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Achim Pross
Head International Co-operation and Tax
Administration Division
OECD Centre on Tax
Policy and Administration
2, rue André Pascal
75775 Paris
France

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Submitted by email: CTPCFC@oecd.org

Comments on the OECD Public Discussion Draft on BEPS "Action 3: Strengthening CFC Rules" 3 April 20115 – 1 May 2015

Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE's members are 41 leading industrial and employers' federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

In the BEPS Action Plan the G20/OECD has set out the aim to develop recommendations regarding the design of controlled foreign company rules and states that this work will be co-ordinated with other work as necessary. Action 3 of this plan stresses the need to address base erosion and profit shifting using controlled foreign company (CFC) rules. Many countries already have CFC rules, but these rules do not always counter BEPS in a comprehensive manner. While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spill over effects in source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled "BEPS Action 3: Strengthening CFC Rules" issued on April 3rd 2015 (hereinafter referred to as the Draft).

General Comments

The mandate for Working Party 11 for Action 3 was to "develop recommendations regarding the design of controlled foreign company rules… that are effective in dealing with base erosion and profit shifting". What is not clear, however, is whether this mandate is interpreted as requiring the development of "best practice" recommendations that individual countries are at liberty to implement into their own domestic law wholly or in part, or in the development of a co-ordinated and consistent

CFC policy that most countries would agree to implement in a consistent and timely manner. It appears from some of the observations and recommendations in the Draft that the output may be a menu of policy options, with commentary on best practice, which countries will adopt where the particular menu option is consistent with domestic policy drivers. BUSINESSEUROPE would support a clear statement of the purpose of implementing a CFC regime and clear recommendations for the implementation of coordinated and efficient CFC regimes that meet the policy objectives. The Draft is not clear whether the purpose of a CFC regime is to capture passive income that has been diverted from a parent entity in a territorial system, or to provide a mechanism to ensure capital import/export neutrality in a worldwide system. A CFC design that attempts to implement conflicting policy objectives is likely to result in failure to achieve either policy, while creating additional administration, confusion and cost. There is also a risk that a recommendation that only sets out policy options will not result in clear or consistent implementation and interpretation of CFC rules and will lead to greater compliance cost and uncertainty, with an effect on foreign direct investment.

BUSINESSEUROPE does not believe that the "minimum standard" approach will provide countries with the necessary information to understand which CFC rules would be most appropriate for their policy objectives, nor will it encourage consistency in the design and implementation of CFC rules. As there appears to be a lack of consensus on the purpose of CFC rules within the working party, a more useful approach would be to critically review the effectiveness of current CFC rules in those jurisdictions that have experience of their operation, and to recommend a small number of clear best practices and more coordinated rules that can be effective and efficient for both tax administrations and tax payers to operate and comply with. This could assist countries in deciding which best practice rules they could implement to tackle BEPS activity that is not addressed by the other BEPS actions, and understand the effect that CFC rules would have on international competitiveness and investment flows.

BUSINESSEUROPE considers that the most effective method for reducing compliance cost within a CFC regime is the use of a combination of subjective, objective and mechanical filters to exclude entities that carry a low risk of CFC or BEPS activity. This allows more effort to be focused by both tax administrations and tax payers on the higher risk entities. As there is no common business model or process used by MNEs, it is not possible to mandate the same tests or order of tests for all businesses: therefore the filter methodology should allow some flexibility in the ordering of tests with the test that has the clearest result for that business being applied first, and using more subjective tests where they operate appropriately for some taxpayers, and allowing more mechanical tests for those businesses where they work better.

BUSINESSEUROPE acknowledges the commitment in the Action Plan on BEPS to co-ordinate the work on development of recommendations on CFC rules with the work on the other Actions of the BEPS plan; however while the Draft refers in paragraph 5 to those other Action Items, the body of the Draft does not make any clear connection with any of the other BEPS actions and it is not clear how or whether any interaction between the CFC recommendations and those on other actions have been considered or addressed. It is critical for the effectiveness of the whole project that a detailed review process is implemented prior to finalisation of all of the 15 Actions to develop a clear agreement over the specific BEPS behaviours and abuses that are being targeted, and which recommendation should be implemented to address the specific issues. Making different recommendations to address the same issue creates unnecessary compliance costs and uncertainty, unless a clear hierarchy of measures is defined. BUSINESSEUROPE would welcome a more detailed explanation of how the various Action Items are being co-ordinated and the existing areas of overlap between Actions are being reconciled to eliminate redundancy and duplication. The BEPS timetable will result in many new international tax rules being implemented in a very short timescale and it is imperative that full attention is given to the co-ordination of those rules to reduce as far as possible unnecessary and duplicative initiatives.

Ensuring proper and effective relief from double taxation is critical to the success of Action 3, and the wider BEPS project. A clear common hierarchy of rules that would apply across different CFC regimes and between CFC regimes, Transfer Pricing rules and actions on interest deductions should be developed as a matter of priority, with efforts to obtain a broad consensus within the participants in the BEPS process on the hierarchy to reduce the opportunity for dispute between countries and MNEs over the order of utilising different measures. Within CFC rules, there should also be clear guidance on the order of foreign tax relief methods to ensure that effective relief is available for foreign taxes paid on both ordinary income and CFC income.

As with other BEPS Actions, the design and implementation of an effective and efficient dispute resolution process is very important, and needs to be linked with the hierarchy of CFC rules and double tax relief to ensure that any practical failures to give effective relief across different country regimes can be rectified promptly.

BUSINESSEUROPE is also concerned by the comment in the preamble to the Draft that refers to the consideration of a secondary rule, to apply to CFC income that had not been subject to "sufficient" CFC taxation in the parent company jurisdiction, which leads on to the principal reference in the draft to other BEPS Action. While the Draft states that this proposal has not yet been considered by the CFA, the prospect of additional imposition of CFC-type taxes by third party jurisdictions is a great concern as this would add significant complexity and administrative cost as well as significant uncertainty for international business and appears to be 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.

In Paragraph 19 of the Draft, in a discussion on the scope of base stripping, there is an implied recommendation that CFC rules should be designed to protect against both base stripping in the parent company jurisdiction, and "foreign to foreign" stripping as the BEPS plan is intended to prevent erosion of all tax bases. This expands the scope of many current CFC rules and creates great uncertainty over taxing rights, double taxation and the applicability of double taxation conventions. This proposal, combined with the reference to potential consideration of a secondary CFC rule, leads to the conclusion that the aim of Action 3 may go beyond the development of best practice in the design and implementation of CFC rules that balance administrative costs with targeted action on abusive structures, an objective that BUSINESSEUROPE would support. The broader objective appears to be the design of a principle of minimum taxation to be applied for all international businesses where transfer pricing, loan interest restrictions, hybrids and other rules, together with action on harmful tax practices of countries does not lead to an effective tax rate that is within a an (undefined) acceptable range. If this is indeed the intent of Action 3, the principle requires detailed explanation and justification as a fundamental change in current international tax policy and practice.

Many of the questions raised in the Draft address complex issues relating to unusual investment or management structures. BUSINESSEUROPE has not had sufficient time to obtain information from its member federations or international businesses to be able to answer all of these questions, and so does not offer an opinion where no response based on practical experience has been provided by members. However, it is the experience of most BUSINESSEUROPE members and representatives of international business that a very significant majority of international business investments and structures are within a 100% owned group of companies where there is no uncertainty over control or profit attribution so that it is not possible to make helpful or informed comments concerning more complex structures. As most business structures are not highly complex, a balance needs to be established between the compliance burden of the many businesses with relatively simple structures and the effectiveness of targeted measures to address the few more aggressive arrangements.

The principal responses of BUSINESSEUROPE to the questions raised in the draft are included in the more specific comments below

Specific Comments

Chapter 2: Definition of a CFC

Any rules for the treatment of transparent entities as separate entities should be consistently interpreted and applied across all countries and appropriate consideration given to the treatment of the entity in intervening jurisdictions as well as the parent's jurisdiction.

CFC rules that apply on an entity basis rely on the calculation of profits and taxes paid or payable in that entity. Where the entity is transparent and is not required to prepare separate accounts, or is a branch or PE and full separate accounts are not prepared, there may be administrative and compliance challenges in obtaining the information required to make CFC calculations: some flexibility in compliance with CFC requirements where accounts are not available would be helpful.

The broad version of the hybrid mismatch rule may be easier to apply in practice as there is no requirement to determine whether there is a base-eroding mismatch, but both versions of the rule would require additional analysis and cost of reporting and preparation of returns. The Draft refers in paragraph 5 to co-ordination with the work on Action 2 (hybrid mismatch arrangements), but it is not clear how there would be a need for a hybrid mismatch rule for CFCs if the recommendations for Action 2 were implemented in either or both of the parent and CFC jurisdictions.

Chapter 3: Threshold Requirements

Experience of applying low-tax threshold tests in practice is that a critical issue is the availability of data to allow the calculation of the threshold test to be carried out. This would be exacerbated where PEs and other transparent entities are included where accounting and tax information is not currently available. The availability of information becomes more of a challenge where parent company CFC reporting or calculation requirements are required at an early date before local accounting and tax reporting has been completed. A consistency in the timing of CFC calculations of several months after the accounting year and would be helpful.

Calculation of effective tax rates is frequently affected by special tax regimes aiming to attract certain investments; differences in the capitalisation, amortisation or tax depreciation of assets; or differences in timing of revenue recognition between different accounting and tax regimes. This can cause wide fluctuation in effective tax rates, and temporary low effective rates in higher tax countries where timing differences, investment incentives or tax holidays are part of the local tax policy. The use of a rolling average effective rate could limit the volatility of the effective rate calculation, although this would create some additional administrative burden, but careful consideration needs to be given to the appropriate period for which the rolling average would apply.

Anti-fragmentation rules can create particular additional challenges where international businesses operate through separate business units with no common management, accounting or reporting systems: similarly, CFC rules that evaluate risk on a country by country basis rather than on a separate entity basis can create reporting difficulties for MNEs whose financial reporting systems do not make information readily available to prepare any country by country consolidation or aggregation.

Experience of MNEs with some current CFC regimes is that detailed calculations of effective tax rates are required for all controlled subsidiaries and other entities treated as controlled, even though for many of them, it is clear that no CFC adjustment would be required, or any adjustment would be immaterial and below de minimis thresholds. The development of a gateway test or tests to eliminate preparation of detailed calculations for entities where there is no risk of CFC adjustment would be strongly supported to reduce administrative costs for both MNEs and tax administrations.

The discussion in Chapter 3 focuses exclusively on monetary thresholds and other threshold options are not addressed. BUSINESSEUROPE would encourage the OECD to consider other options, including time and the use of exempt periods, particularly where different CFC regimes apply to the same group of companies. Changes in ownership can cause companies that were previously outside of CFC regimes to be treated as CFCs immediately on acquisition, whether or not there is any BEPS risk. An exempt period to allow for reorganisation and integration of the new group companies after an acquisition would be of benefit to both MNEs and tax administrations.

While there is currently limited experience of dealing with tiers of CFC regimes, as some of the jurisdictions commonly used for holding companies do not have CFC regimes, BUSINESSEUROPE is concerned that, if the result of Action 3 is that more jurisdictions implement CFC regimes, there will be more practical examples of tiers of CFC regimes, and this will lead to multiple layers of effective tax rate calculations unless there is a common standard that could be applied.

Chapter 4: Definition of control

Control tests that include criteria other than readily available legal ownership or economic control using data that is relatively easy to establish or calculate can create significant practical problems. De facto control is difficult to establish without retrospective review of actions and analysis of facts and circumstances and will in most cases also involve an element of subjective determination. Unless it could be clearly demonstrated that a de facto control test was a requirement to address particular circumstances where significant BEPS behaviours were evident, the cost and complexity of this test would not be justified.

For most international businesses legal ownership and consolidation tests, which are generally carefully examined by external auditors, would be sufficient to establish which entities are controlled and which are not and these tests are unlikely to produce a different result from an economic control test for most MNEs.

The experience of BUSINESS EUROPE in dealing with structures where completely unrelated parties have any influence over activity in an overseas entity is very limited, so no useful comment on the practical problems of applying a control test is possible

Chapter 5: Definition of CFC Income
Questions 9-10

All of the substance analyses have some practical problems and require a greater or lesser level of functional analysis to arrive at a reasonable conclusion with a suitable audit trail and rationale. Some tests are highly complex to interpret and apply, depending on the drafting and interpretation of the CFC laws in the parent jurisdiction. While there may be some common ground between the substantial contribution analysis and functional analysis required for transfer pricing documentation, the tests and analysis are not identical and it should not be assumed that a substantial contribution analysis can be easily developed from existing transfer pricing documentation.

Of the three the viable independent entity analysis requires the greatest level of subjectivity and is therefore more at risk of dispute and controversy, and is less easy to support with a clear audit trail, whereas the employees and establishment test is in theory more mechanical and easier to apply, but in determining whether the CFC has the necessary premises, establishment and employee functions, the analysis becomes in practice similar to a viable independent entity analysis with a requirement to use judgement .

As different MNEs have a range of business activities, accounting systems and levels of internal management and control, there is no single type of analysis that works equally effectively for all. Therefore an approach that permits the reporting group to use its own preferred method to initially determine and document which CFCs have sufficient substance, using one or a combination of the three types of analysis may be more effective and efficient.

Chapter 5: Definition of CFC Income
Questions 11-14

The Draft appears to be based on a view of international business that most transactions relate to high value products with significant IP content where sales or service income includes or could include an embedded royalty or other return for an intangible asset so that CFC treatment of sales and service income is appropriate. The default position as proposed at paragraph 114 is that all sales and service income should be treated as passive unless one of the substance analysis requirements can be met. There are many international business transactions where these assumptions are not appropriate and where there is no direct link between sales or service income and any valuable IP and this is reflected in the active trade or business test found in some existing CFC regimes. Reversing the burden of proof on the basis of the limited analysis in paragraphs 105-106 is unjustified, particularly as enforcement of appropriate transfer pricing rules would address most of the issues relating to invoicing companies and the correct reward for IP.

For the many businesses following a more traditional business model, any CFC rules that define attributable income should therefore be clear that sales and service income are only included where there are significant related party transactions or other characteristics that would justify CFC treatment.

BUSINESS EUROPE is not aware of any existing CFC rules that reduce administrative and compliance burdens relating to these categories of income

Chapter 5: Definition of CFC Income
Questions 15-20

It is not clear how the two approaches would work and in particular, it is not clear how the excess profits approach would work, or how it would be consistent with the other established principles of international taxation included in the OECD guidelines. The approach may be a "simpler and more mechanical" approach as claimed in the Draft, but it introduces a novel principle that seems inconsistent with other BEPS actions as well as the Arm's Length Principle and some EU law principles.

If the excess profits approach is based on current or proposed domestic legislation in any country, providing more details of that legislation and, in particular, the criteria for including or excluding entities from the test would be required before any informed response to the questions posed in the Draft could be made. It would also be necessary to understand why this approach would be needed if all the other recommendations of the BEPS Action Items were implemented. In what circumstances would there still be an "excess return" in a company and would a more targeted measure aimed at those particular circumstances be more effective and efficient that a broad measure that could require calculation and reporting for many entities where no adjustment would be required.
BUSINESSEUROPE is also concerned that this approach would place MNEs headquartered in higher tax rate jurisdictions at a competitive disadvantage. For example, the (excess) profits of a subsidiary of such an MNE, owning and exploiting IP and operating in a lower tax jurisdiction, may be subject to tax in the headquarter jurisdiction, whereas a domestic entity, owning and exploiting comparable IP in the lower tax jurisdiction would pay a lower rate of tax on all of its profits, potentially putting it at a competitive advantage

As the excess profits approach applies a hypothetical "normal" return on almost any investment in a CFC, it is difficult to see how this approach could "accurately attribute income that gives rise to BEPS concerns" and therefore, if the purpose of the Draft is to target particular BEPS concerns accurately, the categorical approach would be the more appropriate of the two.

Chapter 5: Definition of CFC Income
Questions 21-23

The likely practical problem that would arise from the transactional approach is the difficulty of obtaining sufficient accurate data to apply CFC rules on a transactional basis. Experience with existing CFC regimes is that information can be obtained relating to local entity activities and financial results so that existing financial systems can be used, with suitable adaptation and additional information, to compute income attribution. Depending on how the "transaction" is defined, preparing an accurate determination of the profit attributable to that transactional stream could be complex and may require allocation of costs against income that would need to be based on estimates or allocation keys and therefore subject to dispute on audit.

As information at an entity level is more easily available, BUSINESSEUROPE would recommend that best practice would be for attribution to be made on an entity level in most cases, as it is likely that there would be no benefit in carrying out a transactional level analysis for most CFCs. Using some appropriate threshold to identify those entities where further analysis on a transactional level was required to address the concerns noted in paragraphs 128-9 would reduce overall administrative costs and focus on those entities where there could be a material adjustment.

Chapter 6: Rules for computing income

Many businesses experience practical difficulties to a greater or lesser extent in computing the income of CFCs, particularly where local reporting, accounting and tax information is not in the same system as the parent and where there are differences between local accounting and tax rules and those of the parent.

Effectively, many businesses are obliged to prepare duplicate accounting and tax reporting for the CFC to compute income under the same principles as the parent, and to maintain this data for several years to deal with balance carry forwards and tax adjustments. The Draft recommends the use of the parent jurisdiction's rules, which will result in the continuation of the existing practical difficulties that many businesses experience.

If more countries decide to implement CFC rules as a result of this Action, then there would be an additional level of complexity as for each tier of CFC reporting, data analysis and calculation would be required in the local rules of that tier of CFC, so that several different calculations could be required, if the business has several tiers of ownership, which many do for historical reasons rather than tax planning.

Chapter 7: Rules for attributing income

The description of the top-up tax, which is limited to a single paragraph, does not set out all the advantages and disadvantages of this approach as little detail of how this might work in practice is provided. The fundamental principle of whether a top up tax that targets a minimum acceptable tax rate has not been explained in detail, but the top up tax would probably only be appropriate for some jurisdictions that operate a worldwide taxation approach.

Chapter 8: Rules to prevent or eliminate double taxation

Many countries have complex rules relating to the use of foreign tax credits against taxes due in the parent company jurisdiction and their complexity is made more challenging through audit adjustments to domestic and overseas income and taxes which can arise several years after the end of the accounting period. It is rarely a simple matter to obtain full relief for all foreign taxes paid and this is often made more difficult where the nature of the income received by the parent is dividend or deemed dividend income or some other non-trading income. In many countries foreign tax credits are not carried forward, so loss making parents are subject to double taxation (using their losses up to the CFC income inclusion and losing the benefit of foreign tax credits).

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The participation exemption regimes of some countries provide for a 95% or similar exemption, giving an effective tax on 5% of each dividend. A successive dividend through such regimes creates an effective additional tax at each level that is difficult to obtain relief for.

Deemed dividend and flow through treatment of CFC income attribution are not treated the same by many double taxation conventions, and the nature of the flow through income and utilisation of foreign tax credits is not clearly addressed. The credit mechanism is clearer for dividends, and therefore treatment as a deemed dividend is generally a better option.

Therefore, while the Draft notes the principal issues, it appears to underestimate significantly the actual complexity in calculating double taxation relief and makes an apparent assumption that effective relief will be available which, in practice, is often not the case.

The draft suggests a hierarchy of CFC rules and tax relief applied from the lowest tier upwards, with full relief being granted for CFC taxes paid in each lower tier before calculation of the tax due in that jurisdiction. As this hierarchy is critical to improving the chances of effective relief of double taxation, it should be a much clearer recommendation than a single sentence in one paragraph of the Draft, the process for notification of lower tier CFC adjustments and their treatment in the higher tier jurisdiction should be the subject of clear and precise recommendations. The principle of how each tier of CFCs should deal with income and taxes of lower tiers appears to BUSINESSEUROPE to be fundamental to the development of best practice in CFC rules and should therefore be given much greater priority and prominence in the Draft.

BUSINESSEUROPE would strongly recommend that only one set of CFC rules should apply at any one time to any entity. This highlights the fundamental importance of establishing a clear order of how and when different jurisdictions' CFC rules should apply. Clarifying which rules should apply to avoid double taxation and dispute over who has taxing rights over CFC income.

BUSINESSEUROPE would be willing to engage in a constructive dialogue with the OECD on strengthening the CFC rules.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

James Watson
Director Economics Department