Deloitte.

International Tax

United States Tax Alert

April 14, 2015

OECD/G20 BEPS Project Releases Discussion Draft on Action 3: Strengthening CFC Rules

Contacts

Gretchen Sierra
gretchensierra@deloitte.com

Harrison Cohen
harrisoncohen@deloitte.com

Matthew Etzl
metzl@deloitte.com

On April 3, 2015 the OECD released a discussion draft on Action 3 (Strengthening CFC Rules) of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project. The public has until May 1 to submit written comments. The paper (hereinafter the Draft or Discussion Draft) states that it "does not necessarily reflect consensus views of either the Committee on Fiscal Affairs (CFA) or of WP11 [Working Party No. 11] regarding the issues it addresses."

The Draft starts with a brief discussion of overall policy considerations and then makes draft recommendations on the design of six of seven elements that a country must include when enacting a "controlled foreign company" (CFC) regime:

1. Definition of a CFC
2. Threshold requirements
3. Definition of control
4. Definition of CFC income
5. Rules for computing income
6. Rules for attributing income
7. Rules to prevent or eliminate double taxation

The fourth element, "Definition of CFC income," or what the U.S. tax law would call "subpart F income," lacks a recommendation. Even so, the discussion of how CFC income might be defined takes up about one-third of the entire Discussion Draft.

This alert is intended to provide a brief overview of the recommendations and CFC income discussion in the Discussion Draft.

1. Definition of a CFC

The Discussion Draft recommends a broad definition of CFC that would include corporate entities and partnerships, trusts, and permanent establishments (PEs) when those entities are either 1) owned by CFCs or 2) treated in the parent jurisdiction as taxable entities separate from their owners.[1]

In addition, to prevent companies from avoiding CFC rules through the use of disregarded entities or other hybrid arrangements, the Draft recommends a modified hybrid mismatch rule to prevent entities from circumventing CFC rules by being treated differently in different jurisdictions.[2] The Draft explains this as a rule about taking intragroup payments into account “in calculating the parent company’s CFC income” when entities or arrangements are classified differently in the parent jurisdiction, on the one hand, and the payer or payee jurisdiction, on the other. A modified hybrid mismatch rule may include a payment in the income of a CFC where the payment is 1) not included in CFC income, but 2) would be so included if the parent jurisdiction had classified the entity in the same manner as the payor or payee jurisdiction. The Draft gives countries a choice, however, of a “narrow” or “broad” option on this point. Under the broad option, meeting the two above-mentioned conditions would be sufficient to cause the payment to be included in the income of the CFC. Under the narrow option, the two conditions would be necessary but not sufficient; a third condition - that the payment be “base eroding (e.g. deductible in one jurisdiction and subject to a nil or low rate of tax in the jurisdiction of receipt)” - would also have to be met in order to cause the payment to be included in the income of the CFC.

2. Threshold Requirements

The Draft recommends excluding companies from the CFC rules by reference to a “low-tax threshold” based on an effective tax rate. Under the recommendation, in order for a parent company’s foreign subsidiary to be a CFC to which the CFC rules *would* apply, its effective tax rate should be “meaningfully lower” than the tax rate in the parent country (i.e., no more than 75 percent of the statutory corporate tax rate).

The Draft neither recommends nor dissuades countries from adopting a *de minimis* CFC income threshold (cf. Internal Revenue Code section 954(b)(3)(A)), but recommends as a best practice adopting an “anti-fragmentation rule” in conjunction with any *de minimis* threshold. Such a rule would prevent companies from splitting income between several entities in order to fall underneath the

[1] Similar to the U.S. treatment of reverse-hybrid entities, the Draft recommends that where an entity is taxable under the laws of its parent jurisdiction, but fiscally transparent in its jurisdiction of residence, the entity should be included within the definition of a CFC. To accommodate its “low-tax minimum threshold” recommendation discussed in the section below, the Draft recommends that fiscally transparent entities directly held by CFCs should fall within the definition of a CFC. By including partnerships and trusts within the definition of a CFC, the Draft addresses attempts to blend high tax and low tax income at the partnership or trust level to fall below its low-tax threshold recommendation, thus avoiding application of a jurisdiction’s CFC rules.

[2] An example in the Discussion Draft specifically identifies the modified hybrid mismatch rule as supplementing rules provided under Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements. The example involves payments between a disregarded entity wholly owned by a CFC, where both the CFC and disregarded entity’s residence jurisdiction fails to adopt hybrid mismatch rules. Even if the parent company’s jurisdiction adopts hybrid mismatch rules similar to those recommended in the Action 2 Report, without a modified hybrid mismatch rule as suggested in the Action 3 Discussion Draft, the payment would avoid taxation in the parent jurisdiction.

applicable *de minimis* threshold.[3]

3. Definition of Control

The Draft recommends that satisfying either a legal or economic control test (e.g., vote or value tests) should be sufficient to constitute "control." De facto tests may also be applied. At a minimum, a CFC should be treated as "controlled" where residents hold more than 50 percent control, but countries can set the threshold at a lower level to prevent circumvention of the rules. Related parties, unrelated parties, parties "acting in concert," or "concentrated" owners (cf. section 951(b)) could be taken into account to determine whether the more-than-50-percent (or lower) control threshold was met.

4. Definition of CFC Income

The Discussion Draft generally does not provide recommendations for determining what should be included in the definition of "CFC income" (cf. the definition of subpart F income in section 952(a)). Instead, there is a 20-page discussion of general and specific approaches to the definition, often but not always focusing specifically on the treatment of income classified as:

- dividends,
- interest and other financing income,
- insurance income,
- sales and services income, and
- royalties and other IP income.

The discussion is framed as identifying ways to distinguish between substantive business income and passive-type income capable of being manipulated for tax purposes.

The Draft states that defining CFC income purely based on the formal classification of an item of income, or "pure ***form-based analysis***," does not "accurately attribute income earned in the modern business environment," and that "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." The Draft suggests three possible substance analyses:

1. A substantial contribution threshold test (cf. Treas. Reg. §1.954-3(a)(4)(iv)) that identifies active business income by applying a facts-and-circumstances analysis focused on whether the employees of a CFC have made a substantial contribution to the income earned by the CFC. Once the threshold is met, none of the income would be included in CFC income.

2. A viable independent entity analysis, similar to a transfer pricing analysis or the authorized OECD approach under Article 7 (Business Profits) to the attribution of profits to a PE, that looks to the functions performed, assets used, and risks assumed by a particular CFC as compared to entities of the CFC's related group. If it is determined that certain functions, assets, and risks would most likely not have been owned by

[3] Examples provided in the draft include the U.S. targeted anti-abuse rule under Treas. Reg. §1.954-1(b)(4), which creates a rebuttable presumption that the income of two or more related CFCs is aggregated when applying the *de minimis* threshold.

the CFC if the members of the group were unrelated, income derived from such functions, assets, and risks would be included in the definition of CFC income.

3. An employees and establishment analysis that looks to whether a particular CFC has the necessary business premises and number of employees with the requisite skills to perform a CFC's core functions.

The draft next evaluates the pros and cons of two potential approaches for accurately identifying and attributing CFC income that raises BEPS concerns:

1. The categorical approach, which attempts to classify particular categories of income and apply separate rules to each category (cf. the definitions of "foreign base company income" under section 954(a) and (c) through (g)).

2. The excess profits approach, which defines CFC income as any income earned by a CFC in excess of a "normal rate or return" (cf. section 4211 of H.R. 1, 113th Cong., 2d Sess. (2014); General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals, at 20-22 ("Impose a 19-percent minimum tax on foreign income")). The draft suggests defining a normal rate of return as a rate of return an investor would expect to receive with respect to an equity investment, which could be identified by a risk-free rate of return plus a premium reflecting the risks associated with an equity investment.

5. Rules for Computing Income

The Draft recommends using the rules of the parent jurisdiction (as opposed to those of the CFC's jurisdiction or a common standard such as IFRS) 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.

6. Rules for Attributing Income

With respect to the way in which the parent company includes the CFC's income in its own income (cf. section 951(a)), the Discussion Draft identifies a number of issues, and makes specific recommendations on some of them. In particular, a CFC's income should be attributed to each shareholder by reference to their proportion of ownership and their actual period of ownership (in cases of ownership for only part of a year), applying the tax rate of the parent jurisdiction to the income. The "attribution threshold" is recommended to be "tied to the minimum control threshold when possible, although countries can choose to use different attribution and control thresholds depending on the policy considerations underlying the CFC rules." The character and timing of a shareholder's income inclusion is left to each country's domestic law.

7. Rules to Prevent or Eliminate Double Taxation

In situations where CFC income is subject to tax in the hands of the CFC, the Draft recommends allowing a foreign tax credit (as opposed to deduction or exemption) in the parent jurisdiction.

In situations where a CFC has a direct foreign owner subject to the CFC regime in its jurisdiction, and the direct owner has an owner in another country that is also subject to the CFC regime in its own jurisdiction, and each owner would include the same item of the CFC's income in income under its own CFC regime, the draft recommends that the indirect shareholder give a foreign tax credit for the tax imposed on the direct shareholder.

Finally, the draft suggests addressing situations where a CFC distributes income previously taxed under CFC rules, or a shareholder sells the shares of a CFC, by exempting such distributions or gain attributable to previously-taxed income of a CFC (cf. sections 959 and 961).

Conclusion

The question of whether and how the 44 BEPS project countries will coalesce on a recommendation for the definition of CFC income will be a key development to watch for at the public consultation meeting on May 12, and in any subsequent version or versions of Action 3. In addition, it will be important to monitor any developments on a hybrid mismatch rule for the definition of a CFC, threshold requirements, or the definition of control (among others), as some of the recommendations in the discussion draft, if enacted by participating countries, could in some cases represent significant departures from present law.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see http://www.deloitte.com/aboutfor a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Certain services are not available to attest clients under the rules and regulations of public accounting.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's approximately 200,000 professionals are committed to becoming the standard of excellence.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

© 2015 Deloitte Global Services Limited