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BEPS Action 3: Public Discussion Draft on Strengthening CFC Rules: A Legal Critique to the Possible Implementation of a Full-income CFC System

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In July 2013, the OECD published its Action Plan on Base Erosion and Profit Shifting, aimed at ensuring the coherence of corporate income taxation at the international level. Action 3 of the Plan stressed the need to address base erosion and profit shifting through CFC rules, since then existing domestic CFC rules do not always counter BEPS in a comprehensive manner.

The Public discussion Draft (DD) published on April 3, 2015, gave guidance on what so far was an empty box; there was no even a clue on where the OECD was headed concerning this topic. Now we are almost certain that there will be no jump into the void, and that, for the most part, final recommendations (scheduled by next September) will be within expectations but for the issue discussed in this contribution.

The DD considers the constituent element of CFC rules and break them down into the building blocks necessary for the implementation of effective CFC rules. Recommendations are given for all of them but one, i.e., the definition of CFC income. The building blocks include, (i) definition of a CFC; (ii) threshold requirements, (iii) definition of control, (iv) definition of CFC income; (v) rules for computing income; (vi) rules for attributing income; and (vii) rules to prevent or eliminate double taxation.

Comments on the DD are to be submitted until May 1, 2015, and a public consultation hearing will be held by the OECD on May 12, 2015. Final recommendations, as anticipated, are expected in September, 2015.

Before focusing on the definition of CFC income and the critiques on full inclusion CFC regimes, I will surf over the jurisdictional basic concepts and queries commonly associated with CFC legislation.

Pursuant to most contemporary domestic tax systems, the basic rule is that foreign source income obtained by a foreign company is not subject to taxation at the level of resident shareholders in the taxing jurisdiction –even when foreign source income would have been taxed is obtained directly by them– until such income is effectively made available to the shareholders by a profit distribution. This is known as the *deferral principle*, which, in turn, is a direct byproduct of the recognition of the legal and tax separate personality of the foreign entity by the country of residence of the shareholders.

Since a purely mechanical application of deferral may lead to inappropriate tax results in certain situations, tax legislation faces the resulting imbalances through transparency regimes aimed at taxing currently in the hands of the resident taxpayers (i.e., at the time of accrual at the foreign entity level, and regardless of the existence of a distribution), certain types of passive or easily reallocable income (*e.g.*, trading income), obtained through a company residing in a foreign suitable jurisdiction (chosen by the absence of taxes, low taxation, or other preferential treatment geared towards the particular type of income concerned).

Domestic tax transparency regimes embody two different types: the controlled foreign corporation or CFC regimes; and the foreign investment fund or FIF regimes. This second type of transparency regime (usually patterned after or at least in line with that contained in the 1998 OECD Report) either stands alone or complements CFC rules, capturing similar types of *tainted* income obtained through foreign entities not actually or constructively controlled by resident shareholders, as otherwise required by CFC regimes.

The key legal question under international tax law is whether the rectification under certain circumstances (*e.g.*, accumulation of tainted income) of the deferral principle, might constitute an illegitimate or *ultra vires* exercise of tax jurisdiction by the country of residence of the controlling shareholders, as well as whether such correction might be compatible with the application of double tax treaties (DTTs).

The compatibility of CFC rules and DTTs was first admitted by the OECD in *L´evasion et la Fraude Fiscales Internationales* (1987), where it consented to the application of defensive measures like CFC regimes, and then by the OECD MC Commentaries, including its present text.

In favor of the application of this technique it is also argued that under extreme circumstances (i.e., defense of the national tax basis against shifting maneuvers), the country of residence of the shareholders keeps a minimal personal link to correct the undesired outcome, even when, at first sight, that correction might imply to re-characterize a foreign legal entity with separate legal personality as a transparent or pass-through entity for tax purposes, in an apparent conflict (at least in legal terms) with a foreign country’s exercise of its fiscal sovereignty.

Moreover, the widespread practice on point, *i.e.*, the fact that domestic legislation has largely adopted similar rules, evidences the existence of a validating international custom or opinio iuris of International Law. Countries that have adopted CFC or similar anti-shifting regimes include, in no particular order, The US, Canada, Germany, Japan, France, U.K., New Zealand, Australia, Sweden, Norway, Denmark, Finland, Indonesia, Portugal, Hungary, South Africa, Korea, Israel, Italy, Estonia, Spain, Argentina, Brazil, Chile, Mexico, Peru, and Venezuela.

As the DD recognizes, CFC rules need to define attributable income. Moreover, in its chapter 5, the DD states that existing CFC regimes apply one of two general approaches. They apply either a full inclusion system which treats all income earned by a CFC as CFC attributable income regardless of its character (*i.e.*, passive or business income), or a partial inclusion system which only attributes certain types of income earned by a CFC. As the DD also recognizes, under full inclusion systems there is no need to separately define CFC income, but such an approach catches categories of income that do not raise specific profit shifting concerns (*i.e*, operational or business income). Thus, such approach not only is meaningless from a BEPS policy point of view, as the DD stated, but also implies extraterritorial or ultra vires taxation from an international tax law perspective; as a result, it would be advisable not to keep it as an available option in the final

recommendations of Action 3.

The remaining content of the DD, Chapter 5, discusses the various systems for CFC income inclusions under partial inclusion rules only: Form and substance based analysis, types of *tainted* income items, attribution approaches (categorical v. excess profits approach), and application of attribution approaches (entity-by-entity v. individual streams of income).

Turning back to the critique of full-income inclusion CFC systems, it is worth remembering that, back in 1923, The Report of the Experts to the League of Nations clearly kept the taxation of business income to the State of residence of the entity, except when the latter carries out activities in another State through a PE. This basic principle, together with the respect of the separate legal personality of foreign companies, have been essential and undisputed elements of contemporaneous International General and Conventional Law.

Within that context, CFC or similar regimes developed over the last fifty years complement those principles (rather than contradicting them), with defensive measures designed to avoid perceived abuses of tax deferral, through the interposition of foreign entities without an attendible non-tax purpose, solely aimed at accumulating profits abroad that remained untaxed almost indefinitely. These regimes have been admitted by the custom (opinio iuris) of the international community as long as certain commonly-shared objective conditions are met. The elements to which these regimes are conditioned upon, and, hence, deemed compatible with the respect of the separate legal personality of foreign entities are: (i) the shift of easily reallocable targeted (*tainted*) income, including passive (interest, dividends, royalties, rents, and capital gains) or trading income, (ii) to a foreign entity in a no or low-tax jurisdiction, or subject to a privileged tax regime (of a general or specific nature), whether defined objectively or by comparison to the level of taxation at the shareholders' home country. Control and minimal individual equity participation are also conditions under traditional CFC regimes, but might not be so under similar newly-developed FIF rules. CFC regimes of widespread acceptance do not allow attributing to the shareholders, business income obtained by a controlled or related foreign entity in a non-privileged jurisdiction.

Brazil is, perhaps, the only meaningful country, in term of economic relevance, that maintains a full inclusion CFC system. This system incorporated in 2001, has been and still is highly controversial and has originated an intense judicial discussion in Brazilian courts.

According to the original regime created in 2001, and in relation to corporate income tax and social contribution on income (Contribuição Social sobre o Lucro Líquido –CSLL–), the income obtained by foreign controlled or related companies is deemed available, and hence is attributed to the Brazilian parent or participating entity on a current basis, as of the date of closing of the year in which they accrued to the foreign entity.

The rule applied to all kinds of income regardless of its nature (*e.g.*, including business income) and regardless of the level of taxation at which the income is subject at source, so that the Brazilian rules do not consist of a typical CFC regime consented by international custom and the commentaries to the OECD MC but of something different. Moreover, the Brazilian rules contradict the Commentary to article 1, paragraph 26, of the OECD MC and concurrent principles embodied therein; it does not solely apply to certain *tainted* income, *e.g.*, passive, base company (trading) income and/or subject to a preferential regime, but to all income of a foreign related or controlled entity.

The Brazilian CFC regime is thus an exceptional set of the rules that, by removing the legal dividing line between legal entities (i.e., the foreign subsidiary and its Brazilian parent company), goes far beyond the aim of protecting the Brazilian tax basis and contradicts one of the basic paradigms in international taxation. In other words, the purpose of that regime is to tax currently in the hands of the Brazilian shareholders business income of a foreign entity, which is clearly non-reachable under generally accepted principles of International General and Conventional Law.

After an uncertain and zigzagging period, the more recent Brazilian judicial decisions have recognized the incompatibility of the Brazilian CFC rules and the DTTs, giving prevalence to the DTTs over domestic CFC rules (*in re Vale do Rio Doce*, April 2014, and *in re Petrobras*, October 2014). No similar decision with erga omnes effects outside the umbrella of DTTs has been issued yet at the upper tribunal level, so that the issue of taxing currently business income of a foreign subsidiary in a non-privileged jurisdiction under The Brazilian CFC regime still remains opened.

Back in 2013, The Brazilian Executive Branch issued MP 627/13, dated November 11, 2013, altering the design of the CFC regime as previously contemplated (2001 rules) but not its essentials. In accordance to MP 627/13: (i) income (including business income obtained in a non-preferential tax jurisdiction), is deemed realized currently in the hands of the Brazilian parent at the time it accrued to the foreign entity, regardless of whether distributed as a dividend; (ii) payment of the tax can be deferred up to the time of actual distribution or eight years, whichever occurs first, with interest thereon at LIBOR rates so that, at the end of the relevant period, interest must be added up to the amount of income tax to be paid over to the government (as if it were being paid in arrears).

In other words, the extraterritorial effect of the Brazilian CFC rules remained unchanged (although disguised) in MP 627. The need of charging interest thereon as from the accrual period implies that, in economic terms, the separate legal personality of the foreign entity is not respected but merely tolerated, in order to allow postponement of a tax which accrued and remained due on a yearly basis. After a quite prolonged Congressional discussion, MP 627/13 was passed as Law 12,973, published on May 14, 2014.

It is quite clear then that Brazilian CFC rules (before and after MP 627) are denaturalized as a legitimate mechanism to fight the use of foreign base companies to shift income abroad, and as such, unlawfully disregard the separate legal and tax existence of corporate vehicles organized in accordance with the laws of the incorporation country. They are simply revenue-geared provisions aimed at taxing currently in the home country of the parent company, business income of foreign subsidiaries or related entities taxed abroad at comparable corporate income tax rates.

Aside from the issue of whether these rules originate juridical or economic double taxation [the latter is the OECD MC Commentaries' approach], it is undeniable that they imply extraterritorial taxation that confronts with one of the basic paradigms of contemporaneous international taxation (*i.e.*, the recognition of the separate personality of legal entities, and the exclusive allocation of business income to the residence country, in the absence of a PE situated in the source country).

By disregarding the foreign legal entity's separate existence without a fundamental reason, full inclusion CFC rules conspire against the exercise of fiscal sovereignty by third counties under general international law. It is also worth mentioning that the proliferation of these regimes, among other undesirable effect, might also alter significantly the global jurisdictional balance and inter-nation equity among countries in certain other fundamental BEPS' contexts; just think of the

potential alterations that may arise, by cross-reference, on the taxation of the digital economy outputs under Action 1.

Based on the above considerations, it would be highly advisable that the final recommendations block full inclusion CFC systems out as an available implementation of CFC regimes.

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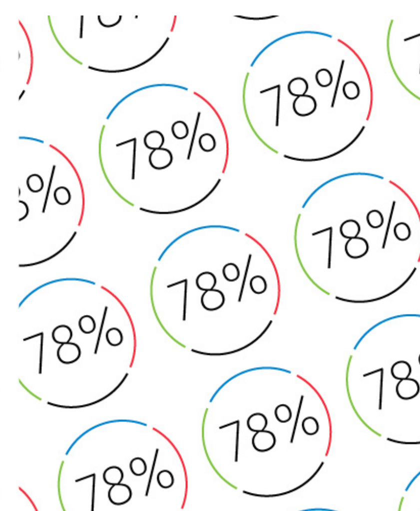

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