OECD releases final report on CFC rules under BEPS Action 3

Executive summary

On 5 October 2015, the Organization for Economic Co-operation and Development (OECD) released its final report on strengthening controlled foreign company (CFC) rules under Action 3 of its Action Plan on Base Erosion and Profit Shifting (BEPS). This report was released in a package that included final reports on all 15 BEPS Actions.

The document, Designing Effective Controlled Foreign Company Rules (the Final Report), reflects a significant change in tone from the Action 3 Discussion Draft, Strengthening CFC rules, released in April 2015. Like the discussion draft, the Final Report provides recommendations for what it describes as the “building blocks” of CFC rules. The Final Report specifies, however, that the recommendations are not minimum standards, but instead “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 Final Report also highlights the differences in countries’ policy objectives as well as the differences in prioritization of those policy objectives and states that the recommendations provide flexibility to countries to act in a manner consistent with the policy objectives of their overall tax system.

The Final Report discusses six building blocks for the design of effective CFC rules:

• Definition of a CFC (including the definition of control)
• CFC exemptions and threshold requirements
• Definition of CFC income
• Computation of income
• Attribution of income
• Prevention and elimination of double taxation
As in the discussion draft, the Final Report provides recommendations for the building blocks, except for the definition of CFC income for which it sets out a non-exhaustive list of approaches that could be used by countries.

EY is hosting a series of webcasts that will provide a comprehensive review of the final BEPS reports and outlook for country action. The Final Report on Action 3 will be addressed in webcasts on:

- OECD BEPS Project Outcomes: Highlights and Next Steps – 15 October, 10 AM, EDT
- Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 – 19 November, 10 AM, EST

Detailed discussion
The Final Report begins with a discussion of policy considerations for CFC rules that reflects a significant shift in tone from the April 2015 discussion draft on Action 3. It then discusses each of the six elements that the OECD has identified as the building blocks of effective CFC rules. The Final Report states that the recommended building blocks “would allow countries without CFC rules to implement recommended rules directly and countries with existing CFC rules to modify their rules to align more closely with the recommendations.”

Policy considerations
The Final Report acknowledges that “the design and objectives of CFC rules can differ from one jurisdiction to another because they reflect different policy choices.”

Therefore, it divides the policy considerations in connection with the design of CFC rules into two categories: policy considerations that are shared by countries and specific policy objectives that countries may prioritize differently. The shared policy considerations include: (i) deterrent effect; (ii) interaction with transfer-pricing rules; (iii) effectively preventing avoidance while reducing administrative and compliance burdens; and (iv) avoiding double taxation.

For other policy objectives that may be implicated by CFC rules, the Final Report identifies two fundamental differences can affect the design of CFC rules: whether the country has a worldwide tax system or a territorial tax system; and whether the country is a Member State of the European Union (EU). The Final Report further notes that two specific policies are influenced by whether the country has a worldwide or a territorial tax system: striking a balance between taxing foreign income and maintaining competiveness; and preventing base-stripping. Finally, the Final Report indicates that limitations on CFC rules within the EU means that the recommendations on Action 3 must be adaptable where necessary to allow EU Member States to comply with EU law, noting that this is relevant to countries outside the EU as well because of competitiveness consideration.

Definition of a CFC
The Final Report sets out two recommendations for defining a CFC: (i) adopt a broad definition so that CFC rules would apply both to corporate entities and certain transparent entities (partnerships and trusts) and permanent establishments (PEs)) and also include a hybrid-mismatch rule that would prevent entities from circumventing CFC rules through different treatment in different jurisdictions; and (ii) apply at least both a legal control test and an economic control test so that satisfaction of either results in a determination of control.

The Final Report recommends that CFC rules apply to transparent entities that earn income that raises BEPS concerns in two cases: (i) entities that are transparent in their home country but are taxable entities in the parent country; and (ii) entities that would not otherwise be taxable and that are owned by another CFC. The Final Report also indicates that PEs may need to be treated as CFCs in two circumstances: when a foreign entity has a PE in another country and when the parent country exempts the income of the PE.

The Final Report recommends that countries address the potential avoidance of application of CFC rules for hybrid instruments or entities. It indicates that one possible approach would be to require an intragroup payment to a CFC to be taken into account if: (i) the payment is not included in CFC income; and (ii) the payment would have been included in CFC income if the parent jurisdiction had classified the entities and arrangements in the same way as the payer or payee jurisdiction. The
discussion draft had divided this recommendation into a narrower option and a broader option, with the narrower option applying only if the intragroup payment were a base-eroding payment.

Regarding the definition of control, the Final Report focuses on two elements: (i) the type of control that is required; and (ii) the level of that control. The Final Report recommends a control test that includes at least legal and economic control and notes that countries could supplement this with a de facto control test or a test based on consolidation for accounting purposes. Regarding level of control, the Final Report recommends treating a CFC as controlled when residents (including corporate entities, individuals or others) hold, at a minimum, more than 50% control. The Final Report notes, however, that countries may set their control threshold at a lower level. The Final Report recommends using one of three approaches to aggregate shareholders for purposes of the control test: an “acting-in-concert” test, aggregation of related parties or a concentrated ownership test. The Final Report 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. Finally, the Final Report states that CFC rules should apply when there is either direct or indirect control.

**CFC exemptions and threshold requirements**

The Final Report addresses CFC exemptions and threshold requirements for the scope of CFC rules, recommending inclusion of a tax rate exemption that would allow companies that are subject to an effective tax rate that is sufficiently similar to the tax rate applied in the parent jurisdiction not to be subject to CFC taxation. Such a tax rate exemption would subject all CFCs with an effective tax rate meaningfully below the rate applied in the parent jurisdiction to CFC rules. The Final Report also notes that this exemption could be combined with a list such as a white list.

Regarding 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 Final Report notes that most CFC rules apply benchmarks that are at most 75% of the statutory corporate tax rate but, unlike the discussion draft, it does not recommend setting the benchmark at such a rate or lower. Rather, the Final Report states that the benchmark should be meaningfully lower than the tax rate in the country applying the CFC rules. The Final Report recommends the use of the CFC’s effective tax rate (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 Final Report 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 (International Financial Reporting Standards) with adjustments made to reflect the tax base reductions that result in low taxation of the CFC income. The Final Report 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.

The Final Report also discusses approaches involving a de minimis threshold or an anti-avoidance requirement, but does not recommend either approach.

**Definition of CFC income**

The Final Report outlines several approaches to defining income but only recommends that CFC rules include a definition of income “that ensures that income that raises BEPS concerns is attributed to controlling shareholders in the parent jurisdiction.” The Final Report recognizes the need for flexibility to ensure countries can design CFC rules that are consistent with their domestic policies and indicates that countries “are free to choose their rules for defining CFC income.” The Final Report further notes that it provides a non-exhaustive list of approaches that the CFC rules could use to attribute income. It further states that, regardless
of the approach a country uses, “CFC rules should, at a minimum, capture the funding return allocated under the transfer pricing rules to a low-function cash box,” although it also indicates that the extent of the income inclusion may be limited in the case of CFC rules that focus on preventing stripping from the parent country.

The Final Report does not include the form-based analysis described in the Discussion Draft and instead delineates four approaches to defining CFC income: (i) the categorical approach; (ii) the substance approach; (iii) the excess-profit approach; and (iv) the transactional or entity approaches. The Final Report also indicates that countries could apply a full-inclusion system.

Categorical analysis
The Final Report’s discussion of a categorical analysis recognizes that countries define the categories differently depending on which of the following factors or indicia they find most relevant: (i) legal classification; (ii) relatedness of parties; and (iii) source of income. The Final Report notes that jurisdictions generally categorize income according to legal classifications, such as: (i) dividends, (ii) interest, (iii) insurance income, (iv) royalties and IP income, and (v) sales and services income.

The Final Report suggests that dividend income could be treated as passive income but excluded from CFC income if it is paid out of active income of an affiliate, if the dividends would have been exempt from taxation in the parent country had they been earned by the parent company, and if the dividends are linked to the CFC’s active trade or business of dealing in securities. For interest and financing income, the Final Report notes that this type of income is more likely to raise BEPS concerns when it has been earned from related parties, when the CFC is overcapitalized, when the activities contributing to the interest were located outside the CFC jurisdiction, or when the income was not earned from an active financing business.

The Final Report suggests that CFC rules could focus on insurance income in three cases: (i) when the CFC is overcapitalized; (ii) when the parties to the insurance contract or the risks insured are located outside the CFC jurisdiction; and (iii) when the insurance income derives from contracts or policies with a related party, particularly if the related party also receives a deduction for the payment of the insurance premium.

The Final Report notes the concern that income from royalties and intellectual property (IP) is highly mobile and can be easily diverted from the location where the value was created. The Final Report states that IP income raises the following challenges: (i) IP income is particularly easy to manipulate because it can be exploited and distributed in many different forms, all of which may have different formalistic classifications under the CFC rules of different countries; (ii) IP assets are often hard to value because there are often no exact comparables; and (iii) income that is directly earned from the underlying IP asset is often difficult to separate from the income that is earned from associated services or products. The Final Report further states that, given these challenges, focusing on royalty income is not enough to attribute all income that actually arise out of IP and that raises BEPS concerns.

The Final Report indicates that income arising from the sale of goods that were produced in the CFC country or from services that were provided in the CFC country generally do not raise BEPS concerns but may raise concerns in two circumstances. Invoicing companies raise concerns because they earn income for goods and services that were purchased from related parties and to which they have added little or no value. IP income raises concerns because income from IP that was shifted into the CFC and to which the CFC has added little to no value is generally considered as sales and services income and could again escape CFC inclusion. The Final Report indicates that categorical analyses based on legal classification may not capture income that raises BEPS concerns if they exclude all sales and services income without taking these two situations into account.

In addition to legal classifications, the Final Report notes that categorical analyses also may look at the relatedness of the parties from which income is earned and at the source of income. The Final
Report notes that many existing CFC rules include related-party income on the basis that such income can be shifted more easily. It further notes that the existing rules can differ based on how much involvement by a related party is required for this purpose.

With regard to the source of income, the Final Report notes that the categorical approach can either take the form of an anti-base-stripping rule or a source-country rule, and the underlying principle is that income earned from a country other than the CFC jurisdiction is more likely to raise concerns about profit shifting. Countries that are focused primarily on preventing the stripping of the parent country's base will only categorize income generated in the parent jurisdiction as CFC income. Countries with anti-base-stripping rules could treat any income generated in a country other than the CFC country as CFC income. The broader approach would be harder to manipulate than a narrower rule focusing on just the parent country, but it may attribute income that has genuinely been earned from activities carried out by the CFC. A broad anti-base-stripping rule could also take the form of a source-country rule, which excludes income from CFC income if it was earned in the CFC country.

Substance analysis
The Final Report notes that substance analyses can use a variety of proxies to determine whether the CFC's income was separated from the underlying substance, including people, premises, assets and risks. Regardless of the proxies used, however, the Final Report notes that the fundamental question is whether the CFC has the ability to earn the income itself. The Final Report further notes that most existing substance analyses are not stand-alone rules but instead apply together with more mechanical rules.

The Final Report states that a substance analysis can use either a threshold test or a proportionate analysis. Under a threshold (or “all-or-nothing”) test, a set amount of activity (as identified through one or more proxies) would allow all income of the CFC to be excluded. Under the proportionate analysis, CFC income would only exclude the income that was proportionate to the amount of activity that the CFC had undertaken.

Recognizing concerns about complexity and interactions with transfer-pricing rules, the Final Report sets out four options of substance analysis and notes that the analysis looks to whether the CFC engaged in substantial activities in determining what income is CFC income.

The first option focuses 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. The Final Report notes that the option could be designed to include certain safe harbors, ratios and other mechanical tests.

The second option would look at all of the significant functions performed by entities within the group to determine if the CFC is the entity that would be most likely to own particular assets or undertake particular risk if the entities were unrelated. This option could be designed as a threshold test, under which all of the income of the CFC would be included if it fell below the threshold of significant functions, or as a proportionate test, under which only the income that the CFC did not have the significant functions necessary to earn would be included.

The third option would measure whether the CFC had the necessary business premises and establishment in the CFC country to actually earn the income and whether the CFC had the necessary number of employees with the requisite skills in the CFC country to undertake the majority of the CFC's core functions. This option could also be designed as a threshold test or a proportionate test.

The fourth option is a variation on the third option and is meant to be consistent with other areas of the BEPS project by using the nexus approach that was developed under Action 5. CFC rules could include a version of the nexus approach as a substance analysis, under which income earned by the CFC meeting the requirements of the nexus approach would not be included in CFC income, while all other income from qualifying IP as defined by the nexus approach would be treated as CFC income. As this option
would only apply to income arising from qualifying IP assets, the Final Report indicates that it may need to be combined with another substance analysis for other types of income.

The Final Report states that substance analyses increase the accuracy of CFC rules, but this must be weighed against the increased complexity and expense that they create.

**Excess-profits analysis**

Another approach to defining CFC income described in the Final Report is a formulary excess-profits analysis. Under this approach, a “normal return” would be calculated for equity investment in the CFC. Any profit in excess of normal return would be treated as CFC income. The Final Report notes that some countries apply a substance-based exclusion as a final step in such an approach.

The Final Report 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 Final Report notes that economic studies often estimate the risk-inclusive rate as being approximately 8% to 10%, although this varies by industry, leverage and country. The Final Report 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 Final Report notes that the mechanical nature of this approach must be weighed against whether it could target shifted income with sufficient accuracy. There is, however, no consensus on whether this approach should be combined with a mandatory substance-based exclusion.

**Transactional and entity approaches**

Finally, the Final Report discusses whether the definition of CFC income should apply 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 entity’s 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 report notes that the transactional approach is generally more accurate in capturing income, although it may increase administrative burdens and compliance costs.

**Rules for computing income**

The Final Report addresses the computation of income of a CFC, providing recommendations on: (i) which country’s rules should apply; and (ii) whether any specific rules for computing CFC income are necessary. The Final Report recommends using the rules of the parent country to compute a CFC’s income. The report describes this approach as consistent with the goals of the BEPS Action Plan and as reducing administrative costs. The Final Report also recommends that countries should have a specific rule limiting the offset of CFC losses so that they can be used only against profits of the same CFC or other CFCs in the same country. Such a rule could apply with a rule limiting offset of losses to similar types of profits. The Final Report also notes that rules regarding loss importation also could apply to the computation of CFC income.

**Rules for attributing income**

The Final Report describes a five-step process for attributing CFC income to shareholders: (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 Final Report recommends tying the threshold for attribution to the minimum control threshold but notes that countries can choose different attribution and control thresholds depending on the policy considerations underlying their CFC rules.

The Final Report recommends calculating the amount of income attributable to each shareholder by referencing the shareholder’s proportion of ownership in the CFC and the period of such ownership or influence. It further notes that attribution rules should ensure that it is not possible to attribute more than 100% of the CFC’s income when legal and economic control may aggregate to more than 100%.
The Final Report recommends that countries determine when income should be included and how it should be treated so that their CFC rules operate in a manner that is consistent with their domestic law.

The Final Report recommends applying the tax rate of the parent country. It also notes that countries could consider a “top-up tax” instead of tax at the full rate.

**Rules to prevent or eliminate double taxation**

The Final Report focuses on three situations in which double taxation may arise: (i) situations in which the attributed CFC income also is subject to foreign corporate taxes; (ii) situations in which CFC rules in more than one jurisdiction apply to the same CFC income; and (iii) situations in which 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. The Final Report further notes that double taxation concerns could arise in other situations, for instance when there has been a transfer-pricing adjustment between two jurisdictions and a CFC charge arises in a third jurisdiction. It states that CFC rules should be designed to ensure that these and other situations do not lead to double taxation.

For the first two situations, the Final Report recommends that countries allow a credit for foreign taxes actually paid, including CFC tax on intermediate companies. Regarding the third situation, it recommends exempting dividends and gains on disposition of CFC shares if the income of the CFC has previously been subject to CFC taxation. The precise treatment of dividends and gains is left to countries to determine so that the treatment is consistent with their domestic law. The Final Report further indicates that countries will need to consider whether their existing double tax relief provisions are effective at relieving all instances of double taxation.

**Implications**

The Final Report concludes the OECD’s work on CFC rules under Action 3. Importantly, the Final Report states that the recommendations are not minimum standards, indicating that it is the choice of countries whether or not to implement the recommendations. The Final Report recognizes that countries have different policy objectives and different prioritization of those policy objectives. The Final Report includes, however, detailed recommendations for the design of CFC rules for countries to consider if they are interested in implementing a new regime or modifying an existing regime. These recommendations, if adopted by countries, could have significant implications for the taxation of global businesses. Companies should evaluate how the recommendations may affect them and stay informed about developments in the countries where they operate or invest.

**Webcasts**

EY is hosting a series of eight tax webcasts that will provide a comprehensive review of the final BEPS reports and the outlook for country action:

- **OECD BEPS Project Outcomes: Highlights and Next Steps – 15 October, 10am EDT**
- **New Reporting under BEPS Action 13 – 20 October, 10am EDT**
- **Digital Economy Developments and BEPS Action 1 – 27 October, 12 noon EDT**
- **Permanent Establishment Developments and BEPS Action 7 – 5 November, 10am EST**
- **Transfer Pricing and BEPS Actions 8-10 – 12 November, 10am EST**
- **Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 – 19 November, 10am EST**
- **Financial Payments and BEPS Actions 2 and 4 – 3 December, 10am EST**
- **Dispute Resolution and BEPS Action 14 – 10 December, 10am EST**

For more information and to register for the webcast series, [click here.](#)
Endnotes


2. The discussion draft had included seven building blocks. The building blocks are reduced to six in the Final Report through the combination of two of the discussion draft’s building blocks into one.

3. The definition of control was a separate building block in the discussion draft.

4. The Final Report considers, but does not recommend, use of the CFC country’s rules for computing income, allowing taxpayers to choose the parent or CFC country’s rules, or use of a common standard such as IFRS.

For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP, International Tax Services, Washington, DC**

- Barbara Angus  
  +1 202 327 5824  
  Barbara.Angus@ey.com

- Andreia Leite Verissimo  
  +1 202 327 6034  
  Andreia.LeiteVerissimo@ey.com

- Min Yu  
  +1 202 327 7396  
  Min.Yu@ey.com
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