The world needs CFC rules that tax profits where value is not created

Kluwer International Tax Blog
October 10, 2017

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Please refer to this post as: Francis Weyzig, 'The world needs CFC rules that tax profits where value is not created', Kluwer International Tax Blog, October 10 2017, http://kluwertaxblog.com/2017/10/10/world-needs-cfc-rules-tax-profits-value-not-created/

Controlled Foreign Corporation rules are a hot issue in Europe and beyond. Last year, EU countries agreed to have national CFC rules in force by 2019. The Big Four – Germany, France, Italy and Spain – need to make minor changes only to their existing rules. (Like in the accountancy profession, there used to be the Big Five, but the UK is on the way out.) The Nasty Four – Ireland, Luxembourg, Belgium and the Netherlands, each with a nasty history of enabling mismatches – don't have CFC rules yet and need to introduce them. Needless to say, this will affect many companies worldwide.

Many tax experts are frowning upon these developments. They are especially critical about the so-called model A for CFC rules in the EU Anti-Tax Avoidance Directive (see Art. 7(2)(a)). Under this model, the home country includes six categories of passive income earned by a foreign direct or indirect subsidiary, or a foreign permanent establishment, in the tax base of the parent company if the foreign tax charge on that income is less than half what it would have been in the home country. For example, if a Bermuda subsidiary of a Dutch parent would earn interest income, the Netherlands would add that income to the tax base of the Dutch parent and tax it at 25%.

Thus, under this model, the home country would tax profits generated elsewhere, even if there is no link at all between those profits and the functions performed, assets employed and risks assumed by the multinational in the home country. It seems the critics have a strong case. After all, who could possibly be in favour of taxing profits where value is *not* created? How could the BEPS project, which is all about aligning taxable profits with economic activity, ever give rise to such rules?

Yet these critics are wrong. CFC rules are a brilliant idea. In fact, it is crucial that all major home countries adopt model A-type CFC rules, which also address foreign-to-foreign profit shifting, for such rules are a cornerstone of the whole BEPS project (see BEPS Action 3 para. 17-18).

To see why, it is useful to have a look at developments in banking regulation. In the aftermath of the global financial crisis, supervisors tried to repair existing laws that had failed to prevent excessive risk taking by large banks. Banks are supposed to be funded with a sufficient amount of equity capital, so they are able to absorb crisis-time losses on their loans and investments without harming anyone but their shareholders. However, big banks had been allowed to use internal models that greatly underestimated credit risk. Moreover, they used hybrid instruments that made their equity capital look much higher than it really was. This increased the returns for shareholders. It was a perfect recipe for a financial crisis.

Predictably, banking supervisors set out to tighten the rules, close a whole range of loopholes, and get tough on hybrids and model specifications. Sounds familiar? Indeed, very much like the BEPS project.

However, they also came up with something completely new. The supervisors introduced a new rule: a bank has to fund all its assets with a minimum proportion of real equity capital, *regardless* of the risk profile of its loans and investments. That was something radical. Indeed, many bankers were critical. Disregarding credit risk? Ridiculous!

It was a superb move. The supervisors recognized how the system had failed (not to be confused with assuming responsibility for that, of course) and realized that over time, banks would discover new loopholes to disguise risks. Inevitably, regulation would lag behind. Therefore they invented a rule that is immune to manipulation of credit risks and will serve as a backstop for new forms of avoidance.

The key effect of this rule is that it changes the behaviour of banks. By taking away the potential gains from underestimating credit risk, it greatly discourages banks to do so. Thus, even if the rule will not be binding for a bank, the mere threat that it might become binding already has the desired effect.

The same goes for model A-type CFC rules. Over time, and that time may be surprisingly short, advisors will find specific channels for profit shifting that remain insufficiently addressed by anti-BEPS rules. If a multinational uses such channels to shift profits to a low-tax subsidiary, a home country with CFC rules would tax those profits. It might then tax profits where value is not created.

However, that will not happen. Model A-type CFC rules will not generate substantial tax revenues themselves. They will only threaten to tax profits that are shifted into a low or zero corporate tax environment. Similar to the new bank rule, the main effect of CFC rules is that they change the behaviour of multinationals. By taking away the potential gains from profit shifting, they make sure that no profit is shifted into a low-tax subsidiary or permanent establishment in the first place.

Thus, the world needs CFC rules to encourage that profit stays in the countries where economic activities take place and value is created. This does not only help to safeguard a home country’s tax base, it benefits all countries where multinationals conduct real business activities, source and residence, rich and poor. Without such CFC rules, the whole BEPS project will very soon be outdated. We should not allow that to happen and encourage all major home countries to be brave and make the right choice, starting with the EU.