

# **BEPS Action Item 3**

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# Introduction

- BEPS
- Plan
- Deliverable
- Assessment
- The aftermath...

# BEPS

- Political project
- All and nothing.. A lack of focus or clear goals
- Scope: Comprehensive reform or Ad-hoc “pragmatic” approach?
- Basic insights
  - Collaboration
  - Comprehensive reform
  - Innovation
- Source, residence and everything in between...
  - Conservative discourse
  - Institutional survival at the heart of the project

# BEPS (Cont.)

- OECD takes the lead
  - Timely delivery (of what?)
- G20 support
  - But consensus
  - Some countries take a step back
  - Some countries preempt the project
  - Unity of the regime and standardization at risk
- Continued political support
  - G7 in June 2015

# Plan

- *Action Item 3 (Strengthen CFC Rules)*  
*“Develop recommendations regarding the design of controlled foreign company rules. This work will be co-ordinated with other work as necessary”*
- Related action items
  - Action 2
  - Action 7

# Plan (Cont.)

- Delivery plan
  - Action item 3: September 2015
- Preliminary
  - Action 3 out of context
  - Variety of goals and practices
- Politics

# Issues

- OECD made it a primarily domestic issue when it refused to view CFC rules as override
- CFC rules are not universal
  - Why not CFC?
- Complexity and costs of compliance and enforcement

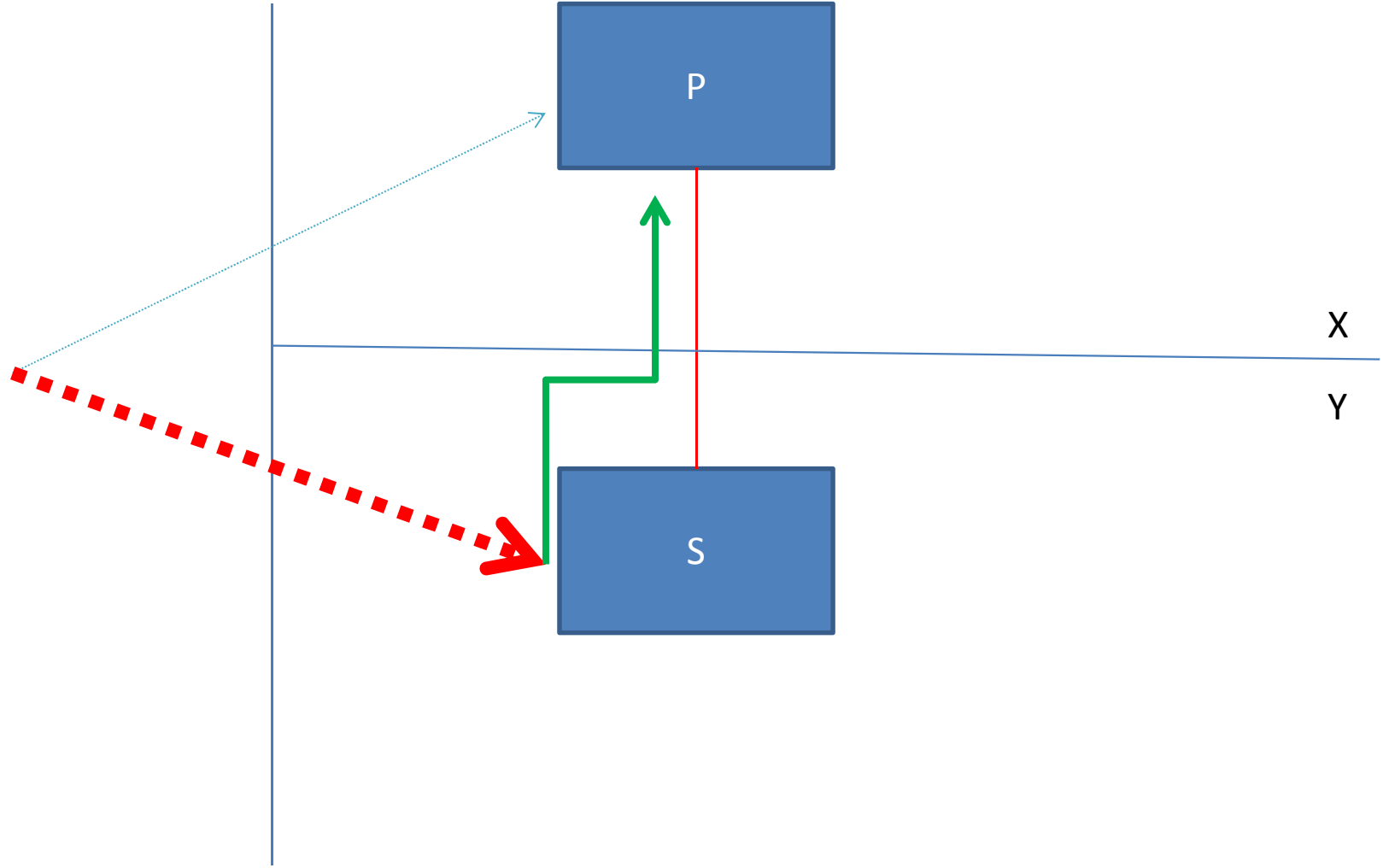
# Issues (Cont.)

- Politics: harsher CFC rules perceived as overly generous to residence states
- U.S. – significant relaxation of the “bite” of the CFC rules: CTB, look through, contract manufacturing
- Huge EU issues with Cadbury Schweppes’ wholly artificial arrangements standard



# Discussion Draft

- OECD releases a discussion draft in April 2015
- Explicit statement regarding the lack of consensus
- Basic story: MNE X resides in high-tax jurisdiction X – shifts profits to low-tax jurisdiction Y by simply organizing a subsidiary Y in that jurisdiction, and
  - Artificially assigns income to Y
  - Inappropriately shifts activities
  - Separate from value creating activities



# Discussion Draft

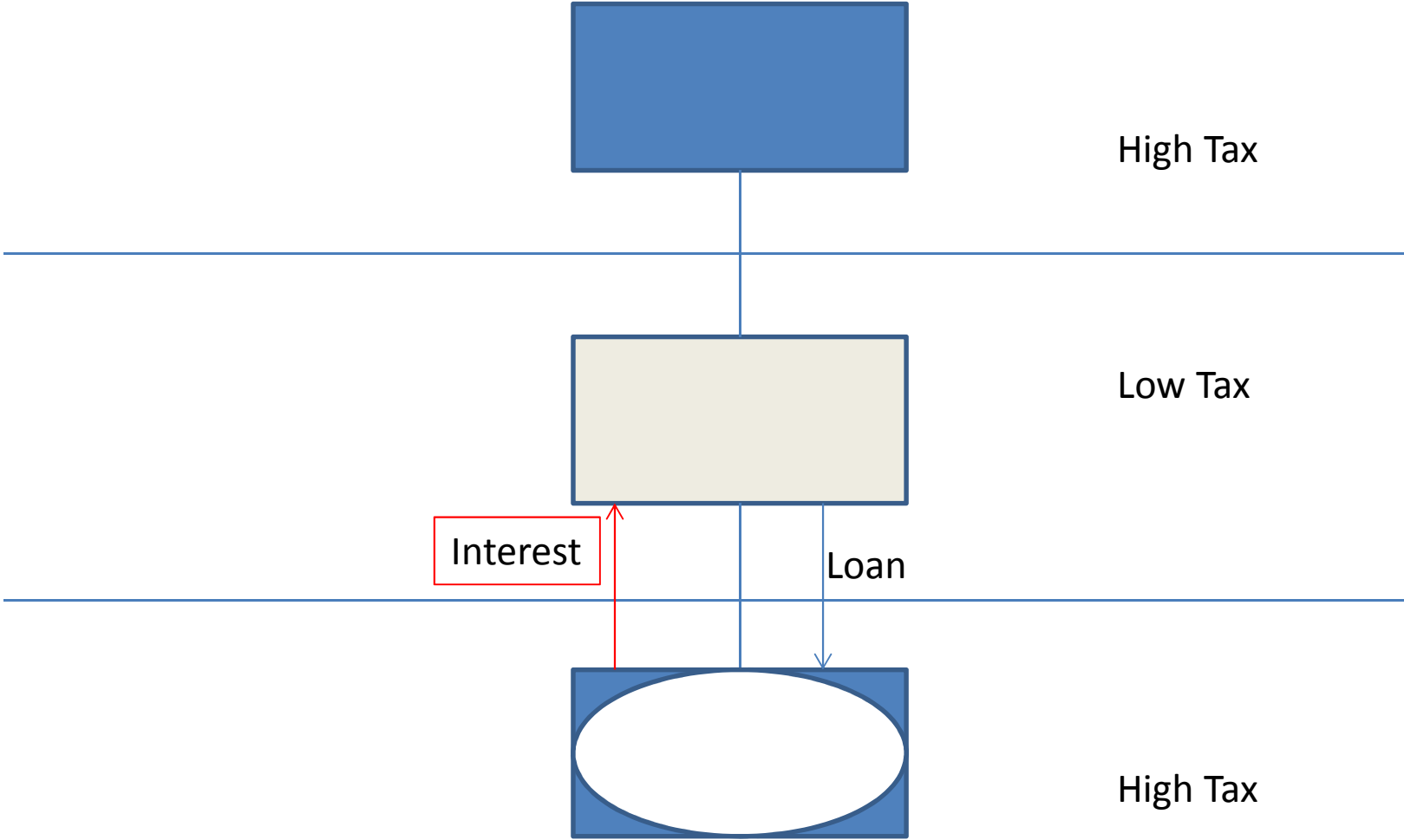
- The discussion draft asserts that transfer pricing alone cannot replace CFC rules
  - TP analyzes transaction by transaction
  - CFC rules govern overall performance of MNEs
- Tensions: Wish to tax foreign income <->
  - Competitiveness
  - Administrative and compliance costs
  - Wish to avoid double taxation

# Discussion Draft

- How to write effective CFC rules?
- Building blocks:
  - *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*

# Definition of a CFC

- Which is the target of the rules?
- The DD focuses on the question whether unincorporated entities should be included
- DD recommends to include p/s, PE, trusts if owned by CFC or treated as separate taxpayers
- DD recommends to include a modified hybrid mismatch rule to prevent circumvention of CFC rules using unincorporated entities
  - Always or only if a payment is base eroding?



High Tax

Low Tax

Interest

Loan

High Tax

# Threshold Requirements

- DD recommends a low tax threshold
  - Based on effective tax rate
  - How to apply to PE?
- Alternatives
  - Deminimis rule
    - For efficiency
    - Can be used in combination with others
    - Gross income / % of gross income
    - Best practice would be to combine rule with an anti-fragmentation rule
  - Anti avoidance rule (motive/purpose)
    - Rejected since not necessary if rules are properly designed

# Control

- Control, participation or influence as a justification for CFC rules
- DD recommends
  - Legal and economic control
    - Countries may also apply de-facto tests
    - Take consolidation into account
  - Direct or indirect
  - More than 50% or lower
    - But, a factual (minority SH) “acting-in-concert” test acceptable



# CFC Income

- No recommendations
- Form based analysis is problematic
  - Passive income
  - Highly mobile income
- Facts and circumstances
  - Substantial contribution (CFC activity level)
    - In contrast with contribution by P
    - Viable independent entity analysis
    - Are necessary activities (to earn income) located within CFC jurisdiction (employees & establishment)

# CFC Income

- What to do with look-thru (passive income) rules?
  - Ex.: Dividends
  - Categorical
  - Excess profits
- Special income
  - Financial
  - Insurance
- Entity or transactional approach?

# Computing CFC Income

- DD recommends to use the rules of Parent jurisdiction
  - Rejecting, choice, common standards, CFC jurisdiction
- Losses limited to jurisdictions
  - Anti loss importation rules

# Attribution of Income to SH

- DD recommends attribution
  - Only to SH with minimum control
    - But, “other” policies possible
  - Proportional attribution
  - Each jurisdiction can determine how and when to include
    - Deemed dividends / subpart F income / directly earned (consistent with OECD approach)
  - Apply tax rate of parent jurisdiction

# Prevent Double Taxation

- Concerns
  - Attributed income is subject to foreign tax as well
    - Recommendation: credit
  - CFC rules in multiple jurisdictions apply in parallel
    - Recommendation: credit
  - Treatment of previously earned income (now distributed (as dividends))
    - Recommendation: exemption of PTE

# Action 3

- Role of CFCs in action 2 context
- What is the BEPS context for CFC legislation?
- What about corporate residence?
- Conservative approach
- Is Collaboration possible?
- Comprehensive
- Innovation

# Action 3 Status

No common ground

- Rhetoric: Profits shifted to CFCs depart from value creation
- But, different approaches and different legal techniques: legal classification, relatedness of parties, source of income, substance, lists...
- Different tax policies impact choice of CFC approach
- Worldwide taxation concerns: long-term deferral and stripping
- Territorial taxation: income shifting

# Action 3 Status

- OECD will likely propose a choice of practices:
  - Identify CFC income based on legal classification, relatedness and source of income
  - Use of proxies, including people, assets and risk
  - Excess profits as CFC income
  - Controversial: intervention in foreign-to-foreign shifting
  - Different standards for EU member states?



# Assessment

- Conformity with basic insights of BEPS
- Double non taxation
  - Tax competition
- Coherence of action items
  - And internal coherence within action 3: many have commented that different practices will result in more double taxation
- Politics (& economics)
  - The position of different groups
- Possibility of technical consensus
- The future of the BEPS project