Revenue Guidance on Controlled Foreign Company Rules

Introduction

Controlled foreign company (CFC) rules were introduced into Irish legislation by Finance Act 2018 and came into effect for accounting periods beginning on or after 1 January 2019. To supplement the legislation, Revenue issued 117 pages of guidance on 22 July 2019 (Tax and Duty Manual Part 35b-01-01), providing insights into how the CFC rules are to be applied in the context of Irish parent companies. It gives an overview of the CFC rules and sets out information in relation to:

- the meaning of a CFC,
- the meaning of “control” and “associated companies”, accounting periods and how residence is to be determined for the purposes of the rules,
- the meaning of “undistributed income” and “creditable tax”, and
- the exemptions available.

This article provides a high-level summary of the key sections of the Revenue guidance.¹

Introduction to CFC Rules
The Revenue guidance begins by giving an overview of the CFC rules and the background to their introduction. It is noted that

“CFC rules are an anti-abuse measure, designed to prevent the artificial diversion of profits from controlling companies to offshore entities in low/no tax jurisdictions. The rules operate by attributing undistributed income of the CFCs, arising from non-genuine arrangements put in place for the essential purpose of avoiding tax, to the controlling company, or a connected company in the State for taxation, where the controlling company, or a connected company, carry out relevant Irish activities (i.e. significant people functions (SPFs) or key entrepreneurial risk-taking functions (KERTs) in the State)”.

A number of exemptions are available, and the CFC rules will not apply where the arrangements have been entered into on an arm’s-length basis or are subject to Irish transfer pricing rules. To the extent that a CFC charge arises, a credit will be available for any tax paid by the CFC on the same income.

Meaning of a CFC
A CFC is a non-resident company controlled by a company or companies resident in the State (known as the “controlling company” or “controlling companies”). If the CFC is considered a partnership under Irish rules, the CFC rules apply on a “look through” basis.

Meaning of “Control”
For the purposes of the CFC rules, a person (a body corporate or an individual) “controls” a company if the person can control or acquire control of, either directly or indirectly, the company’s affairs. A person is regarded as having control of a company if the person has or is entitled to acquire (either directly or indirectly):

• the majority of the issued share capital or voting power (with entitlement to more

than 50% of income on a distribution or

more than 50% of distributable assets on a

redemption/winding-up) or

• any part of the share capital where, as a result, the person would be able to control the make-up of the board of directors (including situations where the person holds a “golden share”).

The rights/powers of a nominee of the person, associated companies or associates of the person are to be regarded as belonging to the person in determining whether the person has or can acquire “control” for the purposes of CFC rules. There are a number of examples of how “control” can be construed in section 1.6 of the Revenue guidance.

Accounting Periods
As set out above, the CFC rules apply for accounting periods beginning on or after 1 January 2019. The Revenue guidance (section 2.2) provides that “a CFC’s accounting period begins on the date it becomes a CFC” (and it “...becomes a CFC when an Irish company becomes its respective controlling company”) and “a CFC’s accounting period is also deemed to begin immediately after the end of the previous accounting period where the company was a CFC for the previous accounting period and continues to be a CFC after the end of that accounting period”.

Section 3 of the manual provides that:

“A CFC’s accounting period ends when the company:

• ceases to be a CFC, or

• becomes or ceases to be resident in a territory, or

• ceases to have any sources of income”.

The cessation rules in s27 TCA 1997 also have application, with an accounting period ending and a new one beginning when a CFC commences to be wound up. Revenue is authorised to make a determination with respect to an accounting period where the
beginning or end of a CFC’s accounting period is uncertain (but for a period of no more than 12 months, until further facts are available).

**Residence**

For an entity to be a CFC, it must be non-resident in Ireland for tax purposes. The Revenue manual (section 3.5) provides that the “first step is to determine whether the CFC is considered resident in a territory under the terms of a double taxation treaty”. It further notes that “If there is no such treaty or the terms of the treaty do not establish residence, a CFC is considered resident in the territory where it is subject to tax by reason of its domicile, residence or place of management”. A change in place of residence will not mean that a company ceases to be a CFC as long as it remains resident outside Ireland. There is a tie-breaker rule where two or more territories could be regarded as the place of residence of a CFC. It provides that a CFC will be regarded as resident:

- where the company’s place of effective management is situated,
- if the place of effective management is in two or more locations, where more than 50% of the company’s assets are situated, or
- where neither of the above applies, where more than 50% of the company’s assets are situated.

If none of the above apply (e.g. if there is no double taxation treaty and the jurisdiction does not have a concept of corporate residence), a company will be considered resident where it is incorporated or formed.

It should be noted that the Revenue guidance does not make reference to the Multilateral Instrument (MLI) and its impact on the determination of tax residence (Article 4, Dual resident entities). However, Revenue published a new manual – Part 35-01-11, "Dual-resident Companies" – on 9 October 2019, which outlines the new rule under Article 4 of the MLI regarding the residence for treaty purposes of companies that are resident in more than one jurisdiction (“the tie-breaker rule”). In such scenarios, Article 4 provides that the competent authorities of the relevant jurisdictions shall determine a sole jurisdiction of residence by mutual agreement having regard to the company’s place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. Where an agreement cannot be reached, the company shall be entitled to treaty benefits only to the extent that the competent authorities are in agreement. Ireland adopted Article 4 when it deposited its instrument of ratification of the MLI, meaning that the tie-breaker rule will impact on Irish tax treaties where the corresponding treaty partner has ratified the MLI and has also opted for the same rule. When the tie-breaker rule is being considered, the taxpayer may apply to the competent authority of either jurisdiction to initiate the mutual agreement procedure (MAP) request. These additional requirements should be taken into account in conjunction with considering the new CFC rules for Irish-headquartered groups.

**Non-genuine Arrangements**

For a CFC charge to apply, non-genuine arrangements must be in place for the essential purpose of securing a tax advantage. To determine whether an arrangement should be considered non-genuine, the Revenue guidance provides that it is necessary to analyse the extent to which:

- the CFC would not own the assets/bear the risks that generate the undistributed income but for the Irish SPF/s/KERTs and
- it is reasonable to consider that the relevant Irish activities (SPFs and KERTs) are contributory to the generation of the income of the CFC.

The manual notes that the term “arrangement” is widely defined, but double taxation treaties are excluded from the definition.
Essential Purpose of Securing a Tax Advantage

The Revenue guidance breaks this test into two elements:

- “essential purpose” test and
- tax advantage.

With regard to the “essential purpose” test, the Revenue guidance (section 4.5.1) provides that it is necessary to consider what the decisive factor of the arrangement was. For an arrangement not to fall foul of the CFC rules, it must be possible to determine “that securing a tax advantage was not the decisive factor in proceeding with the arrangements” in question. It is further noted that the “essential purpose” test is narrower than the “main purpose or one of the main purposes” test that is used in other sections of TCA 1997 or in EU Directives.

The Revenue guidance then explains what is meant by “tax advantage”. It provides that a reduction, avoidance or deferral of an actual or potential charge/assessment to tax or an actual or proposed refund/repayment of an amount of tax (including any increase in same) arising out of or by reason of an arrangement could be considered to be a “tax advantage”.

The guidance provides that where a mix of arrangements are in place and some have a tax advantage as the essential purpose, the income must be segmented, with the CFC charge arising only on the undistributed income attributable to the “tax essential purpose” element.

There are a number of examples in the manual (section 4.5), which are helpful in facilitating a better understanding of this test.

Relevant Irish Activities

“Relevant Irish activities” are SPFs or KERTs that are performed in Ireland. For a CFC charge to apply, the Irish SPFs or KERTs must be performed by the Irish controlling company (or a company connected with the controlling company) on behalf of the CFC/CFC group where the SPFs or KERTs relate to the ownership and risks of the CFC and/or assets of the CFC (i.e. the SPFs/KERTs must be carried out by an Irish company or an Irish branch or agency of a non-resident company).

A key step in the CFC analysis is to identify the SPFs and KERTs in question. The Revenue guidance acknowledges that the definitions of SPFs and KERTs are difficult to capture in legislation and notes that they are to be construed in line with the OECD’s 2010 “Report on the Attribution of Profits of Permanent Establishments” (hereafter, “the 2010 OECD Report”).

The Revenue guidance notes that the 2010 OECD Report does not provide a general definition of SPFs or KERTs but instead focuses on how the SPFs and KERTs are functions in a business that require active decision making. It notes that an analysis is to be carried out of the capital, assets and risks of an entity by reference to where the people functions relevant to the assets and risks are performed. The Revenue guidance makes a distinction with respect to the shareholder’s initial decision to establish and capitalise the CFC, noting that:

“The SPFs or KERTs related to the shareholder’s decision to establish and capitalise the CFC are not the SPFs or KERTs that are the subject of the CFC rules. These SPFs relate to the position of the shareholder of the CFC and not to either the assets or the business risks undertaken in relation the management of the assets of the CFC itself. The SPFs and KERTs in question for each CFC are those
related to the assets of the CFC and the management of the CFC’s business risks.”

Key principles outlined in the Revenue guidance with respect to Irish activities are:

- The relevant SPFs or KERTs will differ depending on the nature of the assets held by the CFC. For example, different SPFs or KERTs are associated with holding and managing loans advanced to group members than those related to holding intangible assets and managing the business risks related to those intangibles.

- In the case of the financial assets of financial enterprises, it is generally the case that the same SPFs will be relevant both to the assumption of risk and to the economic ownership of the assets. For this reason, it is necessary to distinguish between the SPFs of financial enterprises and those of other enterprises.

- The SPFs relevant to the assumption of risk and the SPFs relevant to the economic ownership of assets will vary from business sector to business sector.

- An enterprise may have one or more SPFs relevant to the assumption of risk and to the economic ownership of assets, each of which should be considered in the analysis. The extent of the overlap between the SPFs relevant to the assumption of risk and the SPFs relevant to the economic ownership of assets will also vary from business sector to business sector and from enterprise to enterprise within sectors.

- In relation to the allocation of risks, although risks will initially be attributed to the entity – inherent in or created by the entity’s own SPFs – “regard should be had to any subsequent dealings or transactions related to the subsequent transfer of the risks or transfer of the management of the risks to another entity. A risk is to be attributed to the entity that bears the benefits and burdens of that risk and, in particular, the exposure to gains and losses arising from the realisation or non-realisation of that risk.”

**Arrangements Subject to Transfer Pricing or Arm’s-Length Principle Is Applied**

In addition to the above, no CFC charge will arise where the arrangements concerned are already subject to Irish transfer pricing provisions under s835C TCA 1997. The manual confirms (at section 4.6.4) that where Ireland’s transfer pricing regime does not extend to the non-genuine arrangements, the application of transfer pricing principles (i.e. the arm’s-length principle) should ensure that an equivalent amount of profits is taxed under the CFC charge. The CFC charge is disapplied where the income arises from arrangements where it would be reasonable to consider that such an arrangement would have been entered into by parties dealing with each other on an arm’s-length basis. Further guidance on such arrangements is not provided by the Revenue manual, other than confirmation that “reasonable to consider” is to be treated as an objective test. The reader should note the differentiation between arrangements subject to transfer pricing and those to which the arm’s-length principle is applied. Although the two are similar in nature, they are different tests to consider in applying the CFC rules.

Ireland’s transfer pricing regime will be updated from 1 January 2020, with changes including the incorporation of the 2017 OECD guidelines into Irish domestic rules, bringing arrangements where the terms were agreed before 1 July 2010 within the scope of the transfer pricing rules and extending the transfer pricing rules to non-trading transactions and SMEs. It is important when examining the new transfer pricing rules to be adopted in Finance Act 2019 to consider also the impact that these new rules may have in the context of the application of the CFC charge.
**Undistributed Income and Accounting Periods**

As previously stated, a CFC charge will arise on an amount equal to the undistributed income of a CFC or a CFC group (being all the CFCs of a controlling company) attributable to the relevant Irish activities performed by the controlling company, or a company connected with the controlling company, where there are non-genuine arrangements in place for the essential purpose of securing a tax advantage. The undistributed income of a CFC that is subject to a CFC charge is known as “chargeable income”. For the purposes of the charge, the undistributed income of a CFC shall be regarded as the distributable profits of the accounting period less any relevant distributions made. A key question, therefore, is the mechanism by which an accounting period of a CFC is identified.

In accordance with the legislation (and the Revenue guidelines), the undistributed income that can be subject to the CFC charge is to be reduced by specific relevant distributions made. However, the legislation as drafted (and confirmed in the Revenue manual) provides that the distributable income is to be determined without regard to any local company law prohibitions that may exist on the making of distributions. The Revenue guidance provides for no carve-out or exception to this that would limit the application of this provision. This further confirms the difference between “distributions” for the purposes of the CFC charge and for the purposes of Irish close company provisions. Under the latter, restrictions on the making of distributions due to the operation of company law provisions may be regarded as an exclusion from the close company surcharge.

By contrast, no such exemption is allowed for either in legislation or in Revenue guidance on the CFC rules.

For the purposes of the CFC rules, the Revenue manual details a range of circumstances that will not give rise to distributable profits. These are as follows (per section 4.7.2.4 of the Revenue manual):

- Where there is a loss for the accounting period with the result that there are no profits available for distribution, no CFC charge will apply.
- Profits available for distribution for an accounting period do not include retained earnings related to prior accounting periods.
- Profits available for distribution for an accounting period do not include reserves that may be distributable under local law but that arose from capital contributed to the company during the period (e.g. share premium, informal capital contribution reserve).
- The profits available for distribution for the period are generally the profit-after-tax figure in the profit and loss account or income statement of the company’s financial statements for the period (excluding profits in the character of capital gains).

**Negligible Undistributed Income and Low Profit Margin/Accounting Profit Exemptions**

Where the assets/risks held by a CFC increase the undistributed income of the CFC by only a negligible amount (when compared with the undistributed income of the CFC had these assets/risks not been held by the CFC), the CFC charge may not apply. The Revenue guidance notes of “negligible” that it “takes its ordinary meaning of an amount so insignificant as to be not worth considering”. This should be determined in the context of the particular CFC whose amount of undistributed income is being considered. For example, the guidance (section 4.6.5) explains that

where the value of the undistributed income is €10,000 and it would have been €5,000 had the CFC not held the assets at all or borne the risk at all, the difference can hardly be said to be “negligible”. However, where the income would have been €1,000,000 rather than €995,000, it may be more reasonable to consider that difference “negligible”.


Although the manual does not go further in defining “negligible”, it is helpful that references to the term can be found in s538 TCA 1997 and in Part 19-01-09 of Revenue’s Tax and Duty manual. Case law that has tested this concept may also prove useful to taxpayers and advisers in justifying a position taken when applying this exemption.

Further exemptions are provided for low profit margin and low accounting profits, which are covered in sections 5 and 6 of the Revenue manual, respectively.

**Low profit margin exemption**

The low profit margin exemption (s835U TCA 1997) provides that where a CFC’s accounting profits (defined in section 5.3 of the manual) are less than 10% of its relevant operating costs for the relevant period, no CFC charge will apply. The manual (section 5.2) explains that “relevant operating costs” means the operating costs as construed in accordance with international accounting standards or generally accepted accounting practice. It states that relevant operating costs may not include:

- the costs of goods purchased by the CFC and sold outside the country where the CFC is resident for tax purposes and
- payments to associated enterprises.

This means that for COGS to qualify as relevant operating costs, the goods purchased must be sold in the CFC’s jurisdiction and they must not be sold to or bought from associated companies.

**Low accounting profit exemption**

The low accounting profit exemption (s835V TCA 1997) provides that a CFC charge will not apply where a CFC’s accounting profits (defined in section 6.2 of the manual) are either:

- less than €750,000 with non-trading income of less than €75,000 or
- less than €75,000.

Both exemptions are subject to an anti-avoidance provision such that where arrangements were entered into and it is reasonable to consider that the main purpose (see section 2 above) of the arrangements was obtaining these exemptions, the exemptions will not be available.

**Exempt Period Exemption**

Section 7 of the Revenue guidance manual details the exempt period exemption, legislated for in s835W TCA 1997. The manual provides that:

The purpose of this exemption is to provide controlling companies with a “grace period” for newly acquired CFCs during which the controlling company can organise or reorganise its business so that a CFC charge does not arise. To prevent the taxpayer from triggering a CFC charge, the controlling company must restructure the affairs of its subsidiary during the grace period of 12 months so that it is not considered to be a CFC in the subsequent period. If this condition is not satisfied, the exemption is lost and the CFC charge becomes payable in the subsequent period. Subject to certain exceptions, newly formed CFCs are excluded from the exemption.

The exempt period begins when the Irish parent would be subject to the CFC rules for the first time in relation to that CFC. It ends 12 months later. This exemption is subject to very specific rules, such that full comprehension and detailed review of relevant accounting periods will be required in order to examine the conditions and deem the company as qualifying for such an exemption. It should be noted that the exempt period exemption will not be available for a CFC where:

- the CFC was not carrying on a business before the beginning of the exempt period or
- the controlling company was subject to the CFC provisions in relation to the CFC on 1 January 2019.
Newly formed companies are effectively prevented from accessing the exemption, to prevent groups claiming the exemption for all new subsidiaries. However, an exception to this exclusion provides that the controlling company will not be prevented from availing of the exempt period exemption where newly formed CFCs (CFCs incorporated or formed immediately before the exempt period begins) are formed for the purpose of controlling a company or companies, and the company or companies controlled by the CFC would qualify for the exempt period exemption. This exception to the exclusion is intended to cover acquisition vehicles that are set up before acquiring other companies from a third party.

The Revenue guidance manual notes that the exemption cannot apply where the CFC enters into arrangements and it is reasonable to consider that the main purpose of the arrangements is to secure a tax advantage or the exempt period exemption.

**Relief on Certain Disposals of Shares or Securities in a CFC**

Section 835Y TCA 1997 contains a provision to afford relief where a controlling company or a company connected with the controlling company (referred to as a “disposing company”) disposes of shares in a CFC or a company connected with the CFC (the “disposed company”) and the disposing company has previously been subject to a CFC charge in relation to that CFC by reference to its participation in it. Revenue states in its guidance manual that this provision reflects the fact that profits available for distribution can affect the share value. Therefore, the legislation provides that, as those profits have already been subject to a CFC charge in the hands of the shareholders, in calculating the amount of the chargeable gain, the amount of the CFC charge will be allowable as a deduction against the consideration for the disposal. An amount to be allowed as a deduction can be allowed only once.

This provision is subject to specific conditions, and certain formulae should be applied where there is one or more than one disposing company. Great care should be taken in assessing the chargeable gain in such a scenario, given the complexity of these rules.

**Effective Tax Rate Test**

Section 10 of the Revenue guidance provides details of the effective tax rate (ETR) test.

A comparison is required between the tax paid in the CFC’s foreign jurisdiction of residence and the tax that it would have paid in Ireland had the CFC been Irish tax resident. The legislation provides that profits may come within the scope of the CFC charge where the corporate tax, including any tax on chargeable gains, paid by the CFC is less than half of the tax that would have been paid had the income been taxed on the basis that the CFC was resident in the State.

The guidance refers to the ETR test as “an exemption of last resort”, given the significant administrative burden imposed by the test. The legislation (as set out in Part 35B TCA 1997) allows the taxpayer to consider all other elements giving rise to a potential CFC charge and the other potential exemptions outlined above that may be available before undertaking the ETR test.

The ETR test requires the calculation of a hypothetical Irish tax charge on the CFC’s income under Irish principles. A number of assumptions, outlined in section 10.3.5 of the manual, are required to be made to calculate the corresponding profits in Ireland for the purpose of determining this hypothetical tax charge:

- that the CFC is resident in the State during the accounting period;
that the company has been resident in the State since its first accounting period (this means the accounting period in which the CFC was first regarded as a CFC);

that the CFC will continue to be resident in the State in subsequent accounting periods (unless it ceases to be regarded as a CFC);

that, if the company was resident in the State when it was not a CFC, there is a break in residence between the accounting period where it was resident in the State and was not a CFC and its first accounting period as a CFC;

that the company is within the charge to corporation tax;

that the accounting periods of the company are accounting periods for corporation tax purposes;

that there is no change in the place or places at which the company carries on its activities;

that the company is not a close company;

that the company has made any necessary election or claim for the maximum amount of any relevant allowance, credit, deduction, relief or repayment allowable where necessary;

that the company is not a member of a group or consortium; and

that the company is not entitled to double taxation relief under the laws of its territory of residence.

The manual explains how to deal with differing treatment of income between the tax systems of Ireland and of the foreign jurisdiction. It notes in section 10.2.3 that:

Income is taken into account in calculating the CFC’s foreign chargeable profits but would not be taken into account in determining the corresponding chargeable profits for Irish tax purposes, that income should be excluded when determining the foreign tax paid or borne by a CFC for an accounting period.

The manual also explains how to approach differing treatment of expenditure between the two tax systems. It notes in section 10.2.4 that “… expenditure that is not normally taken into account in calculating the CFC’s foreign chargeable profits should be taken into account where it would be included in calculating the corresponding chargeable profits in the State”.

**ETR test: other considerations**

The Revenue manual notes that in foreign jurisdictions where there is a sole remitter of tax for a group of companies, the CFC’s ETR test should be determined by apportioning the tax paid on the aggregated profits of the consolidated group on a just and reasonable basis to calculate the amount of foreign tax relevant to the CFC being examined.

The manual also notes that corporation tax arising on the profits of a trade of the CFC carried on in the State through a branch or agency are excluded as they are already within the charge to Irish tax.

Further guidance on the assumptions listed above is contained in section 10.3.6 of the Revenue manual, and a detailed example of the practical application of the ETR exemption is given in section 10.5.5.

Given the complexities involved in calculating the hypothetical Irish tax charge, it would be appropriate to determine whether any of the other exemptions might apply before considering the ETR test.

**Conclusion**

Revenue’s 117-page guidance manual is a welcome resource for taxpayers and practitioners coming to terms with a piece of legislation that is completely new and a fundamental change in our tax system. Clarity and precision will be required to dissect the fact pattern of certain groups and
transactions in the context of the CFC rules. Timely updates to Revenue’s CFC guidance when required will be welcomed by the tax community in Ireland.

Given Ireland’s competitive tax rate and the multitude of possible CFC charge exemptions available, real-time documentation of the SPFs and KERTs of a group’s overseas activity will be more important than ever. Ireland’s CFC regime should feature in global expansion discussions with tax advisers/clients at the outset so that potential risks for the group in triggering a CFC charge can be identified. A reactive and relaxed attitude to this regime may result in the taxpayer’s scrambling for the “exemption of last resort”, the ETR test, which could have been prevented if a proactive approach to the regime had been adopted.

As there is now a section in the Form CT1 that requires a taxpayer to disclose several details relating to the CFC rules – such as what exemptions may apply, how control is established and details surrounding the CFC charge – it is crucial that taxpayers take steps to understand fully the CFC footprint that they may already have and to determine how best to manage and comply with Ireland’s new CFC provisions.