BEPS Action 3: Designing Effective Controlled Foreign Company Rules

Controlled foreign company (CFC) rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

Since the first CFC rules were enacted in 1962, an increasing number of jurisdictions have implemented these rules. Currently, 30 of the countries participating in the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project have CFC rules, and many others have expressed interest in implementing them. However, existing CFC rules have often not kept pace with changes in the international business environment, and many of them have design features that do not tackle BEPS effectively.

In response to the challenges faced by existing CFC rules, the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) called for the development of recommendations regarding the design of CFC rules. This is an area where the OECD has not done significant work in the past, and this report recognises that by working together countries can address concerns about competiveness and level the playing field.

This report sets out recommendations in the form of building blocks. These recommendations are not minimum standards, but they are designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries. The report sets out the following six building blocks for the design of effective CFC rules:

- Definition of a CFC – CFC rules generally apply to foreign companies that are controlled by shareholders in the parent jurisdiction. The report sets out recommendations on how to determine when shareholders have sufficient influence over a foreign company for that company to be a CFC. It also provides recommendations on how non-corporate entities and their income should be brought within CFC rules.
- CFC exemptions and threshold requirements – Existing CFC rules often only apply after the application of provisions such as tax rate exemptions, anti-avoidance requirements, and de *minimis* thresholds. The report recommends that CFC rules only apply to controlled foreign companies that are subject to effective tax rates that are meaningfully lower than those applied in the parent jurisdiction.

- Definition of income – Although some countries' existing CFC rules treat all the income of a CFC as "CFC income" that is attributed to shareholders in the parent jurisdiction, many CFC rules only apply to certain types of income. The report recommends that CFC rules include a definition of CFC income, and it sets out a non-exhaustive list of approaches or combination of approaches that CFC rules could use for such a definition.

- Computation of income – The report recommends that CFC rules use the rules of the parent jurisdiction to compute the CFC income to be attributed to shareholders. It also recommends that CFC losses should only be offset against the profits of the same CFC or other CFCs in the same jurisdiction.

- Attribution of income – The report recommends that, when possible, the attribution threshold should be tied to the control threshold and that the amount of income to be attributed should be calculated by reference to the proportionate ownership or influence.

- Prevention and elimination of double taxation – One of the fundamental policy issues to consider when designing effective CFC rules is how to ensure that these rules do not lead to double taxation. The report therefore emphasises the importance of both preventing and eliminating double taxation, and it recommends, for example, that jurisdictions with CFC rules allow a credit for foreign taxes actually paid, including any tax assessed on intermediate parent companies under a CFC regime. It also recommends that countries consider relief from double taxation on dividends on, and gains arising from the disposal of, CFC shares where the income of the CFC has previously been subject to taxation under a CFC regime.

Because each country prioritises policy objectives differently, the recommendations provide flexibility to implement CFC rules that combat BEPS in a manner consistent with the policy objectives of the overall tax system and the international legal obligations of the country concerned. In particular, this report recognises that the recommendations must be sufficiently adaptable to comply with EU law, and it sets out possible design options that could be implemented by EU Member States. Once implemented, the recommendations will ensure that countries will have effective CFC rules that address BEPS concerns.

Sources

- *OECD/G20 Base Erosion and Profit Shifting Project, 2015 Final Reports, Executive Summaries*
- *2015 Final Report on Action 3*

MME observations

The final recommendations are in the form of “building blocks” that are considered necessary for the design of effective CFC rules. The six building blocks include the definition of a CFC and of CFC income and the attribution of CFC income. The recommendations are not minimum standards, but they are designed to ensure that countries which choose to implement them will have CFC rules that effectively prevent taxpayers from shifting income into foreign subsidiaries.

The OECD clearly recognizes the need for flexibility in this area, as the design of CFC rules in different countries reflect differing policy objectives, in particular depending on whether they have a worldwide or territorial tax system or whether they are EU members. The definition of CFC income is one of the key building blocks, but is an area where there are clearly differing views. A non-exhaustive list of approaches (e.g. substance and excess profits analysis) has been included to accommodate those differing views.

Developments in Switzerland

There is currently no CFC legislation in Switzerland, and there is no intention to introduce one in the near future. However, Swiss subsidiaries might be subject to foreign CFC rules and, therefore, the worldwide developments in this area must be monitored carefully.

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