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CFC Legislation – An EU, BEPS and Nordic Perspective

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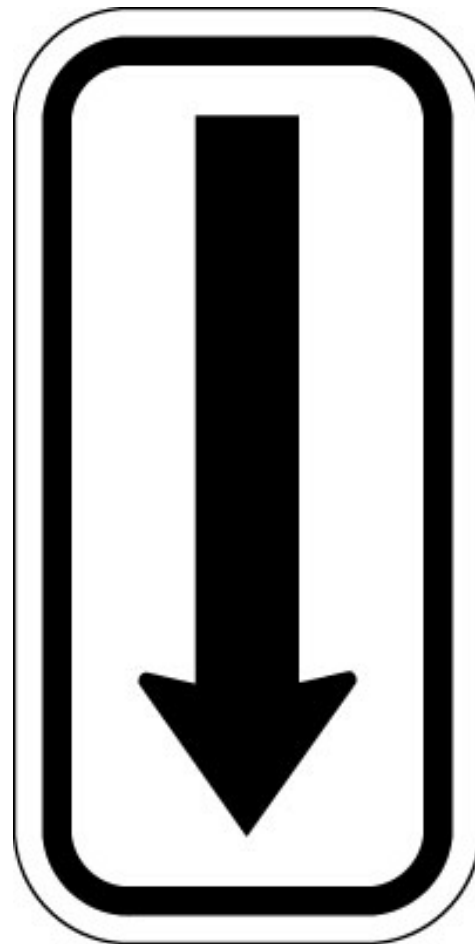
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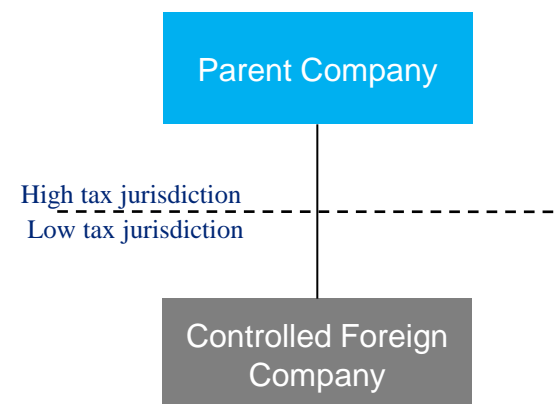
Agenda

- CFC taxation in a nutshell
 - Need and purpose
 - Development and spread
- OECD/G20 BEPS Project, Action 3
 - Building blocks } Discussion
- EU Law and CFC legislation
 - Primary Law
 - ATA Directive
 - CCCTB } Discussion based on a case
- CFC rules and tax treaties } Very briefly
- A Nordic perspective } If time allows
- Conclusions



CFC taxation in a nutshell

- If (effective) CFC rules not in place → Possible to reduce tax burden by shifting mobile assets/income to a company in a low tax jurisdiction
- The opportunity rests on two grounds
 1. The separate entity principle → deferral/sheltering/avoidance
 2. The existence of low tax jurisdictions
- CFC rules → Current taxation at the level of the parent company of the income in the CFC, despite no dividend distribution
- CFC rules mainly have a prophylactic effect
- The compatibility of CFC rules?
 - EU Law
 - Tax Treaties



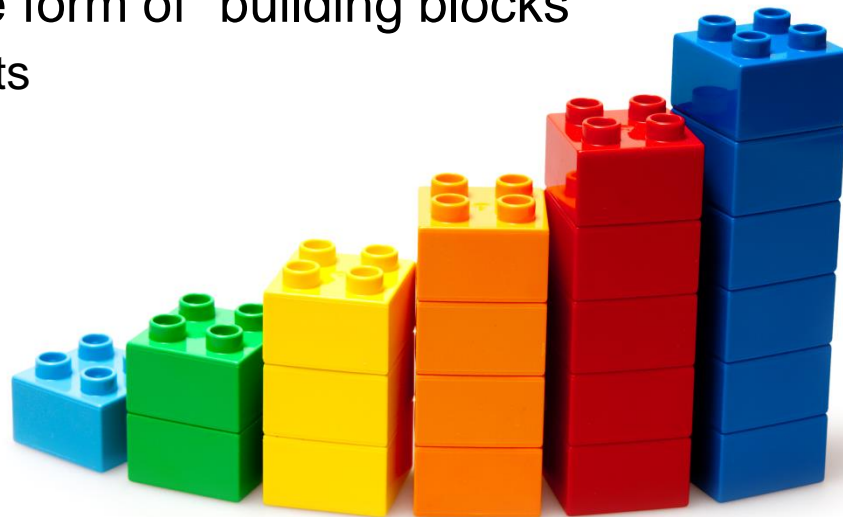
CFC taxation in a nutshell

Development and spread of CFC legislation

- 1962: The US adopts CFC rules (Subpart F rules)
- 1970s: Canada, West Germany and Japan
- 1990s: The Nordic countries (except Iceland, 2009)
- 1998: The OECD adopts recommendation on CFC rules
- 2015: OECD/G20 BEPS Report, Action 3
- 2016: ATA-Directive adopted with CFC rule
- 2016: CCCTB proposal with CFC rule

BEPS – Action 3

- "Perfect storm" → Perhaps the most ambitious reform ever undertaken in international taxation
- 15 action points (covered in 13 reports) within 3 pillars:
 1. Coherence in domestic rules that affect cross-border activities
 2. Reinforcing substance requirements in international standards
 3. Improving transparency and certainty
- Recommendations in the form of "building blocks"
 - Not minimum requirements
 - Effectiveness vs. flexibility



Rules for defining a CFC

- Entities within scope should be broadly defined
 - Corporate entities + certain transparent entities and PEs
 - Include a form of hybrid mismatch rule
- At least both a legal and an economic control test should be applied
 - De facto tests may be included
 - More than 50 % control (but broader policy goals may require lower %)
 - Both direct and indirect participation
 - Aggregating the interests of certain parties
 - "Acting-in-concert test"
 - "Related party test"
 - "Concentrated ownership test"

CFC exemptions and threshold requirements

- Tax rate exemption
 - Exclude subsidiaries subject to sufficiently similar effective tax rate
 - Effective rate = actual tax paid / CFC's income
 - Could be combined with a list (e.g. a white list)

Definition of CFC income

- Should be broad enough to ensure that income – that raises BEPS concerns – is attributed to the parent
 - As a minimum it should capture the funding return allocated under TP rules to a low-function cash box
 - Besides that jurisdictions are free to choose
 1. Categorical approach (legal classification, relatedness of parties, source of income)
 2. Substance approach
 3. Excess profits approach
 4. Transactional and entity approaches

Rules for computing CFC income

- The rules of the parent jurisdiction should be used
- Utilization of CFC losses restricted to the CFC / other CFCs

Rules for attributing CFC income

- Attribution threshold should be tied to the control threshold
- Attribution according to proportion of ownership and actual period
- Free choice on when to include and how to treat (choice of method)
- Apply the tax rate of the parent jurisdiction

Rules to prevent or eliminate double taxation

- Indirect ordinary credit relief for foreign taxes actually paid
 - Taxes paid by the CFC and intermediaries
- Exempt dividends/gains concerning the ownership of the CFC, if the income of the CFC has previously been subject to CFC taxation

BEPS – Action 3 – Evaluation

- The recommendations are relatively vague
- Need to ensure flexibility and different policy objectives → Reduced the report to a catalog setting out different options
- Illustration – The CFC regimes of the Nordic countries are in many ways already in line with the BEPS recommendations, except
 - Finland the only country to apply both a legal and economic ownership test
 - Only the Danish rules include an explicit definition of CFC income
 - None of the countries have rules in place to ensure that CFC tax assessed on intermediate companies does not lead to excessive taxation
- The BEPS report takes an "interesting" (Member State friendly) position when considering CFC rules in connection to EU primary law
 - (We will come back to that...)

- Sunland is an EU Member State located in Southern Europe
- Recently, Sunland has introduced very simplistic CFC rules. The aim is to counter tax avoidance and aggressive tax planning.
- The CFC rules have the following characteristics:
 - Condition 1: Entity domiciled abroad and subject to effective tax rate of less than 45 % of the effective tax rate in Sunland
 - Condition 2: Parent company should have legal control over more than 50 % of the share capital and/or voting rights in the CFC
 - Condition 3: Tainted income should amount to more than 60 % of the CFC's total income. Tainted income = IP income + dividends + interest + capital gains on shares and debt claims.
 - Effect: Parent company should include the total income of the CFC in proportion to ownership percentage and ownership period. Indirect ordinary credit relief for tax paid locally by the CFC.
- **Questions:**
 - 1. Are Sunland's CFC rules in line with EU primary law? And if not, what could be done to fix this?**
 - 2. Which (if any) amendments need to be made to Sunland's CFC rules as a consequence of the adoption of the ATA Directive?**

C-196/04 *Cadbury Schweppes*

- Step 1: National provisions which apply to holdings... giving them definite influence... → Freedom of establishment, cf. para 31
 - The fact that a Community national... sought to profit from tax advantages in force in a Member State other than his State of residence cannot in itself deprive him of the right to rely on the provisions of the Treaty, cf. para 36
- Step 2: ...it is common ground that the legislation on CFCs involves a difference in the treatment... → ...creates a tax disadvantage for the resident company to which the legislation on CFCs is applicable... → ...constitute a restriction..., cf. para. 43-45

C-196/04 *Cadbury Schweppes* (continued)

- Step 3: ...in order for a restriction... to be justified on the ground of prevention of abusive practices, the specific objective... must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due ..., cf. para. 55 [subjective element]
- ...the legislation on CFCs makes it possible to thwart practices which have no purpose other than to escape the tax normally due..., cf. para 59
- ...there must be... objective circumstances showing that... the objective pursued by freedom of establishment... has not been achieved, cf. para. 64
- [CFC taxation] ...must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality, cf. para 65
- ...that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment, cf. para. 67
- The resident company, must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine, cf. para 70.
- **Sunland's CFC-rules: Freedom of establishment, restriction, justified, but not proportional (not limited to wholly artificial arrangements, irrebuttable presumptions)**

- BUT! Perhaps the ECJ is now more willing to accept justifications?
 - See Hilling, Intertax, 2013, p. 294-305
- ECJ may now be willing to relax its tight limits on CFC legislation
 - See Terra & Wattel, European Tax Law, 2012, p. 736 and p. 1014
- [EU law] not, per se, an insurmountable obstacle to strenghten CFC rules
 - See Pistone, World Tax Journal, 2014, p. 3-9.
- CFC rules may be seen as rules aiming to interfere in the allocation of taxing powers, based on a principle of fair taxation → In that case no issues of incompatibility with the fundamental freedoms, cf. Columbus Container Services (do not require demonstration of abuse)
 - See Dourado, Intertax, 2016, p. 440-446.

- OECD BEPS (Action 3, p. 17-18). Alternatives to consider:
 1. Include a substance analysis (economic reality exemption)
 2. Applying CFC rules equally to foreign and domestic CFCs
 3. Applying CFC rules to transactions that are "partly wholly artificial"
 - Cf. C-524/04 *Test Claimants in the Thin Cap Group Litigation*
 4. Designing CFC rules to explicitly ensure a balanced allocation of taxing powers → No need to restrict rules to wholly artificial arrangements
 - Cf. e.g. C-311/08 SGI
- Sunland's CFC rules: None of the limitations/alternatives included → Not in line with primary EU law.

MOREOVER!! Harch criticism of the view presented by the OECD

According to Panayi (Bulletin for International Taxation, 2016, p. 95-112):

- *Cadbury Schweppes* still the main precedent on CFC taxation
 - Not decisions on e.g. thin cap and transfer pricing
- Subsequent case law has reiterated "the wholly artificial arrangements test"
 - Cf. C-201/05 Test Claimants in the CFC and Dividend Group Litigation
 - Cf. C-112/14 Commission v United Kingdom
 - Cf. E-20/13 Fred Olsen and others v the Norwegian State

According to Dourado (British Tax Review, 2015, p. 340-363):

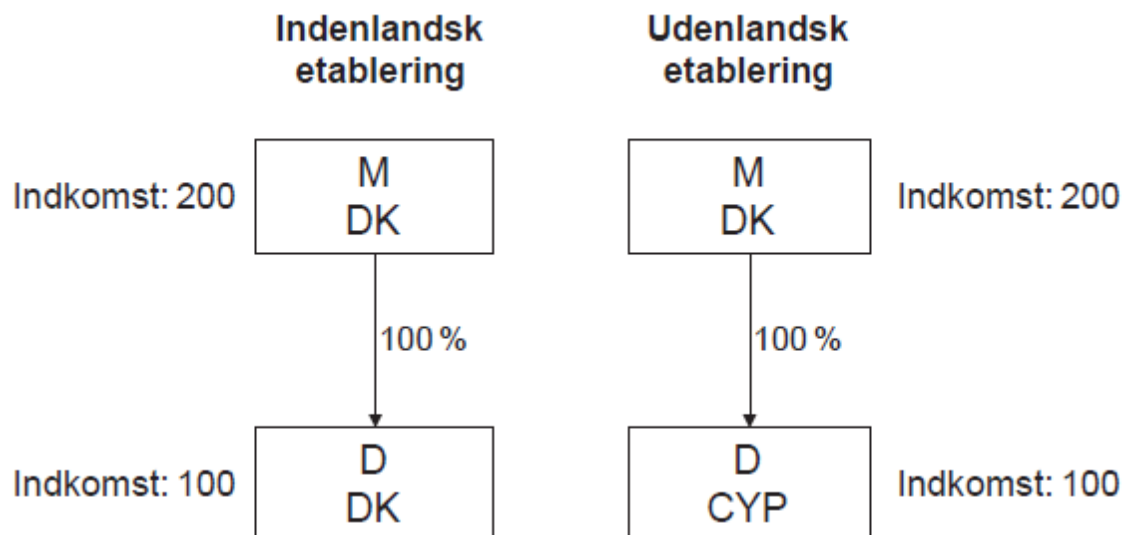
- ...would be incompatible with *Cadbury Schweppes* doctrine on the artificiality test, and it is not likely that the CJEU will reverse its case law

Sunland's CFC rules:

- I am with Panayi on this one 😊 → Introducing OECD alternative 3 or 4 does not ensure that Sunland's CFC rules are brought in line with EU primary law
- So, what are we left with if Sunland's CFC rules should be fixed?

- Possible to ensure compatibility with EU law by including an "economic reality exemption" (OECD alternative 1)?
 - Yes – Commonly used approach by MS
 - Used e.g. by Sweden and Finland, as well as EEA-MS Norway and Iceland
 - But does it make CFC-rules "toothless"?
 - See e.g. Meussen, European Taxation, 2007, p. 13-18
- Possible to ensure compatibility with EU law by applying CFC rules equally to foreign and domestic CFCs (OECD alternative 2)?
 - Approach used by Denmark
 - But the Danish rules probably still constitute a restriction
 - The Danish CFC rules only leads to an additional tax burden – i.e. a genuine tax disadvantage – for the Danish parent company, if the CFC is resident in another country in which the level of taxation is lower than the Danish level
 - See Koerver Schmidt, European Taxation, 2014, p. 3-9
- **Sunland: In my view has to include some kind of "economic reality exemption" in its CFC legislation**

EU Primary Law and CFC Rules



	Indenlandsk etablering			Udenlandsk etablering		
A	Skattepligtig indkomst hos M DK før CFC-beskatning	200		A	Skattepligtig indkomst hos M DK før CFC-beskatning	200
B	Yderligere indkomst fra CFC-selskabet D DK	100		B	Yderligere indkomst fra CFC-selskabet D CYP	100
C	Samlet skattepligtig indkomst for M DK (A + B)	300		C	Samlet skattepligtig indkomst for M DK (A+B)	300

EU Primary Law and CFC Rules

	Indenlandsk etablering				Udenlandsk etablering	
D	Skat, 25 % af C	75		D	Skat, 25 % af C	75
E	Creditlempelse, 25 % af B	-25		E	Creditlempelse, 10 % af B	-10
F	Samlet skat for M DK (D + E)	50		F	Samlet skat for M DK (D + E)	65
G	Dansk selskabsskat for D DK, 25 % af B	25		G	Dansk selskabsskat betalt af D CYP (intet)	0
H	Dansk selskabsskat i alt (F+G)	75		H	Dansk selskabsskat i alt (F+G)	65
I	Cypriotisk selskabsskat betalt af D DK (intet)	0		I	Cypriotisk selskabsskat betalt af D CYP, 10 % af B	10
J	Samlet beskatning (H+I)	75		J	Samlet beskatning (H+I)	75

Amendments needed to be made to Sunland's CFC rules as a consequence of the adoption of the ATA Directive:

- Also applicable to PEs
- Effective tax rate threshold should be enhanced to 50 %
- Control threshold should also apply to economic control
- If Model A is chosen (entity approach):
 - "CFC-income-condition" (60 %) substituted with CFC-income-exception (1/3)
 - Definition of tainted income should be broadened
 - "Substance carve-out" should be introduced for intra EU-entities and PEs
- Model B could also be chosen (transactional approach)

Recap: CFC rule in the ATAD (2016/1164) – An ugly political compromise

- Main conditions:
 - Applicable to both entities and PEs
 - 50% threshold to define direct or indirect, as well as legal or economic control
 - 50% effective tax rate threshold
- Model A: entity approach based on analysis of categories of income
 - "Substance carve-out rule" for applying the approach intra-EU
 - Exemption if "tainted" income \leq 1/3 of total income (optional)
 - Exemption for financial undertakings if "tainted" income from group companies \leq 1/3
- Model B: Transactional approach based on a substance analysis
 - Exemption if accounting profits \leq EUR 750,000, and non-trading income \leq EUR 75,000, or of which the accounting profits \leq 10 % of its operating costs
- Income to be included in proportion to ownership participation
- Relief: Dividends/gains concerning the CFC + Credit relief for tax paid by CFC

ATAD's CFC-rule and primary EU law (ECJ case law)

- Model A – The intra-EU substance carve-out
 - OK only to apply the exemption intra-EU/EEA (not third countries)?
 - Probably yes, if 50 % control threshold applied (definite influence situation)
 - Falls exclusively under the freedom of establishment
 - Cf. C-196/04 *Cadbury Schweppes*, para. 31
 - But what if the MS applies a lower "control" threshold (<50%) → Freedom of capital?
 - As the Norwegian rules do, see Passalacqua & Henie, *Intertax*, 2008, p. 379-388
 - And what if subsidiary does not participate in the economic life → Freedom of capital?
 - E-3/13 *Fred Olsen and others*
 - "Substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances" = "Wholly artificial arrangements"?
 - Probably yes...
- Model B
 - Inspired by UK rules – only applicable to diverted chargeable profits
 - Critique: Not in line with ECJ's "all-or-nothing-approach"?
 - Cf. e.g. Richards, *British Tax Review* 2012, p. 1-13

COM(2016) 685 final & COM(2016) 683 final: C(C)CTB

What are the main similarities and differences of art. 59-60 compared with the ATAD?

- Very similar to Model A
 - Scope, control definition, low tax threshold, definition of "tainted" income, inclusion in accordance with entitlement to profits, relief
- But not a minimum standard
 - No option to refrain from applying the substance carve-out to third countries
 - Exemption if "tainted" income \leq 1/3 of total income (not optional)
 - Exemption for financial undertakings (not optional)
 - Income to be calculated according to the rules of the directive

- Compatibility between tax treaties and CFC rules debated for years
 - The prevalent, but not undisputed, position is that the application of CFC rules is compatible with tax treaties, cf. de Broe, IFA Cahiers, 2010
- A number of interesting cases from various jurisdictions, e.g.
 - Sweden: OMX, RÅ 2008, ref. 24 (lex specialis/posterior argumentation)
 - Finland: A Oyj Abp, KHO:2002:26 (“teleological” interpretation)
- 2003 comments to the OECD Model recognize that CFC rules are not contrary to the model convention, but caution:
 - “...CFC legislation 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”
- Proposal for revised comments in BEPS action 6
 - Unconditional support for the position that CFC legislation should not be considered in breach of tax treaties

The Nordics and CFC Rules

Building Blocks	BEPS	ATA-Directive	Sweden	Norway	Finland	Iceland	Denmark
1) Rules for defining a CFC	<ul style="list-style-type: none"> ● Foreign entity ● Broad definition ● Legal and economic ownership test 	<ul style="list-style-type: none"> ● Foreign entity ● > 50 % of capital, voting rights or profits 	<ul style="list-style-type: none"> ● Foreign entity ● ≥ 25 % of capital or voting rights 	<ul style="list-style-type: none"> ● Foreign entity ● ≥ 50 % Norwegian ownership of capital or voting rights 	<ul style="list-style-type: none"> ● Foreign entity ● ≥ 50 % Finnish ownership of capital, voting rights or profits 	<ul style="list-style-type: none"> ● Foreign entity ● ≥ 50 % Icelandic ownership of capital and voting rights, or control 	<ul style="list-style-type: none"> ● Foreign and domestic entities ● Group has decisive influence (> 50 % voting rights)
2) Exemptions and threshold requirements	<ul style="list-style-type: none"> ● Tax rate exemption ● Optional use of lists, e.g. a white list 	<ul style="list-style-type: none"> ● Low tax condition, < 40 % ● Exemption for listed entities ● Exemption for financial undertakings in EU/EEA ● EU/EEA exemption, unless establishment is wholly artificial or entity engages in non-genuine arrangements 	<ul style="list-style-type: none"> ● Low tax condition, < 55 % ● White/grey list ● Exemption for genuine activities in EU/EEA ● Exemption for shipping activities 	<ul style="list-style-type: none"> ● Low tax condition, < 2/3 ● White/black list ● Exemption for genuine activities in EU/EEA ● Exemption for entities in treaty countries with mainly non-passive income 	<ul style="list-style-type: none"> ● Low tax condition, < 3/5 ● Black list ● Exemption for genuine activities in EU/EEA/treaty countries ● Exemption for treaty countries, unless blacklisted ● Exemption for shipping and industrial activities 	<ul style="list-style-type: none"> ● Low tax condition, < 2/3 ● Black list ● Exemption for genuine activities in EU/EEA ● Exemption for entities in treaty countries with mainly non-passive income 	<ul style="list-style-type: none"> ● No low tax condition ● No exemption for genuine activities in EU/EEA ● Possibility of exemption for entities within financial sector
3) Definition of CFC income	<ul style="list-style-type: none"> ● A definition should be included ● Jurisdictions have flexibility to define ● Entity or transactional approach 	<ul style="list-style-type: none"> ● Income condition, CFC income > 50 % ● Explicit definition of CFC income ● Entity approach 	<ul style="list-style-type: none"> ● No general income condition ● Entity approach 	<ul style="list-style-type: none"> ● No general income condition, but size of passive income relevant if treaty country ● Entity approach 	<ul style="list-style-type: none"> ● No general income condition ● Entity approach 	<ul style="list-style-type: none"> ● No general income condition, but size of passive income relevant if treaty country ● Entity approach 	<ul style="list-style-type: none"> ● Income condition, CFC income > 50 % ● Explicit definition of CFC income ● Asset condition, CFC assets > 10 % ● Entity approach

* The column named "ATA-Directive" shows the content of the original proposal – not the final version

The Nordics and CFC Rules

Building Blocks	BEPS	ATA-Directive	Sweden	Norway	Finland	Iceland	Denmark
4) Rules for computing income	<ul style="list-style-type: none"> Rules in parent company's jurisdiction Losses only deductible against profits of the same CFC or other CFCs in same jurisdiction 	<ul style="list-style-type: none"> Corporate tax rules in parent company's Member State CFC's losses should not be included in parent's tax base, but shall be set off against the CFC's income in subsequent years 	<ul style="list-style-type: none"> Swedish tax rules CFC's losses can only be set off against CFC's positive income in subsequent years Max. 3 years carry forward 	<ul style="list-style-type: none"> Norwegian tax rules CFC's losses can only be set off against CFC's positive income in subsequent years 	<ul style="list-style-type: none"> Finnish tax rules CFC's losses can only be set off against CFC's positive income in subsequent years Max. 10 years carry forward 	<ul style="list-style-type: none"> Icelandic tax rules CFC's losses can only be set off against CFC's positive income in subsequent years 	<ul style="list-style-type: none"> Danish tax rules CFC's losses can only be set off against CFC's positive income in subsequent years
5) Rules for attributing income	<ul style="list-style-type: none"> Attribution threshold tied to control threshold Attribution based on proportion of ownership Apply tax rate of the parent jurisdiction 	<ul style="list-style-type: none"> Attribution threshold tied to control threshold (> 50%) Attribution based on entitlement to profits 	<ul style="list-style-type: none"> Attribution threshold tied to control threshold ($\geq 25\%$) Attribution based on proportion of share capital Application of ordinary Swedish tax rate 	<ul style="list-style-type: none"> Attribution threshold tied to "control threshold" ($\geq 50\%$ Norwegian ownership) Attribution based on proportion of ownership Application of ordinary Norwegian tax rate 	<ul style="list-style-type: none"> Attribution threshold tied to "control threshold", but 25% min. requirement Attribution based on share of total profits Application of ordinary Finnish tax rate 	<ul style="list-style-type: none"> Attribution threshold tied to "control threshold" ($\geq 50\%$ Icelandic ownership) Attribution based on proportion of share capital Application of ordinary Icelandic tax rate 	<ul style="list-style-type: none"> Attribution threshold tied to control threshold (decisive influence) Attribution based on proportion of share capital Application of ordinary Danish tax rate
6) Rules to prevent or eliminate double taxation	<ul style="list-style-type: none"> Ordinary indirect credit relief Also relief for CFC tax in intermediate companies Exemptions for dividends/gains on shareholding in CFC 	<ul style="list-style-type: none"> Relief for foreign taxes not explicitly mentioned Exemptions for dividends/gains on shareholding in CFC 	<ul style="list-style-type: none"> Ordinary indirect credit relief No relief for CFC tax in intermediate companies Rules in place to avoid double taxation with respect to dividends/gains on shares in the CFC 	<ul style="list-style-type: none"> Ordinary indirect credit relief No relief for CFC tax in intermediate companies Rules in place to avoid double taxation with respect to dividends/gains on shares in the CFC 	<ul style="list-style-type: none"> Ordinary indirect credit relief No relief for CFC tax in intermediate companies Rules in place to avoid double taxation with respect to dividends/gains on shares in the CFC 	<ul style="list-style-type: none"> No credit relief No relief for CFC tax in intermediate companies Exemption for dividends on shareholding in CFC 	<ul style="list-style-type: none"> Ordinary indirect credit relief No relief for CFC tax in intermediate companies Rules in place to avoid double taxation with respect to dividends/gains on shares in the CFC

Conclusions

- CFC rules are anti-avoidance rules with a prophylactic effect
- BEPS action 3: Vague recommendations in the form of building blocks
- CFC rules and EU law
 - Cadbury Schweppes doctrine – in my view – still to be respected
 - ATAD CFC rule (model A) probably in line with ECJ case law
 - CCCTB CFC rule: Very similar to ATAD, but not a minimum standard
- CFC rules are normally not in conflict with tax treaties
- The CFC rules of the Nordic countries have a number of similarities, but also notable differences