of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

[2] The OECD BEPS Action Plan

The OECD BEPS Action Plan is addressing artificial avoidance of permanent establishment status in Action Plan 7. Zollo, Sams and Weaver commented that in relation to the OECD Discussion Draft of Action Plan 7, an enterprise may use a disclosed agent that operates for a limited service fee to solicit and negotiate contracts on its behalf and take the position that it does not have a permanent establishment because the enterprise executes all contracts outside the host country. The agent is therefore not considered to exercise an authority to conclude contracts on behalf of the enterprise. The BEPS Action 7 discussion draft contains contained the proposal to eliminate the requirement for the agent to conclude contracts in the name of an enterprise if their activities directly result in the conclusion of contracts. The options would also amend paragraph 6 to restrict the exception for the activities of independent agents.[12]

Article 5(4)(a) to 5(4)(d) of the OECD Model Treaty lists specific activities that do not create a permanent establishment, and Article 5(4)(e) provides an exemption for any other activities that are of a preparatory or auxiliary nature. Zollo, Sams and Weaver commented that in relation to the OECD Discussion Draft of Action Plan 7, option E would make the specific activities listed in subparagraphs (a) through (d) subject to the condition that they must also meet a separate determination that they are preparatory or auxiliary.[13] In relation to tolling arrangements, this would mean that the following principal related exemptions from a permanent establishment in Article 5(4) would potentially only apply if the activities were of a preparatory or ancillary character:

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise.

12. Thomas Zollo, Jim Sams & Brett Weaver, 'KPMG report - BEPS Action 7 discussion draft on preventing artificial avoidance of PE status' (KPMG, 2015).
13. Thomas Zollo, Jim Sams & Brett Weaver, 'KPMG report - BEPS Action 7 discussion draft on preventing artificial avoidance of PE status' (KPMG, 2015).

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CHAPTER 5
Procurement Companies

§5.01 INTRODUCTION

The group procurement function within a multinational group relates to purchasing materials, goods and services by a procurement company, which will then be sold to other companies in the multinational group. These activities generally include liaising with group companies to determine their procurement needs, the analysis and selection of goods and services, the negotiation of the related purchase contracts, arranging any required funding and insurance, quality control and inspection, and making required payments to suppliers.

There are strong commercial reasons for centralising procurement functions in a group procurement company, including in particular the more effective use of centralised procurement staff, and obtaining substantial discounts for purchasing goods and services in much greater quantities than required by individual group companies. For practical reasons, such as communications with suppliers and related time zones, there may be two or more regional procurement companies worldwide. The procurement company may also be a component of supply chain management (SCM), which is a process which seeks to rationalise the movement and storage of raw materials, work-in-process inventory, and finished goods from the point of origin to the point of consumption.

There are also potential advantages in being able to negotiate better terms on a much larger contract, for example the selection of a small panel of preferred global suppliers for legal services may result in their agreement to a higher liability cap in relation to potential actions for negligence than would otherwise be agreed by the legal firms on a much smaller contract.

There may also be scope to negotiate more favourable terms in relation to tax matters such as withholding tax, for example where the supplier may agree that payments are not to be grossed up for paying country withholding tax, and will instead seek to recover a tax credit in their supplying country. The procurement company

therefore pays only the actual contract price without increasing the price for withholding tax.

Group procurement functions may potentially be performed by a company located in a lower taxing jurisdiction. This may include, for example, a general low tax rate such as 16.5% in Hong Kong, with potential exemption if income is treated as derived from sources outside Hong Kong,[1] or a low tax rate under specific tax concessions, for example the International Procurement Centre (IPC) concession in Malaysia provides a tax exemption for ten years.[2]

The procurement structure may also potentially not be treated as a CFC under anti-tax haven rules because the procurement company conducts an active business. This tax planning advantage does not, however, apply in all cases. The United States CFC provisions under Subpart F, for example, may apply to the profits of a group procurement company when this income is treated as 'foreign base income', which include sales, service, and shipping income from transactions with related parties.[3] In this case, for example, United States taxation can apply to the United States parent company on the income of a procurement company located in a tax haven in relation to the procurement company's sales to other companies in the same multinational group.

There is also an advantage with procurement companies for tax planning purposes because payments made to the procurement company for the purchase of materials, goods and services by other group companies would generally not be subject to withholding tax, as the payments are for the purchase of the materials, goods and services, rather than being payments of interest, dividends, royalties or technical service fees, which may be subject to withholding tax in many countries.

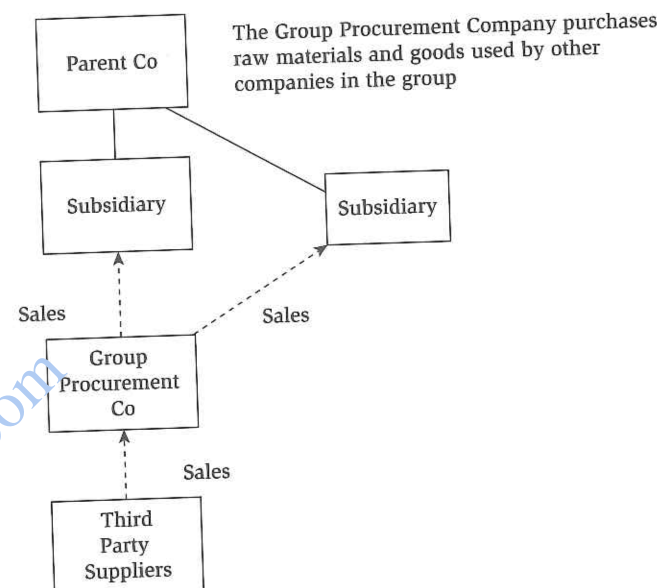
There may be withholding tax in some countries, however, where the procurement company is charged for services. It may be useful in these circumstances to have the third party suppliers enter into contracts with group companies directly, under the terms of a global contract, also known as an 'umbrella contract' which was previously negotiated by the group procurement company and the supplier. The procurement company may then be paid an administration fee by the group companies.

One significant issue with the group procurement structure is that the procurement company must use arm's-length pricing for the sales to related companies in the multinational group, as additional tax and penalties may otherwise be imposed under transfer pricing provisions.[4]

1. *Inland Revenue Ordinance*, E.R. 1 of 2012, s. 14(1) (Hong Kong), and *Departmental Interpretation and Practice Notes No. 21 (Revised) Locality of Profits*, DIPN 21, Inland Revenue Department, Hong Kong.
2. *Income Tax Act 1967*, Act 53, s. 127 (Malaysia).
3. *Internal Revenue Code*, 26 USC (1986) Part III, Subpart F, ss 951–965 (United States).
4. Refer to the transfer pricing focus for manufacturing in Ch. 27 below.

§5.02 GROUP PROCUREMENT STRUCTURE EXAMPLE

Figure 5.1 Group Procurement Structure



The procurement structure relates to product selection, contract negotiation, purchasing, funding and insurance and quality control functions for materials, goods and services required by a multinational group. These functions can be performed by a group procurement company located in a lower taxing country.

The procurement company derives a profit margin between the price paid for the purchases from suppliers, and the price received on sales to related companies in the multinational group. The related profits may be taxed at low rates depending on the location of the procurement company.

The structure requires significant management and related personnel needed for the procurement function, and the related capital needed for this business, to actually be located in procurement country, to potentially reduce the risk that anti-tax avoidance provisions of several countries may apply. Transfer pricing is also a very significant issue, and the related prices should be at arm's-length amounts.

The principal potential tax advantage is that the procurement margin is potentially derived in a low taxing country.

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§5.03 COUNTRY EXAMPLES

[A] Swiss Branch of a Netherlands Co Example

This procurement structure is based on having the procurement functions performed by a Swiss branch of a Netherlands company.

The related profits may potentially not be taxed in the Netherlands as foreign branch income.[5] The tax in Switzerland should apply at reduced rates under cantonal tax rulings. The procurement income should not be treated as passive income under many countries' tax regimes, and so taxation of the parent company under CFC rules may not apply.

The potential benefits are that the procurement margin is not taxed in Netherlands, and reduced Swiss tax rates should apply.

[B] Hong Kong Example

This example of the procurement structure is based on a procurement company located in Hong Kong.

The related procurement profits are generally subject to Hong Kong Profits Tax at a rate of 16.5%. The tax rate is, however, potentially reduced to nil where the source of profits is treated as derived from outside Hong Kong under Hong Kong's territorial tax system. This tax treatment may potentially apply where the related purchase and sale contracts are negotiated and concluded outside Hong Kong.[6] A significant issue with the structure, however, is that Hong Kong is potentially more likely to be on a tax haven list under several countries' CFC taxation systems, in which case the parent company may be taxed on the related profits of the Hong Kong procurement company.

[C] Singapore Example

This example of the procurement structure is based on the procurement company being located in Singapore, and receiving concessional tax treatment under specific tax regimes available in Singapore.

The related profits of the procurement company may potentially be taxed at rates down to 0%, under the International Headquarters (IHQ) concession or the Regional Headquarters (RHQ) concession available in Singapore.[7] Singapore also has a territorial tax system under which there has generally been an exemption for income not received in Singapore. The related rules were, however, updated in 1995.[8] In relation

5. Baker & McKenzie, Doing Business in the Netherlands 2012.
6. *Inland Revenue Ordinance*, E.R. 1 of 2012, s. 14(1), and *Departmental Interpretation and Practice Notes No. 21 (Revised) Locality of Profits*, DIPN 21, Inland Revenue Department (Hong Kong).
7. *Income Tax Act* (Ch. 134), s. 43E, (Singapore).
8. *Income Tax Act* (Ch. 134), s. 10(19) (Singapore).

to trading profits, the updated rules provide that income derived from outside Singapore which is applied in or towards satisfaction of any debt incurred in respect of a trade or business carried on in Singapore is taxable, as the income is treated as received in Singapore. On this basis the better tax result is generally to be achieved using the IHQ and RHQ concessions.

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CHAPTER 6

Distribution and Regional Sales Companies

§6.01 INTRODUCTION

This chapter analyses the significant international tax issues relating to distribution. These issues include the level of taxation in the manufacturing or head office country where the principal is located compared to the level of taxation in the local sales country, whether the manufacturing or head office company has a permanent establishment in the local sales country, indirect taxation issues including VAT and customs tariffs, whether there are payments relating to intellectual property such as royalties, and transfer pricing issues on the sales to the local distributing company.

Regional sales companies may be used, which potentially derive a profit margin in a lower taxing country for related services such as arranging related funding, goods inspection, delivery, foreign exchange management and insurance. Commissionaire structures may be used where the principal retains the most significant business risks, and the local distribution company derives a smaller profit margin. The limited risk buy/sell structure is based on a local distribution company which carries lower risks and derives a lower profit margin.

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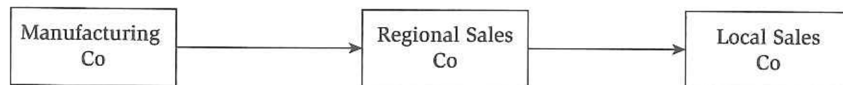
§6.02 REGIONAL SALES COMPANIES

Figure 6.1 Regional Sales Companies

The Regional Sales Company sells group products to subsidiaries in different countries in the region



The use of regional sales companies enables common functions relating to sales, such as invoicing, insurance, shipping, quality control, and legal support, to be performed in one location to support sales in several countries in a region. This centralisation may potentially reduce costs due to economies of scale. The regional sales company may be located in a lower taxing country, so that the margin between purchase costs and sales in taxed at a lower rate.

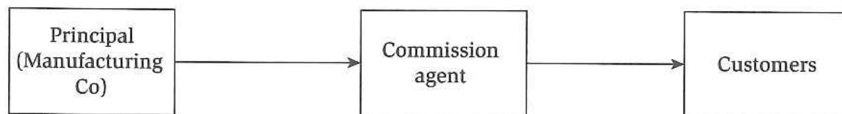
The principle issue is the transfer-pricing requirement that related party sales are at arm's-length prices. This issue is discussed in the transfer pricing chapters below.

There is also the potential application of anti-avoidance provisions, which may apply for example where the regional sales company does not have commercial substance, such as employees and business capital, and runs real business risks.

§6.03 COMMISSIONAIRE STRUCTURES

Figure 6.2 Commissionaire Structures

The Commissionaire structure uses a Commission Agent to sell products on behalf of the Principal



The commissionaire (commission agent) structure is based on local sales companies (commissionaires) which act on a commission basis, where they sell goods in their

own name but on behalf and at the risk of one central company (principal). The commissionaires reduce their activities to the core business of sales.[1]

The commercial advantage of the structure is based on centralising business risks, such as inventory, bad debts and currency risks, centralising the purchase and production of goods reducing back office costs, and centralising the distribution of goods.

The structure may potentially have tax benefits where these home country profits are subject to a low rate of tax. Commissionaire structures are more common in Europe. The related tax issues include the disposal of goodwill, the existence of a permanent establishment in the sales country, VAT arrangements, and the level of the commission for transfer pricing purposes.

The adoption of a commissionaire arrangement has particular tax issues, as companies which previously fully benefited from customer relationships reduce their activities to the functions of a commissionaire. This may result in a profit decrease, and the local tax authorities may consider that there has been a taxable disposal of goodwill to a related party.

The tax authorities may also consider that the commissionaires are permanent establishments of the principal, because the commissionaire is not legally and economically independent from the principal, and that it has, and habitually exercises, the ability to conclude contracts on behalf of the principal. The multinational group should therefore ensure that the related transactions are at arm's length, and that the commissionaire cannot bind the principal in contract.

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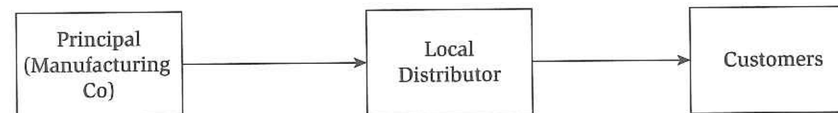
§6.04 LIMITED RISK BUY/SELL STRUCTURES

Figure 6.3 Limited Risk Buy/Sell Structures

Goods are sold to the Local Distributor however the Principal carries the inventory, warranty, and foreign exchange risks



The limited risk buy/sell structure applies where the principal sells the finished goods to the local country distributor. The legal title to the goods therefore passes to the Distributor. The related distribution agreement may provide that the principal bears significant commercial risks such as inventory, warranty, foreign exchange, and the

1. PricewaterhouseCoopers *Switzerland: Commissionaire Structures - Switzerland As A Location For The Principal Supplier*, <http://www.mondaq.com/x/5424/Audit/Commissionaire + Structures + Switzerland + As + A + Location + For + The + Principal + Supplier>.

principal therefore has a higher markup on sale. The distributor in the structure generally bears less risk than under a standard full-risk distributorship, and derives a lower profit margin.

The structure was analysed by Cabrera, Leiman, and Skaletsky, who commented that the activities of the distributor should not result in a local permanent establishment for principal, provided the parties respect the distributor's function and risks as a bona fide buy-sell distributor. Both the distribution agreement and the parties' transfer pricing analysis should include a detailed description of the risks the principal and distributor bear. The parties must act in accordance with the distribution agreement and the principal should not take any action that may result in it having a tax presence or permanent establishment in the country of final sale.[2]

2. Victor Cabrera, Jose Leiman & Marc Skaletsky, *Hub-and-Spoke Arrangements May Result in a Rough Ride– Tax Issues Facing Supply Arrangements in Latin America* (KPMG LLP) 11(6) Practical Latin American Tax Strategies (2008). They also commented that there should be no unrecoverable import VAT issues for the principal as the distributor bears import duties as well as input VAT upon the acquisition of the goods, and should be able to recover input VAT upon the sale of the goods to its customer.

CHAPTER 7

Shipping and Air Transport

§7.01 INTRODUCTION

This chapter reviews the specific provisions relating to shipping and air transport and the allocation of taxing powers in the related model tax treaties, together with related indirect tax issues such as VAT.

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§7.02 THE OECD MODEL TAX TREATY AND OTHER TAX TREATIES

The provisions of Article 8 of the 2014 Model Tax Treaty concern shipping, inland waterways transport and air transport. Article 8(1) provides:

> Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

Article 3(1)(e) provides the related definition of international traffic as follows:

> e) the term 'international traffic' means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State.

On this basis, the OECD Model Treaty can potentially prevent taxation by a state where an airline of another state uses its airspace and airports. However it is essential to note that these provisions do not prevent charges for airspace and airport use.

The OECD also is proposing certain modifications to Article 8(1) as follows:[1]

1. Proposed Changes To The OECD Model Tax Convention Dealing With The Operation Of Ships And Aircraft In International Traffic, Public Discussion Draft, 15 Nov. 2013–15 Jan. 2014, <http://www.oecd.org/tax/treaties/Discussion-draft-international-taffic.pdf>.

Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

There may be advantages for multinational shipping and airline groups to adopt a branch structure in local countries where there may be treaty protection from local taxation providing the related income is derived solely from activities under this article.

§7.03 THE UNITED NATIONS MODEL TAX TREATY

The United Nations Model Tax Treaty contains a similar clause to the OECD Model Tax Treaty, however it significantly provides a very different alternative in relation to shipping in Article 8 (alternative b) as follows:

1. Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
2. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State.

The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations.)

On this basis, where this alternative is adopted in a tax treaty, the allocation of taxing powers over shipping activities which are 'more than casual' in the respective state is to be based on an agreed percentage allocation between the state of effective management and the other contracting state where these shipping services take place.

It is also significant that countries may enter into reciprocal shipping/aviation agreements with other countries, including states that may potentially be considered as tax havens where there is no income tax treaty.

§7.04 VAT ON SHIPPING AND AIR TRANSPORT

In relation VAT, most countries treat international ticket sales are zero rated under the VAT or general sales taxes, so that any value added tax airlines pay on their inputs is fully refundable, although domestic air travel may be subject to VAT. A related International Monetary Fund (IMF) report commented that this reflects a view of the services provided as being essentially exports, and also reflects the potential difficulties in taxing international services that are especially acute in international transport.[2] In

2. International Monetary Fund (IMF), 'Market-Based Instruments for International Aviation and Shipping as a Source of Climate Finance' (IMF, 2011) <https://www.imf.org/external/np/g20/pdf/110411a.pdf>.

the United Kingdom, for example, zero rating applies to all scheduled flights irrespective of the carrying capacity of aircraft.[3]

§7.05 OTHER CHARGES ON SHIPPING AND AIR TRANSPORT

Many countries have introduced charges relating to international shipping and air transport which are not affected by tax treaties. The IMF analysed related charges applying to air transport, and considered taxes on aviation fuel, ticket taxes, and departure and other charges.[4] Tax treaties do not prevent such charges as the charges are not taxed on income or capital. Article 2 of the OECD Model Tax Treaty 2014, for example, provides that:

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

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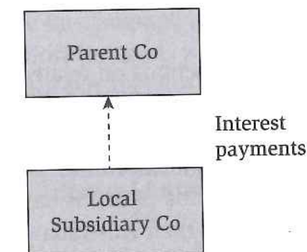
3. HMRC, 'VAT Notice 744A: Passenger Transport', 24 Dec. 2009, <https://www.gov.uk/government/publications/vat-notice-744a-passenger-transport/vat-notice-744a-passenger-transport>.
4. Michael Keen & Jon Strand *Indirect Taxes on International Aviation*, IMF Working Paper WP/06/124 (International Monetary Fund, 2006) <https://www.imf.org/external/pubs/ft/wp/2006/wp06124.pdf>.

CHAPTER 24
Interest Deductions in Subsidiaries and Thin Capitalisation

§24.01 INTRODUCTION

Figure 24.1 Thin Capitalisation



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Thin capitalisation relates to the anti-tax avoidance provisions of many countries which generally limit tax deductions for interest paid on related party debt, for example

for interest on loans from a parent company or a group treasury centre.[1] These provisions can potentially also limit interest deductions on debt to third parties, or where debt is considered to be excessive. In the diagram above, Parent Co has loaned money to Local Subsidiary Co in another country. The interest on the loan paid by Local Subsidiary Co to Parent Co may not be deductible if the loan exceeds that country's thin capitalisation limits.

Several countries use a debt to equity ratio for thin capitalisation, where interest on the amount of debt exceeding the maximum ratio of debt to equity is not deductible. For example, a country may have a 3:1 debt to equity ratio for thin capitalisation, and the debt to equity ratio of the local company is actually 5:1, based on USD 500 million debt to USD 100 million equity. The interest on the USD 200 million excess debt may be treated as non-deductible.

In some countries, thin capitalisation rules may also apply to third-party loans, for example where a parent company provides a guarantee for a third-party bank loan to a subsidiary in the group. Other countries have been introducing additional limitations on interest deductions, such as earnings stripping rules in the United States, interest barrier rules in Germany and Denmark, interest limits applying to the participation exemption limitation in the Netherlands, and the worldwide debt cap rules in the United Kingdom. Instead of debt exceeding the thin capitalisation limits, there may be opportunities to charge other expenses to the local subsidiaries which still allow local tax deductions.

§24.02 COUNTRY EXAMPLES

[A] Australia: Thin Capitalisation

The Australian provisions can disallow interest deductions on related and third-party debt exceeding the safe harbour limits: The limits applying from 1 July 2014 are: (1) the debt limit for general entities of 60% of adjusted Australian assets, corresponding to a 1.5:1 debt to equity ratio; (2) the limit for non-bank financial entities is 15:1; and (3) the limit for banks, as authorised deposit-taking institutions (ADI), is based on minimum capital for banks of 6% of the risk weighted assets of their Australian operations from 1 July 2014.

The related safe harbour provisions allow capitalisation based on an arm's-length debt amount, based on the amount which an independent party would have borrowed from an independent lender. For outward investors from Australia the safe harbour can apply for debt up to 100% of the group's worldwide gearing ratio.[2]

1. Stuart Webber, *Thin Capitalization and Interest Deduction Rules: A Worldwide Survey*, (2010) 60(9) Tax Notes International, 683.
2. *Income Tax Assessment Act 1997*, Division 820 (Australia).

[B] Denmark: Interest Barrier Rules

Danish interest barrier rules were introduced in 2007, and may impose limits on interest deductions. The interest ceiling rule applies where interest expenses exceed 3.5% of assets, and the earnings before interest and tax (EBIT) rule applies where interest exceeds 80% of EBIT. The provisions may apply to debt owed to resident and non-resident creditors, and debt to third parties and related parties.[3]

[C] France: Thin Capitalisation

Interest expenses can be disallowed from 1 January 2007 under the arm's-length test or under the thin capitalisation test. The arm's-length test can disallow interest deductions where the interest rate exceeds the higher of the average interest rate on loans of more than two years granted by banks to French companies in similar circumstances, or the interest rate at which the company could have borrowed from unrelated financial institutions.

The thin capitalisation test can disallow deductions where loans from related shareholders, based on a relationship of more than 50% of voting or financial rights, exceed 50% of share capital, 25% of profits, with interest, depreciation and tax added back, or the interest exceeds interest received from related companies.

[D] Germany: Interest Barrier Rules

In Germany the interest barrier rules introduced in 2008 can generally disallow interest deductions where the company's net interest expenditure exceeds 30% of the company's earnings before interest, taxes, depreciation and amortisation (EBITDA). The interest barrier rule can apply to debt to resident and non-resident creditors, and debt to third parties and related parties.[4]

[E] Italy: Interest Limits

Italy introduced limitations on the deductibility of interest from 1 January 2008. The limits can apply to related and unrelated party debt. The rules provide that interest expenses, net of interest income, exceeding 30% of EBITDA (earnings before interest, tax, depreciation and amortisation) are not deductible. The rules include lease payments which are treated as interest. Banks, insurance companies and financial companies, except for holding companies, are generally excluded from the limits. Interest which is disallowed under these provisions can be carried forward without a time limit, and can be used to offset taxable income within the 30% limit in succeeding tax years.

3. *Corporate Income Tax Act*, Law 111 of 19 Feb. 2004, ('*Selskabsskatteloven*') s. 11B and 11C, and *Income Tax Act*, Statute of 1922 on Income Taxation to the State, ('*Statsskatteloven*') (Denmark).
4. *Income Tax Act*, section 4(h) (EStG), *Corporate Income Tax Law*, s. 8(a) ('KStG') (Germany).

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[F] Netherlands: Participation Debt Limitation

The Netherlands has measures to limit interest deductions relating to foreign participations in the participation debt limitation rules which apply from 2013.[5] The measures apply to interest relating to share investments where the related dividends would be tax free under the participation exemption rules. The amount of the non-deductible interest is based on the ratio of participation debt to the company's total debt. The term participation debt is the amount by which the purchase price of the participations exceeds the parent company's equity. The Netherlands abolished the thin capitalisation ratio provisions in 2013.[6]

[G] United States: Thin Capitalisation

The United States has thin capitalisation provisions which can requalify loans from related parties as equity rather than debt, and therefore disallow the related interest deductions. The practice is that this may apply where the ratio of balance sheet debt to equity exceeds 3:1.[7] Interest may also be disallowed under earnings stripping provisions, where interest is paid on loans from foreign related parties or guaranteed by them, where the lender is not subject to United States tax on the interest, and where the debt to equity ratio exceeds 1.5:1.[8]

[H] United Kingdom: Thin Capitalisation

The United Kingdom can apply thin capitalisation rules to disallow interest deductions for United Kingdom subsidiaries of overseas companies. The rules are based on a transfer pricing approach, with different application for different industries. There is no safe harbour ratio, and an interest disallowance may generally be considered where the debt to equity ratio exceeds 1:1 for many industries. Companies are required to self-assess their borrowing capability in line with arm's-length transfer pricing principles.[9] An Advance Thin Capitalisation Agreement (ATCA) may be made with HMRC to confirm that a company's interest payments are an arm's-length cost of borrowing.[10]

5. *Corporate Income Tax Act* (CITA) s. 13L (Netherlands).
6. Ernst & Young, *Worldwide Corporate Tax Guide 2013* 915 (Ernst & Young, 2013).
7. *Internal Revenue Code*, 26 USC (1986) (United States) s. 163(j) (United States).
8. CCH, *US Master Tax Guide* (CCH, 2013).
9. *Taxation (International and Other Provisions) Act 2010, c. 8* Part 4 (United Kingdom).
10. HMRC, Statement of Practice 04/07, Advance Thin Capitalisation Agreements under the APA Legislation.

[I] United Kingdom: Worldwide Debt Cap

The United Kingdom has also introduced worldwide debt cap rules.[11] These provisions may apply from 1 January 2010 to net United Kingdom debt costs of a United Kingdom group. The gateway test for disallowance applies where United Kingdom net debt, less loan receivables and debt in finance leases, exceeds 75% of group's worldwide gross external debt.[12] The test then compares total net finance costs of United Kingdom members of a group, as the tested amount, to gross external finance costs of whole group, as the available amount. Interest on the excess of the tested amount over the available amount is then disallowed. There is an exemption which may apply to financing income.

[J] United Kingdom: Anti-arbitrage Potential Interest Limits

The United Kingdom has limitations on the deductibility of interest relating to tax arbitrage transactions from 2005.[13] These provisions potentially limit deductibility of interest if there is a mismatch in the tax treatment of that interest in another country. There is also a requirement to report related transactions. The Treasury may then issue rulings that the measures apply.[14] The provisions can apply, for example, to double deductions for the same expense, United Kingdom deductions where the recipient is not taxed, or amounts are received which are not taxable in the United Kingdom. The provisions only apply where HMRC has issued a related notice that the legislation applies. The provisions may potentially deny tax deductions forming part of an arbitrage scheme and certain receipts can become taxable. The provisions can apply, for example, where a United Kingdom company claims an interest deduction, and another country treats the United Kingdom entity as a transparent entity allowing, its own resident investors in that entity to also have the related interest deductions.

§24.03 EUROPEAN UNION CONSIDERATIONS: FREEDOM OF ESTABLISHMENT

There is an issue with thin capitalisation rules under European Union law. The *Lankhorst-Hohorst* case was a judgment of the European Court of Justice (ECJ) made in 2002.[15] In that case, a German company borrowed money from a related Netherlands company. The German thin capitalisation rules were applied by the German tax authorities, and interest was treated as partly not deductible. If the company had

11. *Taxation (International and Other Provisions) Act 2010*, c. 8, and *Finance Act 2009* c. 10 (United Kingdom).
12. Nicholas Gardner & John Watson, *The Debt Cap Explained*, Ashurst LLP.
13. *Finance (No. 2) Act 2005* c. 22, ss 24-31 and Sch. 3 (United Kingdom).
14. HMRC, *International Manual INTM594510 - Arbitrage: Legislation and Principles - Introduction: What Is Tax Arbitrage?* www.hmrc.gov.uk/manuals/intmanual/intm594510.htm at 15 Jan. 2014.
15. *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* (Case C-324/00) [2002] ECR 1-11779 (European Union).

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borrowed from a German lender, however, the thin capitalisation rules would not have applied, and there would have been no limit on the interest deduction. The ECJ held that the German thin capitalisation rules breached freedom of establishment principles in European law, and were not justifiable. European Union countries with thin capitalisation rules were required either to delete these rules, or to make the rules also apply to local country borrowings. Germany replaced the thin capitalisation provisions considered by the ECJ with the interest barrier rules in 2008.[16]

§24.04 THE OECD BEPS ACTION PLAN AND INTEREST DEDUCTIONS

The OECD BEPS Action plan includes review of base erosion arrangements using excessive interest deductions and other financial payments in Action Plan 4 as follows:

> Action 4 - Limit base erosion via interest deductions and other financial payments. This includes the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

The OECD released the related discussion draft in 2015.[17] The discussion draft sought comment on the following approaches:[18]

- Group-wide tests under which the allowable interest deductions for a particular entity are determined based upon the debt position of the group. KPMG commented that an entity's net interest expense would be limited by reference to its allocable share of the group's net interest expense, either by proportionately allocating group capacity by reference to an economic indicator, such as earnings or asset values, or based on a group ratio that compares, for example, the entity's net interest versus earnings to the group's overall ratio of net interest versus earnings.
- Fixed-ratio tests applied on an entity-by-entity basis limiting a company's interest deductions by reference to a benchmark ratio of earnings, assets or equity. Under a fixed-ratio framework, an entity would be entitled to deduct net interest expense up to a specified proportion of its earnings, assets or equity. KPMG commented that the current United States provisions use this method through the 50% of adjusted taxable income limitation. The Discussion Draft noted a perception that even the lower 25% and 30% ratios currently used by other countries may be too high to address BEPS concerns.[19]
- A combination of the above two tests.

16. *Income Tax Act*, s. 4(h) (EStG), *Corporate Income Tax Law*, s. 8(a) ('KStG') (Germany).
17. Public Discussion Draft, BEPS Action 4: Interest Deductions and Other Financial Payments, 1 Feb. 2015 <http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf>.
18. KPMG, *OECD - Initial Impressions of Discussion Draft (BEPS Action 4)* <http://www.kpmg.com/us/en/issuesandinsights/articlespublications/taxnewsflash/pages/2014-2/oecd-initial-impressions-of-discussion-draft-beps-action-4.aspx>.
19. Internal Revenue Code, s. 163(j) (United States).

The OECD Discussion Draft considered that targeted rules may be needed to address specific cases, such as interest paid to connected or related parties; accrued on excessive debt push-downs; or used to fund or acquire tax-exempt or tax-deferred income-yielding assets. These issues were presented for further discussion. It was also acknowledged that special issues were presented by banking and insurance companies. Consideration would also be given to sectors taxed under special regimes such as natural resources, infrastructure, and non-bank or insurance financial companies such as asset management, leasing, and credit card businesses.

§24.05 THIN CAPITALISATION PLANNING

There are several potential thin capitalisation tax planning structures. The structures may include the following, however any planning arrangements will be subject to the specific thin capitalisation tax rules, and the anti-tax avoidance rules, of the countries concerned:

- One approach which may be considered is the use of operating leases over plant and machinery which may be provided by the parent or group treasury company to the local country subsidiary. The operating lease obligations may potentially not be treated as debt for thin capitalisation provisions. The operating leases may also be provided in the form of a sale and leaseback transaction, which would provide the local country subsidiary with funding from the sale of some of the company's assets to the parent or group treasury company, and where the local country subsidiary would then lease back those assets.
- Debt factoring is also a potential planning approach. The local country subsidiary may sell its trade receivables, being amounts owed by its customers and expected to be paid at future dates, to the parent company at a discount to the face value of the receivables, for example they may be sold for 85% of their face value. This discount received by the parent company under the debt factoring arrangement effectively represents the time value of money for the later collection of the receivables, and this discount is therefore effectively interest received by the parent company for providing funding.
- There is also a planning approach where the parent company itself borrows money and may obtain interest deductions in its own country, and the parent company then provides equity to the subsidiary company to reduce that subsidiary company's related party debt. This arrangement effectively moves part of the interest deduction to the parent company. This approach may be used at several levels, where each company borrows to its thin capitalisation limit, and then provides equity funding to its subsidiary. This structure is generally known as 'debt cascading'.
- An older arrangement has been used where the local country subsidiary borrows from a local bank branch, while the parent company deposits funds with the same bank's head office in its own country. The local subsidiary therefore obtains interest deductions on the local bank loan, and the local

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third-party bank debt may not be included in thin capitalisation limits. This structure is generally known as the use of back to back loans. There are, however, several anti-tax avoidance provisions which may apply, particularly where the local subsidiary loans and the parent company deposits have similar amounts and conditions.

- One arrangement is based on the parent company providing a guarantee of the third-party debts of the local country subsidiary in return for a guarantee fee paid by the local country subsidiary. This structure may potentially provide a deduction for the guarantee fee paid by the subsidiary, and also reduce that subsidiary's related party debt.
- An alternative to loan arrangements relates to the use of fees for treasury services. The local country subsidiary may pay the parent company or group treasury company for financial services. These services may include, for example, foreign currency spot transactions such as purchasing the subsidiary's USD derived from overseas sales, and selling local currency to meet local production expenses. These services may also include swap transactions. A foreign currency swap, for example, may exchange a series of USD payments over time with a series of payments of local currency. A fixed to floating interest rate swap can exchange a series of interest payments which are at a set or fixed rate, with a series of payments at a floating rate which can change with market conditions, such as the London interbank offered rate (LIBOR). The parent or group treasury company can derive the related fee income, and the fees may potentially be deductible for the local country subsidiary.
- A simple arrangement may be used where the parent or group treasury company provides a smaller loan to the subsidiary which is within the local thin capitalisation limits, but which is charged at a higher interest rate. This may be arranged, for example, with subordinated loans. The repayments on a subordinated loan on a winding up of a company are only made after payments are made to other creditors. The subordinated loan therefore carries a higher risk of default than other loans, and therefore entitles the lender to a higher interest rate.
- An arrangement may also be used which is based on an asset transfer. The parent company or another group company transfers assets to the local country subsidiary, in exchange for share capital issued by the subsidiary company. This structure essentially increases the subsidiary's share capital and therefore its equity for thin capitalisation purposes. This arrangement therefore allows additional related party borrowing within thin capitalisation limits based on the new higher level of the subsidiary's capital.

CHAPTER 25

Tax Havens and Controlled Foreign Corporations Rules

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§25.01 INTRODUCTION

Controlled foreign corporation (CFC) provisions are principally concerned with addressing tax avoidance structures which use tax havens. The provisions generally address the tax haven issue by taxing the local parent company on the income earned by that company's foreign subsidiaries in tax havens or other low tax rate regimes. The CFC provisions generally apply tax on the 'passive income' of a tax haven company which is not related to an active business, such as interest, dividends and royalty income, as that income is earned in the tax haven company, rather than only taxing the income when the tax haven subsidiary pays a taxable dividend to the parent company. Accordingly CFC provisions may also be known as accruals taxation regimes.

The CFC provisions may not apply to active business income, such as income from production, manufacturing or trading activities which are actually performed in the tax haven country. The provisions may also test what proportion of the tax haven subsidiary's total income is passive income to determine whether CFC taxation should apply.

Some CFC rules use a specific list of tax havens,[1] or the rules may determine that the provisions should apply where the foreign company has a comparatively low effective tax rate. An effective tax rate generally means the tax rate calculated as if the income was derived in the parent country under the parent company tax rules, and this amount is then compared to the actual tax paid by the foreign subsidiary.

1. Jason Sharman & Gregory Rawlings, 'Deconstructing National Tax Blacklists – Removing Obstacles to Cross-Border Trade in Financial Services' (Paper presented at the Beyond the Level Playing Field? Symposium, London, 19 Sep. 2005).

The provisions may use two related tests: (1) a shareholder test to determine whether a foreign company is a CFC because their residents have a sufficient ownership or control of the foreign company; and then (2) test whether particular taxpayers in their country are subject to CFC taxation because they have a sufficient ownership or control in the CFC. For example, the United Kingdom provisions generally require 50% control by one or more United Kingdom residents for a foreign company to be a CFC, and then apply the CFC provisions to United Kingdom residents which hold at least 25% shareholding in that CFC.

These provisions have been adopted by many countries. Countries with similar regimes include:

- Argentina – 1999 – Law 25,239;
- Australia – 1991 – Part X ITAA 1936;
- Brazil – 1996 – A.25 Law 9.249/95 A.21 Provisional Measure 2.158-34;
- Canada – 1976 – S.91-95 Income Tax Act;
- China – 2008 – Corporate Income Tax Law, Circular 82/2009;
- Denmark – 1995 – A.8 Income Tax Law;
- France – 1980 – A.209B French Tax Code;
- Germany 1972 – S.7-14 Foreign Tax Law;
- Italy – 2002 – S.167 Income Tax Code;
- Japan – 1978 – Special Taxation Measures S.40 S.66;
- Mexico – 1997 – Chapter 4 Law for the Coordination of International Tax Affairs;
- Spain – 1994 – Law 42/1994 and 43/1995;
- Sweden – 1990 – Chapter 6 Income Tax Act;
- UK – 1984 – Part 9A Taxation (International and Other Provisions Act) 2010;
- USA – 1962 – Subpart F Internal Revenue Code.

§25.02 EXAMPLES OF COUNTRY CFC PROVISIONS

[A] United States Provisions: Subpart F

The United States provisions generally apply to tax 'Subpart F income' of foreign subsidiaries which are controlled by United States taxpayers.[2] A CFC is defined as any foreign corporation where more than 50% of voting shares in that company are owned by United States shareholders.[3] The provisions then tax United States shareholders which own 10% or more of the foreign company. The provisions apply to several types of income, including Foreign Personal Holding Company Income (FPHCI) such as dividends, interest, rents, royalties, and gains from alienation of property that produces

2. *Internal Revenue Code*, 26 USC (1986) Part III, Subpart F, ss 951–965 (United States).
3. U.S. Master Tax Guide (2014) CCH.

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such income. The provisions may also apply to 'foreign base income' which is essentially sales, service, and shipping income from transactions with related parties, income relating to oil activities and income from insuring risks outside the CFC's country of incorporation. The provisions generally do not apply if the income was subject to foreign income tax in excess of 90% of the related United States tax rate. A foreign tax credit is allowed to reduce United States taxation by allowing a credit for the related share of the foreign income taxes paid by the CFC.

[B] United Kingdom CFC Provisions

The United Kingdom CFC provisions were substantially updated in 2013,[4] and currently apply to a non-resident company which is controlled by United Kingdom residents, and which is subject to a lower rate of tax than the United Kingdom.[5] The taxation provisions can then apply to United Kingdom shareholders with at least 25% interests in the CFC. Under these rules, CFC taxation applies to 'gateway income', which is considered to have been artificially diverted from the United Kingdom, including profits attributable to significant UK personnel functions, trading and non-trading finance profits, and 'captive insurance' income derived from insuring related companies. The provisions do not apply to countries on an excluded territory list, which applies where the headline tax rate is not less than 75% of the United Kingdom tax rate, not more than 10% of CFC income is concessionally taxed, and income does not relate to intellectual property transferred from the United Kingdom. The taxation of CFC income is then generally based on United Kingdom tax rules.

CFC taxation may potentially not apply where related people functions are performed outside the United Kingdom. A United Kingdom company may, for example, have a captive insurance subsidiary located outside the United Kingdom which insures the group's worldwide assets. The interest income derived by the captive insurance subsidiary may not be subject to CFC taxation where the related people functions are performed outside the United Kingdom.

[C] European Union Issues: The Cadbury Schweppes Case

There is a European Union issue whether the CFC provisions of European Union Member States can apply in respect of companies established in the European Economic Area (EEA). In this respect, the European Court of Justice (ECJ) reviewed the previous United Kingdom CFC provisions in the *Cadbury Schweppes* case.[6] Cadbury Schweppes had established two indirect subsidiaries under the International Financial

4. *Taxation (International and Other Provisions) Act 2010*, c. 8, Part 9A, and *Finance Act 2012* (United Kingdom).
5. KPMG, Controlled Foreign Companies – A Summary of the New Rules September 2012.
6. *Cadbury Schweppes Plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case C-196/04[2006] ECR I-7995.

Services Centre provisions in Ireland. These subsidiaries provided group treasury services which were taxed in Ireland at 10%. The United Kingdom tax authorities applied the CFC provisions to tax the United Kingdom parent company on the income of the two subsidiaries. The ECJ noted that the Treaty on European Union ('Maastricht Treaty') prohibited Member States from hindering establishment of a national in another Member State,[7] and that taxation of the parent company would not occur in relation to the income of United Kingdom subsidiaries. On this basis the CFC legislation restricted establishment or acquisition of a subsidiary in a lower tax Member State. The ECJ held that United Kingdom CFC provisions therefore breached European Union freedom of establishment rules, by imposing additional tax because the subsidiaries were located in Ireland, except where the provisions were concerned with wholly artificial arrangements.[8]

The United Kingdom tax authorities initially responded to the case stating that it would exclude that part of chargeable profits that represents the net economic value to the group arising from the work carried out by the company's staff in the business establishment in the other European Union Member State.[9]

In the *Vodafone 2* case,[10] however, the United Kingdom Court of Appeal held that CFC provisions should be interpreted to conform with the ECJ decision, and accordingly that the CFC provisions should not apply to companies established in a Member State of the EEA, and carry out genuine economic activities in that state.[11] The United Kingdom therefore issued the revised CFC rules described above. France and Germany revised their CFC provisions following the *Cadbury Schweppes* decision.[12] France amended its rules in 2005 providing an exemption where the ownership of the foreign company in a European Union Member State did not constitute a wholly artificial arrangement designed to escape tax that would otherwise be payable. Germany amended its rules in 2008 to provide an exemption for companies in the European Economic Area (EEA) for income derived from genuine economic activity carried out in its country of residence.

The European Union has also issued a Council Resolution on coordination of CFC and thin capitalisation rules within the European Union.[13] The Resolution provides a

7. *Treaty on European Union* [1992] OJ C191/1, opened for signature 7 Feb. 1992 (entered into force 1 Nov. 1993) ('*Maastricht Treaty*'). The treaty was substantially updated by the *Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community* [2007] OJ C306/01.
8. Mathieu Isenbaert, *EC Law and the Sovereignty of the Member States in Direct Taxation* 544 (2010).
9. This was set out in the prior version of the HMRC International Tax Manual INTM 210530 (superseded).
10. *Vodafone 2 v. Her Majesty's Revenue and Customs* [2009] EWCA Civ 446.
11. 'Vodafone 2 -v- HMRC: CFC rules' Ashurst Tax Newsletter, June 2009.
12. Sara Luder, *CFCs around Europe*, Tax J., 9 May 2012.
13. *Council Resolution of 8 June 2010 on Coordination of the Controlled Foreign Corporation (CFC) and Thin Capitalisation Rules within the European Union* (2010/C 156/01).

broad and non-exclusive list of cases where Member States may potentially apply CFC provisions, including:

- where there are insufficient valid economic or commercial reasons for the profit attribution, which therefore does not reflect the economic reality;
- where there is an incorporation that does not essentially correspond with an actual establishment intended to carry on genuine economic activities;
- where there is an inadequate correlation between the company's activities and its premises, staff and equipment; or
- where the taxpayer has entered into arrangements that are devoid of economic reality.

§25.03 TAX HAVENS AND THE PARTICIPATION EXEMPTION

There are also anti-tax haven measures in conditions relating to the participation exemption. Many European countries have a participation exemption which can treat dividends from other countries as tax free or 95% tax free in certain circumstances, including the Netherlands, Germany, Belgium, and the United Kingdom. The dividend is tax exempt or concessionally taxed essentially where the dividend is from a company in which the shareholder has a significant shareholding, known as a participation. These countries generally, however, deny the benefit of the participation exemption where the dividend relates to passive activities performed by the subsidiary in a low taxing country. Accordingly, while CFC taxation taxes the parent company as the income is earned by the CFC, the participation exemption rules generally apply tax at a later stage, when dividends are received from the low taxed subsidiary by the parent company. However both measures have provisions against the use of tax havens.

The Netherlands has participation exemption rules, for example, which can treat dividend income from foreign subsidiaries, and capital gains on the sale of the participation shares, as tax-free income.[14] The exemption, updated in 2007, generally applies if the Netherlands company has a participation of at least 5% in the foreign company, and this holding was not a 'low-taxed portfolio participation.' This exclusion applies where the effective tax rate in the foreign country is less than 10% under Netherlands tax rules, and more than 50% of the foreign company's assets are portfolio investments which are not used in the course of business.

14. *Corporate Income Tax Act 1969*, Act of 8 Oct. 1969, Art. 13 (Netherlands).

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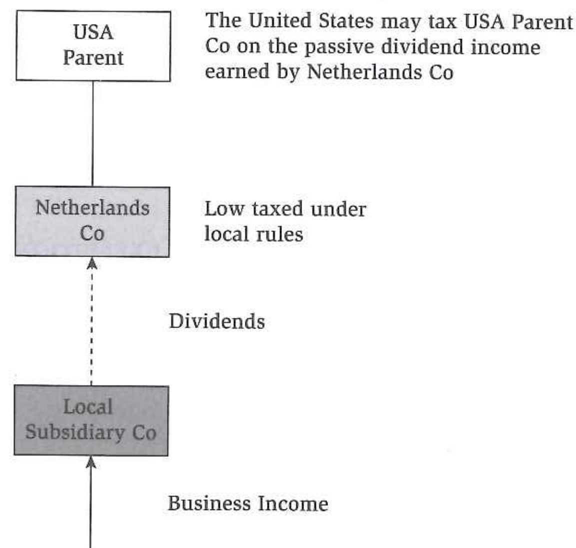
§25.04 ISSUES FOR THE GROUP HOLDING COMPANY

Figure 25.1 Group Holding Company



This issue concerns the ownership of local production companies through intermediate holding companies, for example in the Netherlands. In this example, the United States may seek to impose CFC taxation under SubPart F on USA Parent in relation to the dividend income Netherlands Co receives from the Local Subsidiary.

The Netherlands may be treated as a low effective tax rate country for United States purposes due to the participation exemption, which may exempt the dividends from the Local Subsidiary from Netherlands tax. The United States may also grant a tax credit for the tax paid by Local Subsidiary.

There is a need to review potential CFC issues in the use of intermediate holding companies, as there may be CFC taxation if the intermediate holding company, in this case Netherlands Co, provides any related tax concessions. The benefits of the Netherlands tax concessions may be lost at the level of United States CFC taxation on USA Parent.

§25.05 THE DOUBLE IRISH DUTCH SANDWICH

One structure which has reportedly been used by several United States multinationals to potentially reduce their tax liabilities is known as the 'Double Irish Dutch Sandwich structure.' In general terms, income from royalties, the sale of products, or the sale of advertising, is derived by a first Irish company within a multinational group. This Irish company then pays a deductible royalty to a Netherlands company, with Irish tax at

12.5% tax applying to the margin. The Netherlands company then pays royalties to a second Irish Company and may be taxed in the Netherlands only on the margin. The majority of the income is derived by the second Irish company, which may potentially be exempt under Irish tax rules where it is treated as controlled by management located in another country. The management was generally provided from a tax haven jurisdiction, for example in Bermuda.

It remains to be determined whether the Double Irish Dutch Sandwich arrangement would be effective against the respective transfer pricing and anti-tax avoidance provisions of the countries concerned, however it is understood several of the taxpayers may have obtained related tax rulings from the United States tax authorities. One issue is whether any transfer of intellectual property from the United States to the offshore companies was made at fair market value and was subject to exit tax. There is also an issue whether the related valuation of that intellectual property was made based on current costs and circumstances at the time of the valuation, or if the valuation based on the present value of the related future income streams. In general, a United States taxpayer may be deemed to have sold intellectual property at rates commensurate with the income attributable to that intangible property, regardless of the actual consideration received, and such deemed income may then be taxed in the United States as ordinary income.

United States CFC taxation under Subpart F may potentially apply to the related royalties derived in a foreign subsidiary in a low taxing country. However, the transaction may potentially have been structured as a cost-sharing arrangement by several companies in the multinational group to jointly develop the intangible property. The non-United States rights in the intellectual property developed under the cost-sharing arrangement may be treated as created in the jurisdiction where the intellectual property is intended to be utilised by the foreign subsidiary, and therefore may potentially not be subject to United States CFC taxation.

In general terms it may be argued that the United States may require an effective general anti-abuse rule (GAAR) to address such planning structures. A GAAR rule was recently introduced in the United Kingdom in 2013.[15] The United Kingdom GAAR applies to 'tax arrangements' which are 'abusive'. In broad terms a tax arrangement is any arrangement which, viewed objectively, has the obtaining of a tax advantage as its main purpose or one of its main purposes. A transaction is then regarded as abusive when the course of action taken by the taxpayer aims to achieve a favourable tax result that Parliament did not anticipate when it introduced the tax rules in question and where that course of action cannot reasonably be regarded as reasonable.[16] The existence of an effective United States GAAR provision would potentially have raised the issue of whether the respective companies had sufficient commercial reasons to achieve the desired tax result.

15. *Finance Bill 2013*, s. 208(2) (United Kingdom).
16. HMRC's GAAR Guidance (Approved by the Advisory Panel with effect from 15 Apr. 2013) at www.hmrc.gov.uk/avoidance/gaar-part-abc.pdf at 25 Jul. 2013.

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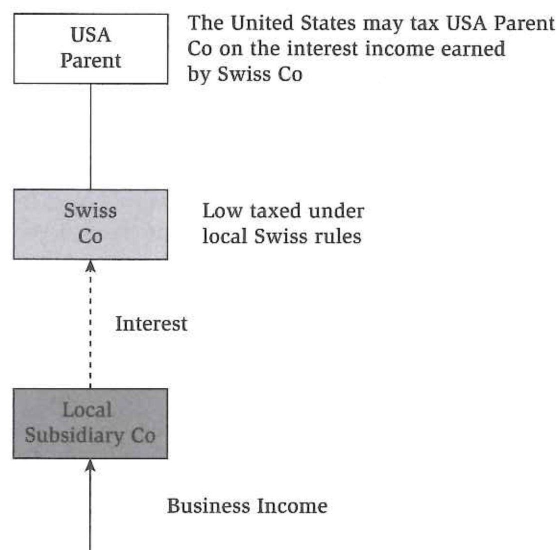
§25.06 CFC PROVISIONS AND THE GROUP FINANCE COMPANY

Figure 25.2 Group Finance Company



[A] Overview

This issue relates to the funding of a multinational manufacturing group through an intermediate group financing company, for example a group treasury or financing company located in Switzerland. The United States may seek to impose CFC taxation under Subpart F,[17] on USA Parent in respect of the interest income derived by Swiss Co.

[B] Tax Analysis

Switzerland is likely to apply a low effective tax rate in this structure. In this case there may be a Swiss Cantonal tax ruling potentially reducing the combined Swiss Federal and Cantonal tax to about 3%.

[C] Issues

The principal issue with the structure is that the parent country's CFC rules, in this case in the United States, may apply to tax USA Parent on the interest income derived by Swiss Co. There may be less scope for tax-planning arrangements to reduce CFC

17. *Internal Revenue Code*, 26 USC (1986) Part III, Subpart F, ss 951–965 (United States).

taxation on interest income in such treasury structures, compared to the potential use of tax planning based on structures such as cost contribution arrangements potentially used in intellectual property structures.

§25.07 UNITED STATES CHECK-THE-BOX PROVISIONS

The United States tax provisions include entity classification or check the box measures which allow certain entities to elect to be taxed on a tax transparent or disregarded basis, or alternatively on a corporate basis, by an election, known as checking the box, on the relevant form. The election is not available for trusts. The elections can also potentially affect whether the results of foreign subsidiaries are brought into United States taxation.

Foreign entities, where the liability of all members is limited, are by default treated as corporations for tax purposes. These entities can elect to be treated as partnerships for transparent tax treatment so that it is the partners that are taxed. Foreign entities, with two or more members, where at least one member's liability is not limited, are by default treated as transparent for tax purposes. These entities can however elect to be treated as corporates for tax purposes so that it is the entity which is taxed.

United States domestic entities cannot elect their own tax status if they are organised under a United States statute that describes or refer to the entity as incorporated or as a corporation, a body corporate, a joint stock company or a joint stock association. United States LLCs and partnerships can however elect their tax classification under these measures.

The election is not available to 'per se' listed corporations, Regulation 301.7701. The companies in this category which may not make the check the box election include, for example:

- Australia - Public Limited Company;
- Canada - Corporation and Company;
- France - Société Anonyme;
- Germany - Aktiengesellschaft;
- Netherlands - Naamloze Vennootschap; and
- Italy - Societe per Azioni.

§25.08 THE OECD BEPS ACTION PLAN – CFC PROVISIONS

The OECD BEPS Action Plan has also focussed on CFC provisions and related anti avoidance measures in Action 3 – Controlled Foreign Company regimes. The OECD released the related discussion draft in May 2015.[18] The related issues and recommendations are as follows.

18. OECD, *Public Discussion Draft, BEPS Action 3: Strengthening CFC Rules*, 12 May 2015 <http://www.oecd.org/ctp/aggressive/discussion-draft-beps-action-3-strengthening-CFC-rules.pdf>.

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[A] Definition of a CFC

The recommendation is to broadly define entities that are within scope so that in addition to including corporate entities CFC rules would also apply to partnerships, trusts, and permanent establishments when those entities are either owned by CFCs or treated in the parent jurisdiction as taxable entities separate from their owners. A further recommendation is to include a modified hybrid mismatch rule that would prevent entities from circumventing CFC rules by being treated differently in different jurisdictions.

[B] Threshold Requirements

The recommendation is to include a low-tax threshold where the tax rate calculation is based on the effective tax rate. The low-tax threshold should also use a tax rate that is meaningfully lower than the tax rate in the country applying the CFC rules.

[C] Definition of Control

The definition of control requires two different determinations: (i) of the type of control that is required and (ii) of the level of that control. The recommendation for control is that CFC rules should at least apply both a legal and an economic control test so that satisfaction of either test results in control. Countries may also include de facto tests where they achieve the same effect. Second, a CFC should be treated as controlled where residents hold, at a minimum, more than 50% control, although countries that want to achieve broader policy goals or prevent circumvention of CFC rules may set their control threshold at a lower level. This level of control could be established through the aggregated interest of related parties or unrelated resident parties or from aggregating the interests of any taxpayers that are found to be acting in concert. CFC rules should also apply where there is direct or indirect control.

[D] Definition of CFC Income

The OECD Discussion Paper does not set out general recommendations for how to define CFC income, but it instead discusses several possible approaches that jurisdictions could adopt. Whichever approach is adopted, CFC rules should accurately attribute income that raises base erosion and profit shifting concerns. CFC rules should accurately define attributable income earned by CFCs that are holding companies, income earned by CFCs that provide financial and banking services, income earned by CFCs that engage in sales invoicing, income from IP assets, income from digital goods and services, and income from captive insurance and re-insurance. In practical terms, this means that CFC rules must be capable of dealing with at least the following types of income:

- Dividends
- Interest and other financing income
- Insurance income
- Sales and services income
- Royalties and other IP income.

The OECD discusses two different approaches that jurisdictions could use to accurately attribute income earned by a CFC:

- The categorical approach is used under some existing CFC rules have separate rules for different types of income, and this approach builds on these rules and has one rule for dividends, another rule for interest, and separate rules for other types of income. If jurisdictions adopt this approach, they could have rules similar to those discussed above. The categorical approach allows jurisdictions to tailor their rules so that each type of income is treated accurately.
- The excess-profits approach. This could involve a simpler and more mechanical approach than the categorical approach referred to above, and could also be used to deal with embedded IP. If such an approach were targeted at specific income, such as IP then jurisdictions could choose to implement an excess-profits approach alongside other, more traditional CFC rules.

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[E] Rules for Computing Income

Computing the income of a CFC requires two different determinations: (i) which jurisdiction's rules should apply and (ii) whether any specific rules for computing CFC income are necessary. The recommendation for the first determination is to use the rules of the parent jurisdiction to calculate a CFC's income. The recommendation for the second determination is that jurisdictions should have a specific rule limiting the offset of CFC losses so that they can only be used against the profits of the same CFC or against the profits of other CFCs in the same jurisdiction.

[F] Rules for Attributing Income

Income attribution can be broken into determining which taxpayers should have income attributed to them, determining how much income should be attributed, determining when the income should be included in the returns of the taxpayers, determining how the income should be treated, and determining what tax rate should apply to the income:

- The attribution threshold should be tied to the minimum control threshold when possible, although countries can choose to use different attribution and control thresholds depending on the policy considerations underlying CFC rules.