European Business Initiative on Taxation (EBIT)

Comments on the OECD Public Discussion Draft on BEPS Action 3: Strengthening CFC Rules

EBIT's Members at the time of writing this submission: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, DIAGEO, GSK, INFORMA, JTI, LDC, MTU, NUTRECO, REED ELSEVIER, ROBECO, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCA, SCHRODERS and TUPPERWARE.

EBIT comments on the OECD's Public Discussion Draft on BEPS Action 3: Strengthening CFC rules

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Dear Achim,

EBIT is grateful for this opportunity to comment on the OECD's Public Discussion Draft on Action 3: Strengthening CFC rules (the "Discussion Draft").

- We generally welcome the OECD's efforts to try to provide further detailed guidance with regard to the strengthening of CFC rules, however, the OECD's latest proposals are in our view as business practitioners extremely complex and will be very difficult to apply. We are concerned that the guidance provided in the Discussion Draft will lead to very complicated legislation and to a severe increase of the compliance costs for both taxpayers and tax administrations.

- We note that the OECD acknowledges that there is no consensus among the BEPS-44. The Discussion Draft mentions that some countries with a territorial system, often supplemented by anti-abuse rules, do not apply CFC rules and that for those countries CFC rules will have to be limited to targeting profit shifting, and that countries with a worldwide tax system may have broader policy perspectives, such as preventing long term base erosion. We note that countries with a territorial system which do not apply CFC rules do not do so for a good reason: they have other instruments to prevent profit shifting (e.g. in the Netherlands by not granting the participation exemption or using the exemption method for passive income and by a Transfer Pricing approach that gives more weight to economic substance than the contractual form).

- EBIT Members are therefore unclear about the exact purpose and remit of the Discussion Draft. Is the idea to describe existing best practices regarding CFC rules, which countries can consider adopting or adhering to at will, and "cherry-pick" from for domestic law purposes, or is the purpose to try to strengthen CFC rules through more coordination? It seems to EBIT that the different goals and perspectives of the BEPS-44 should clearly lead to tailor-made CFC rules. No distinction is made in the Discussion Draft. Also, the proposed approach by the OECD in the Discussion Draft could result in a further move away from a BEPS-44 level playing field and increased competition between many OECD/BEPS-44 countries which have strict CFC rules whilst others outside the OECD/BEPS-44 don't. In our view, the OECD should rather formulate realistic, targeted rules to counter the artificial diversion of profits from parent company jurisdictions which may actually be adopted by the majority of countries.

- The Discussion Draft recalls in the introduction that the OECD's work on CFCs is being co-ordinated with the work on other BEPS Action Items. The Action Items that are most closely associated with CFC rules include Action Item 1 (addressing the tax challenges of the digital economy), Action Item 2 (hybrid mismatch arrangements), Action Item 4 (interest deductions), Action Item 5 (countering harmful tax practices), Action Items 8-10 (transfer pricing), Action Item 11 (methodologies to collect and analyse data), Action Item 14 (dispute resolution mechanisms), and Action Item 15 (developing a multilateral instrument). However, and this is worrying according to EBIT's Members, nowhere in the Discussion Draft is any link made with any of these other BEPS Actions. EBIT is concerned that the OECD is apparently conducting the work on the interlinking BEPS Action Items in silos without coordination, and that the OECD does not appear to follow a holistic approach, as it announced at the start of its BEPS initiative. We believe however that cross-coordination and taking all the BEPS policy interlinkages and the complementarity amongst them into account and reconciling them from the start is key, especially given the potential for overlap and duplication between Actions. It is also pertinent that the BEPS-44 establish a clear hierarchy of application of the above-mentioned Action Items, which EBIT suggests should logically be: first transfer pricing, then interest deduction, and then CFC rules. This would pre-empt and reduce a surge in disputes between countries and MNCs over the right order of application and unrelieved double taxation. Also, there is no clear analysis in the Discussion Draft why CFC rules are still necessary as a backstop after having implemented all the other BEPS Action Items, nor why such broad and complicated CFC rules as proposed are still necessary.

- EBIT is also concerned by the reference to a possible introduction of a secondary rule which could be imposed by BEPS-44 countries on income allegedly sourced in a particular BEPS-44 country which accrues to a CFC which has not been subject to "sufficient" CFC taxation in the parent company jurisdiction. EBIT is not in favour of such secondary rule. This will only be relevant in very, very few situations, and appears to be a potential extension to source country taxation rights. We consider that a parallel can be drawn here with the proposed special measures in the OECD's Public Discussion Draft on BEPS Actions 8-10 where it concerns Special Measures. A secondary rule would add significant complexity and administrative cost and significant uncertainty for MNCs and is another departure from the Arm's Length Principle that the OECD has reiterated should be the basis for the allocation of income between companies and countries. We wish to note that if all BEPS-44 states brought in CFC rules then there would be no need for such secondary rules.

- EBIT Members support the 'building blocks' which the OECD has identified, but we are concerned about the plans regarding identification of the allocation of the appropriate income to the parent territory as set out in Chapter 5. We welcome the OECD's position that full inclusion and excessively broad partial inclusion systems are not suitable and proportionate to prevent base erosion and profit shifting and may have an adverse effect on growth, international trade and investments. The bottom line for us as practitioners is that the aim of applying CFC rules must be to target artificial shifting of profits and not to tax activities where genuine economic activity is taking place in other countries.

- The Discussion Draft seems to implicitly recommend in our view that CFC rules be designed to pre-empt both base stripping in the parent company jurisdiction and "foreign-to-foreign" stripping to prevent erosion of all tax bases. To do so would actually widen the scope of many existing CFC rules considerably and create uncertainty over taxing rights, double taxation and the applicable double tax treaties, and goes beyond the original ambit of Action 3. EBIT is concerned that the OECD's real aim is seemingly to impose a principle of minimum taxation on MNCs where transfer pricing, interest loan restrictions, hybrids and other rules, taken together with action on harmful tax competition do not result in an effective tax rate that is within an acceptable range. However, the range of the acceptable range remains unclear, and we are concerned that this proposal heralds another proposed departure from current international tax practice and policies.

- Compatibility with EU law. The draft suggests that this could be solved by applying CFC rules also domestically. Even if this were legally correct, this does not seem to be a viable solution. It imposes a heavy compliance burden on parent companies of domestic CFCs while one would expect little additional revenue. Moreover, the second comparison in *Cadbury Schweppes* (C-196/04) i.e. Dutch v Irish treasury subsidiaries, and the *Deutsche Shell* restriction case C-293/06, suggest that even extension of a CFC regime by an EU or EEA country may not necessarily render that regime wholly EU law compliant.

Specific comments

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?

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

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

- According to EBIT Members, introducing any broad definition of CFC rules to include transparent entities runs the risk of being over-inclusive, and it should be ensured that the other elements of the CFC rules work effectively to curb double taxation and limit taxation to the types of income that are seen as raising BEPS concerns.
- From our daily experience, we note that the classification of entities for tax purposes is subject to the domestic legal classification of an entity, and we are concerned that different countries may apply different classifications of entities. OECD proposed rules for the treatment of transparent entities as separate entities should be applied and interpreted in a consistent manner across all BEPS-44. The OECD should also give due consideration to the treatment of the entity in intervening jurisdictions as well as the parent company's jurisdiction. In general, the Discussion Draft as it stands will open the door to a lot of unwelcome extra complexity, a huge compliance burden given the detailed technical and legal analysis required and a lot of uncertainty for MNCs.
- We consider that both the narrow and the broad version of the proposed modified hybrid mismatch rule will require substantial additional analysis and an increased admin burden for companies in practice. We urge the OECD to clarify why a specific and apparently different hybrid mismatch rule is contemplated for CFC rules, outside the scope of the BEPS Action 2 recommendation to apply hybrid mismatch rules in parent company and CFC jurisdictions already.

Chapter 3: Threshold Requirements

> 4. What practical problems, if any, arise when applying a low-tax threshold based on an effective tax rate calculation?
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> 5. How could these problems be addressed or mitigated?
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> 6. Does the discussion above correctly address the situation of permanent establishments that are subject to a different tax rate than CFCs?

- Generally, EBIT Members welcome entity-based threshold requirements for CFC regimes as long as they are targeted.

- EBIT Members' experience with existing CFC regimes is that they require a significant admin burden with very detailed calculations of effective tax rates for all controlled subsidiaries and other entities that are treated as controlled, despite the fact that it is clear from the outset that no CFC adjustment would be required for many of them, or that any adjustment would be immaterial and below any de minimis threshold. EBIT urges the OECD therefore to develop clear gateway tests aimed at excluding having to provide detailed calculations for the significant number of entities which do not carry a risk of CFC adjustment. This will help mitigate the admin burden of both taxpayers and tax administrations.

- In our experience a "white list" – such as the UK's Excluded Territory Exemption - further reduces compliance burdens compared with a low tax threshold exemption which requires detailed tax computations that often don't deal adequately with issues such as foreign tax credit relief.

- EBIT considers that as long as there is a consistent application of parent company jurisdiction rules, a tax exempt permanent establishment in the CFC jurisdiction ought to be treated as a separate entity for CFC purposes, and that a low-tax threshold test should be applied separately to the tax exempt PE and the principal entity in the CFC jurisdiction.

Chapter 4: Definition of control

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

- EBIT Members agree generally with the suggestion in the Discussion Draft that both a legal control test and an economic control test can be helpful to mitigate undesirable possible circumvention of CFC rules.

- EBIT does have grave concerns, however where the Discussion Draft apparently agrees to lower the control threshold below 50% across the board, i.e. including aggregation of the ownership of unrelated parties, who individually have no control over the actions of a CFC, are not acting in concert, but who are also resident in the same jurisdiction. The proposed measure would in our view put such taxpayers at a competitive disadvantage compared with CFCs held by shareholders in different jurisdictions.

Chapter 5: Definition of CFC Income

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

10. 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 note in general that the Discussion Draft introduces additional methods i.e. substantial contribution analysis, viable independent entity approach and the employees and establishment analysis. These methods deviate from the OECD's Transfer Pricing approach. However, no thorough or convincing analysis is provided why a Transfer Pricing approach would not lead to acceptable results. Given the diversity of MNCs, who may use different accounting systems and observe different levels of internal risk management and control, there is not a one size fits all analysis. At best, EBIT advocates that MNCs should be able to choose their own preferred method for determining and documenting which CFCs have sufficient substance, using one or a combination of the three types of substance analysis proposed.

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?

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

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

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

- EBIT is concerned that the Discussion Draft in paragraph 114 is over-inclusive where it considers that by default, all sales and service income should be treated as passive income unless one of the substance analysis requirements can be met. In many cross-border business transactions this is simply not the case. In most of these transactions there is no direct link to be found between sales or service income and IP income, as can be seen in the active trade or business test found in some existing CFC regimes, such as those of the UK and Germany. EBIT is concerned that the active income part will become very small as a result of the proposals as is the case for instance in Germany. The proposed approach would shift the burden of proof on the taxpayer to rebut a presumption that all sales and services income is not passive CFC income, which again would include entities that should not give rise to any BEPS concerns, which must be the focus. In our view, reversing the burden of proof on the basis of the inadequate analysis in paragraphs 105-106 would be highly inappropriate and ill-advised. Appropriate OECD BEPS Transfer Pricing rules will in our view take away most of the BEPS concerns relating to CFC substance-based rules.

- When looking at financing income, in order to ensure that CFC rules are appropriately targeted at the artificial diversion of profits, rules should be put in place to ensure that income earned from the investment of trading profits earned by the CFC (and not subject to apportionment) should not be subject to a CFC inclusion.

- EBIT Members consider that the CFC income categories covered in the Discussion Draft are appropriate in the light of BEPS concerns.

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

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

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

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?

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

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

- The Discussion Draft's categorical approach is generally clear but EBIT Members urge the OECD to expand its guidance as to how the specific definitions of income should be included in each category and which categories should be treated as CFC income exactly. EBIT Members are more unclear about the proposed "excess profits approach" which introduces significant complexity and uncertainty about what is to be regarded a "normal" return, and which would need to be considered per company and industry sector. Whilst we appreciate the OECD's objective is to promote a simpler and more mechanical approach, the approach appears to be inconsistent with other BEPS Actions, the Arm's Length Principle and EU law. It also seems to EBIT Members that the excessive profit approach is intended to serve primarily U.S. domestic policy considerations, and not necessarily the common BEPS-44 agenda. We wish to note that if all BEPS-44 states brought in CFC rules then there would be no need for secondary rules.

- Of the two approaches, EBIT Members believe that the categorical approach with adequate substance tests will be more effective in mitigating BEPS concerns.

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

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

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?

- As stated above, an entity approach alone could easily result in over-inclusion and would result in a lower admnistrative effort and cost required from companies. It is also more targeted at higher risk entities which warrant a material adjustment. EBIT considers that using a combination of elements of both approaches may be most appropriate for businesses as they would ensure simplification for low-risk entities and transaction approach proportionality for situations where the safe harbour limits are not observed.

Chapter 6: Rules for computing income

24. 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?

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

- EBIT's Members face practical difficulties with computing the income of CFCs, in particular where local requirements and rules regarding CFC reporting, accounting and tax information differ from that in the parent company jurisdiction, which often obliges them to duplicate accounting and tax reporting, and which also involves keeping data concerning relevant carry forwards and tax adjustment with regard to the CFC on file for a longer period.

- EBIT generally agrees with the Discussion Draft's recommendations on computing the income of CFCs. With regard to the possibility for CFC loss relief, we consider that following parent company jurisdiction loss offset rules can be appropriate in as far as the losses within a CFC can also be used to offset profits in other entities in the CFC jurisdiction, and that they do not prevent the use of fiscal unity related losses.

Chapter 7: Rules for attributing income

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

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

- See our comments above in relation to unrelated parties Chapter 4.

- The use of a top up tax is bound to be limited to some jurisdictions with a worldwide tax system.

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?

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

- EBIT Members consider that the Discussion Draft underestimates the practical difficulties and complexity in calculating double taxation relief and assumes that effective relief will be generally available, which in our experience does not reflect reality. In particular, the Discussion Draft does not seem to take into account CFC jurisdictions which do not or will not adhere to the recommendations outlined in paragraphs 154-155.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are committed to a constructive dialogue with the OECD and are always happy to discuss.

Yours sincerely,

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