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CFC Rules Around the World

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Introduction

The Organisation for Economic Co-operation and Development (OECD's) search for a solution to taxation of the digitalized economy has led it to consider a global minimum tax as part of a broader anti-base erosion proposal.[1] Because a minimum tax could be based on the structure of existing controlled foreign corporation rules (CFC rules), a review of countries' CFC rules is timely.

In general, these rules target multinational companies' ability to shift passive or other types of mobile income to low-taxed jurisdictions. While to some degree these rules follow a similar template around the world, in other respects they vary by jurisdiction. A review of these similarities and differences is important as international organizations and individual countries consider expanding these rules to better address challenges of multinational tax avoidance in the 21st century.

One question that may be considered as the OECD evaluates recommendations for a minimum tax is the extent to which such a regime may be based on the reforms adopted by the United States in 2017. In the Tax Cuts and Jobs Act (TCJA), the United States enacted a provision called the Global Intangible Low-Taxed Income (GILTI, Section 951A).[2] This rule, while built on the existing Subpart F edifice, departs from that structure in important respects. It is questionable whether the mechanism by which it is imposed means that it should properly be called a minimum tax or simply an expansion of a CFC regime. The mechanics of the U.S. GILTI regime and its function as a minimum tax will be important to examine as the rest of the world considers whether to adopt a similar—or different—minimum tax, or to adopt one at all.

This paper undertakes a review of CFC rules around the world as a contribution to the global discussion over the possible expansion of existing anti-base erosion CFC regimes or the potential adoption of a minimum tax. It is organized in six parts. Part I reviews the history of adoption of CFC rules around the world (focusing on the countries identified below) including the initial adoption of subpart F by the

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1 OECD, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy," May 31, 2019, https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf.

2 Unless otherwise noted, all "section" references are to the Internal Revenue Code of 1986, as amended.

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United States in 1962. Part II discusses efforts and proposals to change U.S. taxation in the past 20 years that were the origins of the 2017 reform to the tax code. Part III explains other recent efforts made to address anti-base erosion concerns through CFC rules by the OECD and the European Commission. Part IV discusses the U.S. Subpart F rules in greater detail and goes on to explain the changes introduced by the 2017 tax reform (TCJA).[3] Part V analyzes the different approaches taken to CFC rules in several countries including Japan, France, Germany, the United Kingdom, Colombia, the Netherlands, China, and Spain. All the countries selected have CFC rules in effect with some of them having different economic, legal, and political ramifications. With this selection of countries, it is possible to analyze the necessity of having the rules from different practical perspectives. Part VI concludes with a discussion of the extent to which the need for CFC rules in developed and developing countries should be based on their individual economic situations.

Part I. History of CFC rules around the world

CFC and Subpart F income timeline

U.S. international tax rules have always incorporated some aspects of the country's foreign policy goals. [4] In the first half of the twentieth century, these rules mostly set out to ensure that U.S. companies and investors were encouraged to undertake investment abroad. The U.S. foreign tax credit system—which provided a dollar-for-dollar credit against foreign taxes paid—operated to help achieve those goals.[5]

These goals were even more important in the immediate aftermath of World War II, when, as part of U.S. foreign policy, American private investment overseas was considered an important tool for the rebuilding of Japan and Western Europe.[6]

In the 1950s, encouraging overseas investment augmented U.S. foreign policy by helping to spread capitalism and democracy and contain Communism.[7] Providing U.S. multinationals with the ability to defer U.S. tax on their foreign source income was viewed as an important benefit for economical and geopolitical reasons. U.S. companies doing business in the free world were reaping the benefits of investments in developing countries at the same time that they were helping their economies.

3 The official name is "The Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Pub. L. No. 115–97, 131 Stat. 2054 [hereinafter the Tax Cuts and Jobs Act, or the TCJA].

4 Joseph Brandes, *Herbert Hoover and Economic Diplomacy* (Pittsburgh: University of Pittsburgh Press, 1970), 202.

5 H. Rep., 73d Cong, 2d Sess 9-10 (Dec. 4, 1933), reprinted at 373 in J.S. Seidman, *Legislative History of Federal Income Tax Laws, 1938-1861* (Clark, NJ: The Lawbook Exchange, Ltd.). In 1934, the Ways and Means Committee proposed eliminating the credit and instituting a deduction for foreign taxes, on the grounds of ensuring parity between taxes paid to foreign countries and taxes paid to state governments. This proposal did not pass. See also Roswell Magill and William C. Schaab, "American Taxation of Income Earned Abroad," 13 Tax L. Rev. 115, 120 (1958). The Treasury Department, in response, suggested limiting the credit to one-half of the foreign earned income. See also H. Rep. 704, 73d Cong, 2d Sess 15-16 (1934), reprinted at 373 J.S. Seidman, *Legislative History of Federal Income Tax Laws, 1938-1861*. That pointed out the importance of the credit "to avoid burdensome double taxation and to encourage foreign trade." In 1993, the House proposed eliminating the credit, and the Senate restored it on the grounds that it was needed "to encourage United States exports." In 2017, the TCJA repealed §902, eliminating the indirect foreign tax credit.

6 Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy" Yale Law Faculty Scholarship Series, Paper 1618, 2001, 294, http://digitalcommons.law.yale.edu/fss_papers/1618. For example, to reflect the need of increased investment, during the 1940s and 1950s, proposals were made to replace the foreign tax credit with an exemption of foreign income. See also Melissa Redmiles and Jason Wenrich, "A History of Controlled Foreign Corporations and the Foreign Tax Credit," 132, https://www.irs.gov/pub/irs-soi/historycfcftc.pdf.

7 Graetz, "Taxing International Income," 294.

But by the early 1960s, American attitudes towards overseas investment had undergone a fundamental shift, and ideas of how to best write international tax rules underwent parallel changes.[8] Because of favorable exchange rates, U.S. companies were purchasing European companies and there was pressure on U.S. policymakers to limit overseas investment.[9] The U.S. balance of payments also became a concern. This prompted a rethinking of U.S. foreign and economic policy, including international tax rules applicable to foreign investment. [10]

Tax policies changed to reflect overall shifts in attitudes regarding the incentives to be placed on overseas investment.[11] CFC rules were initially enacted in 1960,[12] with the purpose of gathering information about U.S. companies overseas.[13] The early rules required U.S. companies to provide information on first- and second-tier subsidiaries of U.S. corporations.[14] A CFC was defined as any foreign corporation in which more than 50 percent of the voting stock was directly owned by one or more U.S. corporations for any day of the taxable year of the foreign corporation.[15] With the development of the tax system the rules were used to track foreign tax credits, and after a period of time the rules also supported creation of a new category of income called Subpart F income.

The Subpart F regime however, was actually a scaled-back version of an earlier proposal. President Kennedy's proposal for reform in 1961 called for a complete elimination of deferral of U.S. tax on foreign source income. It was not until this time that the macroeconomic[16] situation of the U.S. triggered the creation of Subpart F income to tax foreign subsidiaries of U.S. companies.

The Subpart F regime grew out of these changing attitudes and concerns over the international economic situation,[17] including concerns over the ability of corporations operating overseas through foreign corporations to achieve deferral of U.S. tax owed.[18]

A concern in the design of Subpart F was capital export neutrality. As stated in a study by the U.S. Department of the Treasury, the Subpart F regime resulted from an amalgam of five concerns: preventing tax haven abuse, taxation of passive income, equity, capital export neutrality, and competitiveness.[19]

8 Some provisions were enacted prior to Subpart F. These provisions were intended primarily to curb certain abusive practices rather than indicative of a shift in the tax policy. Among these provisions are the foreign personal holding company rules appearing in Sections. 551-558, enacted in 1937 to combat investments in the Bahama Islands, Panama, and Canada and to avoid U.S. tax. See Bittker and Eustice __ (ed. § 15.40) [personal holding company rules (secs. 541-547), the accumulated earnings tax rules (secs. 531-537), and the foreign investment company rules (sec. 1246)].

9 Bruce F. Davie and Bruce F. Duncombe, *Public Finance* (New York: Holt, Rinehart and Winston, 1972), 505. (Noting that the "change in the procedure of taxing foreign source income was made not only for equity reasons but also to diminish the attractiveness of direct foreign investments in order to promote balance of payments stability."); Id. 505. ("In the late 1950s and early 1960s foreign investments were seen as the cause of the American balance of payments deficit.")

10 William D. Popkin, "Less Developed Countries and the Revenue Act of 1962", 40 Ind. L. J. 1 (1964). See also Robert J. Patrick, Jr., "U.S. Tax Treaties with Developing Countries," in Robert Hellawell, United States Taxation And Developing Countries (New York: Columbia University Press, 1980), 307, 309. ("In the 1950s, U.S. private investment abroad was closely identified by government policymakers with the U.S. global confrontation with Communism.")

11 Charles I. Kingson, "The Coherence of International," *Columbia Law Review* 81:6 (October 1981), 1151, 1161, for an interesting example of the way in which administrative and regulatory policy (the IRS) have been used to implement foreign policy goals.

12 Revenue Act of 1960 §6038, Pub. L. No. 86-780, 68A Stat. 286, 1014.

13 Redmiles and Wenrich, "A History of Controlled Foreign Corporations and the Foreign Tax Credit," 132.

14 A 50 percent owned foreign corporation was considered a CFC. A CFC that owned 50 percent or more of another foreign corporation was considered as a foreign subsidiary. In that case a 25 percent indirectly owned foreign subsidiary was also under control of the domestic parent.

15 Revenue Act of 1960 §6038, Pub. L. No. 86-780, 68A Stat. 286, 1015.

16 Redmiles and Wenrich, "A History of Controlled Foreign Corporations and the Foreign Tax Credit," 133.

17 Ibid.

18 Vasujith Ram, "Conceptualizing the History of Subpart F," *Tax Notes*, Oct. 12, 2018.

19 Id. See also Office of Tax Policy, Department of the Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations," December 2000, 5-22.

The Revenue Act of 1962[20] (the 1962 Act) was perhaps the first effort to use the income tax laws to limit U.S. investment overseas and represented a fundamental departure from earlier tax policy that was focused on expanding U.S. investment abroad.[21] Another early sign of this shift was the enactment of the Interest Equalization Tax in 1963,[22] which imposed a tax of up to 15 percent on the purchase of foreign securities.

The 1962 reform changed the definition of a CFC. Under the new rules a CFC was any foreign corporation if more than 50 percent of its voting stock was owned by U.S. shareholders for an uninterrupted period of 30 days or more during the foreign corporation's tax year. The definition of U.S. shareholder was included to mean any U.S. person who owned at least 10 percent of the voting stock of a foreign corporation.[23] Attribution rules were enacted to ensure that taxpayers could not avoid CFC qualification through simple tax maneuvering.

While the 1962 Act imposed a less drastic change on the overall system, limitations on U.S. taxpayers' ability to defer their foreign source income were significant. Aside from Subpart F—which imposed current tax on certain forms of income arising from insurance abroad of U.S. risks, from passive investments, from sales and service subsidiaries, and from funds repatriated without payment of U.S. tax[24]—a number of other provisions that were enacted as part of the 1962 Act also were intended to limit overseas investment. For example, section 1248 changed the taxation of income realized upon the liquidation of CFCs or the sale of CFC stock, so that it was taxed as ordinary income rather than capital gain. The 1962 Act also modified the calculation of the foreign tax credit, to ensure the imposition of the full U.S. rate of tax upon all foreign-earned income.[25]

A U.S. shareholder was not required to include Subpart F income in its taxable income if it accounted for 30 percent or less of the CFC's gross income or if CFC distributions were made so that the combined payment of foreign and U.S. taxes were 90 percent or more of the U.S. rate of 52 percent.[26]

After almost 11 years after the U.S. enacted CFC rules, Germany followed by adopting CFC rules in 1972.[27] Before these rules were enacted, profits of foreign companies were not taxed as income to their German shareholders unless distributed. As a result, German companies were able to defer German tax on the profits of their foreign subsidiaries and even avoid tax by moving parent companies out of the country. The very first set of German CFC rules was similar to the U.S. Subpart F rules.[28]

20 See Revenue Act of 1962 [Sections 951-964].

21 Revenue Act of 1962 §12(a), Pub. L. No. 87-834, 76 Stat. 960, 1008.

22 Davie and Duncombe, *Public Finance*, 505. ("In order to approach balance of payments stability, the administration sought to check capital outflows by taxing American portfolio purchase of foreign securities.").

23 Revenue Act of 1962 §12(a), Pub. L. No. 87-834, 76 Stat. 951(b).

24 Revenue Act of 1962 supra note 25 §12.

25 Revenue Act of 1962 supra note 25.

26 Redmiles and Wenrich, "A History of Controlled Foreign Corporations and the Foreign Tax Credit," 133.

27 Martin Weiss, "Recent Developments in the German Tax Treatment of CFCs," *European Taxation*, September 2015, 439, https://www.ibfd.org/sites/ibfd.org/files/content/pdf/et_2015_09_de_1.pdf.

28 Guido Förster and Dirk Schmidtmann, "CFC Legislation in Germany," *Intertax* 32:10, 2014, https://library.croneri.co.uk/iectr-wkus_tal_15926-2004032010-klieuessayintertax2006456.

In 1975, in the U.S., the Tax Reduction Act[29] expanded the Subpart F regime to include some types of shipping income earned by CFCs. The 30 percent threshold for the CFC income inclusion was lowered to 10 percent.[30] The amount of information required from a CFC was also expanded with the creation of Form 5471. These new requirements included schedules for expanded income statements, cost of goods sold, foreign taxes paid, a balance sheet, and earnings and profits analysis.

In 1980, France incorporated a CFC regime into its legislation,[31] making it the fourth country after the U.S., Germany, and Canada (1976) to incorporate such rules into its tax system. In contrast to other countries' decision to enact CFC rules, which had worldwide tax systems, France enacted CFC rules as a legislative response to the abusive use of its participation exemption regime. France has always had a territorial system of taxation, and domestic companies have had the option to locate profits in low-tax jurisdictions by setting up foreign subsidiaries. Under the participation exemption, dividends from foreign subsidiaries were subject to limited taxation. This opened the possibility for base erosion and profit shifting by multinationals that could repatriate accumulated gross income from foreign companies via dividends. The CFC rules were an additional tool to reduce the amount of untaxed foreign earnings for French parent companies.

France's enactment of CFC rules was followed by the UK in 1984. The initial purpose of the rules in the UK was apparently due to the creation of offshore money boxes—paper regimes that led to capital exports, while allowing business to otherwise carry on unaffected.[32]

In the U.S., the Tax Reform Act of 1986 refined the CFC concept further to address the issue of U.S. shareholders transferring 50 percent of the stock of a foreign corporation to foreign shareholders to avoid qualification as a CFC. The legislation expanded the definition of a CFC to include 50 percent[33] or more of the voting power of all classes of stock entitled to vote or the total value of the shares owned by one or more U.S. persons.

Spain enacted its CFC regime in 1995[34] at the same time it undertook a major modification of its income tax rules. The main purpose of the Spanish reform was to open the Spanish economy to foreign investment, something that increased especially after the creation of the European Union in 1993. This contributed to political pressure in support of rules for taxing passive income shifted to low-taxed regimes.

In 2004 the American Jobs Creation Act[35] allowed U.S. shareholders of CFCs a one-time 85 percent dividend received deduction. This was limited to cash dividends received from CFCs. A taxpayer that wanted to apply for the deduction was required to present a qualified reinvestment plan in the U.S.[36]

29 Tax Reduction Act of 1975 §602, Pub. L. No. 94-12, 89 Stat. 26 USC 954.

30 Redmiles and Wenrich, "A History of Controlled Foreign Corporations and the Foreign Tax Credit," 134.

31 Daniel Gutmann and Francois Meziane, "The French CFC Regime," American Tax Policy Institute, https://docplayer.net/18925662-The-french-cfc-regime.html.

32 Steve Edge, "UK CFC Regime - Time To Work Together?" Slaughter and May, July 2018, https://www.slaughterandmay.com/media/621198/uk_cfc_regime_-_time_to_work_together_july_2008.pdf.

33 Revenue Act of 1986 §1222, Pub. L. No. 99-514, 100 Stat 2256.

34 Spanish Income Tax Law of 1995, Pub. L. No. 43-1995, http://www.hacienda.gob.es/Documentacion/Publico/NormativaDoctrina/Tributaria/Impuesto%20sobre%20Sociedades/Ley%2043-1995%20actualizada%20al%2001-12-03%20.pdf.

35 American Jobs Creation Act of 2004 §422, Pub. L. No. 108-357, 118 Stat, Section 965(a)(1).

36 American Jobs Creation Act of 2004 §422, Pub. L. No. 108-357, 118 Stat, Section 965(b)(4).

China enacted CFC rules in 2008, but the first case where the rules were applied by the Chinese administration occurred in 2014.[37]

In the case of the UK, a major overhaul to CFC rules was made in 2012. Spain made a serious modification to the rules in 2015 to incorporate some recommendations of the OECD Base Erosion and Profit Shifting (BEPS) project. Colombia—a latecomer to this type of regime—first enacted CFC rules in 2016.

In 2017, TCJA was enacted and contained several modifications to CFC rules in the U.S. The 50 percent control threshold was expanded to determine control over vote or value. The U.S. shareholder definition was expanded to U.S. persons owning 10 percent or more of vote or value in a foreign corporation. Also, GILTI was created, using some of the existing CFC principles for its calculation. Part IV discusses the GILTI regime in greater detail.

The Netherlands was required to adopt CFC rules in 2019 as a consequence of the European Union Anti-Tax Avoidance Directive (EU ATAD) discussed in greater detail in Part III. All the other European countries that did not have CFC rules in place also must include CFC rules in their legislation.

Part II. The Evolving U.S. Approach to taxing foreign income

Over the past several years there has been a debate around the world on how to eliminate base erosion, profit shifting, and tax deferral.[38] Some of the relevant efforts to solve this problem in the United States are reflected in former President George W. Bush's 2005 advisory panel on federal tax reform,[39] former Representative Dave Camp's tax legislation draft released in 2011,[40] his 2014[41] bill, as well as in the tax proposal[42] published by the Obama Administration in the President's Budget for Fiscal Year 2017.

More global efforts are reflected in the OECD BEPS Action reports released in 2015, which include a set of recommendations to enact rules for the prevention of base erosion and profit shifting.[43] The OECD is currently working to develop a proposal that may include recommendations for a minimum tax. In 2017, the European Union Council issued a directive regarding base erosion and profit shifting to be applied by 2019 in all 28 member states.[44] The recommendations included two possible options for designing CFC rules.[45]

37 Amicorp Group, "The most recent CFC case in China," July, 2017, https://www.amicorp.com/AmiNews/2017/july/the_most_recent_cfc_case_in_china.php.

38 OECD, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy."

39 President's Advisory Panel on Federal Tax Reform, "Federal Tax Reform," Jan. 7, 2005, https://govinfo.library.unt.edu/taxreformpanel/ .

40 Ernst & Young, "21st Annual Health Sciences Tax Conference," Dec. 5, 2011, https://www.ey.com/Publication/vwLUAssets/LS-International_tax_planning_in_todays_environment/$FILE/LS%20%20-%20%20International%20tax%20planning%20in%20todays%20environment.pdf.

41 Chairman Dave Camp, Committee on Ways and Means, "Tax Reform Act of 2014," Discussion Draft, https://web.archive.org/web/20170215131024/http://waysandmeans.house.gov/UploadedFiles/Ways_and_Means_Section_by_Section_Summary_FINAL_022614.pdf.

42 The White House and The Department of Treasury, "The President's Framework for Business Tax Reform Update," April 2016, 2, https://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf.

43 OECD/ G20, "Base Erosion and Profit Shifting Project: Explanatory Statement," 2015, https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf.

44 EUR-Lex, "Council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market," July 12, 2016, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.193.01.0001.01.ENG&toc=OJ:L:2016:193:TOC.

45 The options include taxing non-distributed passive income or non-distributed income from artificial business arrangements. See European Commission, "The Anti-Tax Avoidance Directive," Jan. 28, 2016, https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive_en.

The United States has taken what could be characterized as the most radical step toward trying to solve some of the aforementioned issues. The 2017 U.S. tax reform[46] may cause other countries to follow the steps taken to modify their legislation and enact more aggressive tax rules like those included in the TCJA. Germany and France are already discussing an option to enact a new global anti base-erosion (GloBE[47]) mechanism, a minimum tax similar to GILTI. Also, the OECD is following the steps of the U.S. to design a minimum tax[48] as part of the project to enact a set of recommendations for taxation of the digital economy.[49]

One of the most significant changes in the TCJA is GILTI, sort of a minimum tax created partially to encourage U.S. multinationals to bring their investments back to the U.S. and to tax foreign income that was not reached by CFC rules. GILTI should be examined more closely to determine whether it might be a good refence to design the minimum tax in other countries.

A. Grubert and Altshuler minimum tax proposal

In 2013, Harry Grubert, a U.S. Treasury Department analyst, and Rosanne Altshuler, a professor in the department of Economics at Rutgers University, published a paper titled "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax."[50] The study contains an analysis of different proposals made to improve the U.S. system when taxing cross-border income.

The study reviews four versions of a minimum tax on foreign income: a per country minimum tax with dividend exemption; no active business exception, but a current deduction against the minimum tax base for real investment in the location; a minimum tax at the overall foreign level at a higher rate; and an overall minimum tax with expensing of current investment against the taxable U.S. base. It also discusses a minimum tax at the CFC level but considers that CFC regulations can help to avoid a tax of that kind if created.

The study suggests that for income earned abroad, a minimum tax rate of 15 percent is an appropriate rate. In the proposal, foreign earned income is taxed at a rate equal to the statutory rate on the lower bracket of the U.S. corporate income tax in 2013.[51]

Grubert and Altshuler conclude by stating that a minimum tax makes it possible to improve the system of taxing cross-border income with respect to the lockout effect, income shifting, the choice of location, and to eliminate the complexity that already exists. This study can be considered the starting point for the discussions that resulted in the design of GILTI.[52]

46 Pub. L. No. 115–97, 131 Stat. 2054.

47 Stephanie Soong Johnston, "Germany, France Explore GLOBE Proposal to Tax Digital Economy," *Tax Notes*, DOC 2018-45048, Nov. 13, 2018, https://www.taxnotes.com/beps-expert/corporate-taxation/germany-france-explore-globe-proposal-tax-digital-economy/2018/11/14/28lmx.

48 OECD, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy."

49 Id.

50 Harry Grubert and Rossane Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," SSRN, May 12, 2013, http://dx.doi.org/10.2139/ssrn.2245128.

51 Martin A. Sullivan, "Designing Anti Base-Erosion Rules" *Tax Notes*, April 22, 2013, http://www.taxhistory.org/www/features.nsf/Articles/499620F25830720185257B550046CC6F?OpenDocument.

52 Mindy Herzfeld, "News Analysis: The Origins of GILTI," *Tax Notes* June 25, 2018, https://www.taxnotes.com/worldwide-tax-daily/tax-cuts-and-jobs-act/news-analysis-origins-gilti/2018/06/25/285cf?highlight=GILTI.

B. The Camp Bill

David Lee Camp[53] is a former Republican member of the U.S. House of Representatives from Michigan's 4th and 10th congressional districts. He was chairman of the House Committee on Ways and Means from 2011 to 2015.

In 2011 he developed a draft[54] of a tax reform bill, and three years later he presented the Tax Reform Act of 2014,[55] proposing a comprehensive tax reform addressing individuals, businesses, and pass-through entities. The main goals were to make the tax law simpler, fairer, and flatter.[56]

Camp considered the tax law was outdated and new legislation to promote economic growth and competitiveness for U.S. companies was necessary. Some of the features of the 2011 draft and 2014 bill are similar[57] to the actual reform that passed into law as the TCJA in 2017. One of the most relevant similarities is the idea of enacting a minimum tax as part of the solution to the international tax problems in the system.

In the 2011 draft, Camp included the idea that the U.S. had to transition from a worldwide system to a territorial system. For the transition, the Camp draft considered a one-time tax for untaxed foreign earnings that would be repatriated to the United States. Camp established two repatriation tax rates: one for cash and equivalents of 8.75 percent and one of 3.5 percent for earnings invested in plants and equipment.

With respect to CFC rules, the 2011 draft contained a provision that enabled an election for domestic corporations to treat foreign noncontrolled 10/50 corporations as CFCs. A 10/50 corporation is a foreign corporation in which a U.S. corporation owns at least 10 percent but not more than 50 percent of the stock of a foreign corporation. Variations for the application of these rules are contained in the draft in the case of foreign branches, partnerships, and controlled groups. It also contained a termination of current-year inclusion based on investments in U.S. property, the repeal of previously taxed earnings and profits, the creation of foreign base company intangible income (FBCII) as a new category of Subpart F income, and the inclusion of low-taxed cross-border income as Subpart F income.

Low-taxed cross-border income was required to be included in gross income of a CFC as Subpart F income, unless the taxpayer was able to establish that the income was derived in the home country of the CFC and that it was subject to an effective rate of income tax in excess of 10 percent. The draft proposed lowering the top marginal statutory corporate income tax rate to 25 percent.

53 Biographical Directory of the United States Congress, "Camp, David Lee," http://bioguide.congress.gov/scripts/biodisplay.pl?index=c000071.

54 Ernst & Young, "21st Annual Health Sciences Tax Conference."

55 Chairman Dave Camp, Committee on Ways and Means, "Statutory Text Tax Reform Act of 2014 Discussion Draft," Feb. 21, 2014, https://www.scribd.com/document/209414236/Statutory-Text-Tax-Reform-Act-of-2014-Discussion-Draft?ad_group=35871X943606Xc50693f93aa52bea63b09664fb86aaa5&campaign=SkimbitLtd&keyword=660149026&medium=affiliate&source=hp_affiliate.

56 Lory Montgomery, "Rep. Dave Camp patiently pursues tax reform," *The Washington Post*, July 28, 2012, https://www.washingtonpost.com/business/economy/rep-dave-camp-patiently-pursues-tax-reform/2012/07/27/gJQAPNJuGX_story.html?utm_term=.933f0f400594.

57 Herzfeld, "News Analysis: The Origins of GILTI."

The FBCII consisted of all the CFC intangible income that was subject to a foreign tax rate below 15 percent.[58] Intangible income was defined as income in excess of a 10 percent return on invested business assets. It included an exclusion of 10 percent of the qualified business asset investment from the tax base (QBAI),[59] similar to what now is known as QBAI as enacted in 2017.

In the 2014 bill, the threshold for the high tax exemption to Subpart F income was modified. Under the exemption, an item of income would not be treated as foreign base company income or insurance income for purposes of Subpart F if it had been taxed at or above a threshold rate on foreign tax. For foreign personal holding company income and foreign base company sales income, the threshold was set at 100 percent of the U.S. income tax rate. The bill proposed to reduce the corporate tax rate to 25 percent.

The proposal did not take the common approach to determine if income was active or passive to be categorized as Subpart F income and moved towards a low-tax or high-tax[60] approach for the inclusion rule. The revised categories of Subpart F income (inclusion of intangible income earned abroad) that would fall within the mobile category generally would be defined to include only income taxed at a rate less than 50 percent of the U.S. rate without regard to whether the income was earned as part of an active trade or business. Under the 2014 proposal, financial services income derived from active business could fall into a low-taxed category and therefore be taxed.

The new category of Subpart F income intangible income would have been taxed at a 15 percent rate. The new category of income was taxed below the 25 corporate rate proposed for U.S. corporations.

Finally, the 2014 Camp bill considered limiting the amount of deductible interest expense of a U.S. corporation that is a U.S. shareholder of one or more foreign corporations if the entities were part of the same group.[61] As a step towards a territorial system, the bill also included the elimination of section 902[62] regarding the foreign tax credit to U.S. shareholders.

C. The Obama Administration proposal

In 2015, then U.S. President Barack Obama included tax provisions in his Fiscal Year 2015 Budget[63] with an international plan to reform the U.S tax code.

In the case of CFC rules, the Obama proposal contained a per country minimum tax as part of the Subpart F regime. The tax was applicable to foreign earnings of CFCs or from branches performing services outside the U.S. The rate for the minimum tax was 19 percent, less a foreign tax credit of 85 percent of the per country average foreign effective tax rate. The proposal included foreign branches within the CFC regime. The minimum tax was applicable to all foreign earnings even when those earnings were not repatriated.

58 Jim Nunns, Amanda Eng, and Lydia Austin, "Description and Analysis of the Camp Tax Reform," Urban-Brookings Tax Policy Center, July 8, 2014, 15 https://www.taxpolicycenter.org/publications/description-and-analysis-camp-tax-reform-plan/full.

59 Mindy Herzfeld, "What the OECD Can Learn From the GILTI Regime," *Tax Notes* Jan. 14, 2019, https://www.taxnotes.com/tax-notes-today/global-intangible-low-taxed-income-gilti/what-oecd-can-learn-gilti-regime/2019/01/14/291qz?highlight=Dave%20camp.

60 Nunns, Eng, and Austin, "Description and Analysis of the Camp Tax Reform," 14.

61 Evan M. Migdail, "The Camp US tax reform proposal: what's inside?" DLA Piper, Feb. 28, 2014, https://www.dlapiper.com/en/us/insights/publications/2014/02/the-camp-us-tax-reform-proposal-whats-inside/.

62 KPMG, "2014 Ways and Means Chairman's Tax Reform Discussion Draft," March 2014, https://home.kpmg/content/dam/kpmg/pdf/2015/08/wm-discussion-draft-aug2015.pdf.

63 The White House and The Department of Treasury, "The President's Framework for Business Tax Reform Update."

A one-time transition tax on CFC earnings, that were not previously subject to U.S. tax at a 14 percent rate, was also part of the proposal. Limited to the U.S. tax rate, a foreign tax credit was allowed for the foreign taxes paid associated with foreign earnings. A limitation for interest expense was also applicable when U.S. operations of multinational groups were over-leveraged in comparison to their worldwide operations.

There are similarities in the Obama proposal to the 2014 Camp bill, namely the reduction in the U.S. corporate income tax rate, the inclusion of a minimum tax, and the interest expense limitation. The GILTI, as enacted in 2017, contains many similarities to the proposals in the Camp bill. The reduction of the corporate tax rate to 21 percent was a higher reduction than the one proposed by Camp or the Obama administration.

The differences between the Obama and Camp proposals include the rates for the one-time tax on unrepatriated foreign earnings (14 percent for the Obama proposal and separate rates of 8.75 percent and 3.5 percent in the Camp proposal), and the levels for the effective minimum tax on the future foreign earnings (19 percent in the Obama proposal and a 15 percent threshold under the Camp proposal). The Obama proposal also considered an 85 percent tax credit for taxes paid abroad which was not included in the Camp proposal.

The corporate rate proposed by Obama was 3 percentage points higher than the 25 percent rate proposed by Camp. The Obama proposal for a minimum tax targeted all income rather than the Camp approach that targeted only income associated with intangible assets or considered only to tax an excess return. The Camp approach to a minimum tax on his proposal was closer to the way GILTI operates.

Part III. Other efforts to address anti-base erosion concerns through CFC rules by the OECD and the European Commission.

A. OECD BEPS project and Action 3

After the global financial crisis in 2008, the OECD started work to reduce multinationals' base erosion and profit shifting activities. As a consequence of this effort, the OECD in 2015 published the BEPS project reports, containing recommendations regarding 15 action items[64] to modify the rules of member countries in some cases and in others to revise treaties and standardize them in addition to creating OECD transfer pricing guidelines.

Other BEPS actions contain recommendations to measure and monitor the application of all actions or contain guidelines for disclosing information regarding aggressive planning strategies. Broadly speaking, the BEPS project constitutes a non-mandatory set of possible rules (with different approaches) to eliminate base erosion and profit shifting.

Under the BEPS project there is also an initiative for non-OECD countries known as the inclusive framework. The inclusive framework is a reduced package of four out of 15 of the BEPS project

64 OECD, "BEPS Actions," 2015, http://www.oecd.org/ctp/beps-actions.htm.

actions created to guide countries that are not OECD members on the implementation on minimal standards for anti-base erosion rules. The inclusive framework has been accepted by 129 countries that are part of the initiative.[65] The BEPS actions that are part of the inclusive framework include Action 13 related to transfer pricing documentation (and country-by-country reporting), Action 14 with recommendations for dispute resolution (related to treaty disputes), Action 5 on harmful tax practices (focused on improving transparency), and Action 6 regarding treaty abuse (with model treaty provisions to help to prevent treaty abuse).[66]

The U.S. is an OECD member that has not always been aligned with what the OECD has recommended for addressing base erosion and profit shifting. In the specific case of the multilateral instrument[67] the U.S. has not followed the OECD standard and still uses its own treaty model. Following tax reform in 2017 the U.S. approach has changed significantly with respect to the OECD BEPS project. The U.S. is now taking leadership within the OECD on the project to design tax solutions for the digital economy.[68]

European Union countries have been more eager to adopt the BEPS project recommendations, relative to the U.S. The European Union Council included some of the OECD recommendations in the ATAD that was made mandatory for all its members. In some cases, countries such as France, Germany, and the United Kingdom already had similar rules in place before the OECD published the BEPS project recommendations. However, modifications to their rules have been and are being made as a consequence of ATAD.

The approach taken by the OECD in the BEPS project comes from a global perspective to address aggressive tax planning. The project does not take a country-by-country approach to analyze what causes problems on the taxation of each member country, but rather looks to the harmful practices taken by multinational companies to avoid taxation and tries to recommend a series of strategies to level the playing field for all the members to reduce this problem.

OECD BEPS Action 3[69] refers to possible ways to implement CFC rules and contains a set of recommendations that divides the constituent elements of the rules. Those building blocks are (i) exemptions and threshold requirements, (ii) definition of CFC income, (iii) rules for computing income, (iv) rules for attributing income, and (v) rules to prevent or eliminate double taxation.

The Action 3 report[70] is divided into chapters that carry the necessary elements to design and incorporate CFC rules into a country legislation. It contains two standards to define a CFC. The first standard is used to determine which entities are defined as CFCs. The second standard includes the definition of control and the different ways in which control can be measured (either directly or indirectly) with a threshold of 50 percent and the probability to be measured from a legal and economic standpoint (paragraphs 24 and 25). Both considerations are mostly applied in the same way

65 OECD, "Members of the Inclusive Framework on BEPS," March 2019, https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf.

66 OECD, "Background Brief: Inclusive Framework on BEPS," January 2017, http://www.oecd.org/tax/beps/background-brief-inclusive-framework-for-beps-implementation.pdf.

67 Mindy Herzfeld, "The U.S. Congress Does BEPS One Better," *Tax Notes*, Jan. 30, 2019, https://www.taxnotes.com/worldwide-tax-daily/tax-reform/news-analysis-us-congress-does-beps-one-better/2017/11/20/1xbqx?highlight=BEPS.

68 Stephanie Soong Johnston, "OECD to Consult on Proposed Global Tax Reforms for Digital Era," *Tax Notes*, Nov. 20, 2017, https://www.taxnotes.com/worldwide-tax-daily/base-erosion-and-profit-shifting-beps/oecd-consult-proposed-global-tax-reforms-digital-era/2019/01/30/2936t.

69 OECD, "Designing Effective Controlled Foreign Company Rules: Action 3," OECD Publishing, 2015, 13, http://dx.doi.org/10.1787/9789264241152-en.

70 Id., 21.

in the rules of the countries analyzed in this report.

The Action 3 report[71] also provides recommendations for threshold requirements. Once an entity is considered a CFC it is necessary to address to CFC taxation. When the rate of the country where the subsidiary is located is similar to the one of the parent company, it is not recommended to apply an additional tax at the CFC income. The income exemption when there is a similar rate in the different countries where a company has its operations can be combined with a white list to determine the application of the rules. The white list approach has been well received and incorporated by all the countries analyzed on this report. This list works as a reference of countries where, if there is CFC income production, that income is not subject to additional taxes in the country with the white list.

When CFC status is given to a foreign company, the Action 3 report recommends a method to differentiate which part of the income[72] produced by the CFC is considered taxable in the parent jurisdiction. Generally passive or mobile income are types of income taxable under CFC rules. CFC income is attributable to the shareholders or controlling parties of the CFC and taxed in the parent country. For the determination of income, it suggests different analysis including a substance analysis, a categorical analysis, and an excess profits analysis.

The substance analysis looks to whether the CFC has substantial activities in a country and is not simply incorporated with a tax planning purpose. The question that arises from this analysis is whether the CFC had the ability to earn income itself or not. This kind of analysis combined with a categorical analysis are part of what most EU members have in their rules. The categorical analysis divides income received by the CFC in the different categories by legal definition (dividends, royalties, and other), the source of income, and the relationships among the parties.

The excess profits analysis (similar to the framework for the GILTI[73] in the U.S. rules), is designed to target income that is derived from intangibles using an excess profits calculation. The analysis consists of the calculation of a normal rate of return that then is subtracted from income earned by the CFC; the difference between these two is treated as CFC income. When the rate of return is calculated, risk is given a consideration of 8 to 10 percentage points.

In the analysis, the excess profit return calculation provides an allowance for the normal returns on assets used in connection with the functions carried out in the low-tax jurisdiction. The eligible equity then consists of assets used in the active conduct of a trade or business. The treatment given to assets in a low-tax jurisdiction under the analysis is similar to the applicable treatment under GILTI when calculating the deduction for QBAI.

The normal rate of return is subtracted from all income earned by the CFC that was not subject to taxation under other CFC rules in the parent jurisdiction. The excess is included in CFC income (the same approach is applied for the GILTI calculation). The proposed analysis has a specific focus on income derived from intellectual property, something that was intended with GILTI, but due to some flaws in its design it not only reaches intangible income over a normal rate of return but also other income.

71 Id., 43.

72 Id., 61.

73 Pub. L. No. 115–97, section 14201(a), 131 Stat. 2054 (codified as included section 951A).

The excess profit analysis recommendation and GILTI calculation exclude from the final taxable amount any amount that is already taxed under any other CFC provisions. In the case of GILTI any Subpart F income that is taxed under Subpart F rules is excluded from the calculation of GILTI.

From the OECD perspective, the excess profits analysis can be made under an entity or a transactional approach. In the case of GILTI the calculation is made under the entity approach: all the CFC's tested income is added to determine the amount of a GILTI inclusion for any U.S. shareholder. Because the U.S. approach with GILTI follows some of the BEPS Action 3 recommendations, the OECD is looking at the practical side of GILTI to potentially design a similar rule.[74] However, the OECD would likely refine the design if it is recommended as a worldwide solution.

Following the CFC income computation[75] the Action 3 recommendations suggest two determinations: first i) which jurisdiction's rules should apply (the OECD recommends using the parent's jurisdiction rules), and second ii) whether any specific rules for computing CFC income are necessary to limit the use of losses generated by CFCs when permitted only to the country where the losses are generated or only to offset gains of other CFCs in the same jurisdiction.

Once income of a CFC is calculated[76] then that income can be attributed to the shareholders. The Action 3 report recommends determining which shareholders of a CFC should have income attributed to them, how much income should be attributed, when the income should be included in the returns of the taxpayers, how the income should be treated, and the determination of the applicable rate to that income.

Because CFC income can be taxed in the jurisdiction where the CFC is located, the Action 3 report[77] also suggests rules to prevent or eliminate double taxation. Some of the options suggested include a deduction for the taxes paid by the CFC to the parent company or credit to the parent company for the taxes paid or withheld to the CFC. An exemption method is not recommended because it goes against the purpose of the BEPS project and Action 3. In the case where the parent company has CFCs in multiple jurisdictions a proposed hierarchy rule is recommended to avoid double or multiple taxation or non-taxation scenarios.

Most of the countries considered below incorporated CFC rules before the existence of the BEPS project, while some others that already had the rules in place (like Germany and France are doing) incorporated modifications to their CFC regimes as a consequence of ATAD.

In general, countries have adopted an approach that focuses on the substance present in a CFC and the taxation of passive income (also known as the categorical approach). The U.S. may be the only country that has taken a more aggressive approach when moving to a territorial system with the incorporation of the Base Erosion Anti-Abuse Tax (BEAT) and GILTI.

74 Jennifer McLoughlin, "OECD Faces Tough Test With Global Minimum Tax," *Tax Notes*, Feb. 26, 2019, https://www.taxnotes.com/worldwide-tax-daily/corporate-taxation/oecd-faces-tough-test-global-minimum-tax/2019/02/26/295qv?highlight=OECD%20digital%20tax.

75 OECD, "Designing Effective Controlled Foreign Company Rules: Action 3," 57.

76 Id., 61.

77 Id., 65.

B. The freedom of establishment principle (FOE) and the *Cadbury Schweppes* case

EU member countries have to design and conform their legislation to the governing principles of the EU and the directives issued by its governing bodies.

One of the mandatory principles in the EU is the doctrine of non-discrimination contained in Article 18 of the Treaty[78] on the Functioning of the European Union. Under this principle, no EU member can be discriminated against in any EU country by any reason because the political and economic union is conceived as a common market. The principle guides the way in which the relations between members must be conducted, as well as the enactment of laws.

With the non-discrimination principle as a base, the Treaty develops the freedom of establishment (FOE)[79] contained in Articles 43, 49, and 56. Under the FOE any economic actor, person, or undertaking can pursue economic activities in any of the member states without any impediment. All CFC rules in the EU need to be designed around these principles.

An example of how the application of these principles affects the application of CFC rules in member countries is found with the *Cadbury Schweppes* case.[80] In that case, the UK Special Commissioners of Income Tax referred to the European Union Court of Justice questioning whether the UK motive test (an anti-diversion rule part of CFC rules in the UK) could be applied to a UK parent if there was a subsidiary in a low-taxed jurisdiction.

The company had two subsidiaries in Ireland undertaking treasury activities (carrying third-party debt) as an active business where the tax rate was 10 percent. The UK Special Commissioners considered that the establishment of companies in other member states for the only purpose of taking advantage of a more favorable tax regime was an abuse of treaty freedoms. The UK Special Commissioners asked the European Court of Justice whether applying the UK CFC regime to the parent company in the UK should be considered as discrimination under the principles contained in the EU Treaty, and if it was considered as discrimination, then if the application of the UK rules (motive test) was justified to prevent tax avoidance.

The European Court[81] of Justice decided that a community national seeking profit from tax advantages in force in a member state cannot itself be deprived of the right to rely on the treaty provisions despite the existence of tax motives if the controlled company is actually established in the host member state and carries on genuine economic activities there. Also, in its judgment, the Court mentions that a company established in a member state with a more favorable tax treatment cannot be considered to be in abuse of the FOE.

The Court concluded that it is only permissible for member states to enact laws that violate the FOE principle when the abuse being targeted is related to cases where there is evidence that the allegedly abusive activity is being undertaken as a wholly artificial arrangement only to obtain tax benefits

78 European Union, "Consolidated version of The Treaty on the Functioning of the European Union," *Official Journal of the European Union C* 326:47, October 2012, https://eur-lex.europa.eu/resource.html?uri=cellar:2bf140bf-a3f8-4ab2-b506-fd71826e6da6.0023.02/DOC_2&format=PDF.

79 Id.

80 PwC EU Direct Tax Group, "Judgment in the Cadbury Schweppes Plc," Sept. 12, 2006, https://www.pwc.com/gx/en/eu-tax-news/pdf/pwc_2006-022-newsalert12september2006.pdf.

81 Sara Catley, "Cadbury Schweppes: how sweet it is to be loved by the EU," Thompson Reuters, September 2006, https://uk.practicallaw.thomsonreuters.com/1-204-7986?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1.

derived from it. The Court defined a wholly artificial arrangement to occur only in a limited set of cases such as when a CFC is established only for tax purposes and does not exist physically in terms of premises, staff, and equipment, and does not intend to carry on genuine economic activity in the host member state.

Despite the resolution of the case, which limits the application of CFC rules, the EU Council has enacted directives ordering members to enact stronger CFC rules, trying to eliminate the loopholes that some of the countries have in their legislation, as to incorporate the rules in EU member countries that did not have the rules until 2016 (all of this with the ATAD[82]).

C. EU Council resolutions and Anti-Tax Avoidance Directive

In 2010, the EU Council issued a resolution[83] following the recommendations of the European Parliament and the Economic and Social Committee ("ECOSOC") regarding the coordination of CFC rules and thin capitalization rules in the European Union. The stated purpose of the resolution was to find a proper balance between the interest of combating abuse and to protect the tax bases of member states, while avoiding disproportionate restrictions on cross-border activities within the EU.

From the EU Council's[84] perspective, CFC rules need to be designed properly to avoid the restriction of the exercise of treaty freedoms. This may occur when the application of the rules entails a difference in treatment between objectively comparable domestic and cross-border situations.

In 2016, the European Commission (the "Commission") presented a proposal to incorporate CFC rules in all EU member countries as part of a package of tax anti-avoidance measures. Six months later the European Council adopted the ATAD (EU 2016/1164)[85] laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

The directive contains five legally binding anti-abuse measures, which all member states are required to adopt to combat common forms of aggressive tax planning. Included in the directive are CFC rules. The final date for the application of ATAD was January 2019. The ATAD was made mandatory for all EU members, part of what the OECD recommended in the BEPS project.

According to Article 7 of ATAD, a CFC can be a foreign entity or permanent establishment (PE) of which the profits are not subject or exempt from tax, if the shareholder holds directly or indirectly (or with associated enterprises) a participation of 50 percent of the voting rights, capital, or profits of an entity.

A second requirement to qualify as a CFC is that the corporate tax paid by the entity on its profits is lower than the difference between the corporate tax that would have been charged on the entity by the member state under the applicable tax system of the taxpayer or the actual corporate tax paid by the entity on its profits.

82 EUR-Lex, "Council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market."

83 EUR-Lex, "Council Resolution 2010/C 156/01 on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union," June 8, 2010, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32010G0616%2801%29.

84 Id.

85 EUR-Lex, "Council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market."

The directive proposes two alternative ways for member states to implement a CFC regime. The first option focuses on passive income earned by an entity that qualifies as a CFC, which means that certain kinds of income earned by the CFC that are not distributed during a taxable year have to be included in the tax base of the shareholder.

The list of passive income includes:

i. interest or any other income generated by financial assets;

ii. royalties or any other income generated from intellectual property;

iii. dividends and income from the disposal of shares;

iv. income from financial leasing;

v. income from insurance, banking, and other financial activities;

vi. income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises and add no or little economic value;

An exception to the passive income rule is applicable when the CFC carries on substantial economic activity, meaning that its activities are supported by staff, equipment, assets, and premises. If this exception applies, the CFC income is not included in the shareholder's tax base. The rules use a standard to tax passive income in low-tax jurisdictions and are designed to tax CFC income in cases where wholly artificial arrangements are a reason why the CFC was created. The rules are not designed to penalize or disincentivize active business activities that may occur in the EU.

Under this alternative, an entity or PE is not considered a CFC if one-third or less of its income falls into one of the aforementioned categories of passive income. Also, financial undertakings may not be considered CFCs if one-third or less of their income comes from transactions with the taxpayer or its associated enterprises.

The second alternative (Article (7(1)(a)) looks to the non-distributed income of a CFC that arises from non-genuine arrangements that have been in place for the essential purpose of obtaining a tax advantage. The directive defines non-genuine arrangements as those where the CFC does not bear any risks or owns assets and the income generated is not supported by significant people functions.

There is also a *de minimis* exception for CFC income. If accounting profits of a CFC are less than EUR 750,000, non-trading income is less than EUR 75,000, or if the accounting profits are less than 10 percent of the operating costs of the CFC on that period, there is no inclusion of income in the parent company required.

Article 8 of ATAD for the computation of CFC income,[86] orders:

> CFC income has to be included in the tax base of the taxpayer when the rules apply to passive income. The law of the Member State applies to determine CFC income where the tax is included. Losses are limited to reduce CFC gains and can be carried forward for future periods.

CFC income is calculated according to the arm's length principle, in cases where the non-genuine arrangements rule applies. The amount of income to be included in the tax base of the taxpayer is limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company in cases where it is derived from non-genuine arrangements that have been put in place for the essential purpose to obtain a tax advantage.

Other relevant considerations, after the computation of CFC income in any of the alternatives, include:

- The attribution of CFC income (the directive provides that this should be accomplished proportionately to a shareholder's participation in the entity);
- Timing of the inclusion (the directive provides that income is includible in the tax base of the taxpayer in the tax year of the entity).
- Eliminating a second level of tax in the event of a distribution of pretaxed profits from a CFC.

A participation exemption rule applies for capital gains when a taxpayer disposes of CFC stock and the proceeds had previously been taxed by an inclusion derived from CFC rules. The amount that has already been taxed is allowed as a deduction from the tax base to prevent double taxation.

The member state of the taxpayer allows the deduction of the tax paid by the CFC from the tax liability of the taxpayer in the state of residence.

The main purpose of the ATAD directive is to create a minimum level of protection against corporate tax base erosion and profit shifting throughout the EU, while ensuring a fairer and more stable environment for businesses.[87] Countries such as Ireland, Luxembourg, Belgium, and Netherlands that did not previously have CFC rules in place have already drafted and are discussing or passed reforms to their tax laws. The first revision date of the implementation of the rules will be done by August 2020.

Even if some of the CFC rules contained in the ATAD are similar in design to the ones that the U.S. has in place, the territoriality feature differs from what the U.S. did in the TCJA. In general, the U.S. approach in the TCJA reflects a broader perspective on how to tax outbound investments while remaining attractive for multinational investment. One of the purposes of the directive is for all member countries to have similar rules to encourage the creation of real business activities and to prevent taxpayers from structuring transactions solely for tax planning purposes.

86 Id.

87 European Commission, "The Anti-Tax Avoidance Directive."

Part IV. The U.S. CFC Regime and the TCJA

Before enactment of the TCJA, the United States had a worldwide tax system. That meant that for U.S. persons, all of their foreign income was taxable in the U.S., and taxpayers were allowed a credit for foreign taxes paid as a means of preventing double taxation. While certain types of CFC income were subject to immediate tax in the U. S., the income of CFCs was otherwise only taxed when profits were repatriated. As a result, it was common practice of U.S. multinationals to keep their foreign earnings offshore. There was a constant increase of deferral of U.S. tax on foreign earnings through complex chains of ownership structures that were put in place to reduce multinationals' worldwide tax obligations.

Before TCJA was adopted, an estimated $2.6 trillion in foreign earnings was held by offshore entities of U.S. multinationals, and about $1 trillion of that amount was cash. [88] This was a sufficient reason for the U.S. government to decide about how to address this issue and to provide an incentive for companies to bring these earnings back to the U.S. As mentioned previously, the TCJA included new measures to target base erosion and profit shifting alongside incentives to bring profits and assets back to the country.

Some of these measures include the reduction of the corporate tax rate (from 35 to 21 percent) and the enactment of new provisions including the Foreign Derived Intangible Income (FDII), BEAT,[89] and GILTI. The new tax law also moved the U.S. to a partial territorial system, and GILTI broadened the range of income from CFCs that is taxable to U.S. shareholders of CFCs. In some cases, GILTI applies not only passive income but all the income generated by a CFC if it is considered low-taxed, a wider range of income than that which applied under subpart F rules. In a move towards a territorial system, the U.S. also incorporated a dividend received deduction.[90] A further move to complement territoriality is the transition tax,[91] which is a one-time tax to post 1986 accumulated deferred income applied at a rate of 15.5 percent in the case of cash or cash equivalents and an 8 percent rate for the remaining earnings and profits held abroad. The U.S. reformed the tax system to make it more competitive and to bring U.S. overseas earnings back to the country.

As a backup to GILTI and to apply a tax directly to base-eroding payments, the TCJA also enacted the BEAT. The BEAT[92] is a minimum tax that applies to multinational corporations with gross receipts of $500 million or more, to a tax base that includes otherwise deductible cross-border payments made between related companies when those payments exceed 3 percent of the total deductions taken by the corporation or 2 percent in the case of financial firms.

It may be too early to determine the consequences of the TCJA, but a number of studies[93] have modeled the effects of the TCJA in profit shifting. These studies indicate that the reduction of the corporate tax rate by 14 percentage points may encourage U.S. multinationals to increase their investments in the U.S.

88 Kimberly A. Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act."

89 Pub. L. No. 115–97, section 14401, 131 Stat. 2054 (codified as amended at section 59A).

90 Pub. L. No. 115–97, section 14101, 131 Stat. 2054 (codified as amended at section 245A).

91 Pub. L. No. 115–97, section 14103, 131 Stat. 2054 (codified as amended at section 965).

92 Pub. L. No. 115–97, section 14401, 131 Stat. 2054 (codified as amended at section 59A).

93 Kimberly A. Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act."

There is also a part of the academic community[94] that disagrees with the rationale behind the changes enacted in the TCJA and would have preferred a destination-based corporate tax as a better solution for the BEPS problem and deferral.[95]

On the other side, there is another part of the academic community and several countries that are taking a close look at what the U.S. has done with the GILTI and considering ways to use that model for the rest of the world. Not only has the OECD[96] announced that it is starting to discuss the possibility of a minimum tax, but also France and Germany have announced that they are designing a global anti-base erosion proposal (GloBE).[97] The OECD effort also includes a proposal for a tax on base-eroding outbound payments. Together these would create a new income inclusion rule and a safeguard against treaty overrides.

In March of 2019, Netherlands and Germany released a joint statement where they mentioned that both countries and France had agreed to work together on a minimum tax rate[98] to combat tax avoidance. As part of this work, in 2021 the Dutch government will introduce a withholding tax on interests and royalties. The tax is expected to apply to payments between Netherlands and companies based in countries with a corporate rate lower than 9 percent.

The U.S. CFC rules and GILTI

Under the U.S. rules, a foreign entity is considered a CFC[99] if 50 percent or more of vote or value is controlled by U.S. shareholders. A U.S. shareholder is a U.S. person who owns 10 percent of more of vote or value in the company. Control and ownership under the U.S. rules are determined from direct, indirect, and constructive ownership perspectives.[100]

Once an entity is categorized as a CFC, income that falls into one of the categories as Subpart F[101] income must be included in the gross income of the parent company and taxed at the U.S. rate. CFC income is determined at the entity level and then attributed to a U.S. shareholder to be taxed in the U.S.

Before tax reform, U.S. rules primarily targeted passive income and income derived from low-tax jurisdictions to be taxed as Subpart F income. Subpart F income has subcategories that include insurance income, foreign base company income (foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income [this last category eliminated with the TCJA]), income subject to the international boycott rules, illegal bribes, kickbacks or other unlawful payments, and income derived from any foreign country.

94 Bill Parks, "Brexit — The U.K.'s Opportunity to Fix the World's Corporate Tax System," *Tax Notes*, Nov. 28, 2018, https://www.taxnotes.com/worldwide-tax-daily/corporate-taxation/brexit-uks-opportunity-fix-worlds-corporate-tax-system/2018/11/28/28kjh.

95 Stephen J. Entin and Kyle Pomerleau, "The House GOP's Destination-Based Cash Flow Tax, Explained," Tax Foundation, June 30, 2016, https://taxfoundation.org/house-gop-s-destination-based-cash-flow-tax-explained/.

96 OECD, "Webcast: OECD Tax Talks," Jan. 29, 2019, https://oecdtv.webtv-solution.com/5287/or/webcast_oecd_tax_talks.html.

97 Soong Johnston, "Germany, France Explore GLOBE Proposal to Tax Digital Economy."

98 Government of the Netherlands, "Netherlands and Germany agree to work together on a minimum tax rate," March 27, 2019, https://www.government.nl/latest/news/2019/03/27/netherlands-and-germany-agree-to-work-together-on-minimum-tax-rate.

99 Section 957.

100 Section 958(a) and (b).

101 Section 952.

After 2017, GILTI[102] effectively expanded the CFC regime and the BEAT[103] was introduced to make the system stronger against base erosion. GILTI broadened the tax base for U.S. multinational companies, not only making the U.S. system more complex, but potentially more effective against base erosion and profit shifting.

As in CFC rules, GILTI rules only apply to a CFC[104] if it is 50 percent owned by U.S. shareholders. To calculate the GILTI inclusion, tested income and tested losses of a CFC are netted to determine if there is tested income that will be taxed by GILTI.[105] GILTI also limits the tax credit from the taxes paid corresponding to the GILTI inclusion to 80 percent.

GILTI captures most of the income earned by a CFC with limited exclusions (as Subpart F income and high-taxed income). All the income not excluded is considered for the calculation of tested income. GILTI makes no distinction between active and passive income.

The GILTI regime excludes from tested income 10 percent of QBAI.[106] The QBAI calculation is made on an entity basis, and the amount of interest expense relevant to determine the tested income is subtracted from QBAI. The result of the calculation is the Net Deemed Tangible Income Return that is attributable at the shareholder level. The attribution is only considered for the GILTI calculation when it gives a positive result.

The positive tested income is aggregated at the shareholder level,[107] and the total amount is netted against tested losses. In the GILTI calculation there is a 50 percent deduction of GILTI income[108] at the shareholder level.

A provision for previously taxed income[109] (PTI) allows that income that is taxed as GILTI is not taxed twice, as with other categories of CFC income. PTI tracking ensures the possibility to make the withholding taxes creditable.

In a recent analysis,[110] Martin A. Sullivan, chief economist and contributing editor for Tax Analysts, concluded that the TCJA favors inbound investments in the U.S. and reduces the incentives for U.S. multinationals for outbound investments. The factors that come into play for his conclusion are that the reduction of the corporate rate in the U.S. (to 21 percent), plus the allowance to expense tangible investments, and the deduction for foreign-derived intangible income, provide an incentive for domestic capital formation.

Sullivan establishes the economic scenarios where the application of GILTI results in an effective tax rate that can be less than the statutory tax rate. The scenarios described by Sullivan that generate this result are those where the net deemed tangible income return exceeds tested income (remember

102 Pub. L. No. 115–97, section 14201, 131 Stat. 2054 (codified as amended at section 951A).

103 Pub. L. No. 115–97, section 14401, 131 Stat. 2054 (codified as amended at section 59A).

104 Section 951A(a).

105 Section 951A(c).

106 Section 951A(b)(2)(a).

107 Section 951(A)(a), (c).

108 Pub. L. No. 115–97, section 14202, 131 Stat. 2054 (codified as amended at section 250).

109 IRS Notice 2019/01, 2019-3 IRB 1.

110 Martin A. Sullivan, "Economic Analysis: Post-Reform Double Taxation and Double Nontaxation," *Tax Notes*, Jan. 8, 2019, https://www.taxnotes.com/tax-reform/economic-analysis-post-reform-double-taxation-and-double-nontaxation.

that there is no tax when the GILTI calculation results in a negative number). This results in effective tax rates that can be negative or not nearly close to 21 percent. From this perspective if a U.S. company decides to embark on a new foreign investment, in some particular cases the effective tax rate on that marginal investment could be much less than the U.S. rate.

CFC rules and Subpart F income are the main pillars of the system to protect the tax base of multinational companies from base erosion. With the constant changes and fast developments of commerce and the different ways to do business, there was a necessity to fortify the U.S. system with a new set of measures to protect the tax base. The elimination of deferral brought about the different approach to taxing foreign earnings through GILTI.

Part V. The different approaches taken to CFC rules

A. The French CFC Regime

The French tax regime operates on a strict territorial basis, where only profits generated in the country are subject to tax in France. In France, CFC rules were created in 1980.

CFC Rules in France apply to foreign subsidiaries or permanent establishments of a French company that are controlled by a French parent company. Indirect and direct control of shares or voting rights are considered to determine the CFC status.[111]

The control threshold for CFC purposes is 50 percent, and the rules apply to income generated by any branch or entity that is established or organized in a low-tax jurisdiction, meaning a jurisdiction with a tax rate that is less than 50 percent of the French rate. An anti-abuse provision reduces the 50 percent control threshold to 5 percent if more than 50 percent of the share capital of the foreign entity is directly or indirectly held through French or foreign companies controlled by the French parent company.[112]

If the shares are listed on a regulated market, the French tax authority is obliged to demonstrate that the companies are acting in concert to evidence there is control.

The rules apply when a French company has a subsidiary, branch, or a PE in a different country, and it is deemed to have received income from the CFC. Taxation applies to the pro rata share of income that the French parent should have received. Profits of the foreign entity are aggregated to the tax base of the parent and taxed in France. Also, losses from the parent company can be used to offset the CFC's profits. The French legislation provides that when foreign source income is taxed in France, foreign withholding taxes may be creditable against the French corporate tax in accordance with treaties. There is no deduction for taxes that cannot be credited for any reason.[113]

111 Deloitte, "International Tax France Highlights 2019," April, 2019, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-francehighlights-2018.pdf.

112 Orbitax, "Guideline on French CFC rules published – details," Jan. 16, 2007, https://www.orbitax.com/news/archive.php/Guideline--on-French-CFC-rules-372.

113 Philippe Derouin, "The Inward Investment and International Taxation Review France," *The Law Reviews*, February, 2018), https://thelawreviews.co.uk/edition/the-inward-investment-and-international-taxation-review-edition-8/1152984/france.

A French parent can avoid CFC rules if it demonstrates that the foreign entity carries on effective trading or manufacturing activity, conducted from its country of establishment or registered office. Also, the CFC regime is not applicable to EU companies (safe harbor rule[114]), unless the French tax authority demonstrates that the questioned structure was created exclusively with tax avoidance purposes.

France did not include any modifications to its current CFC regime in the 2019 Budget Bill to reflect the ATAD. The finance bill is focused on other ATAD measures, such as the participation exemption of eligible dividends, which would be increased from 95 percent to 99 percent when dividends are received from French companies within the same consolidated group, EU companies, or companies incorporated in the European Economic Area.[115]

D. The German CFC Regime

Germany has had a CFC regime since 1972, when the German Foreign Transactions Tax Act was enacted.[116]

Under the German regime, a CFC is a foreign company where its capital or voting rights are either directly or indirectly majority-owned by German residents at the end of its fiscal year (the rules apply even when there is a partnership in the chain of companies). The rules apply if the company generates passive income, and its income is taxed below the 25 percent threshold.[117] The effective rate is calculated as a ratio between the taxes levied in the residence state on the passive income of the CFC and the tax base of the CFC determined under German tax law. The CFC is treated as a German company to calculate the ratio; if the foreign tax charge is less than 25 percent of the German charge, the rule is applied. All the requirements must be met simultaneously.[118]

The control threshold for CFC purposes is 50 percent. The share of ownership of all German residents is added to determine ownership; if the sum is more than 50 percent, the rule is applied. Any shareholder with 1 percent or less can be attributed income from the CFC under the German rules.

German law differentiates between passive and active income (there is a list of what qualifies as active income[119]). Examples of active income are agricultural and forestry income, banking and insurance, profits distributions, and income from trading activities. Under German rules the taxpayer rather than the tax administration carries the proof burden to demonstrate if the income received is active or passive income.[120]

114 Id.

115 Deloitte tax@hand, "2019 finance bill contains BEPS / EU ATAD 1 measures," Sept. 9, 2016, https://www.taxathand.com/article/10413/France/2018/2019-finance-bill-contains-BEPS-EU-ATAD-1-measures.

116 Weiss, "Recent Developments in the German Tax Treatment of CFCs," 439.

117 DE: Foreign Transactions Tax Act, (Außensteuergesetz), section 7, National Legislation IBFD.

118 Deloitte, "Taxation and Investment in Germany 2017," May, 2017, 19, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-germanyguide-2017.pdf.

119 Id.

120 Weiss, "Recent Developments in the German Tax Treatment of CFCs," 441.

German tax law also has a *de minimis* rule that exempts low-taxed passive income if it does not exceed 10 percent of the overall income of the CFC,[121] and neither the gross income of the CFC nor the German shareholder exceeds EUR 80,000 during the tax year.

If the CFC is based inside the EU or the European Economic Area, and the taxpayer can prove to the authorities that the company pursues real economic activities, then income from the CFC cannot be attributed to the German shareholder.[122]

Once CFC income is determined, the amount is added to the taxable income of the German shareholder. Taxes paid by the CFC are creditable to the German corporate shareholder only when they are not refundable. Losses generated by a CFC cannot be attributed to the German shareholders but can be carried forward to offset future income of the CFC.

Taxes paid on the attributed CFC income to a shareholder or on the property underlying the attributed income are deductible from the attributed income or may be credited against the German tax (corporate or income tax) charged in the year of payment.[123]

Dividends actually paid by a CFC are exempt to their German shareholders under the participation exemption. The rule is applicable for corporations without exception. In the case of non-corporate shareholders, dividends are exempt only if distributed within a period of seven years from when the CFC income was attributed to the shareholder. If shares of the CFC are sold, capital gains derived from the sale are exempt, subject to the same conditions as dividends, including the seven-year rule period.[124]

A 2018 report[125] from Deutsche Bank explains that CFC taxation is particularly restrictive in Germany. German CFC rules are outdated and are designed to ensure that a certain portion of the foreign income is adequately taxed. According to the report the German tax rules put non-German subsidiaries of German parent companies in other countries at a disadvantage. The report argues that the definition of low-tax rate is too high with a 25 percent rate threshold triggering the application of the rules.

That may be the reason why France and Germany are converging on the creation of a minimum tax to harmonize the EU system.

121 Id.

122 Id.

123 Deloitte, "Taxation and Investment in Germany 2017," 19.

124 Deloitte, "International Tax: Germany Highlights 2019," January 2019, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-germanyhighlights-2019.pdf.

125 Dieter Bräuninger, "German corporate taxes: Growing need for action," Deutsche Bank, Sept. 14, 2018, https://www.dbresearch.com/PROD/RPS_EN-PROD/PROD0000000000476988/German_corporate_taxes%3A_Growing_need_for_action.pdf.

E. The Dutch CFC Regime

The corporate tax system[126] in Netherlands contains a number of features to attract investors. The country did not have a CFC regime until it was made mandatory by ATAD for 2019.

Some of the features of the corporate tax regime in Netherlands include a full participation exemption for capital gains and dividends, favorable tax regimes for patent income, investment vehicles, and income derived from shipping activities. Also, there is no withholding taxation on interest or royalty payments made by the taxpayer.[127]

The Dutch Finance Minister has recently announced a review of the entire tax system to gain a perspective of what should be included in a tax reform effort. A conditional withholding on payments to low-tax jurisdictions will be part of the modifications made to the Dutch system. The plan is to incorporate the conditional withholding regime in 2021.[128]

A foreign company or a permanent establishment is considered a CFC for Dutch law purposes when the entity is a tax resident in a jurisdiction without a corporate income tax, or tax resident in a jurisdiction with a statutory corporate income tax rate of lower than 9 percent, or tax resident of a jurisdiction included in the EU blacklist of non-cooperative jurisdictions.[129]

A foreign entity is considered a CFC if a Dutch corporate taxpayer has a direct or indirect interest of more than 50 percent in a low-taxed foreign subsidiary or PE.[130]

All non-distributed income of the CFC such as dividends, interests, royalties, benefits from the sale of shares, and leasing income, less related costs, are attributed to the tax base of the parent company and taxed according to the Dutch tax regime. In cases where some of the passive income items mentioned are less than 30 percent of the total income or if the CFC carries on substantial economic activities in the country of establishment. those items of income are not taxed as CFC income.

The legislation provides a safe harbor if the CFC is engaged in substantial activities. This exception is satisfied if the wage costs of the CFC are at least 100,000 Euro and the CFC has an office space at its disposal for a period of at least 24 months.

Even if there have been modifications to the Dutch tax system before ATAD, the rules still need to be tightened to comply with all the EU requirements mandated in the Directive. For example, the rules include an escape clause that allows companies to implement minimal economic substance measures (safe harbor rules) and thereby avoid application of the CFC rules altogether.[131]

126 PwC, "Worldwide Tax Summaries: Corporate Taxes 2017/18 Europe," June 1, 2017, https://www.pwc.com/gx/en/tax/corporate-tax/worldwide-tax-summaries/pwc-worldwide-tax-summaries-corporate-taxes-2017-18-europe.pdf.

127 Deloitte, "International Tax: Netherlands Highlights 2019," January 2019, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-netherlandshighlights-2019.pdf.

128 Michael Nienaber, "Germany gets Netherlands on board for global tax revamp," Reuters, March, 2019, https://www.reuters.com/article/us-oecd-tax-germany-netherlands-idUSKCN1R81S4. See also Stephanie Soong Johnston, "Dutch Eye French-German Minimum Tax Proposal with Interest," *Tax Notes*, Jan. 15, 2019, https://www.taxnotes.com/worldwide-tax-daily/tax-avoidance-and-evasion/dutch-eye-french-german-minimum-tax-proposal-interest/2019/01/15/291yr. Where the author quotes Francis Weyzig, that states the Dutch CFC rules include an escape clause that allows companies to implement minimal economic substance measures.

129 PwC, "Dutch implementation of directive against tax avoidance (ATAD 1)," Dec. 18, 2018, https://www.pwc.nl/en/budget-day/dutch-implementation-of-directive-against-tax-avoidance.html.

130 Id.

131 Soong Johnston, "Dutch Eye French-German Minimum Tax Proposal with Interest."

F. The United Kingdom CFC Regime

The UK has had CFC rules since 1984,[132] but in 2012 the UK government enacted a new CFC regime. Under the UK rules a CFC is any nonresident company of which a UK person holds a 25 percent interest directly or indirectly.[133]

In European countries that are part of the EU the application of CFC rules is limited by the application of EU law, the EU constitution, and the judgments of the European Court of Justice. An example of this is the *Cadbury Schweppes* case where treaty freedoms prevailed over the application of CFC rules. A more detailed explanation of the case is provided in Part III.

Control is determined by referring to different standards including legal control (possession of shares or voting rights), economic control (entitlement to a majority of the proceeds or the disposal of the shares of a company), or accounting control (parent undertaking for financial purposes under FRS2, the accounting standard under British rules). Control is also determined under a joint venture test for international companies.[134]

The basic aim of the CFC regime is to identify whether all or a part of the profits of a non-resident UK company should be brought into charge to a UK resident. The charge is the UK tax applied to a UK shareholder of a CFC that applies to the taxable income, not including gains of the CFC.

The CFC regime operates by applying a series of charge getaways to the different types of profits when those profits are not tax-exempt under British law. The getaways are a series of tests that work as filters for profits in order to determine if they have to be taxed. The application of each filter works in sequence. There are five chapters in the UK legislation that explain how these different filters (getaways) can limit or eliminate the application of CFC rules.

A chargeable company[135] is a UK resident company that has sufficient interest in a CFC, with enough chargeable profits to be taxed. A chargeable company will suffer a CFC charge (similar to Subpart F income) only if there are chargeable profits of the CFC, and those profits pass through any of the different getaways (thresholds for CFC charges to apply).

At the entity level there are five exemptions[136] to avoid CFC charges. If any of those apply, the CFC does not need to apply the getaway provisions and all the CFC profits will be exempt. The exemptions are:

- In the case of corporate restructuring the law provides an exempt period for transfers with no charges.

132 Alastair Slater, "Controlled foreign companies: overview," Thomson Reuters, January 2013, https://uk.practicallaw.thomsonreuters.com/9-523-7205?originationContext=document&transitionType=DocumentItem&contextData=%28sc.Default%29&comp=pluk.

133 Deloitte, "International Tax: United Kingdom Highlights 2019," January 2019, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-unitedkingdomhighlights-2019.pdf.

134 HM Revenue and Customs, "Controlled Foreign Corporations and Tax Avoidance," Oct. 10, 2018, https://www.gov.uk/guidance/controlled-foreign-company-an-overview.

135 Id.

136 Id.

- Excluded territories exemption. (When the excluded territory rate exceeds 75 percent of the UK main corporate rate, meaning that taxation is fairly similar in the territory and in the UK.)
- Low profits exemption. (Profits in a period are not more than £ 50,000 or £ 500,000 if non-trading profits are £ 50,000.)
- Low profit margin exemption. (If profits are not more than 10 percent of relevant operating expenditure.)
- Tax exemption. (If the CFC local tax amount is at least 75 percent of the corresponding UK tax.)

If profits are not in any of the exempted categories and pass through one or more of the charge getaways (compromising the Chapter 3 getaway), it is necessary to determine the amount of chargeable profits. The chargeable profits categories are:

- Business profits attributable to UK activities. (concept of deemed UK PE).
- Non-trading finance profits.
- Trading finance profits.
- Captive insurance profits.

To calculate the amount of a CFC charge, it is necessary to apportion the CFC's chargeable profits and creditable tax among the persons with relevant interests in the CFC and charge a sum equal to corporation tax on the apportioned chargeable profits of the CFC, on each chargeable company.

The UK has agreed to modify its CFC rules according to ATAD at least until the Brexit process is completed. The OECD BEPS recommendations have not been considered by the UK government because the authority considers that its CFC rules have incorporated standards that are higher than the ones in the project.

HM Revenue & Customs (HMRC) has issued a policy note,[137] explaining the changes to be made to CFC rules as a consequence of ATAD.

The first[138] relates to the scope of CFC rules, which will be expanded for the purposes of determining if an entity is a CFC. The ATAD requires countries to incorporate a measure of control that takes into account interest held by nonresidents, associates, or related parties, which is something that the UK rules do not take into account under the current rules. The second change restricts the scope of the full and partial exemption rules for finance profits that have been generated by significant people's functions carried out by a controlling company in an EU member state. To comply with ATAD the UK needs to amend its CFC rules to eliminate the exemption that benefits non-trade finance profits.

137 HM Revenue and Customs, "Anti-Avoidance Directive about controlled foreign companies," July 6, 2018, https://www.gov.uk/government/publications/anti-avoidance-directive-about-controlled-foreign-companies-and-eu-exit/anti-avoidance-directive-about-controlled-foreign-companies-and-eu-exit.

138 EY, "UK takes steps to implement EU Anti-Tax Avoidance Directive," July 10, 2018, https://www.ey.com/gl/en/services/tax/international-tax/alert--uk-takes-steps-to-implement-eu-anti-tax-avoidance-directive.

HRMC has stated that it believes that the UK CFC regime is in line with the ATAD approach, but that minor changes are required, as those mentioned above.

G. The Spanish CFC Regime

Spain adopted a CFC regime in 1995.[139] Under the Spanish rules a foreign company is considered a CFC if 50 percent or more (directly or indirectly) of its share of capital, equity, profits, or voting rights are controlled by Spanish shareholders.[140]

Additionally, a foreign company is considered a CFC if the income tax rate is less than 75 percent of the Spanish tax rate. The CFC rules are not applicable to companies that reside in the EU, are set up for economic reasons, and carry on a business activity.

The Spanish legislation contains two ways for applying the CFC rules.

First, a Global CFC[141] regulation applies when a foreign company does not have an adequate structure (HR, material operations) unless it can be justified that there is a specific reason for the existence of the foreign company. If the purpose of existence of the company is not demonstrated and there is not material evidence of the existence of the company, all the income derived from it has to be included in the tax base of the Spanish parent company.

The second case[142] in which the rules apply is when a foreign company complies with the international tax transparency regime but the application of the Global CFC is not applicable. In such case, income in the following categories obtained by the CFC is taxable to the parent:

i. income generated from real estate assets not assigned to a business activity,

ii. income generated from an interest held in the equity of any type of company and from the assignment of own capital to third parties,

iii. capitalization and insurance operations in which the beneficiary is the company itself,

iv. income generated from industrial and intellectual property, technical assistance, real estate, image rights, and the leasing or sub-leasing of businesses and mines,

v. income generated from transfers of the aforementioned assets and rights,

vi. income generated from lending, financial, and insurance activities and the provision of services if they generate a taxable expense in the Spanish resident company,

vii. income generated from derivative financial instruments.[143]

139 Reuven S. Avi-Yonah and Oz Halabi, "US Subpart F Legislative Proposals: A Comparative Perspective," University of Michigan Law School, Jan. 1, 2012, 5, https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1179&context=law_econ_current.

140 PwC, "Worldwide Tax Summaries: Spain," Jan. 31, 2019, http://taxsummaries.pwc.com/ID/Spain-Corporate-Group-taxation.

141 Id.

142 Id.

143 Id.

The positive income obtained in this case will not be included as CFC income for the parent company if over 50 percent of the gross income obtained by the nonresident company due to these services comes from services provided to non-related companies.

If the total amount of CFC income corresponding to one of these categories is less than 15 percent of the total income, there is no CFC income inclusion in the parent company. The only applicable exception is income that comes from derivative financial instruments, which is always includable as CFC income. Income that constitutes a non-taxable expense for a Spanish shareholder, produced by a CFC, is also excluded from CFC income. Dividends and profits are not included as CFC income.

Regarding the ATAD,[144] in 2018 the Spanish Ministry of Taxation included changes to the anti-tax evasion bill proposal. In the bill, CFC rules are expanded to include the definition of a CFC as a permanent establishment. The participation exemption contained in the Spanish regime would not apply in cases where a PE is considered a CFC.

Holding companies owning more than 5 percent in subsidiaries during more than one year will be subject to CFC rules even when they have material resources to manage the participation and do not qualify as companies merely holding assets.[145]

After the reform the only safe harbor in the Spanish legislation is for EU companies that perform an economic activity in lieu of business reasons for its incorporation and operation. A safe harbor for EU-regulated collective investment vehicles is also included.[146]

The reform includes new sources of CFC income, such as sales and services, where the foreign entity does not add significant value to the service, as it is the case of insurance activities, leasing, and financial activities. The mentioned activities constitute CFC income even if the activities are not performed with Spanish counterparties, or where no economic activity is deemed to take place. [147]

H. The Japanese CFC Regime

Japan's CFC rules were enacted in 1978.[148] CFC status is determined either by an equity ownership test or a de facto control test[149] (applicable when Japanese residents, individuals, or corporations have the right to claim almost all residual assets of an entity).

The control requirement to categorize a foreign resident company (FRC) as a CFC is 50 percent of direct or indirect control of the Japanese shareholders over the company.[150] A Japanese shareholder is a company or any associated person that holds 10 percent or more of the outstanding shares of the CFC.

144 EY, "Spanish Council of Ministers releases draft anti-tax evasion Bill for public consultation," *Global Tax Alert*, Oct. 26, 2018, https://www.ey.com/gl/en/services/tax/international-tax/alert--spanish-council-of-ministers-releases-draft-anti-tax-evasion-bill-for-public-consultation.

145 EY, "Spanish Council of Ministers releases draft anti-tax evasion Bill for public consultation."

146 Id.

147 Id.

148 Avi-Yonah and Oz, "US Subpart F Legislative Proposals: A Comparative Perspective," 5.

149 PwC, "Japan Tax Reform – changes to the Japanese CFC regime," June 2018, 2, https://www.pwc.com/jp/en/taxnews/pdf/jtu-20180613-en-137.pdf.

150 Deloitte, "International Tax: Japan Highlights 2019," January 2019, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-japanhighlights-2019.pdf.

In cases where a foreign intermediary owns a foreign subsidiary, the holding ratio of the second-tier foreign subsidiary is determined by the holding ratio of the intermediary of the second-tier foreign subsidiary to qualify the entity as a CFC.[151]

CFC rules may be waived if a foreign subsidiary has facilities engaged in business in the foreign country. The Japanese definition for facilities is connected to the permanent establishment concept; then, under Japanese tax law, any of the following places can be considered as a facility:

- A branch, sub-branch, a place of business or office, factory.
- A warehouse.
- A mine, quarry, or other place of extracting natural resources.
- Any other fixed place of business which is similar in nature.[152]

Even with a fixed place of business established, certain passive income is subject to tax at the level of the Japanese parent company. CFC rules in Japan are focused mainly on passive income, even though there is a *de minimis* rule that excludes passive income from CFC income if the gross amount does not exceed 20 million yens, or 5 percent of the net income before tax in a fiscal year.[153]

In terms of defining CFC income, the Japanese legislation also has a set of active business tests:

i. main business test,

ii. substance test,

iii. management and control test,

iv. local business test or unrelated party test.

If an FRC meets any of these tests, CFC rules are not applicable.

In 2017, Japan included in CFC rules all income that is earned by a foreign related company that is a paper company, a cash box, or a blacklist company that is subject to a corporate tax rate of less than 30 percent of the Japan tax rate. All the CFC income calculations are made at the entity level basis.[154]

These three new categories of CFCs are defined as: Paper companies (companies with no substance or without its own administration or management where the head office is); cash box companies (companies where passive income over total assets is less than 30 percent and securities, loans, and receivables over total assets are less than 50 percent); and companies based in a black list territory according to the OECD standards.[155]

151 PwC, "Japan Tax Reform – changes to the Japanese CFC regime," 2.

152 KPMG, "Taxation in Japan 2016," Nov. 18, 2016, 2, https://assets.kpmg/content/dam/kpmg/jp/pdf/jp-en-taxation-in-japan-201612.pdf.

153 PwC, "Japan Tax Reform – Changes to the Japanese CFC regime," 2.

154 Id., 3.

155 Id.

Japan moved from a worldwide tax system to a territorial tax system in 2009. The motivation for this change was to encourage multinational companies to bring back to Japan the large amount of profits that where retained abroad. For this purpose, the country enacted a foreign dividend exemption that excludes from the Japanese income tax dividends remitted from foreign affiliates to their Japanese parents. The immediate effect of changes made in the Japanese legislation resulted in an increase of repatriation of cash to Japanese parent companies, with the statistics showing a sustained increase of the flow of money returning to Japan.[156]

The dividend repatriation system introduced by Japan encouraged multinational companies to distribute dividends to their parents in Japan, accomplishing one of the goals of the country when moving to a territorial tax system.[157]

According to the United Nations[158] in its economic development report of 2018, Japan's current account balance had a large surplus of $196 billion USD, a number comparable to the one that Germany had for the same period. The surplus may be one of the consequences of moving to a territorial system and the incorporation of CFC rules.

I. The Colombian CFC Regime

The Colombian CFC Regime[159] was enacted into law in 2016 (Law 1819). An entity in Colombia is considered a CFC if:

i. it is not a resident in Colombia and;

ii. it is controlled by one or more Colombian tax residents (whether entities or individuals).

The control requirement for a nonresident entity to be considered a CFC is at least 50 percent of vote, value, or the right to receive profits. If an entity is considered a CFC the shareholders who hold at least 10 percent of the voting shares, or a 10 percent right over the profits, has to include the corresponding share of income of the CFC.

Colombian taxpayers that are subject to CFC rules are not compelled to include assets and liabilities at the CFC level within their income tax returns, but they are compelled to include passive income (costs and expenses).

Any passive income received by a CFC is considered CFC income that is deemed to be received by the shareholder. The law includes a list of income items that are considered to constitute passive income including: (i) dividends or any other form of distribution of profits;[160] (ii) royalties; (iii) income from the transfer of intangible assets or assets that generate passive income; (iv) income from the transfer

156 Tax Foundation staff, "Japan Disproves Fears of Territorial Taxation," Nov. 13, 2012, https://taxfoundation.org/japan-disproves-fears-territorial-taxation-0/.

157 Makoto Hasegawa and Kozo Kiyota, "The Effect of Moving to a Territorial Tax System on Profit Repatriation: Evidence from Japan," SSRN, Aug. 17, 2017, http://dx.doi.org/10.2139/ssrn.2618058.

158 UNCTAD, "2018 Handbook of statistics," 2018, 48-49, https://unctad.org/en/PublicationsLibrary/tdstat43_en.pdf.

159 Colombian Tax Code, Section 882.

160 Dividends or any other form of distribution of profits, or realization of profits from investments in other companies or investment vehicles, will be passive income for CFC purposes, unless the profits correspond to active income. As per Law 1819 of 2016, income will be considered as active if it has its origin in real economic activities carried by the CFC, its subsidiaries, or PEs in the jurisdiction where the CFC, subsidiaries, or PEs have their tax resident or where they are located; and in the case of subsidiaries or PEs if they are indirectly controlled by one or more Colombian tax residents.

or lease of real estate; (v) income from the sale of certain movable assets; (vi) interests or financial yields;[161] and (vii) income from the provision of certain services.

There is an exception for dividends or any other form of distribution of profits (the calculation of dividends in Latin American countries is slightly different from the U.S. and Europe), or realization of profits from investments in other companies or investment vehicles, if those correspond to active business and are then considered active income.[162]

Interests and financial yields are not considered passive income if the controlling entity is a financial institution subject to surveillance of the finance authority in Colombia ("Superintendencia Financiera de Colombia") or if the CFC is a financial institution that is not domiciled, located, or incorporated in a jurisdiction qualified as a non-cooperative jurisdiction, a low- or no-tax jurisdiction.

The Colombian tax system allows a credit for taxes paid by the CFC in the foreign jurisdiction. If the CFC distributes dividends and those were previously taxed as CFC income, those dividends are tax exempt when distributed.

CFC income in Colombia is included in the tax base of the Colombian shareholder and then taxed at the statutory corporate rate, as any other item of income. There is no trigger rate test for the purposes of CFC rules in Colombia.

For Colombia, as well as for other countries in the world that are not capital exporters, one important question is whether CFC rules are necessary or are indirectly a requirement to be part of any world organizations as the OECD (which Colombia is a member) in order to be in the radar of larger economies. CFC rules in Colombia are very similar to the rules of European nations mentioned in this document, limited to passive income, with similar definitions for control and CFC income.

Chile and Colombia are considered by the United Nations Conference on Trade and Development (UNCTAD) 2018 report as the largest outbound investors of Latin America, even if their investments combined declined in 2016 by 18 percent.[163] CFC rules mainly help countries with large outbound investments to avoid perpetual deferral of certain kinds of income. In that case, one needs to question the purpose of the rules in developing countries that have individuals and corporations with very limited outbound investments.

The United States is the largest outbound investor in the world according to the UNCTAD ($419 billion in 2017[164]). It has CFC rules in place for many years and a stronger CFC regime since 2017. As a capital exporter the U.S. likely needs a tax system that facilitates the application of anti-avoidance rules. Compared to the U.S., however, the Colombian total outbound investment represents 1 percent of the U.S. foreign direct investment. Colombia needs to determine if it is more expensive for the country to enforce CFC rules than the collection that comes from its application.

161 Interests and financial yields are not considered as passive income if the controlling entity is a financial institution subject to surveillance of the Financial Superintendence, or if the CFC is a financial institution that is not domiciled, located, or incorporated in a jurisdiction qualified as a non-cooperative jurisdiction, a jurisdiction of low or null taxation, or a jurisdiction which does not exchange information according to international standards.

162 As per Law 1819 of 2016, income will be considered active if it has its origin in real economic activities carried by the ECE, its subsidiaries, or permanent establishments in the jurisdiction where the ECE, subsidiaries, or permanent establishments have their tax resident or where are located; and in the case of subsidiaries or permanent establishments if they are indirectly controlled by one or more Colombian tax residents.

163 UNCTAD, "World Investment Report: 2018," 2018, 6, https://unctad.org/en/PublicationsLibrary/wir2018_en.pdf.

164 Id.

J. The Chinese CFC Regime

The Chinese CFC regime was introduced in 2008. Under Chinese law a CFC is a non-Chinese company that is owned by one or more China tax residents that hold directly or indirectly through holdings at least of 50 percent of the company, including at least 10 percent or more of the voting shares of the company.[165] To be considered a CFC, the company must be effectively controlled by one or more Chinese residents by ownership, capital, business operations, or authority over purchase and sales-related matters.[166]

A Chinese resident shareholder (individual or enterprise) is subject to tax on undeclared profits kept without reasonable business reasons by any foreign company established in a jurisdiction with an effective tax rate 50 percent lower than the Chinese rate.[167]

Chinese legislation excludes from CFC status companies located in any of the jurisdictions considered by China on a white list that includes Australia, Canada, France, Germany, India, Italy, Japan, New Zealand, Norway, South Africa, the UK, and the US.

Chinese CFC rules apply to tax-passive income; income that is derived from active business operations is not included as CFC income. Chinese legislation includes a *de minimis* exception to exclude from CFC income annual profits of a CFC if the total amount of the CFC's profits is lower than 5 million renminbis during the taxable year.[168]

Resident companies must include in taxable income their relevant share of the undistributed profits of a CFC in certain cases. Chinese rules allow an exclusion for profits distributed that have already been taxed on the CFC level.[169]

CFC rules in China are rarely enforced (the first case dates from 2014). The rules were created to prevent Chinese multinationals from leaving profits in low-tax jurisdictions through various arrangements without business substance, but the application of the rules is not common.[170]

The first case when the rules were applied is the *Shandong ruling*. It is the case of a company established in Hong Kong with a registered capital of $3.1 million. A month after the register was completed, the shares of the company were transferred to a Dutch company at the price of $450 million. With a gain of $300 million, the gains were subject to withholding tax in China for $30 million, which was not what should have been the appropriate amount. The capital gains were subject to a withholding not in the appropriate amount. A year after the foreign company applied to be recognized as a resident in China, the recognition was denied by the Chinese authorities. After an assessment by the Chinese tax authorities in 2014, the proper application of the rules led to a tax adjustment. The

165 Michelle Zhou et al., "One giant step forward in Chinese IIT reform," *International Tax Review*, Dec. 10, 2018, http://www.internationaltaxreview.com/Article/3848511/One-giant-step-forward-in-Chinese-IIT-reform.html.

166 Id.

167 Deloitte, "International Tax: China Highlights 2019," January 2019, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-chinahighlights-2019.pdf?nc=1.

168 Nicolas Zhu and Gilbert Shen, "What Is China Doing on Anti-Tax Avoidance?" Bloomberg Tax, Aug. 31, 2017, https://www.bna.com/china-doing-antitax-n73014470746/.

169 Zhu and Shen, "What Is China Doing on Anti-Tax Avoidance?"

170 Amicorp, "Anti-abuse mechanism increase in the era of BEPS," July 2017, https://www.amicorp.com/AmiNews/2017/july/the_most_recent_cfc_case_in_china.php.

Chinese parent company agreed to pay $84 million in taxes.[171]

As is the case of Colombia, and China being a larger economy (second on the UNCTAD report in FDI outflows),[172] there may not be a necessity for the country to have CFC rules in place. The Chinese approach to the base erosion and profit shifting is more focused on the application of transfer pricing rules and not on the application of CFC rules.

The Chinese economy is stagnant, and selectively enforcing CFC rules or any other BEPS limitations enhances the possibility for Chinese companies to expand around the world. It is well-known that the country has been investing in countries abroad, giving loans to other countries under the Belt and Road Initiative,[173] a plan that started in 2013 and has been constantly growing since. The adoption of the rules was possibly a way to comply with the OECD standard, but the lack of enforcement is a way to allow Chinese investments to expand over the world.

Part VI. Conclusion and Considerations for Developing Countries

CFC regimes were created to prevent multinational taxpayers from engaging in tax planning that resulted in base erosion and profit shifting, as well as preventing deferral of tax on foreign earnings. Throughout the years the rules have proved to be an instrument for this purpose but not always secure enough to cause the desired effect. Even if CFC rules are a good tool for this purpose there is still an open question as the OECD begins to consider a broader tax agenda based on such rules: are CFC rules really necessary in countries that are not capital exporters?

One of the approaches to answer the question can be made from the amount of outbound investment of a country. The amount of outbound investment can be considered an adequate indicator to determine if CFC rules need to be implemented. If there is not enough foreign investment from a certain country, why would it be necessary to enact a CFC regime? Countries with smaller capital exports could discourage outbound business operations of their residents if a CFC regime is incorporated in their tax rules because of the higher compliance costs.

As an example, the reporting standards that a CFC regime requires may discourage the possibility to invest abroad that companies in developing countries may be planning. The standards may require additional resources for complying with the tax rules in order to expand their investment in other countries. Those countries will also need to increase the number of professionals in their tax administrations (to enforce the application of the rules). In developing countries, a decision like this will require additional resources invested that could be used for other more urgent needs.

In an OECD tax discussion in January 2019,[174] Pascal Saint-Amans, Director of the Centre for Tax Policy and Administration, mentioned that the Colombian authorities are participating in the initiative to create a model for a digital tax and a minimum tax as requested by the OECD. According to Saint-Amans, Colombia is asking that the design be simple; otherwise, it would not be administrable for the

171 Id.

172 UNCTAD, "World Investment Report: 2018," 6.

173 Andrew Chatzky and James McBride, "China's Massive Belt and Road Initiative," Council on Foreign Relations, May 21, 2019, https://www.cfr.org/backgrounder/chinas-massive-belt-and-road-initiative.

174 OECD, "Webcast: OECD Tax Talks."

country.

China is in an interesting spot between development and underdevelopment. CFC rules may not be the best tool to address base erosion and profit shifting. In the case of China, the rules were enacted in 2008, barely enforced until 2014, and not as a necessity of the country.

It may be possible that the rules are not as necessary because many Chinese companies investing abroad are owned by the government, which may be why those companies do not necessarily create a risk for tax avoidance.

In the near future as a consequence of the consolidation of the Chinese Belt and Road Initiative[175] and as more foreign companies have access to the Chinese markets to establish parent companies there, it may be possible that the necessity to apply the CFC rules grows or even the design of a different system to address tax planning will be needed.

In the case of Latin American or some African countries where the rules may not be needed, it may not be cost-effective to incorporate CFC rules until those countries reach a higher level of development.

Even in developed economies, CFC rules have not been enough of a success to achieve their purposes. An example of this is the U.S., which enacted additional measures to combat base erosion and profit shifting in the TCJA. Even developed countries in some cases did not have CFC rules in place for a long period of time (this was the case of Netherlands until this year). Netherlands has been an attractive place for investment and did not have the necessity to put in place CFC rules until it became mandatory as a result of the ATAD.

In the case of the EU, CFC rules are necessary for different reasons. The single market being surrounded with common commerce principles and legislation creates a necessity for some other common regulations.

Under the EU there are some member countries that are big capital exporters, as there are also other countries with smaller economies, and all share the single market. In such a system it can be easy for companies to relocate in search of the most beneficial conditions (including taxes) for their businesses. That makes the enactment of CFC rules more of a condition than a requirement, to reduce some of the differences among the tax systems in the union.

Other European countries that did not have the rules in place may be affected as a result of the ATAD. This is the case of Luxembourg and Ireland; both have been known as favorable countries to establish subsidiaries that conduct the financial business of multinational companies based in other countries of the EU, and they may become less attractive and even be affected when they adopt CFC rules.

175 The initiative of the government to lend money and operate companies in almost 65 different countries.

Unifying legislation around the world to incorporate rules that level the playing field, reducing profit shifting and base erosion, may be a way to help some countries and could harm others. There is no clear legal way to both level the playing field and to allow developed and developing countries to benefit from the changes to maintain growth and reach equality from different perspectives.

There are upcoming efforts from different countries to create new taxes to protect against base erosion and profit shifting. Because there is still no international consensus about digital taxation or a global minimum tax, some European countries are taking unilateral measures to enact digital taxes, at least until consensus exists on the topic.

There is also a necessity to evaluate the results of measures that have been put in place in recent years to see if any of those measures can be used as a model to other countries. For example, the U.S. short experience with a stronger system needs more in-depth study.

It is very complex for countries to reach consensus on the design and the application of a set of rules to equate the tax treatment of multinational corporations around the world. In most cases consensus is more a political than a technical matter, and that is the reason why some recommendations are not implemented or enforced even if the prescriptions are designed equally for all the participants. It is also important to consider that not all the measures can be applied the same way in different jurisdictions, and even if that happens, the way to apply a set of rules varies depending on the tax culture and economic situation of each country.