

Grant Thornton discussion draft response

BEPS Action 3: Strengthening CFC Rules



Grant Thornton International Ltd
welcomes the opportunity to
comment on the OECD Public
Discussion Draft entitled BEPS
Action 3: Strengthening CFC Rules,
issued on 3 April 2015.

Our observations and detailed
comments are set out within this
document.



General observations

As a general rule, we agree with the comment in paragraph 85 of the discussion draft that CFC rules should be designed to apply only to stripping of the base of the parent jurisdiction.

CFC rules must also be compatible with EU law and the principles established in the Cadbury Schweppes case (C196-04) and related jurisprudence which focus on 'wholly artificial arrangements' while there should not be a two-tier system differentiating the treatment of EU from non-EU territories.

Additionally, we consider that a CFC regime must have a broad range of exemptions to ensure that CFC rules only apply to real cases of artificial diversion of profits from the parent jurisdiction. No single approach to establishing whether an entity should be exempt from CFC rules is likely to be appropriate.

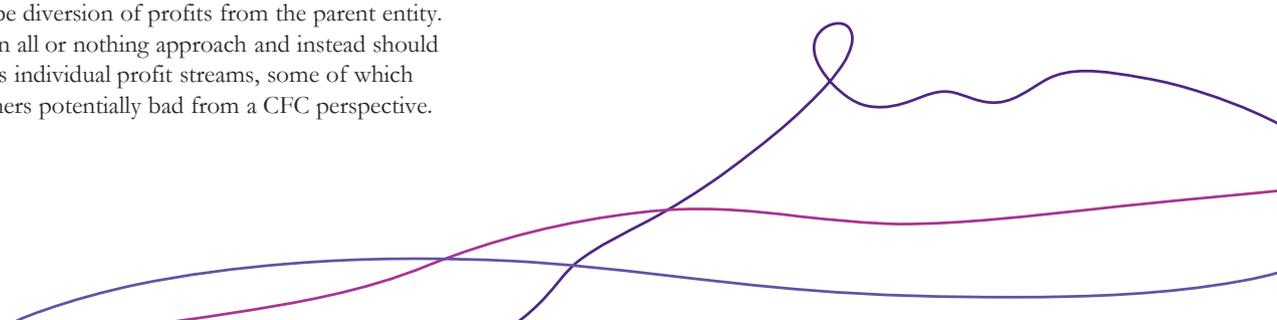
To minimise the compliance burden on taxpayers and ensure CFC rules are targeted at only real cases of serious tax avoidance, there must be provision for exemptions which can apply to an entity as a whole particularly where this is based in a high tax country, has only a minimal amount of profits or a low profit margin. Newly acquired companies not set up to avoid tax in the parent jurisdiction because they were not previously controlled from that jurisdiction should also be able to benefit from a 'period of grace' from the application of CFC rules.

If companies do not meet one of these broad exemptions, then the rules should focus on whether the activities that generate the CFC's profits are in fact located in the parent jurisdiction so that there can be said to be diversion of profits from the parent entity. This should not be an all or nothing approach and instead should focus on a company's individual profit streams, some of which may be good and others potentially bad from a CFC perspective.

Additionally, there should remain scope for the use of offshore finance companies and group insurance vehicles particularly where such entities transact only with companies that are themselves exempt CFCs and not with the parent entity. In such situations, there should not usually be much possibility of artificial diversion of profits from the parent jurisdiction subject to certain limitations which we consider further in our detailed comments below.

Our general comments above and more detailed views expressed in the remainder of this document are mainly based on our practical experience of the recently introduced UK CFC regime which applies to accounting periods beginning on or after 1 January 2013. During the consultation process for this regime which began in 2007, many issues similar to those mentioned in the discussion draft were considered at length. For that reason we believe that the UK CFC rules represent a suitable example of best practice in this area of international taxation.

The length of the consultation process for the UK CFC regime was approximately six years which highlights the difficulty of this area of international tax law and would suggest that the OECD's timescale for making recommendations is unrealistic. If such recommendations are not fully considered they are likely to be unworkable in practice and could in fact lead to loopholes and opportunities for tax avoidance.



We therefore suggest that the OECD does not make any detailed recommendations but focuses instead on publishing a detailed survey of best practices. This information could be obtained by the OECD directly from the tax authorities of the relevant territories which might include the UK, US and Germany, for example. Member countries without comprehensive CFC legislation can then understand the options which might be available to them to combat tax avoidance through the artificial diversion of profits from their jurisdiction.

Chapter 2: Definition of a CFC

1. Would any particular practical issues arise from treating transparent entities as separate entities in the cases listed above? If so, what are they and how could they be dealt with?

The discussion draft notes that CFC rules should apply to transparent entities in two cases: where entities that are not taxable in one jurisdiction are subject to tax in the parent jurisdiction and where entities that would otherwise not be taxable are owned by another CFC.

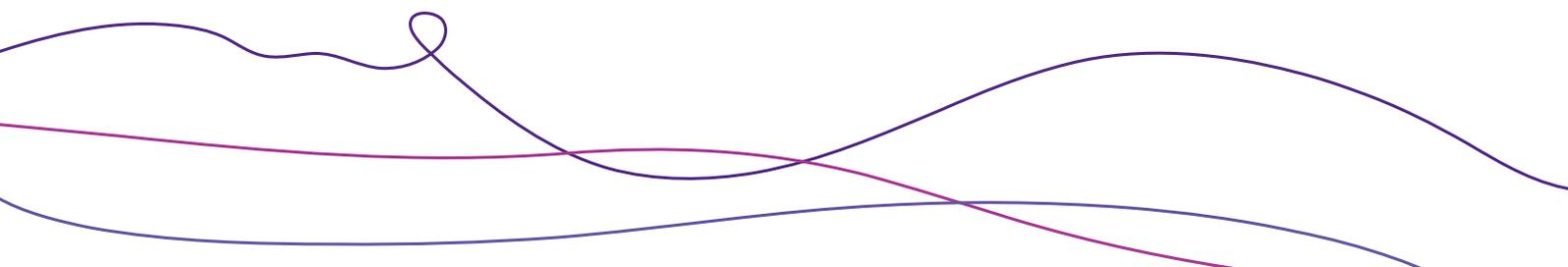
Given that the income of transparent entities is often treated as taxable in the hands of the interest holders as opposed to the entity itself, we do not consider that such a transparent entity should be treated as a CFC. In particular, if such vehicles were characterised as CFCs, this could lead to potential double taxation if their income were included as CFC income of another entity higher in the ownership chain.

2. Should the recommendations consider any other issues related to determining which entities could be considered to be CFCs?

Not all territories apply the same approach to establishing whether an entity is transparent or opaque for tax purposes which could lead to inconsistency of treatment for CFC purposes. In this situation, it may be consistent to apply the entity classification approach used by the immediate parent jurisdiction of the relevant entity.

3. Are there any practical problems with either the narrow or the broad version of the modified hybrid mismatch rule mentioned above?

It should not be necessary to incorporate specific anti-hybrid measures into CFC legislation where such measures already exist in calculating the actual profits of the relevant entities under their domestic laws, including the parent company of the CFC entity. This conclusion assumes that the parent company computes the profits of a non-exempt CFC using the normal tax principles applying to an entity which is resident for tax purposes in the parent company's jurisdiction.



Chapter 3: Threshold Requirements

4. What practical problems, if any, arise when applying a low-tax threshold based on an effective tax rate calculation?

Compliance burden

A low-tax threshold based on an effective tax rate calculation could impose a significant compliance burden in terms of having to apply the parent company's tax rules to the profits of the CFC, particularly if this was to be the only test available of whether an entity is a 'bad' CFC. This would be a huge amount of work for many groups in all but the most straightforward cases.

Where a low-tax threshold is to be used it should apply on a company by company basis as this would be a simpler approach than a calculation using a country by country approach as not all companies in a single jurisdiction may exist with the purpose of artificially diverting profits.

Therefore, while a low-tax threshold test is one possible test that should be used, to mitigate the potential compliance burden, it is important for a country's CFC regime to impose alternative tests such as a 'black' or 'white' list (with additional safeguards which restrict the amount of 'bad' or low tax income of the CFC to a negligible amount such as 10%).

There may also be grounds for completely excluding foreign entities from CFC legislation (subject to an overriding main purpose test) which are based in much higher tax jurisdictions such as the US, Australia, Canada, France, Germany and Japan as with the UK's CFC exemption for excluded territories. Such alternative tests may often be simpler to apply in practice yet still remain appropriately targeted against artificial diversion of profits.

Consistency with other BEPS measures

There is no mention of BEPS Action 6 concerning harmful tax practices in the discussion draft other than in the introductory section at paragraph 5. There may be merit in linking CFC measures with known harmful tax practices either by specifically including them on a 'black' list subject to minimum income thresholds. However, this may be too narrow an approach as it may mean that certain other potentially harmful tax practices not already identified do not fall within the ambit of CFC rules.

Again, the approach in the UK CFC legislation regarding the CFC exemptions known as the tax exemption and excluded territories exemption may provide a practical solution in addition to a simple low-tax threshold test. The tax exemption is specifically prevented from applying in situations where the CFC's territory operates designer rate rules which would allow the CFC to choose its own effective tax rate so that can meet the thresholds of a local tax based CFC exemption in its parent company's jurisdiction.

The excluded territories exemption does not apply where the greater of 10% or £50,000 of a CFC's income is 'bad'. Bad income for this purpose includes:

- income the tax on which is reduced under investment incentives or tax rulings or falls to be repaid to any person
- non-local source non trading income (ie 'mobile' income) that is offset by notional deductions on equity
- profits have not been subject to one-sided transfer pricing adjustments
- trust or partnership income which is not included in accounting profits
- income of the above from permanent establishments in third territories that are excluded countries and which would fall within any of the other 'bad' categories above if the PE were a CFC resident in its country of establishment.

There are also two further tests applying to the company as a whole which focus on whether the company has been involved in an arrangement with a main purpose of obtaining a UK tax advantage for any person and whether intellectual property has been transferred to the company from the UK in the last six years.

In terms of a minimum level of tax to which a CFC should be subject in its territory of residence we note that the foreign tax threshold in the third-country PE anti-abuse measures in BEPS Action 6 is 60%.

Accounting mismatches

There may be mismatches between local accounting rules and the accounting rules of the parent jurisdiction in terms of establishing the profit before tax of the company as the starting point for the taxable profits calculation.

5 How could these problems be addressed or mitigated?

Please see our comments in 4 above.

In addition, to address the potential problem of accounting mismatches, CFC rules could prescribe what acceptable accounting practice should be used which, as with the UK CFC rules, could be local GAAP, GAAP in the parent jurisdiction or IFRS.

6 Does the discussion above correctly address the situation of permanent establishments that are subject to a different tax rate from CFCs?

The discussion draft states at Paragraph 41 that if CFC jurisdictions exempt PEs from taxation, the effective tax rate of PEs of a CFC should be calculated separately from that of the CFC to ensure that the tax rates of the PE and CFC cannot be blended to avoid the low-tax threshold.

While we note this as a potential option, the alternative referred to above under question 4 in relation to the UK excluded territories exemption from the UK CFC rules may also be a viable solution as it should result in a reduced compliance burden.

We would in any case expect this issue to become more prevalent following the implementation by OECD countries of BEPS Action 7 concerning the artificial avoidance of PE status and so a practical solution that does not increase the compliance burden for taxpayers will be essential.

It should also be noted that the UK applies its CFC rules with certain minor modifications to foreign PEs of UK tax resident companies which have elected for their foreign PEs to be exempted from UK corporation tax. Therefore, there should generally be no UK tax advantage for a UK parent company from doing business through a foreign PE compared with a foreign company.

Chapter 4: Definition of control

7. What practical problems, if any, arise when applying a control test?

Control threshold

We consider practical problems are most likely to arise where the control threshold in a CFC regime is too low, eg where this encompasses an unconnected minority shareholder owning in excess of 10% of a CFC but less than 40%. By way of analogy, 40% is the threshold for a UK company's interest in a joint venture to be treated as a CFC but only where the other (non-UK resident) joint venture partner also holds at least 40% but no more than 55%, given that a joint venture partner owning more than 55% is likely to be able to control the joint venture outright.

It is rare in practice for holders of interests of less than 40% effectively to exercise control over a company. Where they 'act together' this will typically be for wholly commercial reasons to ensure efficient corporate governance and not to avoid taxes.

Protected cell companies and incorporated cells

Special rules may be needed to deal with protected cell companies and incorporated cells which are forms of entity which exist in certain jurisdictions.

A protected cell company is essentially a single legal entity comprised of a core and several cells that have separate assets and liabilities, so that the assets and liabilities of a cell are legally ring-fenced from those of other cells. The core capital of the cell is typically held by a third party who exercises control over the protected cell company as a whole, with the core often providing financial management services to the individual cells which are usually owned by non-connected companies.

In substance, an individual cell is like a separate company but it is not always caught by CFC rules of a parent jurisdiction because the wider protected cell vehicle is held by a third party.

Interests in protected cells are typically used to hold investment income or assets of insurance companies which are required for the purposes of meeting future liabilities of the insurance business. In practice, it may be more commercial to structure part of an insurance business in this way to have access to financial management and other services and to ring-fence certain business from a regulatory perspective.

In substance, each cell could be viewed as separate company but from a legal perspective there is only one corporate vehicle. Additionally, where a protected cell company is comprised of a number of cells each owned by third parties, it would also not be possible that any owner of a particular cell can exercise economic control.

More recently, the legal concept of an incorporated cell company has been developed by some jurisdictions. Such vehicles are typically established under the articles of a foreign company and have separate legal personality from the latter company but which are not themselves companies. As the incorporated cell is not a company per se, it may not be treated as a CFC under the parent jurisdiction's CFC legislation.

The UK CFC rules contain specific provisions dealing with individual cells including incorporated cells whereby they are treated as separate companies for CFC purposes. Therefore, the UK CFC rules, including exemptions if relevant, apply to each cell in isolation.

8. Are there particular practical problems that arise when applying a control test that considers interests held by unrelated or non-resident parties? If so, what are they, and how can they be dealt with?

Please refer to the response to question 7 above.

Chapter 5: Definition of CFC Income

9 What are the practical problems with any of the three substance analyses set out? How could these practical problems be dealt with?

In practice, the key issue is likely to be complexity and the compliance burdens which could be generated along with potential uncertainty of treatment. To mitigate these problems, it will be important to choose an approach which is consistent with existing OECD principles.

In this respect we note from page 8 of the discussion draft dated 31 October 2014 concerning BEPs Action 7 that the OECD does not propose significant changes as part of its BEPS initiative to its existing policies on the attribution of profits to PEs (as set out in the July 2010 OECD Report on the Attribution of Profits to Permanent Establishments). Therefore, a substance analysis approach which mirrors these existing profit attribution policies, as with the current UK CFC regime, would appear to assist with managing the practical position.

Such an approach is particularly apt given the OECD proposes that CFC legislation should also be applied to foreign permanent establishments (Paragraph 30 of BEPS Action 3 discussion document).

Do you have experience with applying substance analyses in existing CFC rules? If so, how can these be made more mechanical while still accurately attributing income?

We would draw your attention to the UK CFC rules which follow the approach mentioned in 9 above. In addition, the UK CFC rules contain a number of different safe harbours which focus on such factors as the main purposes of the CFC's trading activities and whether these are intended to avoid UK tax, whether a substantial amount of the profits of the CFC are generated by significant people functions in the UK, eg in circumstances which would not be found in arm's length situations and whether, amongst other conditions more than 20% of the CFC's income is derived from the UK.

Safe harbours approaches such as the above mean that CFC rules should generally only target real cases of serious tax avoidance. They can also be used in the context of mobile income such as passive interest income earned by trading or holding companies. Broadly, the UK CFC rules do not tax such profits unless they comprise more than 5% of trading profits or exempt dividend income of the relevant entity. In addition, safe harbours exist for example where a CFC holds interest-generating funds on a short-term basis pending the payment of dividends or planned investment in trading assets.

11. How can CFC rules accurately attribute income that raises concerns about BEPS (i) in a business that is licensed under an appropriate regulatory body and is market-facing in a particular jurisdiction, (ii) in a reinsurance business carried on by a CFC of a multinational insurance group or (iii) in a 'captive' insurance business of a CFC that is not part of an insurance group? Are there practical problems with current rules that distinguish between these two situations? If so, what are they and how can they be dealt with?

- i. Please refer to the response to question 9 above. In addition, CFC rules could consider whether the regulated entity is excessively capitalised or has excess free assets compared with the position that the local regulator would require in an arm's length situation (plus a prudent commercial buffer). An alternative test could be based on the regulatory requirements of the parent company's jurisdiction although this is likely to impose a significant additional compliance burden in requiring consideration of a hypothetical regulatory scenario. Any such CFC rules would need to make concession to special business circumstances of the CFC, eg where additional capital is needed for ratings agency purposes or because the CFC is entering into a new market.
- ii. Please refer to (i) above. It is of specific note here that the July 2010 OECD Report on the Attribution of Profits to Permanent Establishments focuses on the underwriting function as being the key function of an insurance enterprise. Therefore, if the underwriting function is properly established in the CFC's territory of residence the scope for CFC taxation should be limited. Also, the relevant CFC rules could focus on whether the tax avoided in the parent's jurisdiction from the reinsurance arrangement exceeds the non-tax financial benefits of the reinsurance which might include freeing up regulatory capital in the parent and other jurisdictions to write additional business that would generate profits taxed at normal rates. In this respect, we do not believe it would be appropriate for the parent jurisdiction of the CFC to be able to tax income which is diverted from subsidiaries in other jurisdiction. In this situation, it is up to the fiscal authorities in such other jurisdiction to impose their own restrictions such as deeming the reinsurer to have a local PE.
- iii. We consider that the same approaches as identified in (i) and (ii) above should apply to (iii) as these should also help to establish whether the captive insurance company is effectively dealing with affiliated companies on arm's length terms and reducing their external insurance costs or simply diverting profits in an artificial way.

12. Are there practical problems with applying the same rule to sales and services income and IP income?

Please refer to 9 and 10 above. In addition, a number of entity-level exemptions in the UK CFC rules are based on IP not being transferred to the CFC from the UK in the preceding six years.

13. Are there existing CFC rules that accurately attribute any or all of these categories of income while also reducing administrative and compliance burdens?

Please see 9 – 12 above.

14. Does the discussion above consider all categories of income that should be attributed under CFC rules?

We note that the discussion draft does not consider property income. However, such income is typically not mobile as it can generally only arise in the territory where the property is actually located. Therefore such income is not usually at risk of leading to artificial diversion of profits from the parent company's jurisdiction.

A potential exception to this rule may exist where property located in the parent jurisdiction is held through a company resident in a different territory. This is not generally a problem under the UK CFC rules however, since non-UK resident landlords are subject to UK income tax at 20% on UK source rental income. This rate of income tax is the same as the UK corporation tax rate which would apply if the foreign company holding the UK company was UK resident.

A number of groups have offshore finance companies which receive interest income from entities in other jurisdictions. Again, there should not be any scope for artificial diversion of profits from the parent jurisdiction if such vehicles are not used to finance the parent or other group companies in the parent's jurisdiction. In addition, safeguards need to be in place so that finance companies are not used to make loans to group companies that are not exempt CFCs and so would be able to use interest deductions to reduce their own CFC income.

15. Is it clear how the two approaches above would work? If not, what further detail is required to clarify the approach?

For the reasons mentioned in 9 above, it is not practical or helpful to employ an excess profits approach as this is not consistent with other related OECD principles concerning the attribution of profits.

16. What practical problems arise with applying the categorical approach and the excess profits approach?

Please see 9 - 15 above.

17. How could the practical problems be addressed or mitigated?

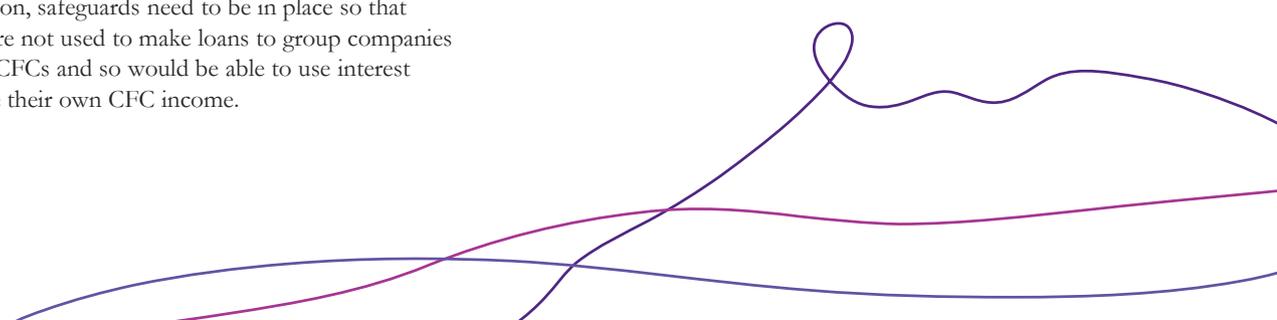
Please see 9 - 15 above.

18. Which approach is most likely to accurately attribute income that gives rise to BEPS concerns? Is one approach likely to be more effective than the other in terms of dealing with IP income?

Please refer to 9 -15 above. It is possible that an excess profits approach might be suitable in cases where IP is held only as a passive investment. However, the same result is likely to be achieved through following the approach set out in 9 above where there CFC owning the IP does not exercise any significant people functions in relation to the IP. Hence, there does not appear to be any merit in employing a different set of rules for IP income.

19. Could the excess profits approach be applied to income other than IP income and what would be the practical implications of this?

Please refer to 9 – 15 and 18 above.



20. What other approaches could be considered for determining excess profits or excess returns?

Please refer to 9 – 15 and 18 above.

21. What difficulties or practical problems arise in applying an entity approach or a transactional approach?

With its current CFC regime, the UK has moved from a pure entity approach to an approach which still focuses on the entity to determine whether a CFC charge should apply, but then, if certain entity level tests are not met, applies a more transaction based threshold tests to determine the actual income chargeable. This combined approach allows the practical aspects of each approach to be adopted, eg an entity based approach to determine first which companies could be subject to a CFC charge combined with a multiple range of further filters to mitigate the compliance burden.

This type of system provides protection from the significant disadvantages of following a single approach, ie the compliance burdens of a transaction based approach and the risk of swamping bad income with good income under an entity basis.

22. What concerns arise from the two approaches in terms of administrative burdens and compliance costs?

Please see 21 above.

In addition, it is likely that taxpayers will be prepared to deal with some level of compliance work to confirm if subsidiaries are carrying out activity or earning income which has a genuine risk of being within both the scope and the intention of CFC rules. However, businesses should not have to carry out a major amount of work to confirm that no CFC charge arises, when it is clear that the activities of the company were never going to be, or were not within the intended scope of CFC rules.

Taxpayers with non-controlling interests in CFCs may find it very difficult to obtain the information necessary to carry out a full CFC analysis. This emphasises the need for the control and attribution thresholds for CFCs to be reasonable and not too low.

23. How could these concerns and/or practical problems be dealt with while still ensuring that the CFC rules achieve an accurate result and attribute income that raises BEPS concerns?

Please refer to our comments on questions 9 - 15 and 18 above.

Chapter 6: Rules for computing income

Do the rules on computing the income of a CFC present any difficulties in practice? If so, what are these and how could they be dealt with?

We consider that the first option for computing CFC income which is to apply the tax laws of the parent jurisdiction is likely to be the most robust and effective method as it should ensure the CFC is treated in the same way as if it was resident in the same territory as its parent. This should produce a sensible and equitable result as it would mean that only profits that would be taxable under the parent territory's tax laws would be picked up for CFC purposes.

OECD member countries should have freedom as to whether capital gains should be included or not within domestic CFC rules. However, there are strong policy arguments not to include capital gains given that the aim of CFC rules is to capture mobile income and not long-term capital growth.

The second, third and fourth options set out in this chapter for computing income do not appear to meet the real objective of CFC rules which is to prevent artificial diversion of profits to low tax jurisdictions where these profits would be taxable under the rules of the parent jurisdiction if they were not diverted, while the final option is too complex to be viable.

We agree that the second option may allow for less income to be attributed under CFC rules and hence create tax planning opportunities while it would be administratively burdensome to apply different tax rules to individual CFCs if they are located in separate jurisdictions.

Allowing the taxpayer to choose between the rules that could apply to compute a CFC's profits could also create complexity and uncertainty while potentially creating planning opportunities if the choice of the rules of one jurisdiction offered distinct advantages from a tax perspective.

The fourth option would potentially require the development of an entirely new tax regime to be applied solely to CFCs and would presumably require detailed consensus of all OECD member countries. This would be a very ambitious approach that is unlikely to be practical or achievable in the remaining timescale for the BEPS project. It would also risk the creation of new loopholes and planning opportunities.

25. Does this chapter accurately reflect the issues that could arise with losses or are there any other situations that need to be considered?

We consider that greater coherency and simplicity would be achieved by restricting the use of CFC losses to other income of the same CFC. This should also reduce the scope for further tax avoidance. Also, such an approach should follow the usual principles of the tax law of the parent jurisdiction which may allow such losses to be offset against other income of the loss-making CFC of the same period or carried back or carried forward to offset prior or future profits.

However, the parent company should not be prevented from using its own tax losses (or losses claimed from other group companies in the parent jurisdiction under local group relief or tax consolidation rules) to offset CFC profits. There should be only a minimal risk of tax avoidance in this situation as such losses would then not be available for offset against other profits in the parent jurisdiction so there should not be instances of double non-taxation.

Chapter 7: Rules for attributing income

26. What difficulties, if any, arise under existing CFC provisions for attributing income?

An ownership threshold of only 10% for attribution to be required is likely to be too low in practice as holders of such small interests in CFCs are unlikely to be able to exploit them for tax avoidance purposes.

A more practical approach, as is the case with the UK CFC legislation, would be not to tie the attribution threshold to the control threshold. For example, the attribution test could require the interest-holder to have a stake of at least 25% and only in situations where the foreign entity is already regarded as controlled from the parent jurisdiction because entities (even if not connected with one another) resident in the latter jurisdiction already control more than 50%.

A 25% test may need to aggregate holdings of connected persons to help reduce the scope for avoidance.

As a general rule, if the interests in the CFC comprise only ordinary shares, then attribution of profits on a pro-rata basis by reference to the extent of the ordinary shareholding should be appropriate. However, there may be instances where there are different types of interests in a CFC, eg different classes of shares with varying income rights including preference shares for example. In this situation, the attribution of CFC income should be carried out on a 'just and reasonable' basis.

This may mean that in some situations a parent entity that controls an CFC and holds the greater part of its share capital would not be subject to an attribution of its profits if the other interest holders in practice are entitled to all of the CFC's income. Clearly, the position could then vary from year to year depending on the level of profitability of the CFC and the nature of the various interests.

27. Does the description of a top-up tax set out all the advantages and disadvantages of such an approach?

We consider that parent jurisdictions should be able to exercise their discretion as to the rate of tax that should apply to CFCs and whether they wish to adopt a top-up tax approach. However, we note that there is the potential with a top-up tax approach based on a minimum tax rate for artificial structuring of a group's operations to move the holding of overseas operations to benefit from more generous CFC rules.

Chapter 8: Rules to prevent or eliminate double taxation

28. Are there any other double taxation issues that arise in the context of CFC rules that are not dealt with here?

Where an entity is subject to the CFC rules of more than one parent jurisdiction, it needs to be considered which parent jurisdiction should have the primary taxing right. Alternatively, the UK CFC rules adopt a more 'territorial' approach and give credit for CFC tax paid in any territory, ie not just that of a subsidiary jurisdiction but also that of an ultimate parent based outside the UK.

29. What administrative or practical difficulties arise currently in respect of double tax relief rules and how could these be mitigated or dealt with?

Please see point 28 above.

We appreciate the opportunity to contribute. We would be pleased to expand on any of the points enclosed. Please contact Alastair Munro, Director for Grant Thornton UK LLP (alastair.i.munro@uk.gt.com) or your usual Grant Thornton contact.



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