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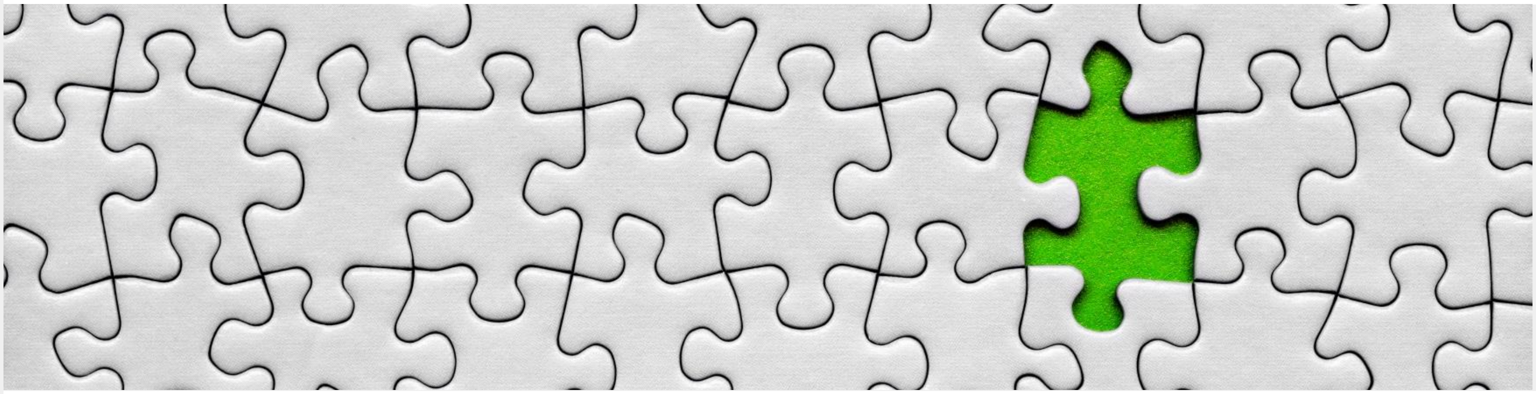

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BEPS Action 3: Strengthening CFC Rules

On 3 April 2015 the 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 CFC Rules. This Action is focused on developing recommendations on the design of domestic controlled foreign company (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” 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.

The paper notes that the aim is to set out recommendations for effective CFC rules that can be implemented in all jurisdictions but acknowledges that, depending on the agreed recommendations, EU Member States may need to make modifications to comply with EU law.

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 recommendation is that CFC rules should apply at least both a legal and economic control test, and that a CFC should be treated as controlled where residents hold more than 50% control. The paper 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 from 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 Discussion Draft makes clear that 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 IP income; and
- 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 categorising different types of income that represent “passive income” as CFC income and excluding different types of income that represent “active income”) and several different versions of substance based analysis (i.e. broadly excludes income that arises from substantial activities undertaken by the CFC itself). The paper then discusses two possible approaches that could be used to determine income that raises BEPS concerns and should be attributed to shareholders, and income that does not:

(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 derived from an active financing business and the CFC is not overcapitalised. The paper notes the particular issues associated with IP; and

(ii) an excess profits approach, which could be more specifically targeted at situations that result in base erosion and profit shifts, 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 attributing income: Broadly, it is recommended that a CFC’s income should be attributed to each controlling person by reference to their proportion of ownership and their actual period of ownership (i.e. 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. At the discretion of individual jurisdictions, 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 2015. A public consultation meeting will be held at the OECD in Paris on 12 May 2015.

Forthcoming Deloitte EMEA Dbriefs Webcast

Deloitte's Dbriefs webcast programme for Europe, the Middle East and Africa will include a discussion on Strengthening CFC Rules on 28 April 2015 at 14.00pm (BST). For further details and to register for the webcast please go to **http://deloi.tt/1NBiiNV** or visit **www.emeadbriefs.com.**

Find out more

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