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„Controlled Foreign Company“ (CFC) - Regulations

or

How states access the tax substrate of other states without an international treaty

Lucerne, August 2017

With special regulations and not based on state treaties, states increasingly interfere in the fiscal sovereignty of other states and thereby circumnavigate international law.

The term «Controlled Foreign Company» (CFC) summarises this multitude of different regulations in the respective states.

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Introduction

- The first CFC-legislation was introduced with the Kennedy tax reform in the USA in 1962.
- At present, 34 states have CFC-regulations in their legislation.
- In the EU, already 13 member states have introduced CFC-regulations.
- Switzerland has no CFC-regulations in place and does not plan the introduction of any such regulations.

→ Why are CFC-regulations of importance for Switzerland nonetheless?

Introduction

As a result of globalisation, the number of transnationally active and multinational corporations is steadily increasing. The economic ties cause conflicts between the national tax systems. These conflicts are partly being resolved by double taxation agreements (DTA). But loopholes and inaccuracies within the international tax system remain and therefore the risk of double- as well as non-taxation. The OECD assumes that many states lose tax substrate through legal – but considered aggressive – tax planning of multinational corporations by shifting profits – through exploitation of loopholes in unilateral law and application of bilateral law - tax efficiently to low-tax countries.

Introduction

Switzerland, as a state with a historically low tax burden and a hub for internationally active corporations, is increasingly affected by measures implemented by countries to prevent this interplay between high- and low-tax countries and the exploitation of fiscal loopholes. One instrument of these measures are the so-called «Controlled Foreign Company» rules.

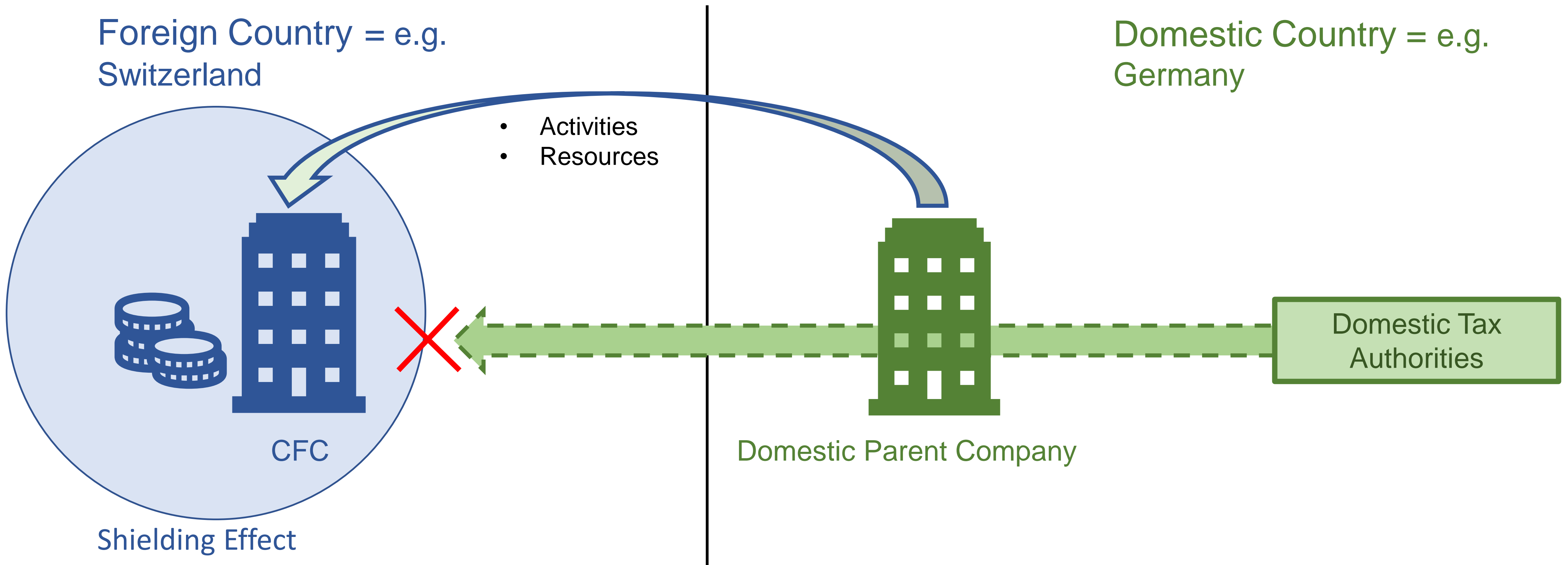
Introduction

- A «Controlled Foreign Company» is a:
  1. Company
  2. Domiciled abroad
  3. That is being "ruled" by a domestically domiciled corporation
- Also called base- or intermediate company in English usage.
- A company designated as CFC is being accused of having been established abroad with the sole purpose of obtaining fiscal advantages. Therefore, CFCs usually meet two other criteria:
  4. The CFC is domiciled in a low-tax country
  5. And typically pursues a passive activity.

How do CFC Rules work?

- When a domestic parent company establishes a CFC in a low-tax country, it relocates certain activities and resources – and therefore a part of its tax substrate - to the low-tax country.
- The CFC generates income.
- If the domestic tax authority wants to tax the CFC's income, it can't do so because the CFC is domiciled in another country.

How do CFC Rules work?



How do CFC Rules work?

- Only when the CFC distributes its profits to the parent company, the domestic tax authority can subject these to taxation.
- But because the parent company rules the CFC by definition, it can decide when the CFC shall distribute its profits. As long as it retains the profits in the CFC, it can achieve a tax deferral through this primary shielding effect. A tax deferral can get the domestic parent company an interest gain and a liquidity advantage.
- Under certain circumstances, it can be possible to return the profits to the CFC tax-free in a country of residence. In such a case, the secondary shielding effect takes effect, whereby the tax deferral achieved by the primary shielding effect is transformed into a definitive non-taxation.

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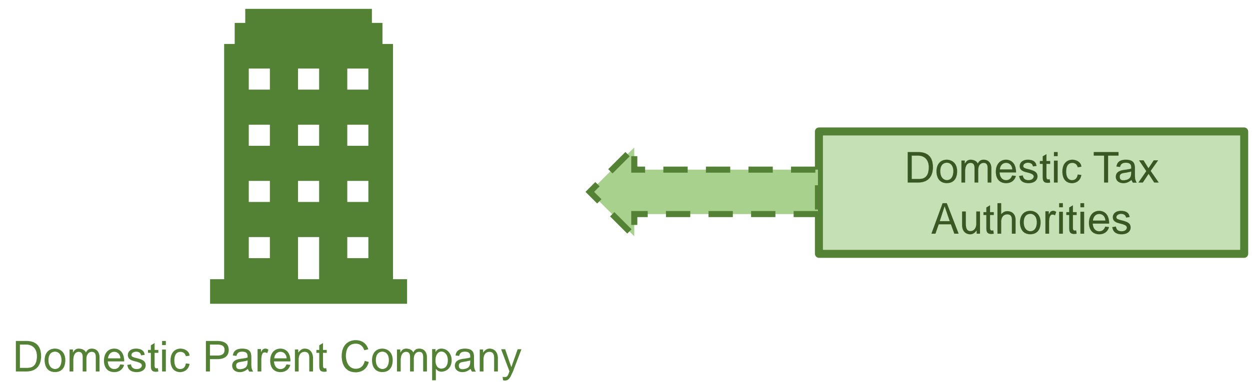
How do CFC Rules work?

Foreign Country = e.g. Switzerland

Shielding Effect

Domestic Country = e.g. Germany



How do CFC Rules work?

- To prevent this, countries are introducing CFC rules. The CFC regulation cancels the shielding effect and adds the CFC's profit as a fictional profit to the domestic parent company's profit already before the actual profit distribution.
- The profit added on can be domestically taxed according to the domestic tax level. That way, the tax deferral resulting from the shielding effect can be reduced or cancelled.

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How do CFC Rules work?

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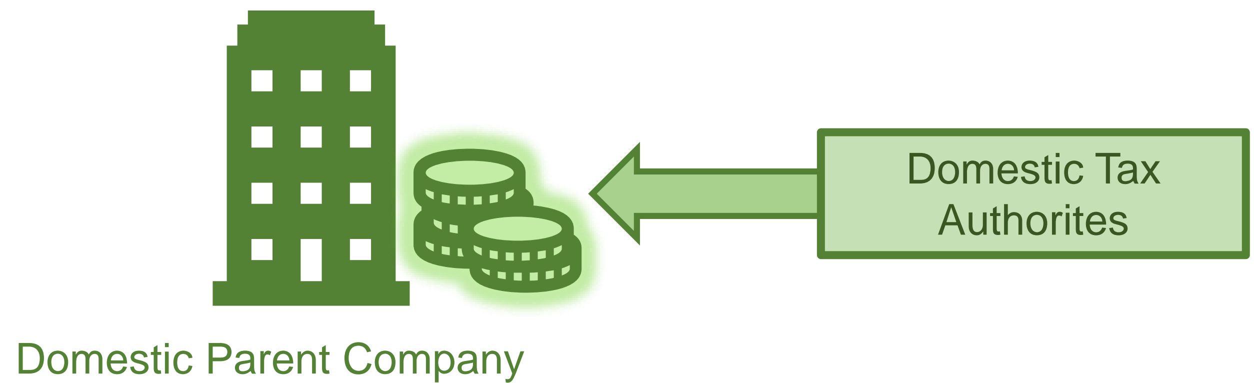

How do CFC Rules work?

- CFC Regulations are unilateral rules of individual states against the migration of tax substrate, which are applied without mutual national agreement.
- These days, there is a vast, hardly manageable variety of CFC Rules and the conditions of when an add-back taxation is applied vary heavily:
    - In principal, all domestic individuals and legal entities fully liable to tax are possible tax subject of the CFC Regulations.
    - Control: the domestic parent company has to be able to influence the CFC in such a manner, so that it can determine the time of the profit distribution. According to the country, various formal and/or factual criteria must be met.
    - Low Taxation→ global or jurisdictional approach
    - Passive Activities = Activities that can be easily relocated und therefore exhibit a high location-flexibility. E.g. Interest-, dividend- and rental income, license earnings and capital gain.→ transactional or entity approach
    - Some CFC Legislations stipulate exemptions and discharges.

International Developments – BEPS Action 3

- The OECD has begun to occupy itself with the so-called harmful tax competition in the 90s.
- 1998, the OECD published the report «Harmful Tax Competition, an emerging global issue». As a defence measure against the harmful tax competition, the report specifically urges states to introduce CFC Rules or similar regulations.
- On October 5th 2015, the OECD published the final reports of all 15 Action Points of the «Base Erosion and Profit Shifting» project (BEPS). One of the 15 measures proposed addresses the CFC Regulations.
- The Action Point 3 contains recommendations regarding standardised approaches and good practises, so-called «Best Practice Recommendations», which the countries can introduce to their national legal systems, but don't have to. The recommendations shall effect a strengthening of the CFC Rules.

International Developments – Guideline 2016/1164

- Also the EU began to occupy itself with the issue of the harmful tax competition at the end of the 90s. On December 1st 1997, the Code of Conduct for corporate taxation was adopted – a political directive for the interaction of EU member states among each other, but still without a specific recommendation to introduce CFC Rules.
- But to this day, it is controversial if the CFC rules are compatible with the EU's Community law.
- In the «Cadburry Schweppes» ruling (2006), the ECJ declared that the CFC Rules are not per se unlawful. But CFC Regulations only conform with the ECT if they solely include purely artificial entities.
- Corroborated through the OECD's BEPS-Project, the EU-Commission published its own action plan «for a fair and efficient corporate taxation» on June 17th 2015.

International Developments – Guideline 2016/1164

- In the course of this action plan, the «Anti-BEPS-Guideline» (Guideline 2016/1164) was adopted on July 12th 2016.
- The Guideline aims to implement the BEPS measures in a coherent and coordinated manner in the EU member states. For this purpose, five measures shall be applied in the EU member states from January 1st 2019. One of these contains regulations regarding controlled foreign corporations (CFCs).
→All EU countries must have introduced CFC Regulations to their legislations by 2019.

Implications for Switzerland - Steuervorlage 17

- Although Switzerland does not have CFC Regulations in its national legislation, they are still not irrelevant. Especially regarding the ongoing dissemination of CFC Rules driven by the action plans of the OECD and the EU.
- **Locational advantage:** In principle, not having CFC Regulations is a locational advantage for Switzerland because multinational corporations usually try to avoid countries with CFC Rules as a domicile.
- **Locational disadvantage:** But subsidiary companies in Switzerland can be increasingly targeted by CFC Rules of other states.
- Switzerland must adhere to international «minimum standards».
  →A premature anticipation of changes in the international tax law practice is therefore essential.
- In the course of the CTR III, one wanted to reduce the cantonal profit taxes in order to maintain locational attractiveness.

Implications for Switzerland - Steuervorlage 17

- But a reduction of the profit tax could lead to Switzerland now meeting the criteria of low taxation in a state with CFC Rules, where, with the existing profit tax rates, it is currently not rated as a low-tax country. The more the profit taxes are reduced, the more foreign-controlled corporations in Switzerland can be targeted by CFC Regulation of other states and be subjected to corresponding disadvantages.
- For the Steuervorlage 17 it would be important to bear this point in mind and to look for alternative solutions to maintain the locational attractiveness.
- It is advisable for Switzerland to keep an eye on the introduction and changes of CFC Legislations of other countries and to implement national reforms in anticipation of these developments.

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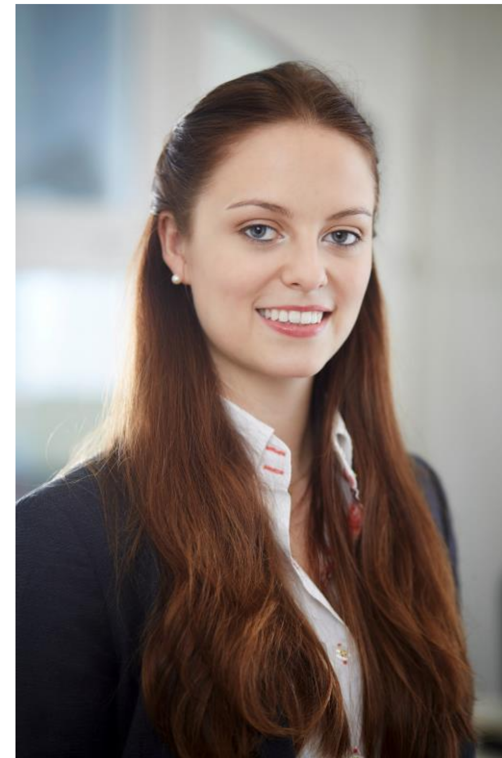

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