Haven Indicator 19: Controlled foreign company rules

What is measured?

This indicator assesses whether jurisdictions apply robust non-transactional controlled foreign company (CFC) rules. CFC rules are a type of specific anti-avoidance rules that target particular taxpayers or transactions. Like other types of specific anti-avoidance rules, CFC rules are more effective than general anti-avoidance rules in capturing the specific type of tax avoidance on which they focus.[1] The rules clamp down on tax avoidance by residents who divert income to their companies in low or no-tax jurisdictions. CFC rules aim to prevent the sheltering of income in controlled companies based in low or no-tax jurisdictions. All use the same mechanism: "The pro rata shares of undistributed income of the CFC, in whole or in part, is attributed to and included in the income of the resident taxpayer who holds an interest in the CFC".[2]

There are two types of CFC rules:

1) Non-transactional type of rules are applied based on an analysis of categories of income (e.g. passive income);

2) Transaction-based rules allow profits to be attributed to the CFC on a transactional basis using the arm's length principle, e.g. OECD Transfer Pricing Guidelines.

Transaction-based CFC rules are much harder to enforce than non-transaction-based rules because of the many different, and sometimes conflicting, ways to implement and interpret the OECD transfer pricing rules. To administer transaction-based rules, the burden of proof is on the tax administrations to justify applying the CFC rules on each individual transaction. In contrast, under non-transaction-based CFC rules, the burden of proof to justify each transaction within the scope of the CFC rules would normally fall on the taxpayer.

A 100 points haven score are given if there are no CFC rules whatsoever in the jurisdiction. In cases where there are CFC rules, but these are only transactional-based type of rules, the haven score is reduced to 75 points. A zero-haven score is given if a jurisdiction has CFC rules and they are non-transactional CFC rules.

The data for this indicator was collected primarily from country analyses and country surveys in the IBFD database.[3] In some instances, we have also consulted additional websites and reports of accountancy firms, academic journals and other local websites.

The scoring matrix is shown in Table 19.1, with full details of the assessment logic presented in Table 19.3 below.

Table 19.1: Scoring Matrix Haven Indicator 19

Regulation	Haven Score [100 points = maximum risk; 0 points= minimum risk]
No CFC rules There are no CFC rules whatsoever.	100
CFC rules are transactional While the jurisdiction applies CFC rules, these are only transactional type of rules which allow profits to be attributed to the CFC according to the arm's length principle, e.g. OECD Transfer Pricing Guidelines.	75
CFC rules are non-transactional The jurisdiction applies non-transactional CFC rules.	0

All underlying data can be accessed in the Corporate Tax Haven Index database[4]. To see the sources we are using for particular jurisdictions please consult the assessment logic in Table 19.3 and search for the corresponding info ID (ID 522) in the database report of the respective jurisdiction.

Why is this important?

Controlled foreign companies[5] are treated as separate entities from their corporate or individual shareholders in the jurisdiction where they are controlled, i.e., the parent jurisdiction. This is based on the corporate personality doctrine, also known as legal personality.[6] They are perceived as autonomous taxpayers under classical corporate tax systems, and their profits are taxed independently from the tax base of shareholders. As such, the profits of the controlled foreign companies are subject to tax in their resident jurisdiction, whereas the controlling shareholders are subject to tax on their CFC income only when profits are distributed as dividends. Consequently, CFC income is often deferred until it is repatriated to the parent jurisdiction.[7]

If the resident jurisdiction of the CFC imposes low or no-taxes, this structure creates two concerns for the tax base of the resident state of the controlling shareholders. First, the controlling shareholders can take advantage of the time period until the CFC profits are distributed and reinvest the deferred taxes at a market or above-market interest rate.[8] Second, the controlling shareholders can divert income generated in the CFC's resident jurisdiction by making base eroding payments to other controlled subsidiaries in foreign jurisdictions. By doing this, the tax

burden is reduced in the CFC's resident state and then taxation is avoided until the income is distributed by the CFCs. This is further exacerbated if the controlling resident state exempts distributed foreign-source (active) business income and enables the repatriated income to be permanently tax exempt, as is the case in the United Kingdom and Japan.[9] The CFC rules thus aim to eliminate profit shifting to controlled companies based in low or no-tax jurisdictions.

There is a dearth of economic studies estimating the scale of profit shifting income by controlling companies into foreign subsidiaries due to poor quality of data.[10] However, recent estimates presented in research by Cobham & Jansky (2018), Crivelli, de Mooij and Keen (2015), Clausing (2016) and Tørsløv, Wier and Zucman (2018) largely indicate a huge amount of lost revenues as a result of shifting income into CFCs based in low or no-tax jurisdictions.[11] These findings are in line with the efforts of many countries to introduce CFC rules to protect their tax base[12] and the public perception that multinational companies often use CFCs to avoid taxes.[13]

In 2013, the OECD stated that weak CFC rules are one of the main sources of base erosion and profit shifting. This was highlighted as part of the OECD and G20 Base Erosion and Profit Shifting (BEPS) project[14]. The BEPS project published a standalone report on CFC rules in 2015 (Action 3: "Designing Effective Controlled Foreign Company Rules").[15] The report indicates several weaknesses of CFC rules and recommends improving their effectiveness by addressing six building blocks. These are, the definition of a CFC, CFC exemptions and threshold requirements, the definition of CFC income, computation of CFC income, attribution of CFC income, and prevention and elimination of double taxation.[16]

Although CFC rules were not included in the minimum standards[17] of the Inclusive Framework on BEPS[18], which the OECD and G20 countries have agreed to implement, the European Union included CFC rules in the Anti-Tax Avoidance Directive (2016/1164/EU), which EU member states were required to transpose into domestic legislation by 1 January 2019.[19] Articles 7 and 8 of the Anti-Tax Avoidance Directive introduce two alternative methods (models) for calculating CFC income. This is based on how the tax base is determined for the application of CFC rules.[20] Model A (non-transactional) allows countries to tax a range of passive income in foreign CFCs, unless that CFC carries out substantive (genuine) economic activity[21]. Model B (transactional) puts an onus on the tax authority to demonstrate that the scheme was put in place "for the essential purpose of obtaining a tax advantage".[22]

The two models of CFC rules contained in Article 7 of the Anti-Tax Avoidance Directive draw on Germany's and the United Kingdom's experience of implementing CFC rules. Model A in article 7(2)(a) takes into account Germany's experience. These rules take the non-transaction

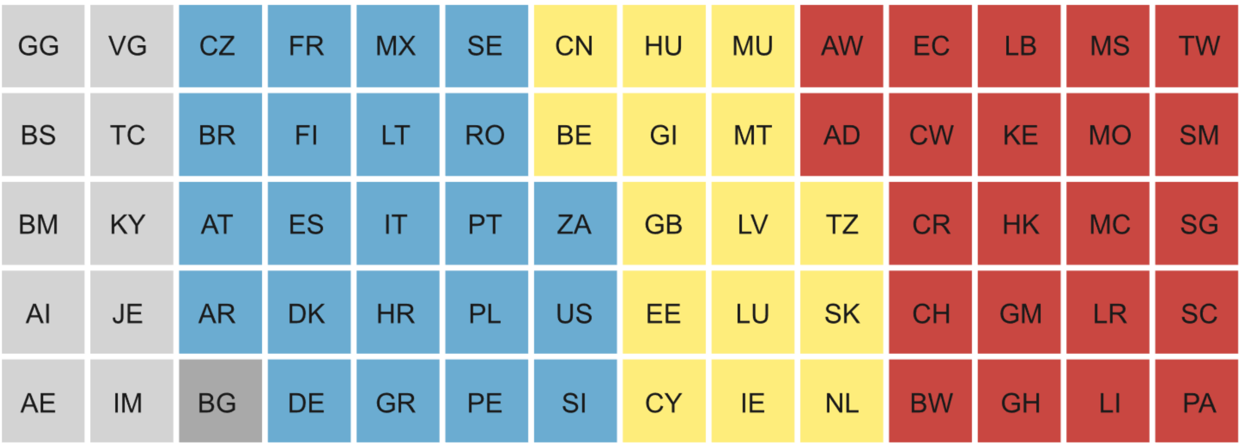
approach and use passive income catalogue based on the analysis of categories of income.[23] Inspired by the United Kingdom, Model B in article 7(2)(b) uses the "principal purpose test" based on substance analysis.[24] As mentioned above, Model B is considered to be weaker than Model A, mainly because the transaction-based rules impose the burden of proof on tax administrations to assess whether applying CFC rules on each transaction is justified.

However, the strength of Model A may be weakened by jurisdictions that choose to abuse the substantive economic activity requirement. This requirement was introduced as a result of the Cadbury-Schweppes court ruling in 2006.[25] In the Cadbury-Schweppes case, the European Court of Justice set precedent when it ruled that the United Kingdom's CFC rules ran contrary to the European Union's Freedom of Establishment rules and the rules could only be justified in relation to wholly artificial arrangements. The implication of this ruling is that in cases where a transaction is almost entirely tax-driven with only a minor economic justification, the European Union's rules would strike down the CFC rules. In order to comply with the requirements set out in the Cadbury-Schweppes case, the Anti-Tax Avoidance Directive has introduced an exception[26] for the application of Model A. Model A shall not be applied when the controlled foreign company carries out substantive economic activity supported by staff, equipment, assets and premises. In other words, if a jurisdiction chooses to introduce a weak substantive economic activity requirement, it may avoid applying CFC rules even in cases where it has adopted Model A.[27]

This optional approach is likely to lead to substantially different legal consequences, even though the underlying facts of the case are identical. Thus, it is likely that CFC Rules implemented by EU Member States according to Anti-Tax Avoidance Directive will still be quite heterogeneous in the future.[28] Prior to Anti-Tax Avoidance Directive, only the following 13 of 27 European Union member states included CFC rules in their domestic legislation: Denmark, Finland, France, Germany, Greece, Hungary, Italy, Lithuania, Poland, Portugal, Spain, and Sweden.[29] With the latest transposition of Cyprus[30] and Czech Republic,[31] all EU member states now have CFC rules. On the other hand, while Taiwan already passed CFC rules in 2016, as of January 2021 these rules have yet to come into effect[32] since the Executive Yuan has not determined the effective date, apparently due to political considerations.[33]

Results Overview

Figure 19.1: Controlled Foreign Company Rules



14% (10 countries): -3: Not applicable

1% (1 countries): -2: Unknown

31% (22 countries): 2: YES, NON-TRANSACTIONAL: Yes, there are non-transactional CFC rules.

21% (15 countries): 1: NO, TRANSACTIONAL: While there are CFC rules, these are only transactional type of rules which allow attribution of profit to the CFC according to the arm's length principle, e.g. OECD Transfer Pricing Guidelines.

31% (22 countries): 0: NONE: No, there are no CFC rules whatsoever.

Table 19.2: Controlled Foreign Company Rules – Haven Indicator Scores

Haven Score	ISO2: Country Name	Haven Score	ISO2: Country Name
100	AW: Aruba	100	IM: Isle of Man
100	AI: Anguilla	75	IE: Ireland
100	AD: Andorra	0	IT: Italy
100	AE: United Arab Emirates	100	JE: Jersey
0	AR: Argentina	100	KE: Kenya
0	AT: Austria	100	LB: Lebanon
75	BE: Belgium	100	LR: Liberia
100	BG: Bulgaria	100	LI: Liechtenstein
100	BS: Bahamas	0	LT: Lithuania
100	BM: Bermuda	75	LU: Luxembourg
0	BR: Brazil	75	LV: Latvia
100	BW: Botswana	100	MO: Macao
100	CH: Switzerland	100	MC: Monaco
75	CN: China	0	MX: Mexico
100	CR: Costa Rica	75	MT: Malta
100	CW: Curaçao	100	MS: Montserrat
100	KY: Cayman Islands	75	MU: Mauritius
75	CY: Cyprus	75	NL: Netherlands
0	CZ: Czechia	100	PA: Panama
0	DE: Germany	0	PE: Peru
0	DK: Denmark	0	PL: Poland
100	EC: Ecuador	0	PT: Portugal
0	ES: Spain	0	RO: Romania
75	EE: Estonia	100	SG: Singapore
0	FI: Finland	100	SM: San Marino
0	FR: France	75	SK: Slovakia
75	GB: United Kingdom	0	SI: Slovenia
100	GG: Guernsey	0	SE: Sweden
100	GH: Ghana	100	SC: Seychelles
75	GI: Gibraltar	100	TC: Turks and Caicos Islands
100	GM: Gambia	100	TW: Taiwan
0	GR: Greece	75	TZ: Tanzania
100	HK: Hong Kong	0	US: United States
0	HR: Croatia	100	VG: British Virgin Islands
75	HU: Hungary	0	ZA: South Africa

Haven Score
Low Haven Score ← → High Haven Score
0 to <25 | 25 to <50 | 50 to <75 | 75 to 100

Table 19.3: Assessment Logic

Info_ID	Text_Info_ID	Answers (Codes applicable for all questions: -2: Unknown; -3: Not Applicable)	Valuation Haven Score
522	CFC-Rules: Does the jurisdiction apply robust non-transactional CFC rules?	0: NONE: No, there are no CFC rules whatsoever; 1: NO, TRANSACTIONAL: While there are CFC rules, these are only transactional type of rules which allow attribution of profit to the CFC according to the arm's length principle, e.g. OECD Transfer Pricing Guidelines; 2: YES, NON-TRANSACTIONAL: Yes, there are non-transactional CFC rules.	0: 100 1: 75 2: 0

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[5] Slightly different terminology has been used in diffrent tax systems such as controlled foriegn affiliates in Canada or controlled foreign corporations in the United States of America, see IBFD International Tax Glossary, Amsterdam, 2009, p. 97.

[6] Even if the corporate personality doctrine covers all type of companies (single or group), it has significant effects on group companies since it makes possible

for them "to have various companies grouped together carrying out various functions that could otherwise be carried out by a single company" (see Alex Magaisa, *Corporate Groups and Victims of Corporate Torts - Towards a New Architecture of Corporate Law in a Dynamic Marketplace* (2002) <https://warwick.ac.uk/fac/soc/law/elj/lgd/2002_1/magaisa/> [accessed 6 May 2019].

[7] Dourado, 'The Role of CFC Rules in the BEPS Initiative and in the EU', 340..

[8] Daniel W Blum, 'Controlled Foreign Companies: Selected Policy Issues – or the Missing Elements of BEPS Action 3 and the Anti- Tax Avoidance Directive', *INTERTAX*, 46/4, 301.

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[27] For example, the Netherlands chose to set a weak substantive economic activity requirement according to which the CFC should be considered to carry out genuine economic activity in the foreign jurisdiction if it: "(i) meets the Dutch minimum substance requirements in its country of residence; (ii) has at least €100,000 of (internally or externally rendered) labor costs; and (iii) owns or rents an office space that is used to perform its activities for at least 24 months." See 'Netherlands Enacts New CFC Legislation - Impact on Multinational Enterprises' <https://www.ey.com/gl/en/services/tax/international-tax/alert--netherlands-enacts-new-cfc-legislation---impact-on-multinational-enterprises> [accessed 12 May 2019].However, recently the Netherlands introduced a legislative change to the substance requirements, applicable as of 1 January 2020, in order to no longer be considered a 'safe harbour' for the CFC rules. Following the legal amendments, the CFC rules can still apply in case the substance requirements are met in cases where the tax inspector demonstrates that there is tax abuse based on the specific circumstances (PricewaterhouseCoopers, 'Amendments to Anti-Abuse Provisions in Dutch Tax Legislation', *PwC*, 2019 <https://www.pwc.nl/en/insights-and-publications/tax-news/pwc-special-budget-day/amendments-to-anti-abuse-provisions-in-dutch-tax-legislation.html> [accessed 3 March 2021]).). While this is an improvement to the CFC rules, it seems the burden may still fall on the tax inspector to deny application of the escape provision in case the substance requirements are only met with the main goal or one of the main goals to avoid the CFC regime (PricewaterhouseCoopers, *Dutch Government Proposes Amendments to Substance Rules Following the Danish BO Cases*, EU Direct Tax Newsalert, 19 September 2019 <https://www.pwc.com/gx/en/tax/newsletters/eu-direct-tax-newsalerts/eudtg/pwc-eudtg-newsalert-19-sep-2019.pdf> [accessed 3 March 2021]).

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[30] Antonis Taliotis, *Cyprus - Corporate Taxation* (12 October 2020), sec. 10 <https://research.ibfd.org/#/doc?url=/linkresolver/static/cta_cy> [accessed 5 March 2021].

[31] Tigran Mkrtchyan, *Czech Republic - Corporate Taxation* (1 October 2020), sec. 10 <https://research.ibfd.org/#/doc?url=/linkresolver/static/cta_cz> [accessed 5 March 2021].

[32] Lin, *Chinese Taipei - Corporate Taxation*, sec. 10.

[33] In their response from 11 December 2020 to our preliminary assessment, the Ministry of Finance in Taiwan mentioned that "Taiwan will consider the situation of a trade war between the United States and China and the impact of COVID-19 on Taiwan's economy, and determine the schedule of implementing CFC rule."