OECD releases discussion draft on CFC rules under BEPS Action 3

Executive summary

On 3 April 2015, the Organisation for Economic Co-operation and Development (OECD) released a discussion draft in connection with Action 3 on strengthening controlled foreign company (CFC) rules under its Action Plan on Base Erosion and Profit Shifting (BEPS). The document titled, *BEPS Action 3: Strengthening CFC Rules* (the Discussion Draft or the Draft) addresses how to use CFC rules to address base erosion and profit shifting. The Draft discusses in detail each of the following core elements or “building blocks” of CFC rules:

- Definition of a CFC
- Threshold requirements
- Definition of control
- Definition of CFC income
- Rules for computing income
- Rules for attributing income
- Rules to prevent or eliminate double taxation

The Draft includes recommended approaches for each of these core elements, except the definition of CFC income, for which several options are included.

Detailed discussion

The 3 April 2015 Discussion Draft under Action 3 identifies seven core elements or building blocks of CFC rules and provides recommendations or options for the design of such elements. The Draft includes a statement that it does not represent the consensus views of the OECD’s Committee on Fiscal Affairs or its working groups. Rather, the Draft is intended to give stakeholders an opportunity to provide input.
before the OECD issues its final recommendations under Action 3 by September 2015. Comments are to be submitted by 1 May 2015. A public consultation is scheduled for 12 May 2015.

The Discussion Draft notes that, in addition to CFC rules, some countries have proposed that further rules could be applied to income earned by CFCs that does not give rise to sufficient taxation in the parent jurisdiction through the rules. These secondary rules would introduce a tax in another jurisdiction (for example, in the source country of the income earned by the CFC). The Draft also notes that the OECD is considering options for special measures with respect to transfer pricing under Actions 8-10, (See EY Global Tax Alert, OECD holds public consultation on BEPS Actions 8-10 on transfer pricing, dated 27 March 2015 for more information), which could be implemented as secondary rules. Similarly, possible future work on options to address the tax challenges of the digital economy could be adapted to apply as secondary rules. The Draft indicates that no decision has been made yet regarding this high level proposal.

The Discussion Draft is divided into the eight chapters, which are summarized below.

**Policy considerations**
The Discussion Draft identifies a series of policy considerations in connection with the design of CFC rules: (i) what is the purpose of CFC rules; (ii) how to strike a balance between taxing foreign income and maintaining competitiveness; (iii) how to limit administrative and compliance burdens while not creating opportunities for avoidance; (iv) what is the role of CFC rules as preventative measures; (v) what is the scope of base stripping prevented by CFC rules; (vi) how to ensure that CFC rules do not lead to double taxation; and (vii) the interaction between CFC rules and transfer pricing rules.

**Definition of a CFC**
Chapter 2 of the Discussion Draft sets out two recommendations for defining a CFC: (i) adopt a broad definition so that CFC rules would apply to both corporate and non-corporate entities (such as partnerships, trusts, and permanent establishments [PEs]) when those entities are either owned by CFCs or treated in the parent jurisdiction as taxable entities separate from their owners; and (ii) include a modified hybrid mismatch rule that would prevent entities from circumventing CFC rules through different treatment in different jurisdictions.

**Threshold requirements**
Chapter 3 of the Discussion Draft addresses threshold requirements with respect to the scope of CFC rules. The Draft recommends inclusion of a low-tax threshold that is based on the effective tax rate (ETR) and that uses a tax rate that is meaningfully lower than the tax rate in the country applying the CFC rules. With respect to the application of a low-tax threshold, a benchmark would compare the tax rate in the CFC jurisdiction
either to a particular fixed rate or to a percentage of the parent jurisdiction's rate. The Draft recommends that the benchmark be set at 75% of the parent jurisdiction's statutory corporate tax rate or lower, which the Draft indicates is the level used by most existing CFC rules.

The Discussion Draft also recommends the use of the CFC's ETR in applying the benchmark. It states that using the ETR would be a more accurate comparison than using the statutory tax rate. For calculating the ETR, the Draft recommends that the income measure should be either the tax base in the parent jurisdiction had the CFC income been earned there or the tax base computed according to an international accounting standard such as IFRS with adjustments made to reflect the tax base reductions that result in low taxation of the CFC income. The Draft also notes that the ETR could be computed broadly or narrowly. A broad approach would calculate the ETR on an entity-by-entity basis or on a country-by-country basis by aggregating income within a country. A narrow approach would calculate the ETR on an item of income basis.

**Definition of control**

Chapter 4 of the Discussion Draft addresses the definition of control, which includes two elements: (i) the type of control that is required; and (ii) the level of that control. The Draft's recommendation for control is that CFC rules should at least apply both a legal control test and an economic control test so that satisfaction of either test results in control for purposes of the rules. Countries may also include a *de facto* control test. The Draft's recommendation for the level of control is that a CFC should be treated as controlled where residents hold, at a minimum, more than 50% control. However, the Draft notes that countries may set their control threshold at a lower level. The specified level of control could be established through the aggregated interest of related parties or unrelated resident parties or from aggregating the interests of any taxpayers that are found to be acting in concert. Additionally, the Draft states that CFC rules should apply where there is either direct or indirect control.

The Discussion Draft states that after determining what constitutes control, the next step is to determine how much control must be present in order for CFC rules to apply. The Draft observes that most existing CFC rules require a “more than 50%” level of control. It states that this test is straightforward and easy to apply when control is held by a single person. However, in the event that minority shareholders are acting together to exert influence, their interests should be aggregated to determine control. The Draft recommends use of one of three approaches to determine if minority shareholders are acting together: an “acting-in-concert” test, an examination of the relationship of the parties, or a concentrated ownership test. The Discussion Draft states that including the interests of nonresident taxpayers under any of these approaches could add to the complexity of the control provisions. As such, the recommendation, as a minimum threshold, does not take into account nonresidents for purposes of determining control.

**Definition of CFC income**

Chapter 5 of the Discussion Draft outlines several approaches to defining income but does not yet include recommendations. The Draft indicates that the approaches to defining CFC income do not reflect consensus as countries have different views on this issue.

The Discussion Draft first states that existing CFC rules apply either a full or partial system of inclusion in defining CFC income. The Draft notes that because the full inclusion system includes all CFC income, there is no need to separately define the income subject to CFC rules. Hence, the discussion in the Draft focuses on the definition of income issues under partial inclusion systems.

The Discussion Draft states that CFC rules should be able to accurately define income in the context of CFCs that are holding companies, that provide financial and banking services or that engage in sales invoicing, as well as income from IP assets, digital goods and services or captive insurance and re-insurance. The Draft states that CFC rules must be capable of dealing with at least the following types of income: (i) dividends; (ii) interest and other financing...
income; (iii) insurance income; (iv) sales and services income; and (v) royalties and other IP income. At a minimum, CFC rules should capture income that raises BEPS issues within each category and should not capture income that arises from value-creating activity in the CFC jurisdiction.

The Discussion Draft states that the general principle is that highly mobile and/or passive income should be covered by CFC rules because it likely has been diverted away from the parent or a third jurisdiction to the CFC jurisdiction. This type of income typically includes, at the minimum, interest, royalties, dividends, and income earned other than in the course of an active trade or business. One approach, according to the Draft, is a form-based analysis that categorizes an item of income based on a formal classification. Under this method, sales, services, and other income that is by its nature more associated with the carrying on of a trade or business would be excluded from CFC income. The Draft states that a pure form-based approach is administratively convenient but it is also easily manipulated and does not address all income that could arise from base erosion and profit shifting.

Because of the drawbacks of a pure form-based approach, the Discussion Draft observes that CFC rules typically apply some degree of substance analysis. The Draft outlines three types of substance analysis: (i) substantial contribution analysis; (ii) viable independent entity analysis; and (iii) employees and establishment analysis.

The substantial contribution analysis would focus on the relevant facts and circumstances to determine whether the employees of the CFC have made a substantial contribution to the income earned by the CFC. Once the CFC has shown a given level of activities, all income earned by that CFC would then be excluded from the definition. The Draft comments that this analysis might be appropriate for several types of income but probably not for IP income. Also it states that it would be possible for companies to aim for the minimal level of contribution, knowing that they could then shield a residual amount of income.

The viable independent entity analysis would aim to assess all of the significant functions performed by entities within the group to determine if the CFC could be a viable independent entity. To the extent that the CFC does not own the assets or undertake the risks, the associated income would be subject to the CFC rules.

The employees and establishment analysis would use a measurement of employees and business premises as a more mechanical way of determining whether the activities required to earn the income are located in the CFC jurisdiction. The main differences between the employees and establishment analysis and the viable independent entity analysis are that (i) the CFC itself must have the employees and establishment necessary for earning the actual income, rather than just the employees and establishment necessary for managing or overseeing the value-creating activities; and (ii) the employees and establishment analysis does not require an analysis of risks or asset ownership.

The Discussion Draft further notes that existing CFC rules also examine whether income is highly mobile by looking at from whom it was earned (i.e., from related parties or from others) and where it was earned. Income earned from a related party is generally treated as CFC income because such income is presumed to have been shifted. Income earned outside of the CFC jurisdiction also is considered to raise profit shifting concerns.

The Discussion Draft observes that existing CFC rules generally use a combination of these approaches. Nevertheless, the Draft states that these rules struggle to accurately determine the income that should be subject to the CFC rules. The Draft therefore considers the need to develop rules to address various types of income that give rise to particular difficulties for existing CFC rules.

The Draft suggests that dividend income could be treated as passive income, but excluded from CFC income if it is paid out of active income (or by related parties out of active income) or if the CFC is in the active trade or business of dealing in securities.
The Draft similarly suggests that interest and other financing income could be treated as passive, but excluded from CFC income if the CFC is in the active trade or business of financing and is not overcapitalized.

The Draft suggests that CFC rules could address insurance income by focusing on one or more of the following factors: (i) whether the income is derived (directly or indirectly) from a related party (and, for a narrower rule, whether the related party is able to deduct insurance premiums paid to the CFC); (ii) whether the parties to the insurance contract or the risks insured are located outside the CFC jurisdiction; (iii) whether the CFC has sufficient substance to assume and manage the risks on its own accord; and (iv) whether the CFC is overcapitalized.

The Draft suggests that CFC rules could treat sales and services income as active income unless it is earned from a related party or the CFC lacks the substance to earn the income itself.

The Draft states that income from royalties and IP has become the most challenging type of income to categorize in the digital economy. The Draft suggests that to effectively address IP income, CFC rules could consider both whether the income is earned from a related party (including whether it was earned for IP developed with a related party) and whether the CFC carried out the required activities to develop the IP underlying the asset. This, however, would require distinguishing between IP income and other income, and the Draft suggests that CFC rules may therefore be more effective if they apply just one rule to sales and services income and IP income that would treat all sales, services, royalty, and other IP income as passive unless the CFC has engaged in the substantial activities required to earn the income.

The Discussion Draft outlines two main approaches to defining what constitutes income subject to CFC rules: the categorical approach and the excess profits approach.

The categorical approach involves separate rules for different types of income. This allows jurisdictions to tailor their rules regarding treatment of each type of income. However, the Draft notes that all types of income would have to be categorized and a substance analysis might have to be applied. The Draft notes that this categorical approach is not dissimilar to a traditional CFC rule that combines a form-based analysis with a substance analysis. The Draft notes that economic studies often estimate the risk-inclusive rate as being approximately 8% to 10%, although this varies by industry, leverage, and jurisdiction.

The Draft defines the “normal return” as the “rate of return” multiplied by the “eligible equity.” The rate of return is an economic concept that begins by estimating the risk free rate of return and then increases it by a risk premium. The Draft notes that economic studies often estimate the risk-inclusive rate as being approximately 8% to 10%, although this varies by industry, leverage, and jurisdiction. The Draft suggests four options for determining risk-inclusive rate of return: (i) a set percentage such as 10%; (ii) a 10-year government bond yield increased by a fixed equity premium; (iii) the corporate group’s cost of capital; or (iv) a combined approach that uses the first or second option but allows groups to opt instead to use their cost of capital.

The Draft defines “eligible equity” as equity associated with the assets used in the active conduct of the trade or business in the low-tax jurisdiction. The Draft suggests using either book value or tax value
from the perspective of the parent jurisdiction to calculate equity, reduced by apportioned liabilities.

Finally, the Draft discusses whether the definition of what constitutes income subject to CFC rules should be applied on an entity or transactional basis. The entity approach is an all or nothing approach, depending on whether at least a specified percentage of the income falls within the definition of CFC income. Under the transactional approach, in contrast, the character of each stream of income is assessed to determine whether that stream of income is within the definition of CFC income. The Discussion Draft considers it to be best practice generally to use the transactional approach rather than the entity approach.

**Rules for computing income**

Chapter 6 of the Discussion Draft addresses the computation of income of the CFC, providing recommendations on (i) which jurisdiction’s rules should apply; and (ii) whether any specific rules for computing CFC income are necessary. The Draft recommends that the rules of the parent jurisdiction be used to compute a CFC's income. The Draft describes this approach as consistent with the goals of the BEPS Action Plan and as reducing administrative costs.

The Discussion Draft also recommends that jurisdictions should have a specific rule limiting the offset of losses to similar types of profits.

**Rules for attributing income**

Chapter 7 of the Discussion Draft addresses how to attribute income to shareholders. The Draft breaks this down into a five-step process: (i) determining which taxpayers should have income attributed to them; (ii) determining how much income should be attributed; (iii) determining when the income should be included in the returns of the taxpayers; (iv) determining how the income should be treated; and (v) determining what tax rate should apply to the income.

The Discussion Draft recommends that the threshold for attribution be tied to the minimum control threshold. However, the Draft notes that countries can choose different attribution and control thresholds depending on the policy considerations underlying their CFC rules.

The Discussion Draft recommends that the amount of income to be attributed to each shareholder be calculated by reference to the shareholder’s proportion of ownership in the CFC and the period of such ownership.

The Discussion Draft recommends that jurisdictions can determine when income should be included and how it should be treated so that their CFC rules operate in a manner that is coherent with their domestic law.

The Discussion Draft recommends that the tax rate of the parent jurisdiction be applied. The Draft also notes that countries could consider a “top-up tax” instead of tax at the full rate.

**Rules to prevent or eliminate double taxation**

Chapter 8 of the Draft sets out recommendations for preventing or eliminating double taxation.

The Draft focuses on three situations where double taxation may arise: (i) situations where the attributed CFC income is also subject to foreign corporate taxes; (ii) situations where CFC rules in more than one jurisdiction apply to the same CFC income; and (iii) situations where a CFC actually distributes dividends out of income that has already been attributed to its resident shareholders under the CFC rules or a resident shareholder disposes of the shares in the CFC.

With respect to the first two situations, the Discussion Draft recommends that countries allow a credit for foreign taxes actually paid, including CFC tax on intermediate companies. With respect to the third situation, the Draft recommends exempting dividends and gains on disposition of CFC shares if the income of the CFC has previously been subject to CFC taxation. However, the precise treatment of dividends and gains can be left to jurisdictions to determine so that such treatment is coherent with their domestic law.
Implications

The Discussion Draft is the first draft of the output to be produced under Action 3 of the OECD BEPS Project. While the Draft makes recommendations with respect to several aspects of CFC rules, it does not make recommendations on the definition of CFC income; in that area, the Draft includes options as there is not yet consensus among countries on a recommended approach. The recommendations and options in the Discussion Draft, if adopted by countries, could have significant implications for the taxation of global businesses. Companies should evaluate how the recommendations and options 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.

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