OECD holds public consultation on BEPS Action 3 on CFC rules

Executive summary

On 12 May 2015, the Organisation for Economic Co-operation and Development (OECD) held a public consultation in connection with the Base Erosion and Profit Shifting (BEPS) project that was focused on Action 3 on controlled foreign company (CFC) rules. The meeting was an opportunity for stakeholders to engage directly with the OECD Secretariat and the country delegates who are responsible for the work on this Action.

Detailed discussion

On 3 April 2015, the OECD issued a discussion draft on Action 3 on strengthening CFC rules (the Discussion Draft or Draft).1 The Discussion Draft focuses on how to use CFC rules to respond to BEPS and addresses what it describes as the core elements or “building blocks” of CFC rules. The Draft includes recommended approaches or options for each of the core elements. The OECD received over 570 pages of comments on the Discussion Draft, which are posted on its website.

The public consultation on 12 May 2015 was a dialogue among stakeholders, country tax officials, and the OECD Secretariat on key issues and concerns raised in the comments. The consultation was hosted by OECD Working Party 11, which has responsibility for the OECD’s work on Action 3. This working group also has responsibility for other BEPS Actions, including the work on Action 2 (hybrid mismatch arrangements), Action 4 (interest deductions and other financial payments) and Action 12 (mandatory disclosure).

Tax officials from 26 countries participated in the consultation. Also participating were representatives of multinational businesses and industry bodies; tax advisors, including EY representatives; and representatives of non-governmental organizations (NGOs). The consultation was live-streamed by the OECD and a recording is available on the OECD website.
General comments
In opening comments, a representative of the Business and Industry Advisory Committee (BIAC) to the OECD expressed concern that the lack of consensus reflected in the Discussion Draft represents a missed opportunity. It was noted that the objective of CFC rules is to complement transfer pricing rules to discourage BEPS and to reduce harmful tax competition but that the Draft fails to clearly articulate such goals. Further concern was expressed that the Draft departs from the common active/passive income structure for CFC rules by including new ideas such as the excess return approach. Moreover, some recommendations in the Draft could inappropriately shift taxing rights from source jurisdictions to residence jurisdictions, which could harm cross-border investment. In summary, the Draft was described as containing extremely subjective recommendations, many of which are duplicative of transfer pricing rules and would be very burdensome on businesses. Accordingly, it was suggested that a better approach may be to survey existing CFC regimes in an effort to identify best practices, which could serve as the foundation for future work by the OECD.

One participant pointed out the EU law influence in the Discussion Draft and urged the OECD to focus on sound CFC design principles, without regard to the consistency of such principles with EU law.

A US delegate questioned the assertion that the CFC rules described in the Discussion Draft might result in inappropriate shifting of taxing rights from source jurisdictions to residence jurisdictions. He argued that residence jurisdictions always have the secondary right to tax, subject to the relief of double taxation. In response, a business participant noted that the Draft seems to allow the residence jurisdiction to tax income currently without regard to how much activity is engaged in by the CFC. Another business participant added that an active trade or business exception to CFC rules would be appropriate, noting that under the US rules, foreign earnings derived from an active trade or business are only taxed when repatriated.

Definition of a CFC, threshold requirements, and definition of control
On the definition of a CFC, business participants stated that development of rules for different entities would be difficult as empirical work has not yet been done on the types of entities to be addressed and how they are treated currently around the world.

On threshold requirements, some business participants described the difficulties in determining effective tax rates (ETRs), including dealing with different accounting and tax rules in different jurisdictions and the effect of timing differences. Another business participant expressed the view that low corporate tax rates should not be viewed as per se inappropriate, noting that corporate taxes generally are regarded as detrimental to economic growth. Finally, business participants requested that any threshold requirements should be kept simple and mechanical for all parties to understand and apply.

The UK delegate noted that the ETR test is important but also argued that such test can be easily manipulated and that therefore other filters may be necessary.

On the definition of control, business participants pointed out that no specific test of control was proposed in the Discussion Draft making it impossible to comment. With respect to the de facto control test, business participants said that a facts and circumstances approach would be too subjective and too difficult to apply. Concern was expressed that in the banking industry lending terms could cause banking entities to be considered as having de facto control. It was also noted that the de facto control test would be difficult to apply in situations where listed companies are involved.

Definition of CFC income
Focusing first on the substance analysis, business participants pointed out that the substantial contribution approach may adversely affect certain industries that extensively use third parties to manage and operate their assets and industries that are subject to regulatory frameworks requiring, for example, the use of a centralized service provider. With respect to the employees and establishment approach, an NGO representative expressed support for the employees and establishment approach if the income can be
divided proportionately on that basis. He added that the employee factor should be based on payroll or compensation. With respect to the viable independent entity approach, one business participant stated that as described in the Discussion Draft, the approach is too vague and subjective and should be made more mechanical.

On the matter of EU laws, it was suggested that the OECD should not allow other laws to affect their recommendations.

With respect to the categories of CFC income, some business participants observed that the Discussion Draft appears to assume that all IP income is passive, which would be over inclusive. They described examples where IP is used in active businesses. The business participants agreed that clarification is needed regarding the level of developmental activities required for an entity to be viewed as an active IP developer. Another business participant suggested that financing and risk of failure also should be considered in determining whether an entity is an IP developer.

With respect to both the categorical approach and the excess profits approach, business participants stated that further clarification is needed. With respect to the excess profits approach, some business participants noted that CFC rules should not impose current tax on active income derived by the CFC regardless of the profit margin. Another business participant stated that the excess profits approach raised questions about where the profits would be considered to have been earned. In this respect, several business participants stressed the need to address the interaction between the CFC rules and transfer pricing rules.

The US delegate who co-chaired the meeting noted that CFC rules are a backstop to transfer pricing rules and as such cannot be seen as unnecessary just because they focus on the same income that is also the focus of transfer pricing. Another US delegate noted that the business commentators’ stated preference is to adopt mechanical rules that are clear and easy to apply, but, at the same time, the business commentators generally are critical of the bright-line excess profits approach. In response to this assertion, business participants pointed out that the proposed excess profits approach does not involve a mechanical measurement that can be easily applied.

In addition, a business participant noted that it is possible that capital in a CFC has no nexus to the parent company’s jurisdiction. In this regard, the OECD should consider adopting rules similar to the United Kingdom’s finance company exemption.

Rules for computing and attributing income and to prevent or eliminate double taxation
Business participants expressed concern that CFC rules could lead to double taxation and suggested consistency is needed between loss and income recognition. Some business participants suggested that home country rules should be used on loss and income recognition.

A business participant pointed out that applying attribution rules can be more challenging for joint ventures as voting power may not always align with economic rights. Some business participants suggested a “just and reasonable” approach similar to the UK rule, which can disregard voting power in favor of economic rights, could be considered as an alternative. The US delegate who co-chaired the meeting noted the difficulties under the US rules when a CFC has multiple classes of stock. He stated that generally the economic interests would determine the attribution of income for purposes of US CFC rules. A participant noted that attribution based on the secondary rule would not be appropriate, to which the US co-chair responded that the OECD does not intend to propose such rule in the final paper under Action 3. Other business participants criticized the idea of a top-up tax (i.e., a minimum tax) at the parent level as a matter of principle. The US co-chair noted that the top-up tax is meant to strike a balance between capital export neutrality and capital import neutrality. Another business
participant pointed out that a top-up tax is inconsistent with the principle of a territorial system. He suggested that the OECD seems to be conflicted between protecting the worldwide tax base and protecting the domestic tax base in a territorial system. The other US delegate indicated that a top-up tax could fit into some territorial systems.

The US co-chair noted that there was agreement on the general objective of preventing or eliminating double taxation as a policy matter, but admitted that the Discussion Draft may have oversimplified how this could be achieved. In this respect, business participants urged the OECD to examine how the rules may work in all possible scenarios. They stressed that any recommendations with respect to CFC rules be designed in a way that does not result in double taxation or double non-taxation.

Business participants raised other scenarios that could lead to double taxation. For example, a transfer pricing adjustment that reallocates income of a CFC that has been taxed under CFC rules as income of an affiliated entity; timing differences in different countries’ income recognition rules causing over-recognitation of CFC income; and two or more jurisdictions applying CFC rules to the same CFC income, resulting in double taxation but without a clear path to resolution through mutual agreement procedures under the relevant income treaty.

Concluding comments
A business participant expressed the view that CFC rules can interfere with the separate entity principle of taxation; in response, an NGO representative countered that this is not necessarily a problem. A business participant expressed concern that the administrative costs of applying anti-abuse rules to everyone indiscriminately could exceed the risk of revenue loss and urged the use of targeted rules instead to address any perceived problems. An NGO representative expressed the view that clear and consistent rules across all concerned countries are needed. Finally, a BIAC representative stressed the need for a study of CFC rules worldwide in light of the lack of consensus at this time.

The US co-chair closed the meeting by stating that the CFC Focus Group will meet in June to review the comments and continue work to finalize the Action 3 report.

Implications
The discussion at the consultation underscores the broad scope of the CFC rules described in the Discussion Draft. However, there is no consensus yet at the OECD with respect to the recommendations and options in the Draft. Nevertheless, it is expected that the OECD will release a final report on Action 3 in the autumn of 2015. Companies should evaluate how the proposed rules may affect them, stay informed about developments in the OECD and in the countries where they operate or invest, and consider participating in the dialogue regarding the BEPS project and the underlying international tax policy issues.

Endnote
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