OSLER

OECD Discussion Draft Considers Controlled Foreign Corporation Rules

APRIL 6, 2015 15 MIN READ

Related Expertise

- Tax: M&A, Reorganizations and Restructuring Transactions

On April 3, 2015, as part of its Action Plan on Base Erosion and Profit Shifting (BEPS), the OECD released a discussion draft entitled "BEPS Action 3: Strengthening CFC Rules" (the Draft) for comments. The Draft stresses the importance of CFC rules in countering base erosion and profit shifting, and makes several draft recommendations regarding the design of domestic CFC rules. Comments on the Draft will be accepted until May 1, 2015, followed by a public consultation on May 12, 2015.

Background

The BEPS Action Plan, published in July 2013, identifies 15 actions to address BEPS and sets deadlines to implement these actions. Action 3 of the BEPS Action Plan relates to the design of domestic CFC rules to prevent BEPS.

Canada currently has a robust set of CFC rules. The "foreign accrual property income" or "FAPI" rules are a broad set of anti-deferral rules applicable to passive income earned by a "controlled foreign affiliate" of a Canadian taxpayer. Passive income for this purpose very generally includes income from property (such as rents, royalties, interest and non-foreign affiliate dividends) and income from certain businesses that either have a link to Canada or do not meet certain minimum employee and other requirements. FAPI does not include income from an active business carried on by a foreign affiliate. A Canadian shareholder is generally required to include, in its income for a taxation year, its share of any FAPI earned by any of its controlled foreign affiliates in such year, regardless of whether or not any amount is distributed by the controlled foreign affiliate to the shareholder. A deduction is available in respect of any foreign taxes attributable to FAPI. If FAPI in a controlled foreign affiliate is less than C$5,000, it is not required to be included in the shareholder's income. There is no "low-tax threshold" or "high-tax kick out" – the FAPI rules apply even if the controlled foreign affiliate is resident in a country that imposes tax at a rate that is equal to or exceeds the Canadian rate. Generally speaking, if FAPI, which is computed using the rules in the *Income Tax Act* (Canada) (the ITA) and in the Canadian taxpayer's functional currency, is subject to foreign tax of at least 25%, no additional tax should be payable in Canada.

A second set of rules relates to the treatment of dividends received by Canadian corporate shareholders from foreign affiliates, including dividends paid out of earnings generated from the conduct of an active business. Canada has a hybrid exemption and credit system for the repatriation of foreign affiliate earnings. Generally speaking, where earnings arise from an active business carried on by a foreign affiliate in a county with which Canada has entered into a tax treaty or tax information exchange agreement, such earnings are included in the foreign affiliate's "exempt surplus," which may be distributed as a dividend to Canada free of any additional Canadian corporate tax. Most other earnings are included in "taxable surplus," which is taxable upon distribution as a dividend to Canada, subject to a deduction in respect of any underlying foreign tax paid on the earnings that generated the surplus. Gains arising on the disposition of certain foreign affiliates (or partnerships) are added to a "hybrid surplus" account, which is half taxable upon distribution (subject to a deduction in respect of foreign tax) and which is meant to mirror the domestic taxation of capital gains.

The main foreign affiliate regime is supported by certain other rules with similar objectives and which apply depending on the circumstances. These rules include offshore investment fund property rules that may impute a return on certain non-controlled investments, non-resident trust rules which tax the earnings of certain trusts, and a rule that may impute interest income on certain direct or indirect low-interest loans to non-resident corporations. A separate “foreign affiliate dumping” regime may also apply to deem cross-border dividends to arise (or to suppress cross-border paid-up capital) in respect of certain direct or indirect investments in foreign affiliates by Canadian corporations that are controlled by a non-resident corporation.

Overview of the Draft

The Draft makes it clear that it does not reflect a consensus view of the BEPS participants, and that it rather reflects a preliminary consideration of the issues for the purpose of seeking public comments.

The Draft begins with a review of various policy considerations relating to CFC rules, including the prevention of profit shifting and long-term base erosion. The Draft notes the importance of striking a balance between taxing foreign income and maintaining competitiveness. In particular, parent country taxes imposed on the income of a CFC result in a competitive disadvantage relative to a competitor of the CFC based in the same foreign jurisdiction that does not have to pay an equivalent tax. A particular concern arises in the context of the European Union, since EU law imposes limitations on CFC rules that apply within the EU. For example, the European Court of Justice has stated that CFC rules must “specifically target wholly artificial arrangements which do not reflect economic reality and whose only purpose would be to obtain a tax advantage.”[1] The Draft also notes the importance in limiting administrative and compliance burdens in a manner that does not create opportunities for avoidance.

The Draft breaks down the constituent elements of CFC rules into the following seven “building blocks” for effective CFC rules:

- Definition of a CFC
- Threshold requirements for the application of CFC rules
- Definition of control
- Definition of CFC income
- Rules for computing income
- Rules for attributing income
- Rules to prevent or eliminate double taxation

1. Definition of a CFC

The Draft recommends broadly defining entities that are within scope of the rules so that, in addition to including corporate entities, CFC rules would also apply to partnerships, trusts and permanent establishments (PEs) when those entities are either owned by CFCs or treated in the parent jurisdiction as taxable entities separate from their owners.

The Draft also recommends including a modified hybrid mismatch rule that would prevent entities from circumventing CFC rules by being treated differently in different jurisdictions. Specifically, this rule would require an intragroup payment to a CFC to be taken into account in calculating CFC income. The Draft considers both a “broad option” and a “narrow option.”

Under the broad option, a payment would be included in CFC income if it is not otherwise included in CFC income, and would have been included if the parent jurisdiction had classified the entities and arrangements in the same way as the payer or payee jurisdiction (i.e., if there had not been a hybrid entity or instrument). The narrow option is similar except that such a payment would only be included in CFC income if it results in base erosion (i.e., deductible in one jurisdiction and subject to no or low taxes in the other jurisdiction). This rule appears to target the U.S. "check the box" election rules, which otherwise allow certain payments between foreign entities to be disregarded for CFC purposes.

Canada's FAPI rules apply to income earned by non-resident corporations, including where such income is earned through a partnership or foreign PE. Similarly, Canada's worldwide taxation rules generally also include income earned by a Canadian resident through a foreign PE or a partnership earning income outside of Canada. Canada's non-resident trust rules apply in certain circumstances to either treat the trust like a non-resident corporation (in which case its income is subject to the FAPI rules) or to deem the trust to be resident in Canada (in which case its worldwide income is taxable in Canada).

Canada's current rules also contain a restriction on the use of certain hybrid instruments. Where applicable, these rules deny recognition of foreign taxes paid by a foreign affiliate.

2. Threshold requirements for the application of CFC rules

The Draft recommends that CFC rules should include a low-tax threshold which must be satisfied before the rules apply. Applying such a threshold, the rules would only apply where a CFC's effective tax rate (as opposed to its nominal tax rate) is meaningfully lower than the parent country's tax rate. Low-tax thresholds are intended to ensure that CFC rules are targeted at companies that pose the greatest risk of profit shifting and reduce overall administrative burdens. Annex II to the Draft sets out various low-tax thresholds used by different countries. Many of these are based on an effective tax rate that is less than a fixed rate or a percentage of the parent's domestic rate. Others use lists of "good" or "bad" jurisdictions to determine whether the threshold is met.

Canada's current rules do not include a low-tax threshold. Such a threshold would be welcome, particularly as it could reduce the burden of having to consider or comply with the FAPI rules in respect of investments by Canadian residents in "high-tax" jurisdictions such as the United States or many European countries.

The Draft also notes that many countries have *de minimis* thresholds, without providing a general recommendation for or against such thresholds. Annex I to the Draft sets out various *de minimis* thresholds in different countries.

Canada's current exemption for FAPI of less than C$5,000 is significantly lower than the *de minimis* thresholds used by many other jurisdictions. For example, the U.S. threshold is the lesser of 5% of gross income or US$1 million. Any expansion to Canada's threshold would also be welcome as it could provide more meaningful relief from the administrative burden of calculating and reporting relatively small amounts of FAPI.

3. Definition of control

The Draft notes that "control" requires two different determinations: (i) the type of control that is required, and (ii) the level of that control. The recommendation is for control to be based on direct or indirect legal or economic control, with the satisfaction of either test resulting in control. Countries may also include *de facto* control tests (or a test based on consolidation for financial accounting purposes) where they achieve the same effect. Secondly, a CFC should be treated as controlled where residents hold more than 50% control, although jurisdictions may set their control threshold at a lower level. The level of control could be established through aggregating interests of related parties or unrelated resident parties, or by aggregating interests of taxpayers that are found to be acting in concert.

Canada's current rules are based on legal or *de jure* control, using a control threshold of more than 50%. In determining control, the interests of non-arm's length persons are aggregated, as are the interests of up to four arm's-length Canadian residents. Thus, controlled foreign affiliate status may arise where a foreign corporation is owned by a small group of otherwise unrelated Canadian residents. In addition, an anti-avoidance rule may apply to deem controlled foreign affiliate status to arise where, for example, shares are acquired or disposed of principally for the purpose of avoiding, reducing or deferring the payment of Canadian income tax.

4. Definition of CFC income

The Draft does not include recommendations on the definition of CFC income that is subject to attribution in the parent's hands (referred to as "CFC income"). Instead, it discusses several options that jurisdictions could implement in order to address BEPS concerns. The OECD is encouraging comments and suggestions during the public consultation about the design of the recommendations that will be included in the final report in September 2015.

The Draft suggests two possible approaches for defining CFC income: (i) a categorical approach, and (ii) an excess profits approach. Under the categorical approach, certain categories of income are included in computing CFC income (such as dividends, interest and other financing income, insurance income, sales and services income, and royalties and other IP income). The Draft acknowledges that interest and other financing income could be excluded from CFC income if the CFC carries on an active financing trade or business and is not overcapitalized. It also notes that such an approach could be combined with a look-through rule that treats interest paid out of active earnings as being active. Generally speaking, this is the approach that Canada has adopted.

Under the excess profits approach, CFC income would include certain excess profits in low-tax jurisdictions. Under this approach, a "normal rate of return" would be identified, and profits in excess of such return would be included in CFC income. The Draft specifically notes the absence of consensus on the excess profits approach. Some countries believe that such an approach would capture income irrespective of whether it arises from genuine economic activity of the CFC with appropriate substance. Other countries believe that excluding a normal return on eligible equity is effective for identifying CFC income that is appropriately attributable.

The Draft also considers whether to attribute income based on a transactional approach or an entity approach.

Canada's FAPI rules are based on a categorical approach, which has been refined over several decades. There does not appear to be any clear policy reason why Canada should abandon such an approach in favour of a more arbitrary or formulaic approach to computing FAPI.

5. Rules for computing income

The fifth CFC "building block" is the manner in which CFC income should be computed. The Draft recommends that the rules of the parent jurisdiction should be used. The Draft also recommends specific rules relating to CFC losses, so that they may only be used against the profits of the same CFC or against the profits of CFCs in the same jurisdiction.

Canada requires that FAPI be computed in accordance with the rules in the ITA, and in the Canadian parent's functional currency (i.e., Canadian dollars absent a valid foreign functional currency election). In addition, Canada has several rules limiting the application of FAPI losses. For example, generally speaking, FAPI losses may only be used to offset FAPI realized in the same controlled foreign affiliate, although there are rules that allow FAPI losses to survive certain corporate reorganizations, such as a merger or winding-up, involving the FAPI loss entity. In addition, FAPI losses that are on capital account may only be used to offset FAPI capital gains, in order to appropriately reflect the domestic loss regime.

6. Rules for attributing income

With respect to the attribution of CFC income, the Draft recommends an attribution threshold tied to a minimum control threshold, without specifying what that threshold should be. In this regard, before an entity can be considered a controlled foreign affiliate of a Canadian taxpayer, it must be a "foreign affiliate" of such taxpayer, which generally requires a minimum equity investment of 10% of any class of shares.

With respect to the amount of attributed income and the timing of its inclusion, the Draft recommends an attribution rule that reflects both proportion of ownership and actual period of ownership. The Draft makes no recommendation as to timing of inclusion. Canada's attribution rules generally look to ownership of the controlled foreign affiliate at the end of its taxation year in order to determine both the quantum and the timing of FAPI inclusion. Recently proposed amendments would refine these rules to take into account ownership changes occurring in the controlled foreign affiliate's taxation year.

The Draft makes no recommendation with respect to the characterization of attributed CFC income for domestic law purposes. Canada treats such income as being income from property, in respect of the shares of the directly held foreign affiliate in the corporate chain in which the FAPI arises.

With respect to the tax rate that should apply to CFC income, the Draft contemplates a "top-up" tax that would apply a set rate, perhaps tied to the low-tax threshold referred to above. For example, if a jurisdiction applied its CFC rules only where a CFC were subject to an effective tax rate of less than 15%, CFC income would only be taxed to a maximum of 15%, regardless of the parent's otherwise applicable rate. The Draft notes that such a top-up tax may not meet all of the policy objectives of the CFC rules, such as their anti-deferral element, and therefore only considers it as an option while preferring (and recommending) that CFC income be subject to the ordinary rate applicable in the parent country. In Canada, FAPI is subject to tax at the taxpayer's ordinary rate (after taking into account the deduction relating to foreign tax, discussed in greater detail below).

7. Rules to prevent or eliminate double taxation

CFC rules must contain protections against double taxation since their effect is to subject income earned in one entity to taxation in the hands of another entity. The Draft recommends that countries provide a credit for foreign taxes actually paid, including CFC tax assessed on intermediate companies. The Draft also recommends that dividends and gains be exempt from taxation to the extent that CFC taxation has previously applied.

Canada's CFC rules generally correspond with the recommendations. A credit for foreign tax paid in relation to FAPI is effectively granted by grossing up such foreign tax to provide for an amount of income that would have generated such tax, had tax at a notional rate (25%) that approximates the Canadian rate applied. The grossed-up amount is then allowed as a deduction in determining the amount of FAPI to be included in the Canadian shareholder's income. As a consequence, if FAPI has borne foreign tax at a rate equal to or in excess of

25%, no part of such FAPI is generally included in net income. Canada's rules currently do not contemplate the scenario where FAPI has been subject to CFC tax in an intermediate jurisdiction – as recommended by the Draft – although in our experience such a situation very rarely arises in practice.

When previously taxed FAPI is distributed as a dividend, Canada's regime generally ensures that such amount is not subject to tax again. Prior to distribution, the amount of FAPI included in income increases the shareholder's cost base in the shares of the controlled foreign affiliate, so that if the shares are sold prior to distribution, the amount of the gain subject to tax in Canada does not include the previously taxed FAPI.

Conclusion

The views and proposals included in the Draft do not yet reflect the consensus views of the OECD or its subsidiary bodies, but are intended to reflect preliminary consideration of the issues for public comment. Canada's FAPI rules appear largely compliant with the preliminary recommendations contained in the Draft. However, Canadian taxpayers and their investors should consider responding to the questions and issues raised in the Draft to ensure that their concerns are taken into account in the final report on Strengthening CFC Rules. While the recommendations in the final report are not binding on Canada or any other country, they may be taken into account by Canada and other countries when deciding on future domestic legislative amendments.

For further information on the material covered in the Draft, please contact any member of our Tax Department.

*****

[1] Haribo Lakritzen Hans Riegel BetriebsgmbH and Österreichische Salinen AG v. Finanzamt Linz, Joined Cases C-436/08 and C-437/08, paragraph 165.