tax charges often result in a high effective tax rate in the franchisor entity solely as a result of third country taxes- before considering additional taxes payable in the franchisor or supporting function jurisdictions. For example, a 10% withholding tax on a 44.7% margin (i.e. the 2014 consolidated average fee margin of IHG) translates to a source country effective rate of 22%. In developing regions however the average margin will generally be lower and the prevailing withholding tax rates often higher-and thus we believe effective source country rates via withholding of 40% or substantially higher can often arise. It is therefore important that Effective Tax Rate tests take such third country withholding taxes into account rather than solely local tax of the CFC tested entity.

C. Comments on the detailed questions raised in The Discussion Draft

We provide comments in the Appendix to this letter concerning the detailed questions raised in The Discussion Draft, referring back to comments given in Sections A. and B above where relevant.

We trust that our above comments and suggestions are constructive. We would be happy to provide additional explanation and comment whether within the forum of the proposed public consultation or otherwise.

Yours faithfully,

C.P. Garwood
Head of Tax
APPENDIX

COMMENTS ON QUESTIONS RAISED IN DISCUSSION DRAFT

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?

   It seems possible that such treatment would increase the possibility of double taxation arising (i.e. both a CFC charge and a charge in the subsidiary with an interest in the transparent entity). Other than that the general compliance burden issues commented on in A.6. and B.4. of our letter are of relevance—such burdens can be reduced by using flexible additional filters as commented on in A.8. and 9. of our letter.

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

   Consideration should be given to the extent to which issues of BEPS concern are already addressed by Action 2 hybrid rules applied by both the overseas jurisdictions and by the parent jurisdiction in a CFC context (e.g. applying normal parent jurisdiction hybrid rules when considering the effective tax rate of the CFC). We are not in favour of the parent applying different rules in a CFC context to those applied in a domestic context (other than perhaps in terms of limitations of elective regimes). We believe that such applications are likely to over—include CFC income (in the context of reasonable targeting objectives for CFC rules) and possibly be contrary to EU law.

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

   See our comments in relation to questions 1. and 2.

CHAPTER 3: THRESHOLD REQUIREMENTS

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

   We refer to our comments in sections A. 5. and 6. and B. 4. (iii) of our main letter. Significant compliance burdens arise for all but relatively simple entities. Distortions which reflect normal acceptable tax policy differences between jurisdictions rather than BEPS can also give rise to inappropriate outcomes—such as can issues such as third country withholding taxes as discussed in Section B. 6. of our letter if not satisfactorily accommodated. We are concerned by the suggestions in paragraph 63 of considering calculations based on separate income categories or based on country aggregates rather than based on entity figures. The former would require information in a level of detail which will not be readily available at parent company level (which is where the calculation would need to be performed) and the latter may require information in a
country aggregation or consolidation form which in most cases will not be available at all.

5. How could these problems be addressed or mitigated?

We refer to our comments in B. 8. and 9. of our letter. A variety of different filters should be available including, for example, a white list approach, an active business exclusion and (if different) some form of substance or business capability test.

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

We refer to our comments in respect of question 2. above. We do not believe it is appropriate to use a different basis for PEs in a CFC effective tax rate context from the normal basis applying in the parent jurisdiction. If the use of different bases is to be contemplated however then we suggest that it should at most be presented as a policy decision for the parent jurisdiction rather than a recommendation (after all many parent jurisdictions, quite rightly, consider it perfectly acceptable for high and low tax income of directly held PEs to be mixed). We can however see the rationale for white list conditions distinguishing PEs in jurisdictions which are not themselves white list jurisdictions.

CHAPTER 4: DEFINITION OF CONTROL

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

A broad ranging need to apply a distinct tax test of control (e.g. if there are multiple joint venture arrangements to consider) may present significant compliance challenges and burdens. The tests applying for accounting consolidation purposes, and the conclusions reached under them, will often be a readily available reference point but may not always provide an appropriate answer –as consolidation can sometimes be required where there is not de facto control. It is however suggested as recommended practice that CFC control rules are based off an appropriately modified form of prevailing consolidation tests –and with guidance supplied to clearly explain the differences between the two. This should help both taxpayers and tax authorities use consolidation data as an initial reference point and avoid the need for completely separate company by company control tests.

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?

Issues of information availability may be problematic when considering unrelated parties. This suggests that unrelated parties should only be considered under anti-avoidance provisions where there is some evidence of parties acting in concert.

CHAPTER 5: DEFINITION OF CFC INCOME

9. What are the practical problems with any of the three substance analyses set out above? How
As a preliminary matter we note our comments in section A. 14 of our main letter concerning the need for CFC rules to complement transfer pricing rules and not conflict with, or overlap with, them. In our view this works most coherently if it is clearly expressed that primary Transfer Pricing provisions (i.e. those excluding special measures) take precedence over CFC rules. CFC rules and Transfer Pricing special measures (if any) should then come into play for items where, in accordance with clearly expressed principles, an alternative or supplementary basis of allocation is used because primary transfer pricing rules are considered not capable of adequately dealing with the situation [for example because the issue concerns the setting of parameters such as allocation of capital or risk which form the context within which transfer pricing rules are then applied].

We make this preliminary comment firstly because we believe that specifying those issues of primacy are necessary to provide a coherent basis for integrating the various international rules and protections. We also comment concerning the interlinking of transfer pricing and CFC rules because it underlies the construction of the new UK CFC provisions—which we are familiar with and which applies the viable independent entity test as the fundamental principle underlying the CFC rules. In our view that is a good fundamental principle but one which is likely to be onerous to apply in detail (notwithstanding the availability of existing transfer pricing analysis to help form the starting point for such further analysis). This is however recognised in the UK provisions which adopt flexible preliminary filters in the way described in sections A. 8 and A. 9 of the main body of our letter. This combination means that the viable independent entity analysis (applied proportionately) may only be required in high risk cases where BEPS is likely to be present. Although there is currently limited experience with the new UK rules we believe that this is a good structure.

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?

For the reasons given in the main body of our letter we do not believe that it is a desirable objective per se to make rules more mechanical. That can often increase compliance burdens rather than reduce them. It may also be questioned whether hard and fast numerical lines are going to be capable of adequately distinguishing between a genuine commercial activity and a BEPS motivated structure given the wide range of normal business models which exist in the modern world.

We suggest that what is preferable is a variety of filters to help separate low risk from high risk entities so that more detailed and onerous tests can be focussed on high risk entities. Our experience of the new UK rules—although limited because of their relatively recent introduction—is that the viable independent entity approach can probably work well if used flexibly as both the ultimate test for high risk entities not capable of exclusion from a CFC charge using preliminary filters, and as the underlying principle for determining where taxing rights should belong. We do have concerns that the use of the test can be onerous, which is why the availability of preliminary and less onerous filters is important. We note however that, even where the viable independent entity test does need to be used it will, to a significant degree, be able to make use of existing transfer pricing analyses and documentation.

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 do not have comments concerning these insurance industry issues.

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

For the reasons set out in the main body of our letter (See section B) we are particularly concerned that the Discussion Draft appears to suggest an indiscriminate approach which treats the existence of IP as in an indicator of BEPS- and then extends this to sales and service income because of the difficulties in segregating these from IP income. As IP of one form or another is all prevalent within most modern business models- as are intra-group service activities- this would seem to us to be an untargeted approach which makes no distinction between normal commercial activity and BEPS. We believe that some form of underlying principles and filters are required to help separate BEPS activity from normal commercial activity. Whether or not those rules or filters need to distinguish between sales and service income and IP income will depend on the filter or principle concerned-for example some active business or functional based filters may not need to.

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

We refer to our comments above and in the main body of our letter. Our experience to date suggests that the new UK CFC rules attribute these categories of income where necessary, and are generally effective in distinguishing between normal commercial activity and BEPS, while doing so in a fashion which ,by using gateway principles and a variety of filters, achieves this without excessive administrative and compliance burdens.

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

We are not aware of other categories of income which require consideration.

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

We believe that both approaches would need further clarification and refinement-for example see our comments under Q12 and elsewhere concerning the inappropriateness (under the categorical approach) of an indiscriminate default assumption of sales, service, royalty and IP income as passive. We do not believe that that reflects the normal profile of the majority of such income. Better methods of discriminating between normal commercial income and BEPS are required.

We believe that even more substantial elaboration and clarification is required with respect to the excess profits approach. For example it is not at all clear how Eligible Equity should be determined (e.g. for a long standing subsidiary of a multi-national following a higher tier acquisition? Or what measure of income should be used in the calculation [accounting or tax? Under which GAAP or tax rules?]

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

See our comments under Q15. We see particular problems with determining the figures to be used for the excess profits approach and also see that approach as involving a very significant compliance burden for the vast majority of entities where it should be fairly clear (in principle) that no CFC apportionment should be arising. Whereas we understand the principle according to which it is considered that the excess profits approach would identify where IP exists, the approach seems to provide no basis for distinguishing between IP (or other income) which is misallocated, and that which is not. It is for example incapable of distinguishing between active IP and passive IP.

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

As previously indicated we believe that, if it is to be used at all, the excess profits tests should be applied at a late stage once alternative filters have been used to identify high risk or misallocated IP. For example preliminary substance and income/expense filters might be used to identify where high value, low associated substance, IP earnings arose which were generating pure income or similar profits.

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 do not see how the Excess Profits approach (in isolation) can accurately attribute income that gives rise to BEPS concerns. It is at most a method for identifying where IP might be situated; it includes no methodology or criteria for assessing whether that IP properly belongs where it is situated or has been diverted from another jurisdiction as part of arrangements giving rise to BEPS concerns. As indicated, we therefore consider that, if the Excess Profits approach is to play a role at all, it needs to play one at a later stage in a CFC process once alternative methods or filters have been used to help identify whether IP (or other assets or activity) giving rise to BEPS concerns is likely to be present. The categorical approach is more targeted-other than with respect to the sales, services, royalties and IP income category as commented elsewhere. Thus whereas in our view the categorical approach as outlined would require additional provisions to further improve its targeting it is more likely to accurately attribute income which gives rise to BEPS concerns. We consider that both approaches require separate provisions to help identify IP income which may give rise to BEPS concerns (e.g. substance and functional role tests, and tests to help identify whether the IP concerned generates a pure income profit type return or is active IP).

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

For the reasons given above we believe that the Excess Profits approach as outlined is not currently well suited to properly attribute IP income giving rise to BEPS concerns. We therefore believe it would be even less well suited to dealing with other categories of income.

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

As indicated we consider that the starting point for consideration of whether profits are misallocated (and therefore excess in the context of the company concerned) should be a functional and activity analysis in the context of the business model of the group concerned and the role played by the company in that business model. We believe that the viable independent
entity approach is a reasonable over-riding principle. To the extent that there is doubt as to whether that is sufficient to deal with all BEPS concerns our understanding is that that is likely to be where low function, high value returns which essentially derive from the investment of financial capital are concerned. We therefore believe that the right approach is to focus any additional measures on circumstances which display those features.

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

We refer to our comments in Section B.4. of our main letter, and in relation to Question 4 above. An entity approach has the advantage in compliance terms that it uses the same unit as a reference point as is used for other reporting and tax return compliance purposes, and therefore has more readily accessible data. Even here however the compliance burden of CFC compliance is very significant [in the context of the need for a CFC charge being the fairly rare exception rather than the norm] unless a variety of low compliance burden filters are liable to separate out low risk from high risk entities. A purely transactional approach is a step change upwards in terms of increased compliance burden as it requires very detailed and intrusive analysis at the parent level of subsidiary financial and factual information which will generally not be available (in the necessary level of detail) at the parent/centre. We note that the two approaches are not mutually exclusive however. The new UK CFC rules, while respecting the entity as the fundamental unit being tested, uses transactional tests as part of its gateway and filtering mechanisms. We believe that a well-structured combined approach can make use of the advantages of each approach while mitigating some of the disadvantages.

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

We refer to our comments in relation to Question 21. A pure transactional approach would be exceptionally burdensome in compliance terms- effectively requiring very detailed additional analysis and tax computations for all group entities whether or not they presented a material CFC risk. We therefore believe the entity should be retained as the primary unit to be tested but, as set out, in response to question 21 we consider that the two approaches are not mutually exclusive, and indeed work best in a well-structured combination. Thus limited/low compliance forms of preliminary transactional and entity based gateways and filters can be used to narrow the scope of detailed compliance work to a small number of high risk entities, with more finely targeted transactional and functional analysis then required for those entities.

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?

We refer to our comments in relation to Questions 22 above and our broader comments in Section A of our letter concerning the use of filtering approaches.

CHAPTER 6: RULES FOR COMPUTING INCOME

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?

We recognise and agree that where a CFC charge ultimately has to be made- or considered in the context of Effective Tax Rate type tests-then a calculation of income according to the law of
the parent jurisdiction is required. As commented elsewhere (e.g. re Question 22 above and in Section B.4. of our main letter) such requirements to restate accounting and calculation data in accordance with parent jurisdiction laws can be very onerous in compliance terms – it essentially represents a duplication of accounting compliance processes for all overseas entities. We therefore recommend the filtering approach described in our submission and adopted in the new UK CFC rules. We note that some of those filters, when considered in context, will appropriately exclude the need for any wholesale restatement in accordance with parent company laws. For example, because white-list approaches are based on more general tax authority judgements of subsidiary regimes being sufficiently similar to the parent jurisdiction regime, any conditions applying may apply more generic accounting based tests of whether specific types of mismatch arise (e.g. whether material levels of income which is recognised for local accounting purposes is not recognised for local tax purposes).

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

We believe that the chapter accurately reflects the issues that could arise with losses but note that that is one subset of the broader issues associated with differences in the timing of recognition of income and expenses between jurisdictions. CFC rules can for example result in the denial of effective relief for normal overseas business expenditure where that expenditure is material and the timing of relief in the subsidiary jurisdiction is different from that in the parent jurisdiction. The same applies with respect to income recognition. In each case such differences can result in a low subsidiary jurisdiction tax rate under parent jurisdiction measures in some years (and thus a CFC charge) even though that timing difference means that in other years there may be a subsidiary jurisdiction tax rate which is higher than the rate measured under parent jurisdiction laws.

CHAPTER 7: RULES FOR ATTRIBUTING INCOME

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

We have no substantive comments concerning this question, which will only have relevance in a very limited number of joint venture type situations. It is not an issue where we are aware of significant problems under the rules of jurisdictions of relevance to us.

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

We believe that this question needs to be considered in the context of the objectives set out for the given CFC regime. If the objective of the CFC regime is to counteract diversions of profit from the parent, and is capable of being accurately targeted on profits diverted, then we cannot understand the rationale for topping up to a rate which is lower than the rate of the parent jurisdiction – as to do so gives an incentive for diversion. We can see a practical rationale for a different approach (for the reasons outlined in The Discussion Draft) where it is concluded that the nature of the issue concerned makes it impossible to accurately delineate between circumstances which involve diversion and those which do not. In our view however a targeted approach is to be preferred wherever possible.

Our above comments apply equally where an intended objective of CFC rules is to provide a disincentive for third country diversion – but they also illustrate some of the reasons why we see
that as a problematic objective for CFC rules. If the relevant provisions can be appropriately targeted then the taxing rights with respect to the profits diverted should go to the jurisdiction whose tax base has been eroded and not to the parent jurisdiction under CFC rules. If however there are areas where the rules cannot be appropriately targeted then, not only is the parent jurisdiction perhaps receiving some taxing rights which properly belong to another jurisdiction (whether the subsidiary jurisdiction subject to the charge or the third country jurisdiction involved), but the parent jurisdiction is perhaps suffering competitive disadvantages as a result compared to parent jurisdictions who do not impose such charges.

**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?

We note the timing difference points made in relation to Question 25—which can result in a form of double taxation. Otherwise we believe that Chapter 8 captures the main categories 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?

The Discussion Draft correctly identifies the need (in connection with multiple jurisdiction CFC issues) to set clear provisions concerning which jurisdictions rules have the priority of application. We note that there is the same need to give an order of priority between the application of Transfer Pricing and CFC rules—and in our view Transfer Pricing rules should take precedence (for reasons of broader international coherence and consistency). We note that, for the multiple jurisdiction CFC issue, an order of priority may not in itself be sufficient if there are significant differences between the relevant CFC rules and measurements.
VIA E-MAIL

Mr. Achim Pross  
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Re: Comments on Discussion Draft on BEPS Action 3: Strengthening CFC Rules

Dear Mr. Pross:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, telecommunications, oilfield services, transportation, computer technology, energy, pharmaceuticals, beverages, software, IT systems, publishing, and electronics. The group’s purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

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1 The current membership of the IAPT is made up of the following companies: Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; A.P. Møller-Maersk A/S; AstraZeneca plc; Baker Hughes, Inc.; Chevron Corporation; Cisco Systems, Inc.; The Coca-Cola Company; Exxon Mobil Corporation; Hewlett-Packard Company; Johnson Controls, Inc.; Juniper Networks, Inc.; Microsoft Corporation; Procter & Gamble Co.; REXL Group plc; Repsol S.A.; TE Connectivity Ltd.; Thomson Reuters Corporation; Transocean Ltd.; Tupperware Brands Corporation; and Vodafone Group plc.
The Alliance 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 in the Annex to this letter.

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 would appreciate an opportunity to speak at the consultation. We also stand ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Sincerely yours on behalf of the Alliance,

James E. MacLachlan
Baker & McKenzie LLP
Counsel to the Alliance

Annex: Comments on the 3 April 2015 Discussion Draft on BEPS Action 3
ANNEX

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON THE 3 APRIL 2015 DISCUSSION DRAFT
ACTION 3: STRENGTHENING CFC RULES

1 MAY 2015
IAPT Comments on the 3 April 2015 Discussion Draft

Action 3: Strengthening CFC Rules

I. Introduction

Interaction between Action 3 and other BEPS Actions

1. It is clear that recommendations for CFC rules to combat base erosion and profit shifting (BEPS) cannot be developed in isolation but need to be framed in conjunction with other relevant BEPS Actions in order to minimise overlap/duplication and the consequent risk of double or multiple taxation. So, while we welcome the Discussion Draft as the OECD’s first significant published analysis of the role of CFC rules, it is essential that further OECD work on Action 3 is carried out and finalised together with its work on other related Actions, particularly on hybrid mismatches (Action 2), interest deductions (Action 4), harmful tax practices (Action 5) and on the transfer pricing guidelines (including risk, recharacterisation and special measures) (Actions 8-10), in order to clearly identify BEPS risk scenarios and to determine a hierarchy of BEPS measures to ensure that the same scenario is not ultimately covered by more than one measure.

2. It is for this reason that it would be very helpful to understand how the OECD’s further work on Action 3 is being coordinated with other relevant Actions in order to ensure a coherent package of BEPS measures (see Discussion Draft, para 5.) and also when, how and by whom (for example, the Committee of Fiscal Affairs or the Working Parties) the interaction between recommended CFC rules and, in particular, the outcomes under Action 8-10, as well as transfer pricing rules more generally, will be addressed “at the end of the process” (Discussion Draft, footnote 2 on page 7). If the “end of the process” means the fourth quarter of 2015, we are concerned that there is not now sufficient time to resolve these complex interactions or even to make clear recommendations within Action 3 for the design of CFC rules.

Policy objectives of BEPS-targeted CFC rules

3. We address this fundamental issue in more detail in Section II. below headed “Policy Considerations”. However, we would summarise out main comments as follows.

4. It is difficult to see any reason in principle why a parent jurisdiction having a territorial system, or even a worldwide system, should have the right to tax diverted CFC profits which arise from a genuine value-creating activity or investment in a third jurisdiction. The fact that the source jurisdiction may be unable and/or unwilling to tax the diverted profits does not seem to us to justify parent jurisdiction taxation of those profits, even if over-inclusive CFC rules may indirectly disincentivise source country BEPS into CFCs (i.e. the so-called “spill-over” effect). Such value creation in a third jurisdiction is not due to base erosion of the parent country but reflects the ability of a multinational enterprise to establish operations in multiple jurisdictions to enhance its markets and hire key employees in foreign jurisdictions.

5. In our view, the Action 3 recommendations should focus solely on protection of the parent jurisdiction from artificial diversion of profits to a low taxed CFC which results in double non-taxation or less than single taxation and which cannot be prevented by the application of the arm’s
length principle under transfer pricing rules or, only if necessary, by narrowly targeted special measures endorsed under Actions 8-10.

6. Similarly, robust transfer pricing rules which apply the arm’s length principle (supported, only if necessary, by narrowly targeted special measures which go beyond the arm’s length principle) should be developed as part of the work under Actions 8-10 to deal with foreign-to-foreign stripping achieved by the artificial diversion of profits from a third (source) jurisdiction where they are genuinely earned to a low-taxed CFC.

7. We strongly prefer a categorical approach over an excess profits approach to determine artificially diverted parent company CFC profits to be included as taxable income in the parent jurisdiction. However, CFC profits should not be included under a categorical approach to the extent that they arise from assets, risks, functions, customers or capital genuinely located or managed in the CFC jurisdiction.

   Primary CFC rule combined with a secondary rule

8. Although not recommended in the Discussion Draft and still under consideration as part of the ongoing work under Actions 8-10, we would have some concerns about any recommendation for CFC rules as the primary rule to capture CFC profits diverted from a third jurisdiction, with special measures to operate as only as a secondary rule to allocate low-taxed excess CFC profits to that jurisdiction where “sufficient” CFC taxation is not imposed in the parent jurisdiction. Clearly, the arm’s length standard under transfer pricing rules should operate as the primary rule to protect the source country tax base. Further detailed consideration should be given to whether and in what circumstances recommended CFC rules or special measures (that go beyond the arm’s length principle) at source country level should operate as a primary or secondary rule to pick up otherwise untaxed income.

   Recommendations or options for CFC rules

9. Whilst some variation in recommended CFC rules should be permitted in order to cater for the particular economy and tax system (e.g. worldwide or territorial) of each parent jurisdiction, as well as any overriding international obligations (e.g. under EU law), we would — without underestimating the challenge here — strongly support the development of consensus-based common underlying design recommendations. The adoption of a “menu” of recommendations or options for CFC rules should not be endorsed. Otherwise, a complex array of different CFC rules will likely emerge, resulting in increased compliance/administrative burdens, uncertainty and double tax risks.

II. Policy Considerations

10. We agree that the policy considerations discussed in Chapter 1 of the Discussion Document are those that are mainly relevant to the design of recommended CFC rules to combat BEPS. However, we have a number of particular comments which we would highlight.

   Purpose of CFC rules

11. The Discussion Draft acknowledges (in paragraph 4) that the Action 3 best practice recommendations for CFC rules should be limited to what is necessary to combat BEPS and that wider aims, for example concerns about long-term deferral in worldwide tax systems, are outside the scope of the BEPS Action Plan for CFC rules. We completely agree: such concerns do not need to be
addressed by immediate CFC inclusions. However, in order to frame clear recommendations for the design of CFC rules in order to combat BEPS it is vital first to define BEPS. The starting point is to refer to the definition as set out in the July 2013 Action Plan which states:

BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdiction where the activities creating those profits take place. No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices which artificially segregate taxable income from the activities that generate it.

12. Thus, as noted in the Public Discussion Draft on Action 11 (Improving the Analysis of BEPS) published on 16 April 2015 (see paragraphs 101-103), differences in countries’ tax rates do not amount to BEPS on their own. Nor does the effective relocation of economic functions, assets and risks to another country to take advantage of a lower tax rate. However, artificial arrangements put in place to exploit tax rate differences are BEPS.

13. Accordingly, BEPS behaviours which “strip” the tax base of the parent jurisdiction normally include (but are not necessarily limited to): (a) transfers/acquisitions of hard to value intangible or mobile assets to/by low-taxed CFCs for less than full market value but where it is difficult to apply the arm’s length principle, (b) over-capitalisation of low-taxed CFCs and (c) contractual allocations of risk to low-taxed CFCs, in the cases of (b) and (c) where the arrangements would be unlikely to occur between unrelated parties because the CFC does not have sufficient substance to manage and control the functions, assets and risks that result from the arrangements.

14. In our view, the purpose of BEPS-targeted CFC rules should only be to combat these and other artificial arrangements which “strip” the parent jurisdiction tax base and result in double non-taxation or less than single taxation. Recommendations for the design of such CFC rules should therefore not go beyond what is necessary for that purpose. It is not clear to us, however, whether the Discussion Draft is suggesting the need for one set of Action 3 recommendations for territorial tax systems and another (for example, in order to capture foreign-to-foreign stripping) for worldwide tax systems. It is essential that further work is undertaken to define what types of behaviours constitute BEPS from the parent jurisdiction more precisely so that properly targeted best practice recommendations for CFC rules to combat such BEPS behaviours can be designed.

Balance between taxing foreign income and competitiveness

15. We agree, as discussed in the Discussion Draft (see paragraphs 11-14), that the Action 3 recommendations should so far as possible be the same for EU Member States and non-EU Member States, but that EU Member States may need to modify the recommendations in order to comply with developing case law of the CJEU. Competitiveness issues aside, even a two-tier CFC system (one for the EU and another for all other countries) will be unduly complex and burdensome. A single global minimum standard for BEPS-targeted CFC rules is highly desirable not only from that perspective but also in order to maintain rough parity of competitiveness among parent jurisdictions.

16. We are not entirely clear, however, why competitiveness concerns would be more effectively reduced by combining a minimum standard for CFC rules (which should by definition be able to ensure sufficient CFC taxation in the parent jurisdiction) with a secondary rule of taxation in another jurisdiction, e.g. the source country of the income earned by the CFC. In any event, as discussed in paragraph 8 above, we have some concerns that the source country should only be able to invoke
narrowly targeted special measures (that go beyond the arm’s length principle) as a secondary rule in circumstances where the parent jurisdiction CFC rules do not impose sufficient taxation. How would those circumstances be defined and which jurisdiction should have “first bite at the cherry” in relation to income which is paid from the source country?

**Limiting administrative and compliance burdens while not creating opportunities for avoidance**

17. In our view the administrative burdens and compliance costs imposed by recommended CFC rules to combat BEPS should be strictly proportionate to and serve the purpose of those rules as discussed in paragraphs 11 to 14 above, i.e. to target artificial arrangements involving CFCs with insufficient substance to manage and control the relevant functions, assets and risks and which reduce the parent jurisdiction tax base and result in double non-taxation or less than single taxation. CFC rules which also target foreign-to-foreign stripping are likely to involve significantly greater administrative burdens and compliance costs in the parent jurisdiction.

18. However, we would not support mechanical but over-inclusive CFC rules, for example under the excess profits approach, notwithstanding that these rules may be less complex and burdensome from an administrative and compliance standpoint. In our view, well-defined substance-based rules, with suitably targeted entity-level exemptions, should strike the right balance between administrative/compliance burdens and costs on the one hand and preventing tax avoidance through artificial diversion of profits from the parent jurisdiction to low-taxed CFCs on the other.

**CFC rules as preventative measures**

19. We would agree that CFC rules for combating BEPS from the parent jurisdiction involving CFCs with insufficient substance to manage and control the relevant functions, assets and risks should not also have as a primary aim to maximise corporate tax revenues for that jurisdiction. Such a policy objective would tend to encourage parent jurisdictions which are less sensitive to competitiveness concerns to opt for a fuller-inclusion type of CFC regime. BEPS-targeted CFC rules should be designed solely or mainly to act as a deterrent against the behaviours discussed above that artificially erode the tax base of the parent jurisdiction, while at the same time not penalizing the synergies that occur in a multinational group.

20. The rate at which a CFC tax is imposed in comparison to the source country rate of taxation on profits may or may not in fact deter foreign-to-foreign stripping but, as noted in paragraph 12 above and acknowledged in this and other Discussion Drafts, the issue of differential tax rates is not per se within the scope of the BEPS project. In other words, BEPS-targeted CFC rules should not have as a policy objective to drive convergence of tax rates. Countries should be free to set tax rates according to their economic and other priorities, subject to consensus-based recommendations under Action 5.

**Scope for base stripping**

21. We note that the Discussion Document reflects a lack of consensus as to whether recommended CFC rules should be designed to target BEPS behaviour which causes foreign-to-foreign (as well as parent jurisdiction) stripping. In our view, however, the difficulty in principle with primary CFC rules which attribute to the parent jurisdiction income diverted from a third country to a CFC jurisdiction is that the diverted profits do not end up being taxed in the jurisdiction from which the profits have been artificially shifted. This is hard to justify as a matter of principle, particularly
where such jurisdictions are developing countries and may lack the capacity to apply the arm’s length principle under transfer pricing rules and any OECD-endorsed special measures effectively, unless the parent jurisdiction is willing to rebate the CFC tax to those countries, at least in cases where they have not been able to tax the diverted profits. No such recommendation or option is mentioned in the Discussion Draft.

22. In our view, there are other more directly effective and targeted ways within the scope of the BEPS project than CFC rules of protecting non-parent company source countries from BEPS into CFCs that require further detailed consideration, in particular robust transfer pricing rules, narrowly targeted consensus-based special measures (where the arm’s length principle is clearly deficient) and anti-hybrid mismatch rules. Developing countries should be supported in their efforts to frame tax laws and build administrative capacity to operate those laws effectively. We would, however, strongly oppose other protective measures being adopted by source countries simply because the tax rate in the CFC jurisdiction is considered to be too low, for example by disallowing relief for or imposing withholding taxes on interest or royalty payments etc.

Avoiding double taxation

23. As previously noted, the risk of double (or even multiple) taxation is exacerbated where CFC rules are designed to combat foreign-to-foreign stripping as well as parent jurisdiction stripping. If the parent, CFC and source jurisdiction each tax the same slice of CFC profit, which jurisdiction has primary taxing rights and how would the ordering rules for double tax relief work? If, however, BEPS-targeted CFC rules are designed only to capture profits artificially diverted from the parent jurisdiction, rules to avoid double taxation as between the parent and CFC jurisdictions only should be more straightforward although not without complications (see further discussion in Section IX. below).

CFC rules and transfer pricing

24. It is acknowledged that, as outlined in the Discussion Draft, in some cases of artificial diversion of profits from the parent jurisdiction to a CFC, such jurisdictions may justifiably consider that there is a need for CFC rules as a supplement to the arm’s length standard under transfer pricing rules in order to protect their tax base. The focus of Action 3 should therefore be on recommending CFC rules which prevent parent jurisdiction stripping only in those circumstances where the problem cannot be effectively addressed by application of the arm’s length principle under transfer pricing rules. In this way the two regimes should complement one another in a coherent manner.

25. However, it is vital that any narrowly targeted special measures that go beyond the arm’s length principle as eventually recommended under Actions 8-10 in order to protect the tax base of the parent jurisdiction from BEPS do not apply to the same artificially diverted profits as included CFC rules recommended under Action 3 (or vice versa). This will only result in complexity, confusion and additional administrative and compliance burdens/costs.

26. Finally, insofar as the Discussion Draft suggests otherwise, we do not consider it necessary or justified for parent jurisdiction CFC rules to target foreign-to-foreign stripping in order to indirectly support (or even replace) the operation of the parent jurisdiction’s own transfer pricing rules.
III. Definition of a CFC\(^2\)

**General Comments**

27. We do not disagree in principle with the recommendation that partnerships, trusts and, subject to the comments below, permanent establishments (PEs) that are either owned by CFCs or treated in the parent jurisdiction as taxable entities separate from their owners should also be treated as CFCs although this will result in additional complexity. We comment on Question for consultation 1 below on some practical issues arising from this treatment. However, in order to minimise any unnecessary administrative and compliance burden, we do not consider that a foreign PE of a CFC should itself be treated as a CFC where virtually all of the CFC’s activities are carried on through the PE and there is very limited (if any) substance in the CFC’s jurisdiction of incorporation. Such structures are common in, for example, the upstream oil and gas sector where they exist for purely commercial reasons.

28. The broad option for a modified hybrid mismatch rule is over-inclusive as it would apply even where there is no double non-taxation or less than single taxation. Income would be included in the parent jurisdiction (whether or not recognised in the CFC jurisdiction) even though no corresponding deduction is given in the source country. In line with our previous comments, this would subject more income to CFC taxation than is necessary to combat BEPS which would be beyond the scope of Action 3. In addition, the broad option could pick up income shifted from a third country to the CFC jurisdiction as well as income genuinely earned in the CFC jurisdiction. In our view, this also goes beyond the purpose of BEPS-targeted CFC rules which should be focused only on parent jurisdiction stripping.

29. The narrow option for a modified hybrid mismatch rule is better aligned with BEPS-targeted CFC rules but could still result in foreign-to-foreign “stripped” income being included in the parent jurisdiction. Further work under Action 3 is required to refine the precise scope of a properly targeted narrow option. This work needs to be co-ordinated with work on other related Actions, in particular Action 2 (hybrid mismatches), Action 4 (interest deductions) and Actions 8 - 10 (transfer pricing guidelines) on special measures.

**Questions for consultation**

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<th>Question</th>
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<td>1.</td>
<td>Would any particular practical issues arise from treating transparent entities as separate entities in the cases listed below? If so, what are they and how could they be dealt with?</td>
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**IAPT Comment:** The main practical issue is that (re)determination of the (non-corporate) entity’s profits under international standard accounting rules or the tax rules of the parent jurisdiction may not be straightforward in practice and detailed deeming rules would be necessary to clearly prescribe how the (re)determination should be undertaken. Other issues

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\(^2\) Our comments in Sections III to IX relate to the sections in the Discussion Draft which consider the “building blocks” for effective CFC rules. However, our comments on the specific questions for consultation are limited. Most of these questions are concerned with practical issues. Given the extremely short consultation period, and in the absence of consensus-based recommendations, it has not been possible to evaluate the practical issues raised by most of the questions for consultation. However, the IAPT is ready to provide further input on these matters as the work of the OECD on Action 3 continues.
include (i) how to apply the CFC control test to certain transparent entities (e.g. trusts);³ (ii) how to deal with cases where the transparent entity’s income is included in a third jurisdiction; and (iii) how to calculate the effective tax rate in a non-exempt foreign PE of a CFC.

IV. Threshold Requirements

General Comments

30. Although we agree, in principle, that it is appropriate to determine the low-tax threshold based on an effective tax rate of the CFC by reference to the statutory corporate tax rate in the parent jurisdiction, in our view a single threshold for inclusion of the CFC which is set at 75% of that rate is too high, particularly for parent jurisdictions which have relatively high corporate tax rates. In our view, other options should be considered, for example (a) a fixed threshold rate (e.g. 10%) or (b) the lesser of 50% of the parent jurisdiction tax rate or fixed “floor” rate (e.g. 10%). Consideration should also be given whether to allow the threshold rate to be determined by reference to the effective tax rate of all CFCs in the group combined. In any event, unrelieved third country withholding taxes on CFC income should be included as tax paid in the numerator for the ETR calculation. In our view, a company-by-company approach would seem to pose the fewest administrative and compliance problems (as compared to an income stream-by-income or country-by-country approach).

31. The main challenge with the recommended (ETR) approach is that it requires the profits (or losses) of potentially every CFC in the group (including any transparent entity deemed to be a CFC) to be calculated either under an international accounting standard (e.g. IFRS) or the parent jurisdiction’s own tax rules. For parent companies in some jurisdictions which have a worldwide tax system, this may not entail a significant incremental compliance burden compared to existing requirements. However, for large groups with parent companies in most jurisdictions which have some form of territorial tax system, this approach is likely to be unduly burdensome when, in the final analysis, income of only a few (if any) CFCs may be attributed to the parent jurisdiction.

32. In order to mitigate this burden, and so rule out further consideration of CFCs which are low-risk from a BEPS standpoint, we consider that the following initial exclusions (or “filters”) should as a minimum be included as Action 3 recommendations rather than merely as options:

(a) a de minimis exception for CFCs with a low level of profits coupled with an anti-fragmentation rule (noting from Annex I of the Discussion Document that such an exception is quite common); and/or

(b) an exclusion for CFCs resident in a “white” list of jurisdictions which meet specified high-tax rate and tax base indicia.

33. We would urge further consideration of an anti-avoidance test (e.g. in the form of a principal purpose test), if not as a threshold requirement, at least as an exclusion to disapply CFC rules in circumstances where a transaction or structure is demonstrably not undertaken to achieve artificial diversion of profits to a CFC from the parent jurisdiction. The reality is that, however well drafted a CFC regime based on a categorical approach may be, there will be unanticipated circumstances where CFC income is attributed to the parent company but should not be. In those circumstances, the

³ An issue for trusts is a conflict of rules regarding the tax residence of the trust, which will vary by form of trust and jurisdiction where the trust is formed or the location of the beneficial owners.
taxpayer should not be precluded from showing, if it can, that the arrangements are not motivated to achieve artificial diversion of profits from the parent jurisdiction. In addition, such an exclusion would help ensure that the CFC regime is compatible with EU law. To ensure consistency, it would be helpful for the OECD to produce published commentary on the scope/application of an anti-avoidance exclusion to enable countries to publish appropriate guidance and, subject to resourcing constraints, also to operate an advance ruling facility.

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? |

IAPT Comment: Where (as discussed in paragraph 27 above) virtually all of a CFC’s activities are carried on through a foreign PE and the entity has very limited (if any) substance in its jurisdiction of incorporation, then the de minimis threshold should be determined by reference solely to the tax rate in the jurisdiction of the PE.

V. Definition of Control

General Comments

34. We consider that it should in most cases be sufficient to combat BEPS from a parent jurisdiction for recommended CFC rules to apply both a legal and economic control test where residents of the parent jurisdiction hold more than 50% control. The definition of control should be clear, certain, and easy for both taxpayers and tax administrations to apply. However, a management, dominant influence or other de facto control test should not be recommended as a primary or alternative test for control as it would be too imprecise to serve as a common international standard and would therefore increase not only significant administrative and compliance burdens but also the risk of taxpayer/administration disputes. An alternative control test based on accounting consolidation would, in our view, be unnecessary if the legal and economic control tests are clearly framed and robust. In any event, such a test would be unstable as it would be impacted by changes in accounting practice that may have nothing to do with combating BEPS.

35. An “acting in concert” test to determine whether the requisite level of control by a group of resident minority shareholders exists should not be recommended. In our view, it would be too uncertain as it would require a fact-based analysis in order to determine whether in practice the shareholders acted together (or acquiesced) in order to influence the CFC. As with a de facto control test, an “acting in concert” test is, as noted in the Discussion Draft (paragraph 71), likely to pose significant administrative and compliance burdens. It also does not serve as a solid basis for a common international standard of control because there could be wide variations among parent jurisdictions as to how the test is framed and/or applied in practice.

36. In our view, the recommended test for determining whether a group of resident minority shareholders control a CFC should either be where they are related parties (as defined) or by reference to a “concentrated ownership” requirement where each shareholder owns a minimum (e.g. 10%) voting or economic interest in the CFC. In either case, however, it will be necessary to develop complex related party ownership attribution rules in order to provide a clear basis for establishing the existence of more than 50% control. Either test should, in practice, capture most BEPS behaviours involving groups controlled by resident minority shareholders.
VI. Definition of CFC Income

General Comments

Introduction

37. We start by commenting on key aspects of the overall approach of Chapter 5 of the Discussion Draft. First, we agree that the correct focus is to develop recommendations for narrowly targeted partial-inclusion rules that only attribute income that raises BEPS concerns within each category of “mobile” income, i.e. dividends; interest and other financing income; insurance income; sales and services income; royalties; and other IP income (Discussion Draft, paragraphs 83-84). Second, if the Action 3 recommendations for CFC rules are designed only to combat parent jurisdiction stripping, then income should not be attributed to that jurisdiction if it arises from genuine value-creating activity or investment in any other jurisdiction (Discussion Draft, paragraph 85). Lastly, as noted in paragraph 7 above, CFC rules should not attribute income that arises from genuine value-creating activity or investment in the CFC jurisdiction itself (Discussion Draft, paragraph 85).

Pure form-based analysis

38. We agree that inclusion of CFC income as taxable profit in the parent jurisdiction based purely on formal classifications of income is not well targeted to deal with BEPS and may lead to arbitrary over- or under-inclusion of income. Also, in addition to being manipulable, it is not readily adaptable to business changes. Finally, a pure form-based analysis is unlikely to be compatible with EU law.

Substance analysis

39. Some form of workable test to determine whether the CFC income arose from substantial activities genuinely undertaken by the CFC itself is clearly essential to ensure compliance with EU law by Member States of the EU. In addition, as noted in paragraph 15 above, the test should apply in all jurisdictions so that there is a single global standard. It is also essential that the substance test is framed to ensure that the CFC rules are properly targeted to deal with BEPS from the parent jurisdiction. Each of the three options for a substance analysis has advantages and disadvantages (whether or not combined with a form-based analysis), as set out in the Discussion Draft (paragraphs 87-95). We would highlight the following points:

(a) Substantial contribution analysis: To the extent that it operates as an all-or-nothing entity level threshold test, this analysis could be over- or under-inclusive, depending on the facts. It is therefore not well targeted to combat BEPS from the parent jurisdiction⁴. On the other hand, it is arguably more objective than the other two options below and therefore easier to apply in practice. However, by focussing only on the activities of the CFC’s employees, this approach assumes that the provision of capital and bearing of risks by a CFC are not valuable inputs to its business.

(b) Viable independent entity analysis: This creates a fiction that groups can and do operate stand-alone businesses in each country, but this is not how most (increasingly

⁴ It is worth noting that the “substantial contribution” rules in U.S. regulations do not work as an entity-level test. Instead they look to whether the CFC’s contributions to the manufacturing of particular products are substantial enough to justify treating the income from the sale of those products as active (i.e. excluded) CFC income. Thus, the rules are capable of operating as a proportionate, income-based test.
integrated) multinational groups are now actually organised. It may therefore be
difficult for many CFCs to satisfy this test in practice. It could also provide scope for
tax authorities to substitute their own view after the fact as to what constitutes a
“viable independent” CFC, which would create significant uncertainty and
controversies. For this reason, detailed published guidance, if not advance rulings, is
likely to be necessary to ensure some degree of certainty. In addition, under this
analysis the CFC’s misallocated assets and risks may not properly belong in the
parent jurisdiction. To that extent, it is over-inclusive. However, it may be better
targeted at BEPS than option (a) to the extent that it can operate as a proportionate
income-based test, although it may often be difficult in practice to apply the test to
individual income streams.\(^5\)

(c) Employees and establishments analysis: This is a less fact-intensive and more
objective approach than option (b) and requires more CFC substance than option (a),
but like option (b) can operate as a proportionate test and so may be better targeted
than option (a) at BEPS, although, again, it may often be difficult in practice to apply
the test to individual income streams. On the other hand, as with option (a), it ignores
any analysis of risks or ownership of assets in the CFC.

40. Whatever the advantages or disadvantages of each option, the recommended option(s) should
be designed, so far as possible, to be compatible with the arm’s length principle and to ensure that any
resulting inclusion of CFC income at parent company level does not consist of income that has
already been or could be taxed as a result of a transfer pricing adjustment.

Categorical approach

41. The treatment of dividends, interest/financing income, insurance income, royalties and other
income as prima facie “passive” (and therefore potentially subject to inclusion) is a reasonable
starting point, so long as effective substance-based and other more mechanical exclusions are
available to reclassify the income as “active” (and therefore excluded) where the value-generating
activity or investment is genuinely undertaken outside the parent jurisdiction.\(^6\) It is particularly
important in this regard that there is a robust exclusion for interest or other financing income of a CFC
which arises from funds not provided from or managed in the parent jurisdiction, although, given that
money is fungible, the tracking and tracing rules needed to identify such excluded CFC income would
be complex. For this reason, a mechanical partial exclusion for some portion of the intra-group
finance income (e.g. by reference to a percentage) should be considered as a proxy for a
substance-based exclusion. The rate of the CFC tax charge on the attributed portion of such finance
income could be the same as the standard corporate tax in the parent jurisdiction. The design of an
exclusion of this kind will need to be coordinated with the further work on Action 4 (interest
deductions) and the options for special measures being considered in Actions 8-10 (transfer pricing).

\(^5\) The equivalent of a viable independent entity test in the UK CFC rules applies where the entity has “independent capability”
and “commercial effectiveness”. It is a “gateway” test (to exclude non-financial income of a CFC which has UK-managed
assets or risks) which as a practical matter in many cases operates more as an entity-level test because it focuses on the
“business” of the CFC rather than individual income streams.

\(^6\) For example, U.S. law excepts from current taxation dividends, interest, rents and royalties paid by one CFC to a related
CFC if the payment arises from active income. See Internal Revenue Code § 954(c)(6). While this provision expired for tax
years beginning on or after January 1, 2015, the Administration recommends extending the provision as part of its
international tax reforms. A similar (albeit permanent) exclusion is a feature of the Canadian “foreign accrual property
income” (FAPI) rules.
42. The radical option in the Discussion Draft to treat sales and services income as passive if it includes any IP-derived income unless the CFC is engaged in substantial local activities (including IP development) required to earn the income is, however, a major concern. It would result in significant over-inclusion of income which is genuine business income (bearing in mind that IP is now a more or less integral part of every business model) and which may well have no real economic connection with the parent jurisdiction. This option goes well beyond the base erosion of the parent jurisdiction and foreign-to-foreign base erosion. It is hard to see the rationale of this option if the objective of the Action 3 recommendations should be to target only diversion of profits from the parent jurisdiction by artificially segregating income in a CFC from the activities or investment which generate it.

43. Our strong view, therefore, is that sales and services income (whether or not it includes any IP income or derives from a related party) should be treated as active (i.e. excluded) unless it is derived from a related party in the parent jurisdiction and arises to a CFC which lacks its own (or access to) substance, capacity and resources outside the parent jurisdiction needed to manage its income-generating activities.

Excess profits approach

44. In our view, the disadvantages of this approach identified in the Discussion Document significantly outweigh the advantages cited. Our particular concerns are as follows:

(a) a mechanical excess profits approach is not explicitly focused on BEPS behaviour and so does not identify where the “stateless” CFC income is actually created and therefore should be allocated for tax purposes;

(b) it will be very difficult to quantify a single normal return appropriate for a very broad range of fact patterns across the whole MNC population or to allow for year-on-year business fluctuations within a group;

(c) the excess return may include income arising from genuine economic activity of the CFC outside the parent jurisdiction and/or where there is appropriate substance in the CFC jurisdiction;

(d) it may also pick up income shifted from a third country to the CFC jurisdiction where there is no parent jurisdiction stripping;

(e) a formulaic approach of this kind (without adjustments) could either lead to taxpayer abuse (under-inclusion) or unfairness (over-inclusion);

(f) it would penalize and disincentivize CFCs that created different intangibles from commercially-driven sharing such intangibles to create a new product;

(g) various factually complex adjustments/exclusions (e.g. substance-based) will be required to ensure that only “stateless” CFC income shifted from the parent jurisdiction is picked up, resulting in as much (if not more) complexity than a targeted categorical approach, and

(h) by allowing only a normal return on equity, excess profits approach may disadvantage service sector and other less capital-intensive businesses, particularly those with high risks/margins.

45. For these reasons, our strong view is that the excess profits approach should not be included as an Action 3 recommendation in relation to any type of income. If it is to apply to royalties and
other IP income only, then it should: (i) only apply to residual IP income of a CFC after application of the arm’s length standard under transfer pricing rules, (ii) be a supplementary or cross-checking CFC income inclusion test and not the only or primary test, (iii) include substance-based and other mechanical exclusions/exemptions to ensure that only income which is artificially diverted from the parent jurisdiction (e.g. through the transfer within a specified prior period, e.g. six years, of hard-to-value IP to a limited function CFC) is targeted and (iv) treat expensed off-balance sheet IP owned by the CFC as forming part of its eligible equity.\footnote{It is interesting to note that the U.S. President’s 2016 Budget did not retain any option for an excess profits tax aimed at the transfer of an intangible to a CFC from a related party in the United States but instead proposed a more broadly based minimum CFC tax (of 19% less 85% of foreign tax credits for a rate of 22.3% for earnings above an allowance for corporate equity) that would apply on a country-by-country basis.}

All-or-nothing entity-based or transactional approach

46. We would agree with the conclusion in the Discussion Draft that best practice would be to apply a transactional approach to determine whether or not any particular type of CFC income is attributable under the categorical approach. A transactional approach is more targeted at BEPS behaviour than an entity approach although it will involve a greater administrative and compliance burden.

VII. Rules for Computing CFC Income

General Comments

47. We agree with the Discussion Draft recommendations that:

(a) tax rules of the parent jurisdiction should apply to compute attributable CFC income;

(b) CFC losses may be used against the attributable profits of the same CFC or other CFCs in the same jurisdictions;

(c) parent company losses may be used against attributable CFC profits; and

(d) CFC losses may be carried forward or back for use against profits within (b) or (c) above arising in other years.

48. With regard to paragraph 47(d) above, we consider that, where there is a change in ownership of a CFC, its losses should not be extinguished and should continue to be available for the purposes of CFC rules in the new parent company’s jurisdiction if they would continue to be available to resident companies of that jurisdiction.

49. We acknowledge that, insofar as the policy objective of Action 3 recommendations is only to prevent artificial diversion of parent jurisdiction profits, it would be difficult to justify the offset of CFC losses resulting from the same artificial arrangements against profits of the parent company or CFCs in other jurisdictions. It should be noted, however, that under EU law it would not be possible to preclude (without justification) the offset of other losses arising to a CFC resident in one Member State against the profits of its parent company resident in another Member State.

50. It will be necessary to develop detailed and clear rules to identify and quantify “imported” CFC losses which may not be offset against profits of the CFC itself, affiliated CFCs in the same jurisdiction and the parent company.
VIII. Rules for Attributing CFC Income

General Comments

51. We agree with the broad recommendations in paragraph 143 of the Discussion Draft for this building block. However, it will be necessary to develop detailed and clear rules, either for the deemed dividend theory or the flow-through approach, to address the mechanics and tax implications of attribution of CFC income where the CFC is held by the ultimate parent company (or controlling minority shareholders) indirectly through one or more intermediaries located outside the parent jurisdiction which is applying the relevant CFC rules.

52. We do not consider that a “top-up” (“minimum”) tax rate should be recommended as the tax rate which applies to attributed CFC income, but countries should be able to retain this as an option, particularly where the rules for defining CFC income result in an attribution of CFC profits that have not been artificially diverted from the parent jurisdiction.

IX. Rules to Prevent or Eliminate Double Taxation

53. We agree, as recommended in paragraph 155 of the Discussion Draft, that the parent jurisdiction should give credit relief for foreign taxes paid in the CFC jurisdiction on attributed CFC income and for foreign CFC charges paid by intermediate companies on the same CFC income. Credit should, however, also be allowed for third country taxes (e.g. withholding taxes) imposed on attributed CFC income. We also agree that there should be a hierarchy of rules to determine which countries with CFC rules applying to two or more holding companies in a chain of ownership should have priority CFC taxation rights. We note that different policy considerations could be relevant to the determination of which country’s CFC rules should have priority where both the parent country (Country A) and the intermediary country (Country B) have CFC regimes that would require inclusions of income from a lower tier CFC (in Country C).

54. For example, there is a view that it may be more appropriate to prioritise the CFC rules of the jurisdiction of the ultimate resident shareholder(s) than the CFC rules of the jurisdiction whose resident shareholder is closer to the CFC in the chain of ownership. The holders of that view argue that, if the goal of BEPS-targeted CFC rules is only to capture profits which have been artificially diverted from a parent jurisdiction, those profits are more likely in many cases to have been created in the jurisdiction of the ultimate resident shareholder(s) than in an intermediate holding jurisdiction. Another view is that the Discussion Draft’s recommendation, which gives priority to the Country B CFC rules over the Country A CFC rules (e.g. by requiring Country A to give a credit for the Country B CFC tax imposed on the Country C profits), is more appropriate. Holders of that view argue, for example, that requiring a higher tier country to give credit for taxes imposed at a lower tier is more consistent with normal “indirect credit” mechanisms and is just as likely as the other view to give priority taxing rights to the country from which profits were shifted to the Country C CFC. The IAPT members do not have strong views one way or the other as to which view should prevail, so long as the recommendation is for an approach that will consistently prevent double taxation that could arise from the application of multiple CFC rules.

55. We agree that the parent jurisdiction should exempt dividends out of included CFC income (subject to appropriate matching rules) and refund CFC tax paid to the extent this equals any dividend withholding tax imposed in the CFC jurisdiction. The parent jurisdiction should also exempt gains or
give a basis step-up on a direct or indirect disposal of shares in a CFC to the extent that previously included CFC income is reflected in the gain, whether or not the parent jurisdiction normally exempts gains on share sales. A pre-sale dividend may not necessarily be feasible, and there is no reason in principle why a CFC share sale “cum-dividend” should be disadvantaged compared to an “ex-dividend” share sale.

56. Significantly more detail and guidance is therefore required as part of the Action 3 recommendations on the mechanics for an effective system of double tax relief. Experience of worldwide tax systems with foreign tax credit relief rules, as well as territorial systems which operate such rules in relation to CFC charges, should be taken into account in developing effective double tax relief rules under Action 3.

57. We set out below some examples of potential double taxation scenarios in the context of BEPS-targeted CFC rules to illustrate the challenge of framing effective multilateral double tax relief rules.

Example 1

If profits of CFC1 that have been attributed to its foreign parent (PCo) are reallocated to CFC2 in a third jurisdiction as a result of an appropriate transfer pricing adjustment and the jurisdiction of CFC1 makes a corresponding adjustment, then the PCo jurisdiction should give credit relief for resulting third country tax against any CFC charge on the reallocated profits of CFC2. In order to avoid a double CFC inclusion of the reallocated profits in the PCo jurisdiction, it may also be necessary for that jurisdiction to reverse PCo’s inclusion of CFC1 profits. If, there is no (or insufficient) corresponding adjustment in the CFC1 jurisdiction but there should have been, the parent jurisdiction should be required to give credit relief for any CFC1 jurisdiction tax charge imposed on unadjusted CFC1 profits attributed to the PCo jurisdiction (up to its foreign tax credit limitation).

Example 2

Assume that a source jurisdiction denies deductions for royalty payments to an entity in another jurisdiction where the effective tax rate on the payee is considered insufficient by the source jurisdiction. If the income from such royalties is also subject to inclusion in the parent jurisdiction under its CFC rules, how can double taxation be avoided that arises from the denial of the deduction? Disallowing a deduction for royalties would frequently result in a very high effective tax rate. A CFC which owns intangibles and bears all the related costs may only earn a profit of, say, 25% of its royalty income. In this case, even if the tax rate in the CFC jurisdiction is nil, disallowing a deduction for a royalty paid by a company in a source jurisdiction with a 25% tax rate would produce an effective tax rate on the profit derived from the royalty of 100%. This double tax outcome would be exacerbated to the extent that the parent jurisdiction also taxes the double-taxed profit under its CFC rules. A hierarchy of complementary double tax relief rules would be needed to deal with this scenario so that CFC’s profits end up being allocated to and taxed once in the correct jurisdiction. (This example also illustrates the punitive and inappropriate results of disallowing a deduction for payments that are considered to be insufficiently taxed in the recipient (CFC) jurisdiction, and why such an approach should be strongly discouraged by the OECD.)

Example 3

If, in example 2, the source jurisdiction imposed a withholding tax on the royalty payment instead of denying the deduction this can produce a similar double taxation result. In this case,
double taxation would be avoided if the parent jurisdiction gives credit relief not only for tax paid in the CFC jurisdiction on CFC profits but also for the third country withholding tax.

Example 4

The timing of foreign taxes imposed on a CFC as a result of challenges from tax authorities relating, for instance, to transfer pricing adjustments or anti-avoidance rules can be many years after the relevant transactions. In order to avoid double taxation in the event of a successful challenge and where there has been a previous CFC charge by reference to the same CFC income, credit relief should be given in the parent jurisdiction for the subsequent foreign tax. This will require a mechanism in that jurisdiction to re-open any closed CFC returns.