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30 April 2015

Achim Pross
Head, International Co-Operation and
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Paris, France

Via Email: CTPCFC@oecd.org

RE: Public Discussion Draft on BEPS Action 3: Strengthening CFC Rules

Dear Mr. Pross:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly. Pursuant to Action 3 of the Plan, on 3 April 2015 the OECD published a document entitled *BEPS Action 3: Strengthening CFC Rules* (hereinafter the Discussion Draft or Draft). The OECD solicited comments from interested parties on the Draft no later than 1 May 2015.

On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments. In addition, TEI requests the opportunity to speak in support of these comments at the Public Consultation regarding Action 3, to be held in Paris on 12 May 2015.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws,

at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.[1]

TEI Comments

Lack of Consensus in the Draft: Double Taxation and Administrative Complexities

TEI commends the OECD for its thorough discussion and analysis of CFC rules and the building blocks necessary to make them effective. The section of the Discussion Draft regarding rules to prevent double taxation[2] is particularly welcome, as it is clear that the OECD recognises that widespread adoption of CFC rules will result in more than one country's CFC rules applying to a single CFC's income. Regrettably, the Discussion Draft underestimates the complex issues that will arise should countries adopt inconsistent, and yet broadly applicable and overlapping, CFC rules.

This will undoubtedly occur unless the OECD produces specific and robust recommendations regarding the design of CFC rules. The Discussion Draft fails at this critical task. While the Draft includes sections entitled "recommendations," most of those sections state recommendations in the alternative or as minimum standards, especially on the more difficult issues. For example, for purposes of "control," the Draft states a CFC should be controlled "where residents hold, at a minimum, more than 50% control, although countries that want to achieve broader policy goals or prevent circumvention of CFC rules may set their control threshold at a lower level."[3] A recommendation that says control can be established above or below 50% control is no recommendation at all. Finally, the Draft makes no recommendations regarding the definition of CFC income.

Multiple, overlapping, inconsistent and potentially tiered CFC rules are a recipe for rampant double taxation. As noted, the OECD addresses the issue of potential double taxation in the Discussion Draft, recommending that countries provide an indirect foreign tax credit for local taxes paid and also for any taxes paid to an intermediate jurisdiction in a tier of CFCs as a result of that jurisdiction's CFC rules. The Draft acknowledges that countries may need to change their double tax relief provisions for CFC tax paid in an intermediate country to qualify an eligible foreign tax for crediting purposes.[4] Similarly, the Discussion Draft states that countries should provide a tax credit for any withholding taxes imposed on a subsequent dividend distribution from a CFC to its parent. Finally, the Draft notes that "it may be

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[1] TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

[2] Discussion Draft, p.61-64.

[3] *Id*. at 27.

[4] *Id*. at 62.

appropriate to provide a refund of CFC taxes paid equal to the amount of the withholding tax if the dividend was paid out of profits that were subject to CFC tax . . . ."[5]

TEI agrees that a foreign tax credit should be provided in these situations to alleviate double taxation. The example in the Discussion Draft, however, misleadingly suggests that claiming and determining the amount of a foreign tax credit in the presence of multiple CFC rules will be a simple matter. But the situation quickly becomes much more complicated when more CFCs are added to the picture, where CFCs are not wholly owned, where timing differences in when tax is due and paid arise, in determining the mechanics of claiming a credit for taxes paid in Country B by Subsidiary B for income earned in Country C by Subsidiary C, and if countries have different CFC rules. In addition, the Draft does not address how these rules would apply in the case of a cross-border merger or acquisition or where there is a change in control of a CFC.

Further, it is unclear how multiple tiers of CFC rules may interact with some of the newly enacted taxes intended to combat BEPS, such as the U.K. Diverted Profits Tax. The Draft also does not discuss the interaction of the CFC rules with double tax treaties. Thus, even with an indirect foreign tax credit and/or some kind of hierarchy of the application of multiple CFC rules across jurisdictions (by, *e.g.*, giving priority to the CFC rules of the jurisdiction whose resident shareholder is closer to the CFC earning the income in the chain of ownership), there will be situations that give rise to double taxation.

These practical concerns and other difficulties make it even more essential that countries adopt consistent CFC rules and that the OECD make robust recommendations to further help shepherd the process in that direction. It would be hard enough for multi-national enterprises (MNEs) to comply with a consistent set of substantive CFC rules adopted around the world merely because of different administrative rules (*e.g.*, different year ends, tax due dates, estimated tax payments), and this would only be exacerbated with inconsistent and overlapping CFC rules.

What is the Role of CFC Rules in the BEPS Project?

The Discussion Draft notes that the work on BEPS Action 3 is being coordinated with the work on Actions 1 (digital economy), 2 (hybrids), 4 (interest expense), 5 (harmful tax practices), 8-10 (transfer pricing), 11 (data analysis), 14 (dispute resolution), and 15 (multilateral instrument). The overlap with so many other BEPS actions raises the question of whether CFC rules would even be needed should countries adopt the recommendations under the other actions. Indeed, it might be prudent for the OECD to suspend its work on CFC rules, which it historically has not addressed, until it has had time to review results of the remainder of the BEPS project. The OECD could then determine whether CFC rules are necessary at that time.

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5 *Id*. at 63.

Such a review could be timed with the review of the country-by-country reporting template, which is to take place in 2020.

More broadly, the substantial overlap with the other BEPS actions and the clear lack of consensus among OECD member states raises the question of what role CFC rules should play in the BEPS project. Historically, CFC rules have been a way to force the distribution of certain income earned overseas, in particular low taxed or passive income. In addition, very few countries have implemented CFC rules historically, raising the question of why the OECD is advancing such an uncommon method of combating tax avoidance in the BEPS project, especially when the avoidance at issue – the use of offshore IP to generate untaxed royalty income (it seems) – appears to be a problem only in isolated countries. In this regard, the excess profits approach appears to be a way to combat this sort of tax avoidance, and yet it is included within a discussion of CFC rules generally, when their historic focus on passive or low taxed income. The excess return approach, however, would tax all income above a certain level no matter its character. If this kind of tax planning and income is the focus of the OECD's efforts in this area of the BEPS project, why not say so directly and dispense with the lengthy discussion of CFC building blocks, control thresholds, income streams, low tax calculations, double taxation, *etc.*? While TEI would oppose such an approach as generally in conflict with the arm's length principle, the excess return approach – which has its own complexities and uncertainties – would appear to at least eliminate the need for an additional set of complex CFC rules.

Finally, the lack of widespread adoption of comprehensive CFC rules to date may indicate that most countries do not view them as necessary to police base erosion and profit shifting. If that is the case, why are these rules included in the BEPS project? This would counsel caution when recommending countries implement these rules across the board and again perhaps the OECD would be better advised to put off recommending CFC rules to address base erosion and profit shifting until it is clear such rules are needed and a consensus can be developed.

Specific Points and Answers to Selected Questions for the Consultation

Question #9: What are the practical problems with any of the three substance analyses [of CFC income] set out above [substantial contribution; viable independent entity; and employees and establishment]? How could these practical problems be dealt with?[6]

The viable independent entity analysis would likely lead to increased disputes between taxpayers and the tax authorities with the associated increase in time and expense on both sides. This will occur because the analysis requires the creation of hypothetical situations (*i.e.*, how

[6] The lack of comments on the "substantial contribution" analysis in this section should not be viewed as agreement with that analysis as set forth in the Discussion Draft.

unrelated parties "would have been most likely to allocate assets and risks"), instead of looking at the actual activities performed by a CFC to determine its substance.

The employees and establishment analysis subjects the CFC to taxation if the CFC outsources its core business functions or value-creating activities and only retains management or oversight activities. Many MNEs outsource functions to other countries for legitimate business reasons (*e.g.*, lower labour costs) and not to avoid tax. This approach would penalise those companies and create a competitive disadvantage for them even in situations where tax planning played no role in the outsourcing decision.

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

Applying the same rule to sales and services income and IP income will substantially and unnecessarily increase the administrative and compliance burden for many if not most taxpayers (and tax authorities). This is because: (i) most taxpayers will have sales and/or service income even if they do not have royalties and IP income; and (ii) most sales and services income that is active business income will be included in CFC income unless the taxpayer can substantiate that it meets the "substance" test.

Categories of CFC Income

Page 46 of the Discussion Draft states that "interest and financing income earned by a CFC will generally be treated as passive (and therefore included) unless the CFC had the required substance to earn the income itself and the CFC was not overcapitalised." It would be useful if the OECD provided additional guidance regarding when a CFC is overcapitalised.

Also, with respect to sales, services, royalties and IP income, royalties and IP income are often bundled into the pricing of goods and services and therefore it may be difficult to separately determine such income. This would not be an issue if sales and service income are also included in CFC income; however, such inclusion would raise the difficulties we discuss above under question 12. If sales and services income are not included in CFC income, it would be helpful to have a *de minimis* threshold where splitting out royalties and IP income would not be required (*e.g.*, if royalties and IP income was less than 15% of the total price or less than some specific threshold amount). Thus, if a taxpayer were confident that its royalties and IP income was less than 15% of sales it would not need to separately state such income, even if the taxpayer was uncertain of the exact percentage of sales.

Question #16: What practical problems arise with applying the categorical approach and the excess profits approach?

The excess profits approach would subject income in excess of a "normal return" from the activities that produced the income to taxation as CFC income. Such an approach targets IP income earned in low tax jurisdictions under the theory that any income in excess of a "normal return" from purchasing and selling and providing services or manufacturing must be attributable to intellectual property.

TEI recommends that the OECD clarify and provide examples as to how this approach would function, or how it is even necessary, in light of the transfer pricing rules. Specifically, it is unclear what is meant by "Transfer pricing rules would apply prior to the application of the excess profits approach, so this would only apply to income that remained after transfer pricing rules had been applied."[7] If transfer pricing rules are appropriately applied, it seems that the return left in the CFC should be arm's length. By taxing any "excess" profit over a normal rate of return, the OECD appears to be saying either that (i) the transfer pricing rules have not been applied appropriately, or (ii) CFCs can only make a certain percentage return no matter what industry they operate in and anything in excess will be taxed at the parent's rate. If the issue is that the arm's length principle has not been applied appropriately, then the perceived problem should be fixed via changes to the transfer pricing rules and not through CFC rules, which will be new and difficult to administer in many jurisdictions.

By dictating how much of a return a CFC is entitled to, especially after transfer pricing rules have been applied to determine that the return is arm's length, tax authorities are either admitting that they cannot reliably administer the transfer pricing rules or simply declaring that a return that is "too high" is evidence of some kind of undetectable yet real manipulation of the international tax system by taxpayers. If an excess profits tax is to be implemented, there should at least be an annual update of acceptable normal rate of return by industry provided by tax authorities. In addition, if this normal rate of return will override profits determined under transfer pricing rules, this would make transfer pricing studies irrelevant; therefore, CFCs subject to the excess profits tax should no longer be required to conduct transfer pricing studies or keep transfer pricing documentation to justify their return.

Conclusion

TEI appreciates the opportunity to comment on the OECD Discussion Draft regarding CFC rules. As noted above, TEI requests the opportunity to speak in support of its comments at the scheduled public consultation in Paris on 12 May 2015.

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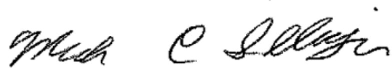
[7] Discussion Draft at 48.

These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of TEI's legal staff, at +1 202 464 8353, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.



Mark C. Silbiger
International President