BEPS MONITORING GROUP

Comments on BEPS Action 3:
Strengthening the Rules on Controlled Foreign Corporations (CFCs)

This report is published by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This paper has been prepared by Sol Picciotto and Jeffery Kadet, with comments and input from Martina Neuwirth, Markus Henn, and other members of the Group.

We welcome this opportunity to comment on the Discussion Draft, and would also be willing to speak at the public consultation on the subject.

SUMMARY

Rules on controlled foreign corporations (CFCs) override the 'separate entity' principle by providing that, in defined circumstances, profits channelled to an affiliate of a Multinational Enterprise (MNE) in a low-tax country can be attributed to its parent and taxed by the home country of the MNE. In effect CFC rules give the primary right to tax business profits to the source country (where the activities take place), thus ensuring neutrality between domestic and foreign-owned firms, but a secondary right to the country of residence of the foreign owner, to ensure neutrality between home and overseas investments. CFC rules should act as a deterrent removing the incentive for MNEs to shift profits out of source countries. To achieve this however, they must be set at a high standard and coordinated. A weak standard which is left to states to implement would be counter-productive, as it would encourage source states to reduce their tax rates, and hence worsen the race to the bottom in corporate tax.

We therefore support adoption of full inclusion approach, under which the home country would tax all CFC income, with a credit for foreign taxes paid. An acceptable alternative would be a substance test based on the proportion of profit to employees, determined by payroll costs. It should apply if the effective tax rate in the CFC's country of residence is below 95% of that of the home country, since a high threshold is essential both to remove pressures on source countries to reduce their tax rate, and to ensure competitive equality between MNEs from different home countries. We urge rejection of a 'top-up tax' as an inadequate alternative which would give unfair advantages to MNEs which continue to engage in BEPS behaviour.

Such strong CFC rules could give the BEPS project some chance of success, but weak rules would mean its failure. The inability to coordinate CFC rules until now has led to their weakening, due to economic globalization allowing MNEs to play states off against each other. Strong and coordinated international action is now needed in order to ensure that MNEs are taxed 'where economic activities take place and value is created'. In our view the most effective response to BEPS would be to adopt a more explicitly unitary approach to MNEs, for example by systematizing and regularizing the profit split method with defined concrete allocation factors and weightings for all commonly used business models. Apportioning profits according to appropriate measures of real economic activity would leave states free to set their corporate tax rates, balancing encouragement of investment in real

activities with optimizing tax revenues. The BEPS Project has preferred a different approach, including CFC rules, but it remains to be seen whether it can achieve agreement on the high standards necessary to make them effective.

1. General Remarks

A. Status of the Proposals

1. Measures on controlled foreign corporations (CFCs) date back to the adoption by the USA of Subpart F in 1962 to deal with deferral by US-based MNEs of US tax on foreign income by structuring corporate groups to route investments through intermediaries in convenient jurisdictions. The US at the same time referred the general issue of treaty abuse to the OECD,[1] but for over half a century no effective action has been taken on this broader issue. Subpart F introduced the principle that, in specified circumstances, the income of a foreign subsidiary would be treated as having been distributed to and hence taxed directly in the parent entity's country of residence. Gradually some other countries also introduced CFC rules,[2] but consensus has not been possible on this principle through the OECD, due to the insistence of many on the principle that affiliates should be treated as separate entities even if they form part of a single enterprise. The CFA in 1986 approved two reports on the use of Base and Conduit companies,[3] but doubts were cast by some states on the compatibility of CFC rules with the separate entity principle in tax treaties, and the Committee suggested that CFC rules should be guided by an international consensus, to be formulated by the CFA. This has not been done formally, but language was included in the Commentary to article 1 of the model convention from 1995 which in effect provided criteria to validate such measures, and these were amended in 2003 and 2010. The CFA returned to the issue in 1996 with a report whose purposes included consideration of 'whether uniformity should or can be reached in the design of a CFC regime', but which in the event resulted in a purely descriptive analytical and comparative study.[4] As this brief account shows, agreement on this issue has eluded the OECD, so CFC rules have been left for each state to formulate.

2. The present Discussion Draft (DD) remains unclear about the extent or form of coordination envisaged. It includes draft 'recommendations', but nothing is said about the form these might take, i.e. whether they are intended simply as a basis for national legislation, or for inclusion in the model convention, or indeed in the proposed multilateral convention. The intention seems to be to leave it to states to legislate as they wish, guided by the recommendations. These will inevitably establish an international standard, but one which will be more likely to constrain the extent of national legislation than empower countries to enact strong and effective CFC rules. The DD states at various points that some states may wish to go beyond its recommendations, which aim to deal only with BEPS aspects. States may nevertheless feel inhibited in doing so, particularly if they wish to diverge from specific recommendations, especially as the Commentary to Article 1 (para.26) still states that

> 'States that adopt controlled foreign companies provisions or the antiabuse rules referred to above in their domestic tax laws seek to maintain the equity and neutrality

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[1] The OECD Fiscal Committee in early 1962 created Working Party 21 on Tax Avoidance through the Improper Use or Abuse of Tax Treaties, consisting of the US and Denmark; it produced reports in 1963, 1965 and 1967, was expanded to include Germany, and reported again in 1975 as Working Group 21 of WP 1.

[2] Beginning with Germany's Aussensteuergesetz of 1972.

[3] Published a year later in *International Tax Avoidance and Evasion. Four Related Studies*; they are now included as R(5) and R(6) of the `Full Version' of the 2010 Model Convention (OECD 2010)

[4] *Controlled Foreign Company Legislation*, (OECD Fiscal Committee, 1996).

of these laws in an international environment characterised by very different tax burdens, but such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer'.

The issue of when taxation is 'comparable' is at the heart of CFC rules, so retaining this broad and vague statement in the Commentaries is clearly unsatisfactory. It seems unlikely that agreement can be reached on common standards for CFC rules. In our view therefore this paragraph should be replaced by a clear statement that states are free to adopt any CFC provisions they consider appropriate.

B. Competition and Coordination

1. CFC rules are central to balancing residence and source tax rights, or reconciling capital export and capital import neutrality. They may be applied by countries which in principle assert tax rights over worldwide income, with a credit for foreign taxes paid, or those with an essentially territorial tax system, but which wish to limit the exemption of foreign-source income to that which derives from active business which has not shifted income from the home-country tax base.[5] In effect CFC rules give the primary right to tax business profits to the source country (where the activities take place), thus ensuring neutrality between domestic and foreign-owned firms, but a secondary right to the country of residence of the foreign owner, to ensure neutrality between home and overseas investments. If capital-exporting countries adopt strong CFC rules, capital-importing countries can be insulated from pressures to offer incentives or reduce their tax rates. On the other hand weak CFC rules, which apply a low threshold to define CFC income, retain the incentive for MNEs to shift income from operating affiliates in high-tax source countries into intermediary jurisdictions with lower tax rates (through above the CFC threshold), thus continuing the race to the bottom in corporate tax rates.

2. We do not agree with the suggestion in the DD (para. 8) that subsidiaries of parent companies which are subject to broad CFC rules are at a competitive disadvantage compared to local companies. This is a red-herring that MNEs have repeated so often that some politicians believe it. Rather, the aim is to ensure competitive equality by depriving such foreign-owned affiliates of opportunities for profit-stripping, which gives them an unfair advantage over their competitors which have less opportunity or inclination to engage in such practices.[6] Hence, we agree with the characterization in the DD of CFC rules as a deterrent (para. 16), and with the suggestion that effectively taxing CFC income at a high rate would protect the source country tax base (para. 17). **Source countries should support strong CFC rules.** We also support the implication (paras. 18 and 19) that, to be effective against BEPS behaviour, CFC rules should not protect only the home country tax base but extend to foreign-to-foreign profit stripping. As the DD states, this is particularly important for developing countries, which the G20 has stated should also benefit from the BEPS project.

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[5] The distinction between worldwide and territorial systems is much less clear in practice than in theory, and the weakening of CFC rules in effect has moved worldwide towards territorial systems. Indeed, it has been pointed out that the weakening of Subpart F by the US, combined with generous foreign tax credits, is more generous than an exemption system: Fleming, Peroni and Shay, 'Worse than Exemption', *Emory Law Journal* 59: 79-149 (2009). For an empirical comparison of effective tax rates of US MNEs with those based in EU countries (many of which have exemption systems) see Avi-Yonah and Lahav, 'The Effective Tax Rate of the Largest US and EU Multinationals', U of Michigan Public Law Working Paper No. 255 (2011).

[6] Competitiveness is discussed in Kadet, 'U.S. Tax Reform: Full-Inclusion Over Territorial System Compelling', *Tax Notes* 15 April 2013 295-301, at 298-9.

3. The weakening of CFC rules in recent years has resulted from several factors due to growing economic globalization: (i) competition between countries to attract MNE headquarters leading to regionalization and head office relocation or 'inversions'; (ii) increased difficulty of defining 'active' income due to the growing importance of services (including financial services) and intangibles, and (iii) the trend to reduction of corporate tax rates and offering tax breaks, making it hard to distinguish between a 'low' and 'normal' tax rate. In our view, as made clear in our previous submissions, the most effective response to these trends, in order to ensure that MNEs are taxed 'where economic activities take place', would be to adopt a unitary approach to MNEs, for example by systematizing and regularizing the profit split method with defined concrete allocation factors and weightings for all commonly used business models. Apportioning profits according to appropriate measures of real economic activity would leave states free to set their corporate tax rates, balancing encouragement of investment in real activities with optimizing tax revenues. The presumption in the present rules that affiliates should be treated as separate entities facilitates and indeed encourages BEPS behaviour.

4. To the extent that they effectively override the independent entity assumption, CFC rules could also counteract BEPS behaviour. To be effective, however, they would need to be either (i) targeted and coordinated multilaterally, or (ii) adopted by all or most home countries of MNEs on a full-inclusion basis.

5. Under a targeted and coordinated system, CFC rules would apply to any income which has benefited from tax advantages which are considered illegitimate, for example due to hybrid mismatch arrangements (HMAs), or harmful tax practices (HTPs). The DD recognises that there is an interaction between this action point and those on HMAs and HTPs. However, although it includes proposals aiming to link CFC rules to HMAs, nothing is said about HTPs. This is understandable in view of the form taken by the proposals on HTPs. These have not established clear rules which are easy to apply but broad principles, particularly the 'substantial activities' requirement, which has now been supplemented by detailed provisions attempting to define 'nexus' in relation to IP regimes. As we pointed out in our comments on the Agreement on the Modified Nexus Approach, these are complex and would require careful monitoring to be effective, including intrusive auditing of company expenditures under 'track and trace' regulations. Yet it seems that compliance will be left to the countries introducing the measures themselves, perhaps subject to general oversight through the Forum on HTPs. This would be toothless unless backed by counter-measures, which could be provided by the application of CFC rules. However, unless such counter-measures were properly coordinated it would be a tit-for-tat system at best; even with such coordination it would likely be ineffective in stemming the race to the bottom in providing corporate tax breaks.

6. In our opinion, therefore, if the CFC proposals are to be effective they must be designed on a broad full-inclusion basis, and be applied by all countries in which MNEs have resident parent companies. If the BEPS project is to stand any chance of success within the framework laid down in the Action Plan, such strong CFC rules are absolutely essential. It is also important that they be applied by all relevant countries. Achieving such collective action will not be easy, especially in view of the unfounded concerns for 'competitiveness' articulated by some politicians. In our view this 'competitiveness' focus only leads to beggar-thy-neighbour policies, and we are very sad to see some of these arguments expressed in the DD (paras. 8-9). Although it correctly points out that collective action can overcome those concerns (para.10), in our view there is no need to adopt minimal standards to ensure this, as suggested there. In practice, there is rarely much scope for a MNE to choose where to locate its true headquarters. Choice of head office may be possible where there is a joint venture set up

from several existing large otherwise unrelated companies, or a cross-border merger or acquisition, but there will very seldom be any choice when a truly new business is being formed, and still less to change location of the head office when a firm has been long established in its home base. Artificial relocation of the head office can be dealt with by combining place of incorporation with place of effective management to determine residence.

7. All states could benefit from strong, well designed CFC rules which are widely adopted. When the UK weakened its CFC rules in 2012 the government estimated that the measures would cost the UK £1b a year in revenues, while charity Action Aid estimated that the cost to developing countries would be £4b. The BEPS project offers a unique opportunity to establish strong tax rules on a coordinated basis. If it results instead in weak rules which are left to states to apply individually it would be worse than ineffective, it could be a recipe for further encouraging the race to the bottom in corporate tax. The main losers would be developing countries, since they cannot easily resist pressures to offer tax incentives to attract investment, and they are more highly dependent on corporate tax revenues. However, developed countries would also lose, as their tax bases continue to be eroded by profit-shifting. Our comments in the next section, answering the specific questions posed, attempt to spell out in more detail the design implications of these considerations.

C. The Issue of EU Law

8. In our view, the BEPS project should aim at devising the best global solution, without concerning itself with compatibility with EU law. It should be recalled that at the root of the EU's difficulties is the principle, dating back to the Treaty of Rome of 1957, that direct taxes are a matter for national states, which has become increasingly incompatible with increased economic integration and the creation of a single market. The jurisprudence of the European Court of Justice (ECJ), briefly discussed in the DD, aims generally to push states away from unilateral solutions and towards a more joint approach to corporate taxation, the need for which has been accepted by the European Commission since the Ruding report in 1992. The difficulty has been reaching agreement among the member states, especially with continued enlargement of the EU now to 28 states. Although there are considerable political and institutional difficulties, a number of strategies are available, and the EU has much stronger legislative powers than other regional organizations. A comprehensive technical solution already exists with the proposed Common Consolidated Corporate Tax Base (CCCTB); although this can certainly be refined and improved, the main obstacles to its adoption are clearly political. The European Commission is preparing an Action Plan, which it has said will include a re-launch of the CCCTB and ideas for integrating the OECD/G20 actions on BEPS at EU level. The BEPS project should aim at strong and coordinated CFC rules, and the EU should work constructively to ensure their implementation compatibly with EU law. It would be inappropriate and unfortunate if discussion of the niceties of ECJ jurisprudence were used to weaken proposals on CFCs in the BEPS project. A well designed global approach to CFCs should pose no significant technical problem for adoption in the EU. Since almost all EU member states are also members of the OECD, such coordination should be possible.

2. RESPONSES TO SPECIFIC QUESTIONS

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?

One practical issue could arise where a transparent partnership (or other transparent vehicle such as a transparent LLC) has one or more minority CFC partners. Any such minority partners might not have full access to the details of the partnership's operations and its accounting and tax information. As such, the parent of such a minority CFC partner might be unable to access the information necessary to apply its home country CFC rules to their CFC's partnership share.

To deal with this issue, perhaps the final BEPS proposals for domestic BEPS legislation could include a requirement for controlling owners of transparent vehicles treated as CFCs to provide information reasonably required by all other owners to comply with any CFC rules applicable to them. It seems doubtful that such a requirement would cause any release of trade or financially sensitive information.

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

We suggest a broad definition which is not limited to a parent-subsidiary relationship, but includes any entity under common control. This would be a better way of dealing with structures aimed at avoiding CFC rules than a general anti-avoidance rule. It would also help encourage all relevant countries to introduce strong CFC rules.

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

No serious practical problems noted. Applying the wider approach would seem simpler since there would be no need to examine the tax effect on country C of any payment made by C Co. Also, we agree with the point in para. 38 that the broad rule helps ensure the coherence of CFC rules by taking account of all rather than specific income of a CFC.

Chapter 3: Threshold Requirements

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

5. How could these problems be addressed or mitigated?

We see no need for a *de minimis* threshold, which would be an unnecessary complication. There could be a danger of setting it too high, while the claimed advantage of ease of administration seems to be negated by the need for refinement by the addition of dual thresholds such as in the UK, or an anti-fragmentation or anti-abuse provision as in the US.

We agree with the reasons in para. 52 for not including an anti-avoidance requirement.

Low-tax threshold

As argued in section 1 above, CFC rules should be designed as a deterrent to BEPS behaviour and hence be designed primarily to protect the tax base of the source country, by removing the incentive to shift profits from the source country, since they would anyway be subject to full and current taxation by the home country. From this perspective, there is no reason for a low-tax threshold, and some commentators have indeed proposed even a unilateral total-inclusion approach as a more practical alternative to worldwide formulary apportionment.[7] If it is not possible to achieve agreement on either high CFC standards or our suggestion outlined above that the profit split method be significantly expanded, then we strongly

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[7] For example, Kleinbard, 'The Lessons of Stateless Income', *Tax Law Review* (2011), available at: http://ssrn.com/abstract=1791783; Fleming, Peroni and Shay, 'Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig', *Michigan Journal International Law* 36: 1-57 (2014); Kadet, 'U.S. Tax Reform: Full-Inclusion Over Territorial System Compelling' *Tax Notes*: 295-301 (2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2275488; and Kadet, 'Worldwide Tax Reform: Reversing the Race to the Bottom', *Tax Notes International* 69(12) (2013), available at http://ssrn.com/abstract=2231915.

suggest that the benefits of countries changing from their present territorial and deferral taxing models to a worldwide current taxation approach (with a narrow country-by-country foreign tax credit mechanism) be brought into the discussion. Both the territorial and deferral systems strongly motivate MNEs toward BEPS behaviour. On the contrary, where an MNE knows that all its income, wherever earned in the world, will be subjected to current home country taxation, that BEPS motivation is eliminated. If just a relatively small number of countries that are the home-countries of MNE groups were to adopt such an overall approach, BEPS behaviour would significantly fall with greater tax revenues for all countries and a much more level playing field for all MNEs.

The reluctance towards this approach would seem to be because of a perception that it restricts the power of the source state to exercise its tax rights to lower its tax rate to attract investment, since the profits would anyway be taxed at the home country tax rate if it is higher. This would indeed be the likely consequence, given the concern of governments especially of capital importing countries to attract investments. Equally, the deterrent effect on MNEs to shift profits from source countries is seriously reduced if the home country threshold on CFC income is significantly lower than the source country tax rate. As explained above, we regard this dissuasive effect on source country base erosion to be an important and perhaps primary objective of CFC rules. For all these reasons we advocate a threshold of 95% of the home country rate.[8] This leaves some small leeway for source countries to reduce their rate to attract investment, perhaps to compensate for other impediments to cross-border investment, but to an extent that would not significantly distort neutrality. Further, if a source country desires to use tax incentives to attract investment, it can attempt to negotiate tax sparing provisions in its treaties with important investor countries. While this would allow some tax competition, at least it would reflect the agreement of both the source and residence countries that this is economically desirable.

Another motive for adopting a lower threshold is that MNEs may threaten to relocate their headquarters (corporate inversion) away from countries applying CFC rules based on a high threshold. Indeed, this type of threat has been a major motive for the weakening of CFC rules in recent years, notably by the UK. However, as we argued in section 1 above, a central aim of the BEPS project is precisely to adopt a more coordinated approach, to help states withstand the very inappropriate pressures they are under from MNEs that make unilateral action so difficult. Any tax rate threshold proposed under the BEPS project will in practice establish an international standard for an acceptable minimum tax rate for MNE income. Even if the proposals do not take the form of binding treaty rules (which seems likely) they would carry considerable weight, given governments' concerns about the effects on investment. Furthermore, such a strong approach for a high international standard should counter the competitiveness objections since all MNEs would be subject to the same rules.

Hence, we should also make it clear that we do not advocate a threshold based on a percentage of the home country rate unless that percentage is close to 100%, i.e. 95% as we suggest. Significant disparities have developed between tax rates of OECD countries, even those which are in principle considered to be high-tax. A threshold based on a percentage significantly less than 100%, such as 75% as suggested in the DD (para. 56), would create a strong incentive for countries anxious to attract inward investment to reduce their tax rates to undesirably low levels. Countries which have reduced their tax rates for 'competitiveness' reasons, such as the UK, should have no valid reason to apply a significantly lower threshold than their own in defining CFCs, since it would encourage others to out-'compete' them.

[8] We also advocated this threshold in our submission on BEPS Action 8-9-10 on Special Measures.

Adopting a high threshold would also avoid the need for 'white' or 'black' lists. Further, at least for countries applying a foreign tax credit, there would be no need to calculate the effective tax rate.

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

As the DD mentions (paras. 34 and 63), the issue of treatment of PEs only arises for countries applying the exemption method. In such cases, we support the proposals for a broad approach to this calculation set out in para. 63. However, we suggest that this could be on a country-by-country basis, since the country-by-country reports which will be required (at least for large MNEs) under AP13 will include aggregate data for each country. We consider it undesirable for countries to exclude the income of a PE from this calculation.

Chapter 4: Definition of control

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

In our view, inclusion of a de facto control test is necessary, essentially as a targeted anti-avoidance rule. We do not accept that this would involve 'added costs, complexity and uncertainty for taxpayers', since where de facto control is an issue, it will virtually always be the result of contractual, legal, and operational structures created by the taxpayers themselves that are meant to achieve tax objectives which could not be accomplished more directly. As a simple example, there are accounting rules for variable interest entities that will apply to many situations that would not be caught by either the legal or economic control tests. There is clearly a need for a de facto control test. It must be included either by adding it as a separate test or, alternatively, by expanding the economic test to include not only legally enforceable economic results, but also resulting from other contractual or relationship factors. For example, where a key local individual, who for all practical purposes acts as an employee or representative of an overseas company, owns the shares of a local company which conducts the local business of the overseas company, only a de facto or expanded economic test would treat such a local company as a CFC.

We would also support inclusion of financial statement consolidation as another test. However, we see consolidation rules and how a company is treated under consolidation rules as a factor that would be relevant in applying other tests, including a de facto test.

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?

In our view, related parties should be presumed to act in concert. Hence, attribution rules should be positively recommended and not just treated as an acceptable add-on. They are clearly not difficult to apply. All groups maintain organization charts that show the total of common ownership for all group investments. If a country's CFC law requires attribution rules to be applied, it's simply not correct to say that it adds to complexity and expense of compliance.

Hence, we see no difficulty with respect to related nonresident parties. We also see no practical issue in requiring all residents who have some minimum ownership percentage to report those ownership interests. The only practical issue is where an under 50% or over 10% owner does not know if there are other resident 10% or greater owners. All 10% or greater owners, directors, officers, etc of such foreign companies could be required to provide to the tax authorities robust information on such foreign companies to the extent known to them.

Usually this is information that will be known to such persons who act as directors or officers.

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?

For the reasons outlined in section 1 above, we advocate a full-inclusion approach. As we explain in that section, it should not be limited to protection of the home country's tax base. It must be made clear throughout the BEPS process that this is an international effort to combat profit shifting with respect to all countries. Hence, **any suggestion such as that in para. 85 that it is acceptable for a country to enact CFC or other rules that protect solely its own tax base and that would specifically allow BEPS-motivated structures to beggar other countries is simply not acceptable.** This must be removed from the Report. In addition to the policy reasons discussed above, we see many practical difficulties in applying criteria to define the specific income that raise BEPS concerns. This is certainly the case if a formal approach is adopted. This is clear from the discussion in para. 88, which suggests that attributing royalties, interest and dividends may be problematic because they may be considered in some circumstances to result from an 'active business' (the example of 'active financing' is given). It adds indeed that this may not involve BEPS concerns, whereas the structuring of finance within an integrated corporate group is a major technique for BEPS. As we stated above, adoption of weak recommendations on CFCs would fatally weaken the BEPS project, by encouraging a race to the bottom, instead of stronger coordination to strengthen all countries' tax systems.

However, a viable alternative to full-inclusion could be **a substance test based on an employee and establishment analysis, applied on a proportionate basis**. This could be quantified on the basis of payroll costs. It is suggested in para. 92 that this could be difficult to apply because it would 'require a comparison of the employees and establishment in the CFC to the employees and establishment that would be required to earn the overall income, which may be a difficult comparison to undertake'. However, the data which will be made available through the Country-by-Country reports and Transfer Pricing Documentation Master File should facilitate such a comparison. The aim of this new reporting standard is precisely to enable a BEPS risk analysis, so using it to guide the application of CFC rules would be entirely appropriate. One difficulty is that these reports are at present to be required only for MNEs with a turnover of 750m euros, however similar documentation requirements could be introduced for all groups identified as potentially falling within CFC legislation.

We see both principled and practical problems with both the substantial contribution analysis and the viable independent entity concept, especially as they are both essentially threshold tests. Many MNEs have now developed highly sophisticated structures based on functional fragmentation. This makes it difficult or impossible to decide whether or when an entity makes a 'substantial contribution' or is 'viable'. Hence, a threshold test is inadequate. In addition, these tests would require detailed facts-and-circumstances analysis which is resource-intensive and subjective, so as recognized in para. 92 'would increase administrative complexity and compliance costs and may lead to uncertainty'. That paragraph also suggests, however, that an advantage would be the similarity of this approach to transfer pricing methods which also apply such a facts-and-circumstances analysis. In our view this is a disadvantage. As we have stressed in our submission on the transfer pricing proposals, these methods are totally unsuitable, especially for developing countries. The aim of the BEPS project is to ensure that MNEs can be taxed 'where economic activities take place and value is created'. This is not a binary choice, but requires a proportionate test. In our view, the relative objectivity of the 'employees and establishment test' on a proportionate basis is the only practical approach that can provide a meaningful result. It analyzes limited, objective and easy-to-determine factors that are administrable and will provide fair results.

II. How CFC rules can accurately attribute income that raises BEPS concerns

As stated above, our preference is for a full inclusion approach, or alternatively inclusion based on a substance test applied proportionately using employee payroll costs. In our view, transactional approaches are particularly inappropriate. However, we will add some comments in relation to these questions for the sake of completeness, especially to deal with exceptional cases.

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?

Banks and other regulated financial enterprises are among those who most make use of BEPS structures. In order to provide a 'bright-line' rule but with flexibility, we suggest for (i) a rebuttable presumption for inclusion in CFC income of all such income. If a bank, financial institution, or other regulated CFC can establish to the satisfaction of the appropriate home country tax authority that it does have substantive operations in the CFC country that in fact earned the relevant income, then the earnings would be excluded from CFC income.

Considering the mobile nature of reinsurance and captive insurance companies, we recommend blanket coverage for both (ii) and (iii) that all such income earned by a CFC will be CFC income.

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

We strongly agree with the broad approach suggested. The subjectivity of the distinction between sales and services on the one hand and IP on the other creates a total inability for tax authorities to deal with this issue. A broad approach like this is the only practical answer. There should be no practical problems, especially considering that this broad treatment eliminates so many subjective judgments from any analysis.

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

Nothing to add.

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

Generally yes. We believe, though, that the rents, leasing fees, and capital gains mentioned in paragraph 97 should be included in CFC income as well. As a result, we suggest that addition guidance be given and that they be added to the final recommendations for a definition of CFC income.

III Possible Approaches.

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

While the discussion draft is sufficiently clear for its purposes, we suggest that future recommendations include suggested draft statutory or regulatory language that individual countries could then tailor to their needs.

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?

We generally recommend approaches that provide broad coverage based on objectively determined factors; these will best minimize any practical problems. Where there is an exception available based on a facts and circumstances analysis, applying that is at the option of the taxpayer. As a result, such additional work is limited to those taxpayers who wish to establish their qualification for such an exception.

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?

We believe that either could provide an administrable approach that gives fair results. However, we believe the use of the excess profits approach to be better since we see that as being overall more inclusive, less susceptible to abuse, and easier to apply by taxpayers and monitor and examine by tax authorities. It is also the more appropriate approach to apply in relation to our preferred broad definition of CFC income using a substance test based on an employee and establishment analysis, applied on a proportionate basis.

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

Even where IP might be a lesser issue, there are synergies that exist in most MNEs that allow higher profits on a group-wide basis. For this reason, it is very reasonable for the home country of the parent to apply CFC rules that do not allow such excess profits to be placed in low- or zero-taxed CFCs.

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

No suggestions.

IV. Should CFC rules apply an entity or transactional approach?

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?

The discussion in the DD accurately outlines the varying efforts and costs by taxpayers to comply and for tax authorities to administer and audit these approaches, and it seems that neither of the two possibilities outlined has any insurmountable difficulties or practical problems. On balance, our preference is for the entity approach, which would be simpler and easier to administer.

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?

We agree with the recommendation in para. 133 that the income should be calculated according to the legal requirements of the parent company's jurisdiction, based on the explanation in para. 132. Use of financial accounting standards such as IFRS would be inappropriate, as they are unsuitable for tax purposes and not accepted by tax authorities. As we have suggested in other submissions, especially in relation to the use of the profit split method in transfer pricing, we recommend that the OECD should work on developing a harmonised tax accounting standard, which could build on the methodology and standards in the CCCTB.

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

Yes. We have nothing to add to the discussion in the chapter.

Chapter 7: Rules for attributing income

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

We agree with the recommendations outlined in para. 143, and the reasons given in the subsequent discussion.

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

The description is broadly accurate, and we not only agree with the conclusion that a top-up tax is undesirable, but recommend that it should be firmly rejected. Its only justification is the purely pragmatic one of perhaps making it easier for a country with a significantly higher corporate tax rate than other countries to adopt proper CFC rules. However, in our view it is essential for any such country to grasp the nettle and introduce whatever changes are necessary to bring its tax rates and international tax rules more in line with other countries and with the package of proposals from the BEPS project. As the discussion in the DD points out, adopting a top-up tax would eliminate the deterrent effect that in our view is a key element in CFC rules, to eliminate BEPS behaviour and protect both source and residence country taxation. Finally, a top-up tax would give those MNEs which benefit from it a wholly undeserved competitive advantage over other MNEs which have not engaged in BEPS behaviour. A top-up tax would be wrong in principle, damaging in practice, and should be rejected.

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?

The discussion in the DD seems comprehensive to us. We agree with the recommendations outlined in para. 155, for a credit if the CFC has been taxed where it is resident or in another country with CFC rules, and for exemption of dividends and gains from income which has been taxed, to be determined by the CFC rules of the country concerned. The rule hierarchy proposed in paras. 159-160 seems appropriate. It is clearly especially important to eliminate double taxation via these methods if a broad full-inclusion approach is adopted as we have recommended.