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BEPS Action 3: Strengthening CFC rules

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On April 3, 2015 the Organisation 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 on Action 3 in relation to strengthening controlled foreign corporation (CFC) rules.

As with other discussion drafts on BEPS Actions, the proposals do not represent a consensus view from the G20/OECD governments involved but are designed to provide preliminary but substantive proposals for public analysis and comment.

OECD proposals

The discussion draft identifies seven “building blocks” as the design principles for 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.

The building blocks are as follows:

Definition of a CFC: CFCs should include corporate entities, trusts, non-transparent partnerships and permanent establishments where the income of the permanent establishment is exempt in the head office jurisdiction. A further recommendation is to include a modified anti-hybrid rule to prevent entities from circumventing CFC rules by the use of hybrids. For example, by treating an overseas subsidiary as transparent for tax purposes, a parent company may be able to take advantage of a same country exception from its CFC rules.

Threshold requirements: Threshold requirements can to be used to limit the scope of CFC rules and exclude entities that pose little risk of BEPS activity. The recommendation is to include a low-tax threshold (similar to the “lower level of tax” test adopted by many jurisdictions with existing CFC rules) based on the effective tax rate of the CFC.

Definition of control: The CFC rules should apply at least both a legal and economic control test, and a CFC should be treated as controlled where residents hold more than 50% control. The discussion draft notes that jurisdictions should be free to lower their control threshold below 50%. Control could be established through aggregated interests of related parties or unrelated resident parties or through aggregating the

interests of any taxpayers that are found to be acting in concert. Additionally, CFC rules should apply where there is either direct or indirect control.

Definition of CFC income: The CFC rules must be capable of dealing with at least the following types of income:

- dividend income
- interest and other financing income
- insurance income
- sales and service income, which can often be linked with intellectual property (IP) income;
- royalties and other IP income

There was no consensus on how CFC income should be defined and the discussion draft considers different options. These include a form based analysis (i.e., broadly categorizing different types of income that represent “passive income” as CFC income and excluding types of income that represent “active income”) and several different versions of substance based analysis (i.e., broadly excluding income that arises from substantial activities undertaken by the CFC itself).

Two possible approaches to analyzing the nature of income are discussed:

- (i) a categorical approach which adopts separate rules for each type of income to identify the CFC income. For example, interest and financing income could be included as CFC income unless the interest is derived from an active financing business and the CFC is not overcapitalized. It was noted that this approach could be combined with a look-through rule that would consider interest to be active finance income if deductible by the payor against its active business income (like Canada’s rule in subparagraph 95(2)(a)(ii) of the Income Tax Act), but noted that such a rule could raise foreign-to-foreign base stripping issues; and
- (ii) an excess profits approach, which could be more specifically targeted at situations that result in BEPS, including IP, by calculating a “normal return” and then subtracting this normal return from the income earned by the CFC, with the difference treated as CFC income.

There are different views of the excess profit approach and 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. The paper also discusses whether CFC income attribution rules should take a transactional approach (which attributes individual streams of income) or an entity approach.

Rules for computing Income: The discussion draft recommends using the rules of the parent jurisdiction (as opposed to those of the CFC’s jurisdiction or a common international standard) to calculate a CFC’s income. The draft further recommends that CFC losses be permitted to be used only to offset profits of CFCs in the same jurisdiction.

Rules for attributing income: Broadly, it is recommended that CFC’s income should be attributed to each controlling person by reference to the person’s proportion of ownership and the actual period of ownership (in cases of controlling ownership for part of a year), applying the tax rate of the parent jurisdiction to the income.

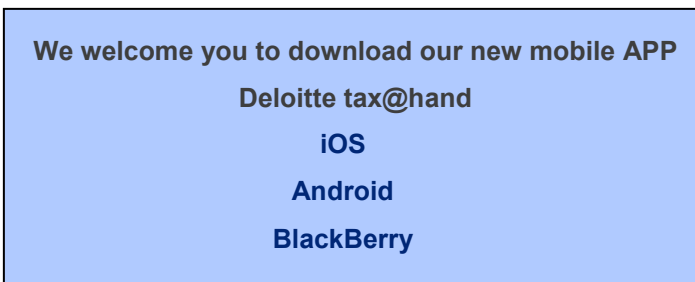
Rules to prevent or eliminate double taxation: CFC rules should allow for a credit for foreign taxes actually paid, including CFC tax paid by intermediate companies in cases where CFC rules in more than one jurisdiction apply to the same CFC income. Consideration should also be given to an exemption for dividends from CFCs and gains on the disposition of CFC shares in cases where income of the CFC has previously been subject to CFC taxation.

Timetable

The OECD has requested comments on the Discussion Draft by 1 May 1, 2015. A public consultation meeting will be held at the OECD in Paris on May 12, 2015.

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